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Trouble Spotting: Assessing the Likelihood of a Turnaround

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INTRODUCTION

Can It Be Fixed?

If this is your starting point, then you have probably waited too long. By this point in time, you have already heard from your vendors, shareholders, customers, and employees that the business has a problem. Collectively, these stakeholders are sorting through the wreckage seeking answers to questions ranging from "What's in it for me? to "What are my alternatives?" to "How did this happen and when do I get my money?" Behind these questions is each stakeholder's desire to assess:

- The fundamental causes of the company's distress
- Action steps required to affect a "turnaround"
- Management's ability and related costs to execute a turnaround plan
- Alternatives to a turnaround and the related costs
- Goals of the various stakeholders
- The value that can be realized from a turnaround, a sale or liquidation of the business

In the final analysis, value is the only thing that matters to stakeholders, as well as, of course, some timely cash or potential for capital appreciation. Value means different things to different stakeholders and may include cash repayment and new collateral for lenders and creditors; preservation of jobs and benefits for employees; or, alternatively, the avoidance of the opportunity cost of staying "in the game" for all stakeholders. Regardless of the form of value, each stakeholder must have access to the necessary information to make an informed decision on the appropriate course of action.

The Turnaround

For purposes of this chapter, we will define *turnaround* as follows:

> An all-encompassing plan that maximizes an underperforming company's value for the benefit of its stakeholders through a four-step process of stabilization, analysis, repositioning, and strengthening.

Rather than focus on the death spiral leading to a bankruptcy, our view of turnarounds begins much earlier in the business life cycle. It is the ability to detect and spot the signs of trouble early in the cycle that leads to a more rapid and successful turnaround. The business demise curve is graphically illustrated in Exhibit 1.1. In a later chapter, we will explore the early warning signs leading to trouble.

While there are several definitions and attributes one could ascribe to the concept of turnaround and underperformance, this chapter will focus on value as the key element of a turnaround. In almost any turnaround, whether in the context of a bankruptcy case or an out-of-court workout, the value of the company is what all stakeholders and investors wrestle with.

Today's real-time information, supplied to us by the Internet and 24-hour news channels, provide the astute stakeholder with an extraordinary amount of information to digest. Notwithstanding today's technical advantages over yesteryear, our savvy stakeholder must still assess the likelihood of a turnaround in down market conditions, in industries as complex as high technology, to assessing the ramifications of a global economic meltdown on his or her stake.

We will address assessing the likelihood of a turnaround in a high-technology

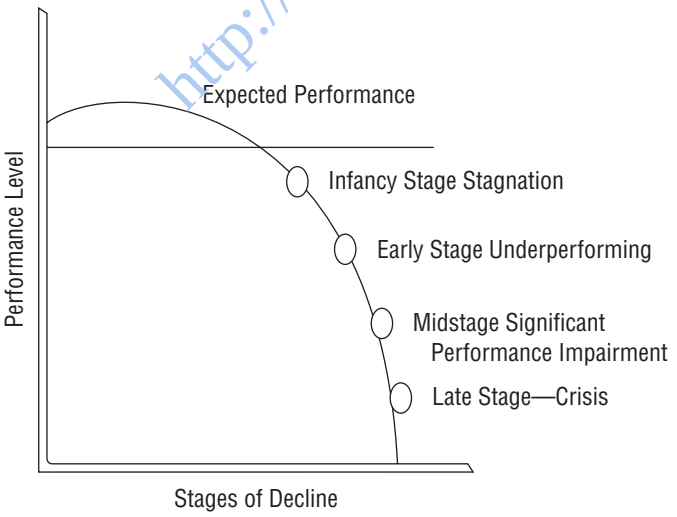


Exhibit 1.1 The Business Demise Curve

company later in this chapter. We will also consider the question of whether the company can be "saved" and what that means, including:

- An analytical approach to shareholder value or destruction
- Fixing the business with tools, a crisis manager, and hard work
- Managing expectations, including assessing what can be done and making it happen

For now, however, we will explore some fundamental concepts in assessing a turnaround.

FUNDAMENTAL CAUSES OF UNDERPERFORMANCE

Did You Hear the One About . . .

The performance excuses of companies in trouble have been repeated too many times to remember, but they usually go something like this:

- "Although our results are disappointing, we are very excited about the new product line that we plan to bring to market."
- "We will have improved results next quarter."
- "Bankruptcy is just a hiccup; we have a fresh start, our future is bright."

If you have visited the insolvency abyss, these statements and their permutations probably sound all too familiar but provide little in the way of useful reference points for future business decisions by the lender or investor.

Why Do Businesses Fail?

Although the onset of a crisis may come as a surprise, the underlying situation has frequently affected the company for a long period of time. Indeed, a well-designed set of metrics focused on important drivers of value could save many businesses.

Management is often unable to discern whether it has a firm grasp on the link between the company's macro goals and the micro shareholder value drivers on a day-to-day basis. Although generic value drivers lack specificity and cannot be used effectively at the grassroots level, a well-designed program to implement drivers can help steer the business.

Poor management information systems typically receive the blame for the inability of management to "see it coming." In reality, most companies do not understand the value drivers that create shareholder value, which we will discuss further shortly.

Another crisis in the making is the product of today's volatile merger and acquisition (M&A) environment and the inappropriate expansions embarked on in search of the fabled synergies. We have all heard the "1 + 1 = 3" boardroom banter as the mantra for acquisitions. With the recent strength of the economies in

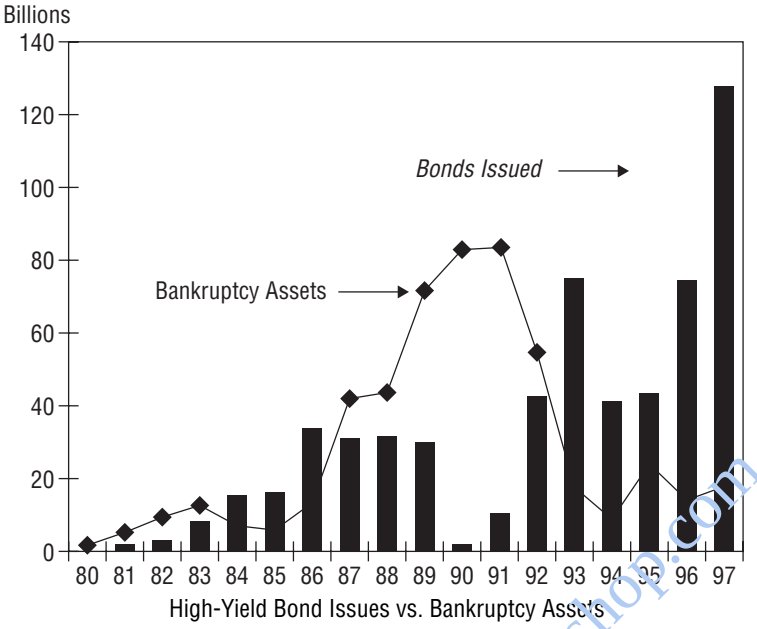
the United States and continental Europe, chief executive officers (CEOs) may decide to pursue expansion strategies that involve acquisitions at high multiples. Although a deal might look good on paper, postmerger integration of the new acquisition can sometimes fail to go forward with the projected ease of execution, creating enormous problems for management. Such issues may not only place serious demands on senior management time, but there is the good possibility that they will involve additional costs, including debt that could expose the new company to shifts in business climate or interest rates. This does not bode well, since overaggressive financing at the end of a business cycle accounts for many company failures.

On another front, the global impact from the demise of once-thriving emerging markets in Korea, Thailand, and Indonesia is having a significant impact on U.S. companies. Once profitable joint-venture opportunities for U.S. companies may lead to underperforming investments, loss of production, and, in some instances, financial peril. This phenomenon has most notably affected semiconductor companies that rely on the Asian marketplace for its low-cost manufacturing base. We will explore the impact of these events as it affects the likelihood of a turnaround in the high-technology sector.

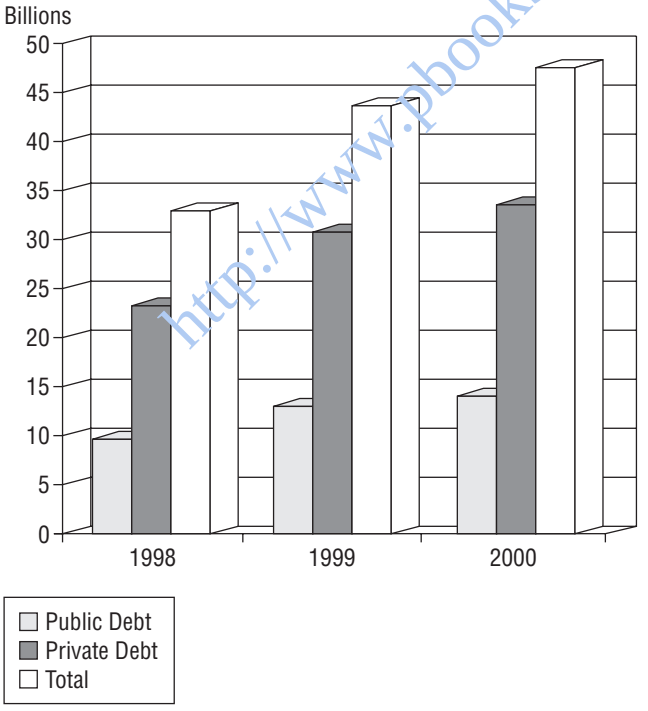
As Exhibit 1.2[1] indicates, the linkage of growth in highly leveraged transactions and the proportion on bankruptcy assets is quite strong, albeit time lagged. That is, as highly leveraged deals increase as a form of financing for companies, the natural growth in bankruptcies based on historic default rates is fairly evident. In particular, a 24- to 36-month lag from the time of issuance of the highly leveraged debt appears to boost the amount of corporate bankruptcies. Moreover, based on current indications, the amount of highly leveraged transactions appears to be approaching record levels that may in time lead to significant increases in assets experiencing bankruptcy.

There is a recurring pattern in business cycles that somehow manages to lure even the most sophisticated business people time and again.

- As the cycle progresses, money chases deals ever more aggressively. Yes, participants comment on the excessive prices being paid for businesses, and, yes, lenders note that interest rate spreads have vanished.
- By the time the cycle nears its peak, industry/strategic buyers are often outbid by financial buyers, who focus on supposed growth prospects and efficiency gains to justify prices that would exceed the most extravagant synergy gains that an industry player could expect from a merger.
- Cash flows tighten as the business cycle turns down, or markets simply fail to deliver forecasted growth.
- Business decisions become less than optimal as investment in operating plant or new product development is curtailed, and the underlying value of the company is traded in for short-term survival.
- Management and shareholders are put in a position where, if they do not address the situation, performance and value will begin to erode.
- Eventually, businesses in which the situation is allowed to continue, face a funding crisis and potential failure.



High-Yield Bond Issues vs. Bankruptcy Assets



Expected Supply of New Default Debt: U.S. Only—Face Values

Exhibit 1.2 High-Yield Bond Issues and New Default Debt

Although the symptoms of distress can affect all companies from time to time, management's astute interpretation and diagnosis of these symptoms is critical to taking appropriate actions. In the distressed company, management typically is aware of the problems but unable to formulate and execute a strategic turnaround plan without outside assistance.

Outsiders, lenders, or investors must make their own assessments of the company's performance in order to judge whether current management is capable of determining the corrective actions to be taken, as well as implementing the resulting turnaround plan.

Two Classes of Problem

The company in trouble usually has two types of problems—internal and external—although many would argue that the former are the cause of the latter.

Internal. In a recent survey on business failures conducted by PricewaterhouseCoopers,[2] at the top of the list of internal woes is *ineffective management*. This is where the proverbial buck stops, because every failing company is theoretically under the control of the CEO, chief financial officer (CFO), and other senior executives. "Management failure" was cited as number 2 among primary causes of business failure, as well as the number 1 secondary factor (see Exhibit 1.3 for a summary of the causes of business failure).

The most common of the internal problems found on the road to bankruptcy—all leading back to ineffective or incompetent management—is excessive leveraging of company assets. The company is trying to do too much with too little. As a measure of a company's ability to stay in business, despite a variety of financial setbacks, capital is critical to offsetting losses without going out of business. Undercapitalization can be deadly, as the company performs a complex and endless balancing act. Who decides the appropriate level of debt and equity? *Management!*

Other internal problems frequently point to a lack of good internal controls, which may range from lack of planning and budgeting to poor management information systems. They may also stem from outmoded ideas about the way to do business today, such as concentrating customers in too narrow an unprotected niche or a failure to penetrate new markets.

A rigid organizational design can create obstacles to effective communication, forcing managers into decisions in a vacuum when important information is readily available within their own organization through a simple phone call. Weak middle management exacerbate organizational design problems as they often lack the creative problem-solving skills required to overcome such obstacles. Notwithstanding middle management, it is senior management that sets the tone, creates the organizational design, and sets the foundation for how effectively the organization communicates.

Whatever part the CEO may play in these potential calamities—and it is assumed to be a large one—he or she no longer takes all the blame for a company's downfall. While in decades past, corporate health was predominantly the charge

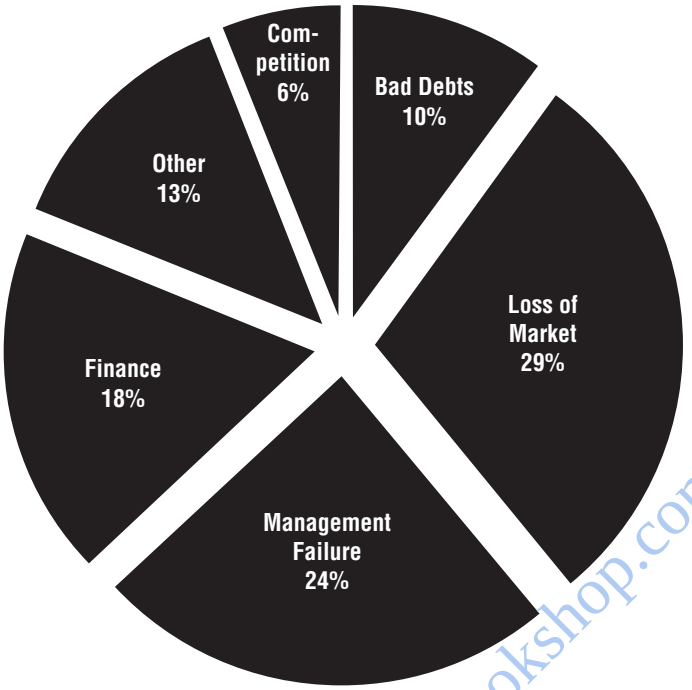


Exhibit 1.3 Causes of Business Failure

In a survey of companies that had serious financial difficulties but subsequently achieved some form of turnaround or change in ownership, management, senior managers, and company advisors all regarded "foresight or planning issues" as the company's major problem.

of management, that is no longer the case. The board of directors today is expected to play an increasingly large role or face the consequences. An increasingly activist shareholder body, particularly among pension funds such as California Public Employees' Retirement System (CALPERS) and other institutional investors, has shown that there is no place to run or hide from the inadequacies of management or its boards.

External. From the external side, one could argue that the causes of a company's downfall are not always foreseeable. However, it could also be argued that the prescient CEO understands and develops contingency plans for the volatility of a company's environment, whether or not it is actually on the horizon. This would include:

- The cyclical nature of business, including general industry conditions, foreign competition, shifting consumer preferences, declining market for products or services, obsolescent technology, global impacts

- Economics, including labor problems, natural disasters, scarcity of strategic resources
- Politics, including regulatory issues and other legislation relating to business in general or a specific industry

After the stakeholders have identified the root causes of the problem, the next step is to determine the action steps and costs required to affect a turnaround that sufficiently addresses the problems.

THE PLAYERS

Rising from the Ashes: Shareholder Value and the Stakeholders

According to legend, when the mythical phoenix reached the end of its 500-year life, it set itself aflame and was reborn from its ashes. Can a company that has entered bankruptcy do the same? More specifically, can a troubled company's value be recreated once it has been destroyed?

To investigate the concept of recreating value, consider what constitutes value[3] and how the stakeholders of a company perceive it (see Exhibit 1.4).

The Value of Value

Many companies today declare themselves to be on "a relentless quest for value." This might sound good on the cover of an annual report, but what exactly does it mean? From our point of view, the phrase simply means that the company wants its business to create, preserve, and realize value for all its stakeholders, ranging from owners to employees.

The shareholder value of a particular company may not always be clear, even to its principals, and they frequently look to outside consultants to help them conduct what we call *shareholder value analysis*, in order to help them develop a philosophy of value creation and position themselves to thrive in the global financial environment. At a basic level, this involves:

- Understanding where they are (from a value creation perspective)
- Develop strategies for improving their position
- Establish a system of rewards for employees who play a role in these improvements

In today's marketplace, financial value is the key issue, specifically relating to cash that takes the form of:

- The return it gives to shareholders
- The cash flow that is the sign of a healthy company in the eyes of the marketplace

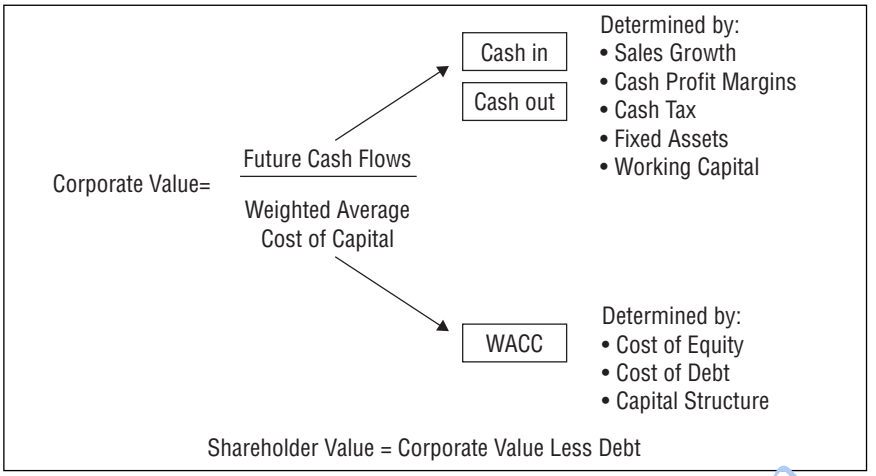


Exhibit 1.4 Corporate Value Formula

Who's Who Among a Company's Stakeholders

Among the factors to consider in determining whether a company can be regenerated into a strong, viable entity is an understanding of the motivational factors of all parties-in-interest and what they expect to receive from the entity.

Stakeholders. A company's stakeholders can be broken down into four basic categories:

- Shareholders seek total returns in the form of dividends and capital appreciation.
- Debtholders seek prompt repayment of their loans in the form of principal and interest (their profit).
- Employees want higher wages and salaries as well as job satisfaction and security.
- Customers and suppliers want a steady stream of goods and services at prices and terms that provide good value for their "investment."

They each have a stake in the continued health of the company, although certain of them might be happy to "take the money and run."

Shareholders. A company is owned and operated for the benefit of shareholders, whose liability is limited to the amount of their investment; therefore, their main concern will be total return—a combination of capital appreciation and dividends. Shareholders desire a return at least as great as that obtainable on an investment of similar risk elsewhere in the market, and to achieve these goals they delegate a business's operational authority and power to the management team.

The split between "church and state"—in this case, investors and management—traditionally meant a hands-off attitude on the part of many institutional shareholders. If they did not like the way one investment in their portfolio was performing relative to others, they would sell their shares in the company and perhaps buy those of a competitor.

This quiet disenchantment with the underperforming company's performance gradually gave rise to shareholder activism, with investors such as CALPERS, the California pension organization, and Mercury Asset Management, taking leading roles in questioning management decisions and seeking changes to protect their investments. Despite these efforts, shareholder claims on company assets are generally last in line in an insolvency situation. Therefore, it is investor mobility that serves as an important check on management power. In order to appease shareholders, companies may authorize substantial dividend payments, possibly in excess of what they can afford.

A good example of this approach comes from the U.K. recession of the 1990s, when 60 percent of companies maintained or increased dividends in the face of falling profits. By contrast, 28% cut dividends and only 12% of companies missed a dividend payment. Most evidence suggests that companies have a target payout rate for dividends and seek to maintain this even when business conditions are unfavorable (i.e., they are willing to sacrifice long-term shareholder value creation in favor of the short-term shareholder satisfaction).

Debtholders. Debtholders provide funds in the form of loans, generally receiving a return on their investment in the form of interest. A lender's primary risk is default—the risk that interest payments will be missed and the face value of the loan will not be repaid when due.

Debtholders have a more limited stake in a company than shareholders, with less upside potential, usually limited to interest margin and their return of principal. If all goes well, the debtholder repeats the process, potentially increasing the amount of principal loaned.

Management finds debt attractive for the very reason that debtholders have limited their upside potential. If the company has a high probability of success, management will seek to raise additional debt, because this will leave more gains for shareholders. If the likelihood of success is not as high, then management may seek equity capital to meet additional financing needs.

Management. While management is the appointed guardian of the company's assets on behalf of shareholders, some may suggest that a natural conflict exists. Fragmented shareholdings and an institutional hands-off policy can result in considerable power being absorbed by management, which can award itself a substantial part of value created by the company.

It is in reorganization situations that the interests of management can deviate most from those of the shareholders. Presumably, a company in difficulty is one that has already made a series of poor decisions. In a recent survey,[4] "management failure" was cited as number 2 among primary causes of business failure, as well as the number 1 secondary factor, by a wide margin.

Although management can probably look forward to remaining in place during recovery, if the situation demands a turnaround manager, it is highly likely that management will be the first to be sacrificed as new strategies are introduced and implemented.

Employees. Employees represent the core of many businesses and collectively embody the know-how and human capital of the company. Increasingly, it is the company's ability to differentiate itself in this area that will create the conditions for long-term survival. Management has to ensure that crucial employees are retained, because their loss can jeopardize a recovery program.

Customers/Suppliers. In business reorganization situations, it is important that both suppliers and customers are convinced that they have a material interest in the company's continued operation. This is easier to do when the cost to the customers and suppliers of switching is high or when there are a few alternatives.

These relationships can be fortified with long-term contracts. The stake can become so high that the customer or supplier buys the other out. When that happens, a market transaction is replaced by an "insider" transaction and the company becomes more vertically integrated. This phenomenon appears to be weighted to industries that may have a high-technology component (i.e., telecommunications, computers, software, etc.).

VALUE RE-CREATION AND ALTERNATIVE STRATEGIES FOR A TURNAROUND

In all but the most dire situations, there will be a number of choices available to stakeholders for retrieving their investments in an operation (see Exhibit 1.5).

- *Sell it.* The first option is to dispose of the business as quickly as possible, in order to obtain reasonable fair value.
- *Liquidate it.* A second option is the liquidation of the assets in the form of a "wind down." This course of action may be appropriate where the assets have significantly greater value to potential purchasers than to the current business operator. For example, a factory site with substantial real estate development value may have higher intrinsic value when sold to a mall developer than as an ongoing manufacturing operation. The liquidation option, while unappealing to employees and most business managers, may, in some instances, yield the highest value to its stakeholders.
- *Enhance it.* A third option involves seeking short-term performance enhancements that could enable the business to generate enough cash to mollify creditors without concern for its long-term outlook. In this instance, the focus is typically on making improvements to the business, either by raising the effectiveness of business processes or by eliminating poorly performing operations, products, or customers. This option is not meant to set the busi-

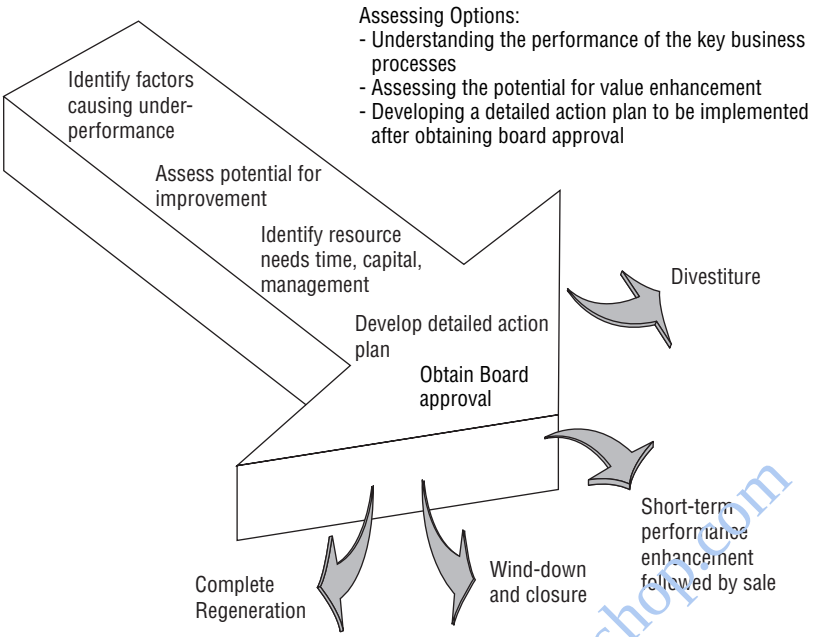


Exhibit 1.5 When Business Is Seriously Underperforming, Various Options Must Be Assessed

ness up for sale but to maintain the company's competitiveness through tighter controls, including more judicious spending on capital expenditures.

The Four Phases of the Turnaround

The option of pursuing a full turnaround is clearly the most far-reaching. Although it has the highest level of risk, it also offers the company the greatest opportunity to return to financial health. As depicted in Exhibit 1.6, every phase of the value recovery process, from stabilization to strategic repositioning and strengthening of operations, will be involved.

Phase I: Stabilize. In general, the first step in helping a troubled company is to assess the situation and take immediate actions to stabilize it. This is not a time of refined analysis; rather, it is a focused effort to stem losses, conserve cash, and take action. The focus of this phase is:

- Increasing cash flow because "cash is king"
- Reducing losses and cash demands of the business

The assessment must take place quickly, generally with the assistance of skilled turnaround professionals, in order to:

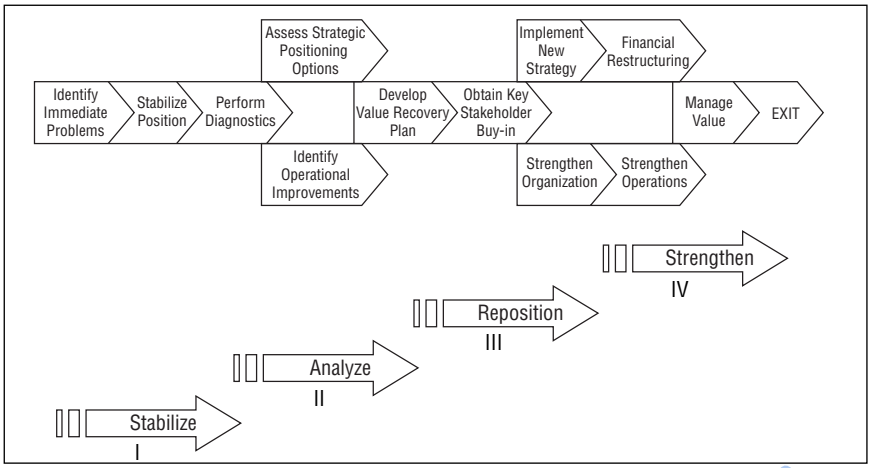


Exhibit 1.6 Value Recovery Process

- Reschedule payments
- Reduce working capital demands
- Renegotiate future commitments

Noncore assets may have to be sold to generate cash, and a sense of urgency must be instilled throughout the organization, from the top down. Foremost in the collective mind of management must be the survival axiom:

OUT OF CASH + OUT OF CREDIT = OUT OF BUSINESS

During this phase, it is critical to build credibility with lenders in order to buy the time necessary to put a long-term value creation plan into place.

Phase II: Analyze. Once immediate cash needs have been addressed and important stakeholders have bought into a restructuring process, the company needs to analyze its business prospects. A thorough business plan review must be conducted to determine, among other things:

- What business results can be achieved?
- What debt can be supported?
- What unknown hurdles must be overcome?

During the course of this process, other factors may arise that give pause to even a seasoned turnaround professional. The company must nevertheless pursue a strategy to revitalize the company with vigor. The process of recreating value in the business, *business regeneration*, must focus on the strategic position of the company as well as its operational effectiveness. To assess the likelihood of the turnaround, the company must address:

- The core competencies of the business and how they are being exploited
- Which products and customers should be retained and which should be eliminated

This diagnostic phase should give stakeholders a better understanding of the business and choices available—alternatives focused around products or processes offering competitive advantage in selected markets.

In order to regenerate the business and unlock its value potential, the company must determine what resources are required, in terms of time, capital, and management. Generally, the turnaround will call for the addition of outside expertise, because it is unlikely that the current management team will be able to convince stakeholders that they can "do it right this time." After all, they are being called upon to re-create value that their earlier actions may have helped destroy.

Phases III and IV: Reposition and Strengthen. After the analysis phase, the next and most crucial phase will require the company to create a value recovery plan that needs buy-in from all major stakeholders. There will be a fine line between the resources the company can commit to the program from internal cash flow and additional resources needed from stakeholders. The management team, along with its advisors, must produce the actions necessary to create new growth.

The value plan will have two distinct parts:

Financial Restructuring. The first part of the value plan involves financial restructuring, that is, taking a look at the company through the eyes of a financier. Management will seek to bring in new funds in the form of debt when a good outcome is reasonably certain, enabling upside potential to be distributed to the shareholders.

A financial restructuring that involves raising more equity sends out contradictory signals to the market. As the most expensive form of financing in the long term, equity is something a company will look for when the outcome of its plans is uncertain.

Organizational Restructuring. Accompanying the financial restructuring package, as the second part of the value recovery plan, must be equally strong measures to strengthen the organization. The options could include:

- A new management structure
- Installation of a new executive compensation program that is heavily weighted to defined targets in the recovery plan
- A dedicated effort to manage the key business drivers identified as part of the value chain

By combining new financial structures with new organizational initiatives, the sound basis for recovery and recreation of value can occur. As the recovery process continues, it may be possible to find a buyer who will pay a significant premium for the company reaping the most value to the organization.

ASSESSING A TURNAROUND: FOCUS ON TECHNOLOGY SECTOR

The technology sector is a prime example of some of our concepts relative to turnaround and underperformance. The technology sector poses many interesting situations relative to defining adequate performance. Finding a margin of safety in companies that trade at 40 times book value and 10 times sales does require some creativity, if not antacid tablets. The technology sector of the U.S. economy is a major driving factor of gross national product (GNP) and a place where re-emerging companies tend to trade based on their prospects rather than general market direction.

In assessing a turnaround opportunity, investors tend to shy away from battered technology stocks for a variety of reasons. Growth investors tend to prefer companies with bright prospects and often believe that once a technology stock has fallen, it is very hard for them to regain their position. Value investors tend not to mind taking a chance on a fallen angel, particularly those companies that are not heavily covered on Wall Street (although most are covered closely).

Most value investors tend to favor predictable businesses. This tends to cause enormous problems for value investors in technology as rampant technical innovation creates enormous uncertainty for even comparatively healthy technology companies.

In attempting to assess the likelihood of a turnaround for a technology company, an investor should consider whether the company has enough cash to stay solvent while its managers figure out what is wrong and how to fix it. Consider our example for the assembly and test equipment companies in the integrated circuit manufacturing sector in Exhibit 1.7.

Companies operating in an environment in which the supply-and-demand factors are severely cyclical need enough cash and credit to survive the massive swings in the cycle. This phenomenon is quite curious as a smoothing of book-to-bill indicates that overall demand in this sector has been growing at over a 17% compounded annual growth rate. Interestingly, deep trough periods of 9 to 15 months have been experienced during the same period. This cyclical swing

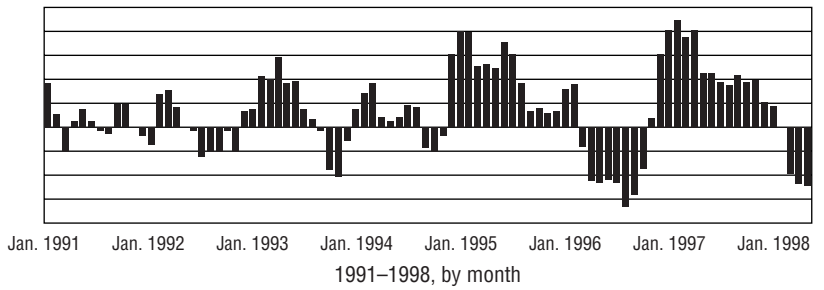


Exhibit 1.7 Assembly and Test Equipment Book-to-Bill Ratios, 1991–1998
Source: Morgan Stanley Dean Witter Research, Assembly and Test Equipment.

creates havoc for a short-term investor and does create uncertainty among shareholders as to whether the trough is really a cliff.

It is the management of these companies that must make the critical decisions on how best to survive the trough periods. Unlike most industrial companies, high-technology companies must continue to invest heavily in research and development (R&D) despite downturns in demand. Fortunately for most technology companies and unlike manufacturing companies, high-technology companies tend to have low fixed costs. That is, by reducing labor requirements during trough periods (layoffs), technology companies can reduce their variable costs low enough to withstand the down periods and buy the time to turn around the business. Of course, this logic does not help if the technology company has loaded itself up with debt and cannot meet debt service payments.

Fortunately for some technology companies, many have a monetary advantage as they may be flush with cash from a past initial public offering (IPO) or they may have raised additional funds in the form of preferred convertible securities or some other equity instruments when times were better.

Of relative importance in considering the likelihood of a turnaround in the technology sector is whether the company has another form of financial life support that it can rely on when its primary market is weak or under pressure. Things like service agreements, maintenance contracts, and software/hardware upgrades may provide enough revenue to help buy time.

Got Something to Sell?

Of course, as with any business, a key criterion to assess in technology companies is determining whether the company still has something to sell. Cash alone will not drive a technology stock's value up in the marketplace; one must determine whether it has niches and viable products. Unlike manufacturing companies, which tend to generate products that an investor can fundamentally understand, technology companies reinvent themselves on almost a daily basis. Therefore, it is important to assess a company's track record in *bringing out products* to market. If "research and development is the touchstone of a technology business,"[5] then it is important to validate a company's ability to achieve significant returns from its R&D spending. The investment in R&D must be carefully scrutinized much as an investor in a manufacturing company looks at capital expenditures to determine whether management has been reinvesting in the business.

More importantly, when things are not going well for a technology company, consider whether the company has increased its R&D spending (generally in excess of 7% of sales) or whether the company has decreased these initiatives. Naturally, one needs to look at research and development spending relative to industry competitors to benchmark the situation.

Percentages of spending are not everything. You need to consider whether the R&D spending has been spent wisely. To assess this, we like to revisit the annual reports to see whether the company was able to deliver on projects it had under development in the past years. Moreover, one could consider what percentage of a company's revenues has come from products introduced in the past three years (hopefully at least 50%).

The Management Thing

Many high-technology companies faced with poor performance tend to need new management before a turnaround can begin. The boost a new CEO can give a company faced with first-time underperformance should not be underestimated. The return of Steve Jobs helped Apple Computer stock achieve a 118% total gain in the first half of 1998.

The key action a new manager can bring to an underperforming technology company is cost containment. When technology companies are thriving, management's focus tends to be on keeping the engineers happy, and cost control takes a backseat. When the company gets into trouble, management needs to be able to control costs. Many times, a new manager is brought in to do the layoffs and cost containment because prior management either did not recognize the problem or refused to do it.

While the major example is an American company, its ramifications reach much further, not only for U.S. companies considering business relationships with foreign partners, but for foreign businesses as well (despite the differences in their local laws).

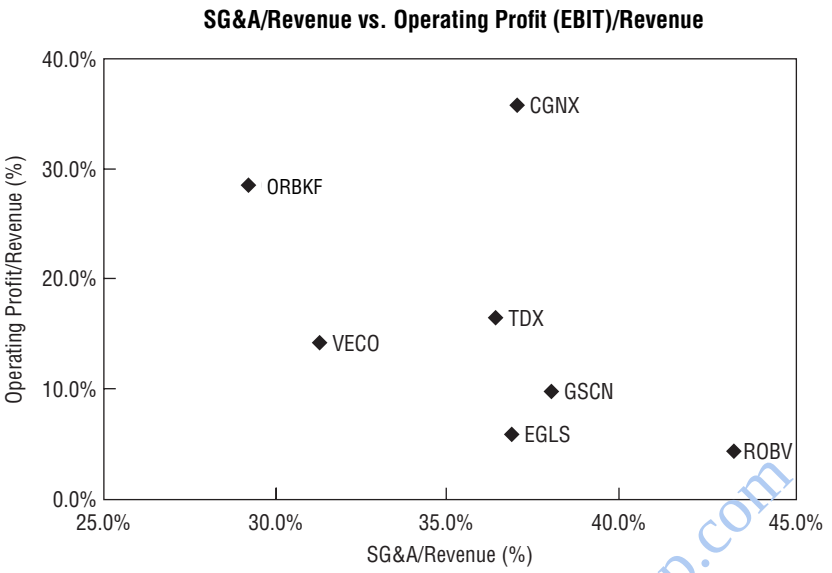
Benchmarking Can Be Fun?

Perhaps a critical factor to assess in a high-technology company is whether the company's balance sheet is strong enough to withstand a down period. We like to do a sector chart analysis in which the company's balance sheet and income statement performance can be benchmarked relative to perceived competitors, as indicated in Exhibit 1.8.

The sector charts help one analyze his or her company versus the competition. For instance, in looking at the balance sheet performance, companies operating in the top right region of the Inventory Turns versus Return on Assets (ROA) charts are the strongest performing of the groups in terms of inventory utilization as their investment in inventory is minimized. For most high-technology companies, minimizing the investment in inventory can be a good thing because not only does it require less working capital financing, but the company minimizes an investment in a product which may becoming obsolete as new variants are seemingly created every day.

A company in the top left region of the Days of Sales versus ROA chart is not only yielding strong returns on balance sheet assets, but also is in a good position in terms of keeping customers on a tight leash. The further you yield credit to your customers, the more subject you are to a downturn in the economy. For instance, in the capital equipment sector of the integrated circuit industry, many customers are global and heavily concentrated in the Pacific Rim. Weakness in global economies and specifically in the Pacific Rim not only may make it more difficult for these customers to pay for product, but devaluation of their currency vis-à-vis a U.S. high-technology company exporter can further exacerbate a tenuous situation.

In considering the amount of SG&A (sales, general and administrative) expenses a high-technology company invests in, one has to understand the relative



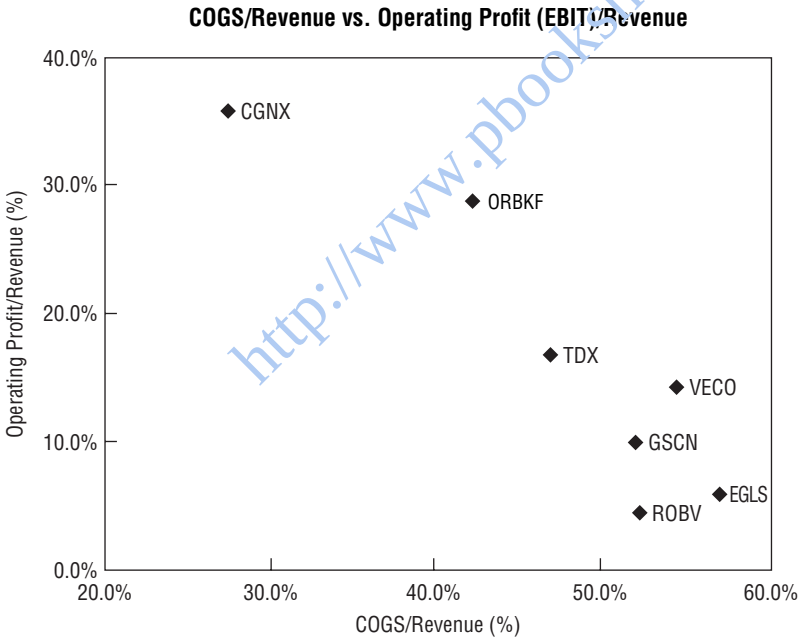
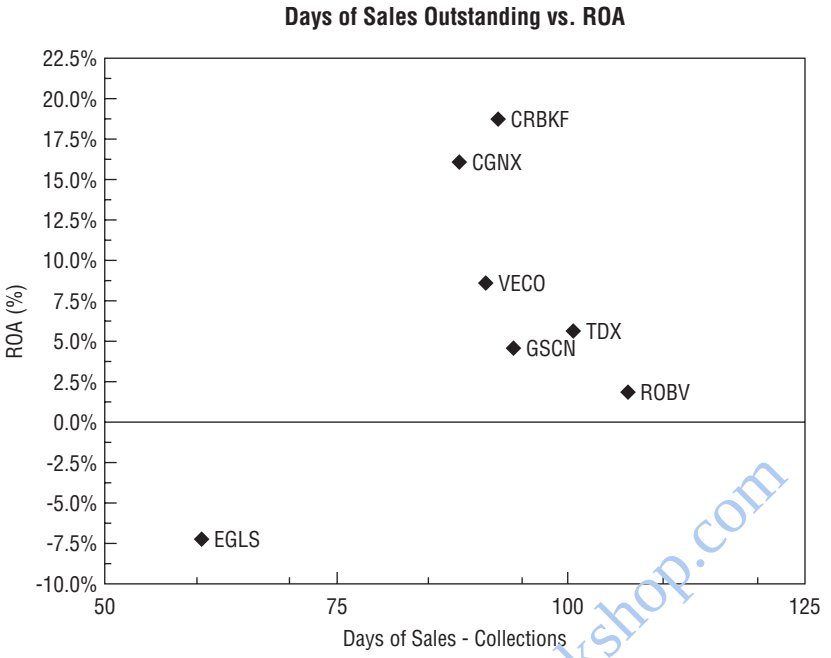


Exhibit 1.8



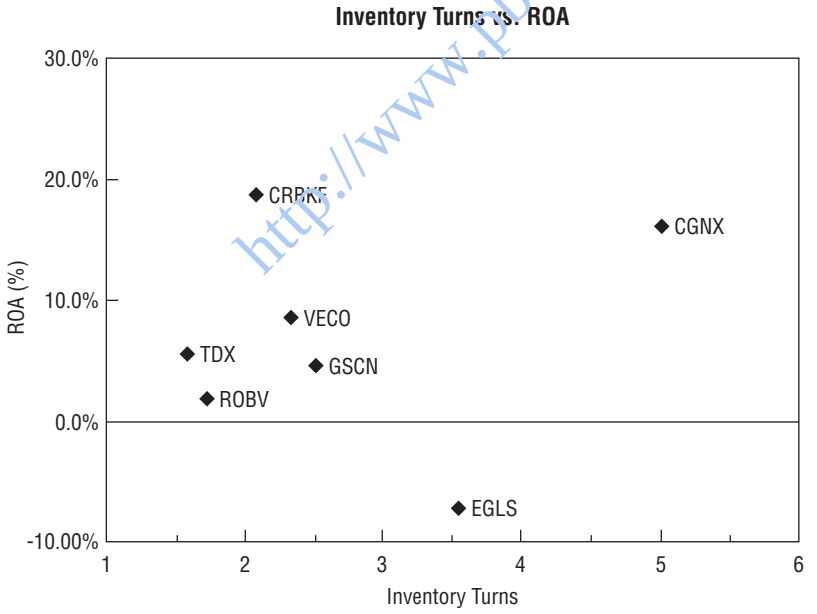


Exhibit 1.8 ***(Continued)***

components of sales expense. Is the level of sales expense appropriate for the business? Will the investment in research and development bring immediate results? Therefore, careful scrutiny as to the underlying fundamentals involved in the income statement side of our analysis must be performed. High-technology companies in particular may in fact require incremental R&D spending even though the company is facing a liquidity crisis.

What Do the Analysts Say?

Of course, notwithstanding all the fundamental analysis in the world, when a company is in the technology sector, a successful turnaround must also be played out in the public arena. The CEO/CFO team must direct a successful turnaround not only inside the company but also outside the company. The credibility of the management team should not be underestimated, particularly in technology companies that may not have a long track record. As the darlings of the investment community, technology companies are closely scrutinized and in many instances are valued far in excess of financial performance. With price to earnings ratio (P/Es) in the stratospheric 40x range, it is no wonder that when the technology company announces weak or lower-than-expected results, the stock can plummet more than 50% of its market capitalization.

In assessing these situations, the management team cannot lose sight of what got them to this stage of demise. Rather, a rededication to the fundamental aspects of the business is critical. Typically, the CFO, "guardian of the numbers," must placate the technology community, analysts, and investors to drive a turnaround plan. Moreover, continued investment in R&D, the lifeblood of most technology businesses, must continue to be made. In these times, assessing the likelihood of a turnaround in the technology sector boils down to the key ingredient: Is management credible?

NOTES

1. *Bankruptcy Almanac*. New Generation Research, Boston, MA. 1998.
2. Survey by Business Planning and Research International for PricewaterhouseCoopers LLP.
3. Alfred Rappaport, *Creating Shareholder Value*, Free Press, New York, NY, 1986.
4. See note 2 above.
5. Michael Murphy, *Every Investors Guide to High-Tech Stocks and Mutual Funds*, Broadway Books, New York, NY, 1997.

2

Looming Financial or Business Failure: Fix or File—a Legal Perspective

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INTRODUCTION

As the availability of credit continues to expand, the opportunities for financial distress and commercial failure increase proportionately. This environment creates multifaceted challenges for debt collection and rehabilitation of distressed businesses. These challenges have resulted in a dynamic evolution of the law of bankruptcy and reorganization. The responses to the challenges implicate the selection of alternatives for rehabilitation of businesses and the recovery of claims against debtors. The particulars of the governing principles of law, the proclivities of individual bankruptcy courts, and the condition of credit markets have all impacted on any decision by a distressed business or its creditors to seek relief under the federal bankruptcy law. The Bankruptcy Act of 1898, as amended, which governed bankruptcy proceedings until November 1, 1979, provided financially distressed businesses with a number of options to deal with financial or operational failure. Most distressed businesses under that Act had a choice of (a) liquidation under chapters I through VII; (b) chapter X (corporate reorganization); or (c) chapter XI (arrangements). None of the choices were particularly palatable to the distressed business debtor that desired to retain a measure of control over its destiny and protect the interests of equityholders.

In addition to the notoriety and perceived stigma of bankruptcy that prevailed during most of the existence of the former Bankruptcy Act, liquidation was not a desired solution, and chapter XI had significant limitations in terms of its scope and the ability to deal with secured and other reorganization needs pursuant to an arrangement. The comprehensive provisions of chapter X that, generally, mandated the appointment of one or more disinterested trustees in

any chapter X proceeding, effectively ousting management, and the rigid immutable application of the absolute priority rule, which in most cases eliminated equityholders and sometimes junior creditors, as well as the extended term and expense of a chapter X proceeding, discouraged the use of that chapter.

The 1973 report of the National Bankruptcy Commission that had been appointed in 1970 recognized the limitations of the former Bankruptcy Act and recommended the enactment of a single reorganization chapter in lieu of chapters X, XI, and XII (real property arrangements) of the former Bankruptcy Act.[1] After extensive consideration and numerous hearings over the following four years, Congress enacted the Bankruptcy Reform Act of 1978. Congress adopted the recommendation of the National Bankruptcy Commission and provided for a single business reorganization chapter as part of title 11 of the United States Code (the Bankruptcy Code). The 1978 Bankruptcy Code and chapter 11 were intended to eradicate the perceived barriers to effective bankruptcy reorganization. Many provisions were enacted to encourage distressed business debtors to seek relief under the Bankruptcy Code before the economic erosion precluded effective reorganization, including the retention and expansion of and statutory preference for the debtor in possession concept of former Chapter XI. The Bankruptcy Code was intended to significantly reduce or eliminate the stigma of bankruptcy by recognizing that there must be a remedy for overextension of credit and the vicissitudes of economic cycles. However, from the perspective of many, it appeared that the Bankruptcy Code was debtor friendly.

Nonetheless, it took a number of years subsequent to the effective date of the Bankruptcy Code and the onset of another economic cycle of recession for the aversion to bankruptcy reorganization to dissipate. As the economic conditions of the early 1980s deteriorated and high-profile, publicly owned corporations began to use the provisions of chapter 11, its popularity as a strategic, tactical business option became a reality. The commencement of chapter 11 cases by Johns-Manville Corporation, a *Fortune* 500 corporation, and its affiliates,[2] demonstrated the ability to use chapter 11 reorganization provisions to deal with mass tort litigation that had affected the financial stability of a business. The continuation of Continental Airlines as a functioning commercial airline after the 1983 commencement of its chapter 11 case[3] established that even in a highly sensitive industry, a business could operate and survive in the context of chapter 11. Thus, the Bankruptcy Code did accomplish a lessening of the stigma associated with bankruptcy as it became recognized that the general public would continue to patronize the businesses of chapter 11 debtors. In addition, the enforcement of the debtor protection provisions of the Bankruptcy Code by the bankruptcy court increased the attraction of chapter 11 as a strategic and viable business option for a distressed debtor.

As the size and volume of the chapter 11 cases in the late 1980s and early 1990s mushroomed and the perception of debtor-friendly bankruptcy courts persisted, creditor constituencies joined forces and mounted vigorous efforts to moderate the bankruptcy courts. Legislative lobbying began in earnest and over time, significant and far-reaching amendments were made to the Bankruptcy Code for the purpose of tilting the playing field to a more level or pro-creditor

stance. Debtors' powers as to (1) assumption and rejection of executory contracts, particularly as to shopping centers and collective bargaining agreements; (2) retiree benefits; (3) scope and enforcement of the automatic stay; and (4) use of collateral security of secured creditors, among others, were contracted.[4] Significant changes were made in the Federal Rules of Bankruptcy Procedure (the Bankruptcy Rules) to facilitate administration of chapter 11 cases for the benefit of creditors.[5] Consistent and persistent pressure has been exercised to limit a debtor's exclusive right to file a plan of reorganization.

The surge of huge chapter 11 cases as a result of the merger and acquisition mania of the 1980s also resulted in the recognition that the debt of a distressed business constituted a commodity that could be traded by speculators and investors. Financial institutions and other creditors desiring liquidity did not hesitate to sell claims held against a debtor. Trading in distressed debt often resulted in a concentration of debt in major investors, who then assumed a very key and significant role in the chapter 11 case, sharply limiting a debtor's ability to control its destiny through the chapter 11 process. Questions concerning the survival of the new value corollary to the absolute priority rule to retain equity interests by the old equityholders raged in the courts. The debate illuminated the high level of sophistication of distressed debt traders and their use of the absolute priority rule to eliminate or reduce the role of junior creditors and equityholders in the process of bankruptcy reorganization.

As a result, bankruptcy reorganization has become less appealing to a distressed debtor than it may have been in the early 1990s. The pendulum has moved back to a more creditor-oriented process reminiscent of proceedings under the former Bankruptcy Act. The perceived loss of control by virtue of the changes that have occurred in chapter 11 has caused the distressed debtor to defer and delay resorting to chapter 11 reorganization as a means to restructure. Chapter 11 has become the option of last resort.

This chapter briefly reviews restructuring alternatives that may be considered by debtors and creditors confronted by a financially distressed business. Restructuring and reorganization is not a science. It is an art that encompasses negotiation skills, economic analyses of the particular business, the nature of the industry, a reality recognition factor, and a wide range of legal issues. As a result, there may not be any certainty that the restructuring alternative chosen by the distressed business and accepted by its creditors and interest holders will be successful. Due diligence and comprehensive consideration of the material facts are prerequisites to any decision as to restructuring and the need to commence reorganization under the Bankruptcy Code.

ALTERNATIVES TO CHAPTER 11 REORGANIZATION

The onset of financial distress triggers the need on the part of the debtor's management and policy makers to undertake the inquiry necessary to ascertain the causes of such distress. The disappearance of liquidity and the incurrence of operational and financial losses do not occur spontaneously. Before determining an

appropriate cure for the problems, the distressed business must ascertain the nature of the problems and their pervasiveness. The distressed business must establish whether the causes of the distress are aberrational or persistent. Once the causes are isolated, the distressed debtor must determine if the problems are curable or terminal. That evaluation will materially influence the ultimate decision as to how to effect a restructuring.

Depending on the conclusions as to the causes and remedial actions that may be necessary to fix the problem, there are a number of informal means to cure illiquidity or excessive debt burdens. Among such options is the infusion of additional equity capital by current equityholders or third persons. To attract equity investors normally means that the causes of the problems of financial distress have been appropriately isolated, cures established to eradicate them, and that the prospects for growth are good. If all of those elements are present, the need to resort to formal restructuring is remote.

In the more common cases, the situation is not as black and white. The lines are less clear, and, usually, the distressed business has overexpanded and is overleveraged by substantial debt obligations. Often, default under various debt instruments is looming. Sometimes, the situation is aggravated by indications or assertions of misconduct or poor executive leadership, pending or potential litigation, and public dismay.

The first objective of any restructuring effort is to stabilize the operation of the business while the restructuring process is pursued. In those cases in which a simple equity infusion is inappropriate, the effort must be made to avoid default and the race to the courthouse with the potential dismemberment of the business's assets and properties. The commencement of debt collection litigation will impair the ability to effect an informal restructuring and may prejudice and destroy the value of all or a part of a debtor's business. Therefore, waivers of defaults and standstill agreements may serve to maintain the status quo while protecting the interests of all affected parties.

The price requested for waivers and standstill agreements may become a major factor in the determination of the appropriate restructuring option. If the cost is too high in terms of fees, charges, and demands for the granting of liens and security interests in favor of the creditors and waivers of potential bankruptcy protections, it may compel the distressed debtor to resort to formal restructuring under the Bankruptcy Code. The debtor's policy makers are subject to fiduciary duties in the context of the insolvency of the debtor or the fact that the debtor may be in the vicinity of insolvency. At that point, the policy makers must consider the interests of all parties and not prefer any one party over another.

Accordingly, in making the decision of whether to fix or file, the distressed business has to consider, among other issues:

- Fiduciary duties to all parties in interest, including, usually, creditors and any potential liability in connection with such duties
- The nature of the problems confronting the distressed debtor and their severity

- The effectiveness of any proposed cure, whether by reason of additional equity infusion, borrowing, disaggregation, sale, or restructuring
- The cost of effecting the cure in terms of the impact on the continuing business or the sale or other disposition of the business and its assets and properties
- The ability to prosecute any claim for the benefit of the debtor, including actions to avoid particular transactions as preferences or fraudulent transfers under the Bankruptcy Code
- The nature or type of liabilities and indebtedness of the distressed business and the probability of resolving pending or proposed litigation that has or might affect the viability of the distressed business
- Compliance with any applicable securities laws
- The costs and expenses of restructuring under the different alternatives

Each element of the decision-making process requires comprehensive examination and evaluation. Distressed businesses should employ the expertise of qualified professionals in reaching conclusions as to any proposed restructuring or reorganization. While a nonbankruptcy restructuring may be preferable, it is extremely important that the distressed debtor, and often its creditors and equityholders, agree that the restructuring proposed will be a permanent fix and not simply a temporary solution. If the latter occurs, it is probable that the restructuring scenario will be repeated in the very near future in circumstances of heightened tension and more limited opportunities for the distressed business.

In the face of the vagaries that are integral to the restructuring process, notwithstanding the distaste for the uncertainty of chapter 11 cases, the fixing of the ailing debtor may necessitate resorting to relief under the Bankruptcy Code. Because of the desire to avoid contact with the bankruptcy court as much as possible, various bankruptcy-related restructuring options have been developed. The following parts of this chapter describe those developments, as well as the traditional chapter 11 case, and reiterate the considerations that must be evaluated in the circumstances of fixing the problems or filing for relief under the Bankruptcy Code.

OUT-OF-COURT RESTRUCTURING

An out-of-court restructuring, or workout, is a nonjudicial process pursuant to which a distressed debtor and its significant creditors attempt to agree on an adjustment of the debtor's obligations. In the simple case of a nonpublic corporation or business entity that is dealing with a comparatively limited group of creditors of the same class, a composition of the outstanding debt may be accomplished by agreement. In the workout, it generally seeks to exchange or amend its existing debt and, sometimes, to change the composition of its equity interest holders. If the debtor is a publicly owned entity, it may exchange existing publicly traded securities for new securities with different terms through a consensual exchange offer under the Securities Act of 1933, as amended (the

"Securities Act"). Consensual exchange offers, generally, are implemented in one of the following ways:

- *Registered exchange offer.* A registered exchange offer requires the filing of a registration statement, usually on form S-4, with the Securities and Exchange Commission (SEC). The SEC takes 30 to 60 days to comment. The debtor requires additional time to respond to the SEC comments. A registered exchange offer has the benefit of avoiding restrictions on the securities that can be imposed if the exchange offer is premised on certain exemptions to the securities laws.
- *Section 3(a)(9) exchange offer.* Section 3(a)(9) of the Securities Act provides an exemption from the registration requirements of the Securities Act. Such an exchange offer generally must satisfy three requirements: (1) the exchange must involve the "same issuer," (i.e., the exchange must be initiated by the issuer for its own securities); (2) the debtor's old securities holders must not be asked to contribute any consideration other than the exchange of the old securities (with certain exceptions); and (3) the issuer may not compensate any person directly or indirectly for soliciting the exchange. The last requirement means that a debtor cannot compensate an investment banker to assist in the solicitation of the exchange nor may the banker's fee be dependent on the outcome of the exchange offer.
- *Other techniques.* In addition to the foregoing options, an issuer of securities may: (1) implement an exchange offer predicated on the private placement exemption set forth in Section 4(2) of the Securities Act; or (2) implement a settlement exchange under Section 3(a)(10) of the Securities Act, which requires, among other things, that a qualified court or governmental entity (other than a bankruptcy court) approve the exchange.

Apart from exchange offers, a debtor may obtain written consent to the modification of existing securities through a consent solicitation; amend equity securities in accordance with the company's charter, bylaws, and applicable nonbankruptcy (mostly state) law; and/or repurchase existing securities for cash, which is normally not an option for a distressed debtor. Under nonbankruptcy law, most public debt indentures require unanimity to change the payment-related terms of the security, and any dissenters must be bought out in cash or pursuant to the original terms of the debt issue. These "holdouts" can use their bargaining leverage to drag out any out-of-court restructuring process by demanding additional concessions, which may come at the expense of other creditors or interest holders.

COMBINATION EXCHANGE OFFER AND CHAPTER 11 PROPOSAL

An exchange offer or other out-of-court restructuring may simply not be feasible for a debtor, due to the requirement that each and every impaired creditor is required to consent to the proposal. Under chapter 11, a confirmed plan of reorga-

nization will bind minority creditors and equityholders as well as dissenting classes of such persons. Therefore, an exchange offer combined with a proposed chapter 11 plan and a provision notifying holders that the debtor may commence a chapter 11 case and use acceptances of the exchange offer as acceptance of the chapter 11 plan may be very effective to induce the requisite approvals of the exchange offer.

PREPACKAGED CHAPTER 11

A prepackaged chapter 11 case contemplates that the debtor negotiates the terms of its restructuring with its major creditors and then prepares a disclosure statement and solicits acceptances of its chapter 11 plan before it commences its chapter 11 case. Prepackaged chapter 11 cases commonly are referred to as single-track or dual-track cases. A single-track case is the classic case in which the debtor negotiates and proposes a reorganization plan and solicits acceptances of the plan with the specific intent to commence a chapter 11 case on completion of a successful solicitation. In contrast, a dual-track case, as noted above, combines a traditional exchange offer with the solicitation of a prepackaged chapter 11 plan. The exchange offer will govern if the required percentage of acceptances is reached. If such percentage is not obtained, however, then the acceptances of the exchange offer are treated as acceptances of the chapter 11 plan of reorganization.

Although the debtor may have the necessary plan acceptances, it is possible that a prepackaged plan will not be confirmed if dissenting creditors attack the adequacy of the prepetition disclosure, the solicitation process, the classification and treatment of claims, the tabulation of votes, and/or the feasibility of the prepackaged plan.[6] In the event a prepackaged case gets sidetracked by such issues, the total restructuring period and, perhaps, the expenses incurred may correspond to that of the traditional chapter 11 case.

When a prepackaged case is successful, the results are impressive. An example is the case of *Consolidated Hydro, Inc.* (CHI).[7] CHI was a holding company with a significant number of subsidiaries. The subsidiaries operated hydroelectric installations throughout the United States and each had its own debt obligations. The financial restructuring of CHI involved the conversion of $184 million of public bonds into 100% of the common stock of the reorganized company, the conversion of $240 million of preferred stock into warrants, the elimination of all existing equity interests, and the payment of 100 cents on the dollar to creditors holding general unsecured claims. CHI launched a section 3(a)(9) exchange offer on August 9, 1997; the holders of the public bonds and the preferred stock overwhelmingly accepted the plan. On September 15, 1997, CHI commenced its chapter 11 case. The bankruptcy court did not schedule a disclosure statement hearing. Several common stockholders objected to confirmation. After a contested confirmation hearing, the bankruptcy court confirmed the plan. CHI's plan became effective on November 6, 1997, just 52 days after the commencement date. As contemplated by the chapter 11 plan, none of CHI's subsidiaries or their operations were affected by CHI's chapter 11 case.

PREARRANGED CHAPTER 11

If there are too many creditors or classes of creditors or equityholders to effectively solicit, or pending litigation or other factors preclude the lead time necessary for a prepackaged chapter 11 case, the debtor's restructuring may also be effected through a prearranged chapter 11 case. In a prearranged case, as of the commencement date, the debtor will have reached an agreement on the terms of a plan of reorganization with one or more of its major creditor constituencies, but will not yet have solicited acceptances of its plan. Typically, the reorganization plan and disclosure statement are filed together with the chapter 11 petition, putting such cases on a fast track toward confirmation. An example of that technique is the case of *G. Heileman Brewing Company, Inc.* and its affiliates.[8] They commenced chapter 11 cases by filing voluntary petitions together with a joint chapter 11 plan on April 3, 1996. The plan was confirmed on June 26, 1996, fewer than 90 days later.

TRADITIONAL CHAPTER 11

A traditional chapter 11 case is commenced by the debtor's filing of a chapter 11 petition. Within days of the commencement of the case, the United States Trustee appoints an official committee of creditors and, in certain cases, additional committees of creditors or equityholders. Each official committee is entitled to retain professionals at the expense of the debtor's estate.

The duration of a traditional chapter 11 case depends on (1) the extent to which the debtor's operations have to be reorganized, (2) the amenability of the bankruptcy court to granting extensions of the debtor's 120-day exclusive period for filing a plan, and (3) the extent to which creditors resort to litigation to resolve issues among or between them. Reorganization of a large debtor pursuant to a traditional chapter 11 case is rarely concluded in less than one year and typically takes 18 months to two years.

A chapter 11 case was the ideal vehicle for *R.H. Macy & Co.*,[9] the operating revenues of which were insufficient to meet its operating costs, even without debt service, when it commenced its chapter 11 case in 1992. While under the protection of chapter 11, Macy's was able to install new operating standards and systems and turn losing operations into a profitable business. While the process took over three years, the enterprise value of Macy's was increased by over $1.5 billion. Ultimately, pursuant to its chapter plan, Macy's was acquired by Federated Department Stores.

Macy's was an atypical chapter 11 debtor due to its size, which may account for the duration of the case. Moreover, the results obtained in Macy's may not be achievable today; the introduction into the bankruptcy arena of distressed debt traders has changed the dynamics of chapter 11 because, to such traders, time is money. The need for a fast and substantial return colors all judgments and causes demands for a quick finish to any chapter 11 case. From that perspective, as a general matter, distressed debt traders who gain control of the creditor con-

stituencies do not believe that operational problems must be cured during the chapter 11 case administration. Their credo is "more bankruptcy is less good" for the debtor and their investment. Consequently, they are more concerned about rehabilitation of financial statements and a projected capital markets exit for debtholders. It may work in some cases and, in others, may result in the proverbial "chapter 22" case.

IDENTIFICATION OF THE CAUSES OF THE DEBTOR'S DISTRESS

The decision to seek relief under the Bankruptcy Code is not one lightly taken. Ironically, however, the decision is easiest for a debtor that has severe operational problems. A business that is unable to generate enough revenue to pay its operating expenses has fundamental business problems that require aggressive measures. The possible causes of the debtor's problems are many: its expenses are higher than those of its competitors, it sells an obsolete product, it sells a product that has caused personal injury on a massive scale, or it has been mismanaged. Regardless of the specific cause, the need for remedial action usually is immediate, and the extraordinary remedies of chapter 11 become increasingly attractive. Indeed, it may be that commencement of a chapter 11 case is the debtor's only realistic hope for reorganization or even survival.

The decision is much more difficult, however, for a business that appears to have sound operations and projected earnings but is simply unable to satisfy its debt service obligations or a crippling legal judgment.[10] For such a debtor, the decision to enter the bankruptcy arena with the concomitant imposition of bankruptcy court and U.S. Trustee oversight, the intrusion of one or more creditors or equity committees, and the ever-present uncertainty of what may transpire in the process may jeopardize an otherwise potentially viable business. The potential for second-guessing the debtor's policy makers always exists. In those circumstances, a record that demonstrates the debtor's consideration of all relevant factors will be an appropriate defense.

ANALYSIS OF DEBTOR'S NEED FOR THE EXTRAORDINARY REMEDIES AVAILABLE IN CHAPTER 11

Automatic Stay

Upon the filing of a voluntary petition for relief under chapter 11 of the Bankruptcy Code, all persons are enjoined from commencing or continuing any judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced prior to the commencement date.[11] The automatic stay generally enjoins parties from instituting or continuing any lawsuit to obtain property of the debtor's estate, to create or perfect a security interest in property of the estate, or to obtain or enforce a judgment against the debtor in an attempt to collect on a claim against the debtor that arose prior to the com-

mencement date.[12] Filing a chapter 11 petition is often necessary in order for a debtor to stave off a foreclosure action or a creditor's enforcement of a judgment. For example, when Texaco, Inc. was the subject of an $11 billion judgment in favor of Pennzoil Company, Texaco delayed commencing its chapter 11 case until it believed it could no longer preclude Pennzoil Company from enforcing its judgment. Nonetheless, the delay may result in an attack upon the chapter 11 case as not being filed in good faith or on the basis that there is no possibility of reorganization.[13]

Additional Financing

Often, the debtor's crisis is precipitated by a default under its working capital facility that precludes additional advances until a restructuring is completed. If the debtor needs immediate access to additional financing, it may find that it is better able to obtain credit in a chapter 11 case than in the workout context. The Bankruptcy Code enables the trustee or debtor in possession to obtain unsecured credit or incur unsecured debt in the ordinary course of business.[14] The court may also authorize the debtor in possession to obtain credit or incur debt outside of the ordinary course of business on a secured or unsecured basis.[15] The Bankruptcy Code establishes a hierarchy of those permissible credit transactions in which the debtor in possession may engage. Subject to bankruptcy court approval, the debtor in possession may obtain credit or incur indebtedness which: (1) is unsecured or has administrative expense status; (2) has superadministrative expense status or is secured by a lien on unencumbered property or a junior lien on encumbered property; or (3) is secured by a superior or equal lien on encumbered property.[16] The bankruptcy court may not authorize the incurrence of secured credit unless the debtor in possession (DIP) cannot obtain unsecured credit.[17]

An additional or alternative financing vehicle for a chapter 11 debtor is the use of cash collateral, which may be available for a debtor that is able to sustain its operations by utilizing the cash it generates. If the debtor had secured financing prepetition, substantially all of its cash is likely to constitute cash collateral, which may not be used absent consent of the secured creditor or court approval.[18] In order to establish that it is entitled to use cash collateral, the debtor must provide the secured creditor with adequate protection. In the retail or manufacturing industry, in which collections generated by the sale of inventory will often constitute cash collateral, adequate protection may be provided by making periodic interest payments or by providing a replacement lien on postpetition receivables.

Conventional wisdom has generally been that the commencement of a chapter 11 case enables a debtor to obtain unsecured trade credit more easily than would be the case outside of such a proceeding, due to the administrative expense treatment afforded to postpetition claims of suppliers. Historically, the most common form of DIP financing involved unsecured loans coupled with superpriority administrative expense status. The recent trend in DIP financing, however, has been toward DIP financing secured by all unencumbered assets of

the debtor, a junior lien on encumbered assets, and, in certain cases, a priming lien. With the increased popularity of secured DIP financing, certain vendors have been unwilling to restore normal delivery of inventory and unsecured credit terms. To continue in business, debtors have been constrained to resort to alternative sources of inventory supplies or to agree to prepayment, payment on delivery (COD), or the granting of a lien in favor of trade vendors.[19] Depending on the protection ultimately granted to the trade, the debtor may not be able to take advantage of the float provided by normal trade terms and the amount of financing required by the debtor is likely to be greater. The debtor and, ultimately, its creditors bear the cost of a larger DIP financing facility through higher commitment and unused line and other fees. In sum, therefore, depending on the debtor's industry, the conventional wisdom that trade credit may be more readily available in chapter 11 may be inapposite.

Rejection of Executory Contracts

Subject to the approval of the bankruptcy court, a chapter 11 debtor may reject any executory contract or unexpired lease.[20] Through rejection under section 365, the Bankruptcy Code provides a mechanism for a debtor that seeks to contract substantially the size or geographic distribution of its operations. The ability to reject leases in the exercise of the debtor's business judgment is particularly useful to a retail debtor that has hundreds of stores located throughout the United States. Although rejection under Section 365 is not cost free,[21] the lease rejection tool has enabled many retail debtors to reposition themselves and to focus their operations on a core group of store locations.

The Bankruptcy Code also enables a debtor in possession to reject a collective bargaining agreement if the court finds that a proposal calling for necessary modifications to the agreement has been rejected by employee representatives without good cause.[22] Section 1113, which sets forth rigorous standards governing whether rejection will be permitted, was enacted in 1984. Even if rejection of the collective bargaining agreement is approved by the bankruptcy court, the union generally remains the authorized representative of the employees, and the employer and the union have the obligations imposed on them under applicable federal labor laws to negotiate in good faith to try to agree on the terms of a new collective bargaining agreement.

Nevertheless, a debtor whose operating expenses are disproportionately high for its industry due to a burdensome collective bargaining agreement may have the ability to obtain some relief in the context of a chapter 11 case. Similarly, the DIP may modify retiree benefits if it can demonstrate that the proposed modifications are necessary to permit the reorganization of the debtor and have been rejected by the authorized representative of the retirees without good cause.[23] The extent to which employees have a claim for lost wages under a rejected collective bargaining agreement depends on whether the agreement includes a guarantee of employment.[24]

In the event that the bankruptcy court authorizes the rejection of an executory contract, or unexpired lease, the nondebtor party will have an unsecured claim

for damages arising from the rejection. In most cases, however, such a claim is treated like all other unsecured claims and may receive only the consideration that is proposed in the chapter 11 plan. In order to prevent huge damage claims arising from the rejection of long-term employment contracts or unexpired leases from consuming the assets available for unsecured creditors, the Bankruptcy Code limits the amount of the claims that may be asserted as a result of such rejections.[25]

The ability to reject leases and executory contracts, and the concomitant limit on the magnitude of certain damage claims arising therefrom, are powerful reorganization tools. Although the DIP cannot modify an executory contract, collective bargaining agreement, or lease without the consent of the *contra* party, the leverage afforded to the debtor by the rejection power will often enable a debtor to renegotiate such agreements on more favorable terms.

Relief from Anti-Assignment Clauses and Other Restrictive Provisions

The DIP may assign an executory contract or unexpired lease to a third party notwithstanding a contractual provision that prohibits, restricts, or conditions the assignment thereof.[26] In order to justify such assignment, the DIP is required to provide adequate assurance of future performance of the contract or lease.[27] Unlike the case in the out-of-court context, assignment of a contract or lease relieves the debtor from liability for any breach that occurs subsequent to the assignment.[28] The Bankruptcy Code, therefore, offers a mechanism for the debtor to capitalize on valuable assets that may not fit with the debtor's business plan, but that may be of value to third parties.

Bankruptcy courts have also relieved debtors from complying with "going dark" provisions contained in many shopping center leases. Such provisions preclude tenants from conducting going out-of-business sales, in order to uphold the image of the center and, where percentage rent is payable, maintain earnings. In cases in which the debtor determines to close stores and conducts liquidation sales, such lease provisions directly conflict with the bankruptcy policy of maximizing the value of the estate. Landlords have been largely unsuccessful in arguing that debtor tenants are required to comply with such lease covenants in cases in which bankruptcy courts have approved liquidation sales.[29]

Despite any contractual provisions to the contrary, the chapter 11 debtor may sell property free and clear of any interest of any other entity, such as a secured party, if one of the following is true: (1) applicable nonbankruptcy law permits a sale free and clear of such interest; (2) the entity consents; (3) the interest is a lien, and the proposed sale price exceeds the aggregate value of all liens on the property; (4) the interest is in bona fide dispute; or (5) such entity could be compelled in a legal or equitable proceeding to accept a money satisfaction of its interest.[30] In addition, under certain circumstances, the DIP may sell its own interest as well as the interest of any co-owner in property in which the debtor had an undivided interest as a tenant in common, joint tenant, or tenant by the entireties.[31]

In order to obtain approval of a request to sell property free and clear, the DIP

will still have to satisfy the bankruptcy court that the sale on the terms proposed represents a reasonable business decision. In addition, in most cases, the bankruptcy court will issue an order that provides that the lien of the secured party will attach to the proceeds of the asset sale, to the same extent as it existed on the original asset, without any further action by the secured creditor. The advantage of a sale "free and clear" under Section 363(f) is that it enables the DIP to effect a sale of an asset, the value of which may be diminishing, even though issues regarding the extent and priority of the liens thereon remain to be resolved. In effect, Section 363(f) prevents a secured creditor from using its ability to consent to a sale as unfair leverage in order to extract a distribution to which it might otherwise not be entitled.

Ability to Bind Nonconsenting Creditors

The keystone of an out-of-court restructuring is consensus; no creditor may have its rights adversely affected in an out-of-court restructuring unless it has specifically agreed to less favorable terms.

The Bankruptcy Code defines acceptance of a plan by a class of creditors as acceptance by at least two thirds in amount of claims and more than one half in number of holders that have voted on the plan.[32] Moreover, under the cram-down mechanism,[33] a plan can be confirmed even if it has not been accepted by every class of claims and interests, if it is "fair and equitable" and satisfies other statutory criteria. Commencement of a chapter 11 case may, therefore, be necessary if the debtor is unable to obtain the requisite number of acceptances to its out-of-court restructuring proposal.

Unliquidated or Contingent Claims

If the magnitude of the claims against a debtor cannot be ascertained, formulation of a reorganization plan that fairly allocates the assets available for distribution among the debtor's creditors and stockholders is virtually impossible. The Bankruptcy Code provides a mechanism that debtors may utilize in order to estimate any "contingent or unliquidated claim, the fixing or liquidation of which . . . would unduly delay the administration of the case."[34] Estimation of claims may be solely for purposes of voting, as in the chapter 11 case of *Johns-Manville Corporation*,[35] in which the court estimated thousands of asbestosis claims at $1 each for voting purposes, subject to each claimant's right to establish the actual amount of his claim after confirmation of the plan. Alternatively, estimation may be used to allocate the consideration distributed under the plan, as in the chapter 11 case of *Eagle-Picher Industries, Inc.*, in which consideration was allocated among unsecured creditors and personal injury plaintiffs allegedly injured by asbestos manufactured by Eagle-Picher.[36] Finally, estimation may be for purposes of allowance of a claim under the plan, in which case the creditor is barred from litigating its claim and establishing its entitlement to a greater distribution.

Section 502(c) has been particularly useful to debtors faced with mass tort liability. The estimation procedure enables the debtor in such circumstances to

quantify the claims for which it has to provide treatment under its reorganization plan and, therefore, proceed with plan formulation. Moreover, although plaintiffs cannot be deprived of the ability to have their personal injury claims adjudicated in state court proceedings, chapter 11 offers a vehicle for centralizing liquidation of such claims in a claims processing facility such as those used by Manville, Eagle-Picher, and others.

Avoidance Actions

If the debtor has a significant fraudulent conveyance claim under applicable state law, the statute of limitations for which may be near expiration, the commencement of a chapter 11 case may be preferable to an out-of-court restructuring. Pursuant to the Bankruptcy Code, a transfer may be set aside as a fraudulent conveyance only if it occurred within one year before the date of the filing of the petition. However, because a DIP may avoid any transfer of property that may be avoided under applicable state law by a hypothetical creditor holding an unsecured claim against the debtor, in chapter 11, transfers of property may be subject to the generally longer limitations period of state fraudulent transfer law.[37] Under the Bankruptcy Code, the DIP has two years after the commencement of the case to commence an action, the statute of limitations for which had not expired as of the commencement date.[38] The loss of a potentially valuable asset through the expiration of the limitations period may be a critical factor in the debtor's decision as to the appropriate restructuring vehicle. Indeed, the desire to prevent one creditor or group of creditors from "getting a leg up" on the others by escaping any potential liability might prompt creditors to commence an involuntary case against the debtor even during restructuring discussions.

In a similar vein, the 90-day and one-year periods during which preferential transfers to noninsiders and insiders, respectively, may be avoided[39] should be borne in mind by the debtor, both to ensure that a potentially valuable asset is not lost and to anticipate the possible commencement of an involuntary case by creditors allegedly harmed by such transfers.

Tax Advantages

Outside of the bankruptcy context, where debt is canceled, in whole or in part, for less than the full amount owing, a debtor will recognize cancellation of debt (COD) income, which likely will be taxable in whole or in part.[40] When a nonbankrupt debtor is insolvent (under the tax code, when the debtor's liabilities exceed the fair market value of its assets as determined immediately before cancellation of debt), the amount of COD income recognized will be the amount, if any, by which the amount of the debt canceled exceeds the amount of the insolvency; the remaining amount of the cancelled debt will be applied to reduce the debtor's favorable tax attributes (such as net operating losses and other loss and credit carryovers).[41]

For a debtor in bankruptcy, however, no portion of a simple COD will be taxable if the debt is cancelled pursuant to a bankruptcy discharge; instead, only the amount discharged will be applied to reduce the debtor's favorable tax attributes.[42]

If a proposed restructuring of the debtor's operations includes significant asset sales, the tax treatment of certain transfers under state law may influence whether sales should be conducted pursuant to a plan of reorganization or pursuant to an out-of-court workout. Under the Bankruptcy Code, "the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 . . . may not be taxed under any law imposing a stamp tax or similar tax."[43] Outside the contest of a confirmed chapter 11 plan, however, the Supreme Court has upheld the general power of a state to impose sales or use taxes on bankruptcy liquidation sales under chapter 7 or chapter 11.[44]

Section 1146(c) raises two issues: what kind of taxes are within its scope and when does a transfer occur "under a plan." Transfer taxes on real estate are included within its scope,[45] although taxes on a transferor's gain are not.[46] With respect to sales and use taxes on transfers of personal property, the breadth of the exemption is unclear. Arguably, any tax that is imposed on the transfer itself is within the spirit of the exemption.

Courts have generally held that any sale conducted in order to effectuate a plan is a sale under a plan and therefore within section 1146(c). A significantly higher standard may apply, however, if the sale occurs before confirmation and particularly before the filing of the chapter 11 plan.[47]

Exemptions from Securities Laws

Transactions involving the offer, sale, or exchange of securities in connection with a reorganization under chapter 11 are exempt from the registration requirements of Section 5 of the Securities Act, the proxy solicitation rules under the Securities Exchange Act of 1934, the "going private" rules, and certain other federal securities regulations.[48] In addition, such transactions are also exempt from registration requirements under state securities laws. The rationale for the exemptions is that the oversight generally provided by the SEC in such transactions is provided by the bankruptcy court, which must approve the transactions and the related disclosure, after notice and a hearing. Thus, the chapter 11 debtor is spared the time and expense necessary to comply with overlapping statutory frameworks.

Exclusive Right to File a Plan

A chapter 11 debtor is provided with a 120-day "exclusive period" during which only the debtor may file a reorganization plan.[49] The retention of exclusivity is key to the debtor's ability to control the outcome of its chapter 11 case. During the exclusive period, the debtor is afforded an opportunity to stabilize its operations and formulate a long-range business plan, which is then used as a foundation for its reorganization plan, all without the distraction that might result from plans that could otherwise be filed by other parties-in-interest. In addition, the debtor's senior management and employees can focus on the debtor's operations, rather than the implications of any plan proposals on their own futures. As long as exclusivity is maintained, all creditors and other parties-in-interest must negotiate the parameters of a reorganization plan with the debtor.

The "Breathing Spell"

Another benefit of chapter 11 is that it offers a debtor a "breathing spell" within which it may negotiate the restructure or payment of its prepetition indebtedness to creditors while continuing to operate its businesses and thus preserving (or enhancing) the going concern value of its business. Moreover, a chapter 11 debtor is generally not required to make payments in respect of its prepetition debts. Once a debtor files for relief under chapter 11, interest ceases to accrue on its unsecured and undersecured debt. Particularly for operating companies, the opportunity for the debtor, in the first instance, to formulate and test a business plan that will form the basis of its reorganization plan is invaluable.

RISKS ATTENDANT TO THE COMMENCEMENT OF THE TRADITIONAL CHAPTER 11 CASE

Chapter 11 offers a distressed debtor innumerable restructuring options that are simply not available in the out-of-court context. Prior to the decision to seek relief under chapter 11, the distressed debtor must take into account the significant risks attendant to chapter 11.

Loss of Control

One of the radical innovations of American bankruptcy law is that, absent extraordinary circumstances, the debtor's policy makers and management remain in place in a chapter 11 case (i.e., the DIP concept). By rejecting the rule under chapter X of the former Bankruptcy Act, in which a trustee was automatically appointed to run the debtor's affairs, Congress concluded that debtors would be encouraged to seek relief under chapter 11 before their businesses became moribund.[50] Thus, consistent with congressional intent, the debtor is not automatically displaced at the commencement of a chapter 11 case. Since 1978, a number of statutory amendments and the return swing of the pendulum have eroded the DIP concept.[51] As a result, as noted, debtors are more reluctant to make the chapter 11 decision unless there is no other choice.

The Fishbowl Effect

By commencing a chapter 11 case, a debtor commits itself to extensive disclosure concerning how it operates its business, with whom it does business and on what terms, and its financial, operational, and other problems. The debtor is transformed, in part, into a debtor in possession, subject to the oversight of the bankruptcy court and its creditors, acting as one or more creditors' committees. Although a public company may be generally accustomed to the disclosure requirements of federal securities laws, for the privately held debtor, the disclosure requirements may be daunting. Debtor executives must appear for and be examined at the initial meeting of creditors, as well as periodic adjournments thereof, and at creditors' committee meetings.[52] Some protection may be available against disclosure of trade secrets, confidential research, or other valuable proprietary

commercial information; however, such information usually will be made available to creditors' committee members, and confidentiality cannot be guaranteed.

Transactions Outside the Ordinary Course of Business

While the chapter 11 debtor is free to operate its business, it must obtain bankruptcy court approval for transactions out of the ordinary course of business.[53] Management is almost always shocked at how this limitation imposes upon its ability to operate its business. When the time needed for educating the creditors' committee, preparing the necessary pleadings, and providing appropriate notice is included, many debtors, especially those that do not have an orderly and well-planned introduction into chapter 11, feel that their ability to operate effectively in a competitive business environment is crippled. Apart from timing issues, management has to learn that its business decisions may be second-guessed, often by persons who may not be familiar with the peculiarities of the debtor's industry.

Retention of Senior Management

The employment contracts of the debtor's senior management (as well as other employees) will be executory contracts subject to assumption or rejection in chapter 11. Absent assumption of their contracts, members of senior management lack the assurance that their claims for bonuses or severance will be entitled to administrative priority and therefore paid in full. In most cases, the thresholds for performance bonuses set forth in existing employment contracts make no sense in the debtor's current condition. Nevertheless, retention of experienced and expert management is critical to the debtor's survival. In order to ensure that key members of management remain with the debtor soon after the commencement date, the debtor will want to prepare and file motions for the assumption or modification of existing agreements or the execution of new agreements.

From the creditors' perspective, however, such motions are often brought on just as the creditors are realizing the magnitude of the debtor's problems. One natural reaction is for creditors to blame the very management whose contracts are before the bankruptcy court. Creditors may, therefore, be unsympathetic to the debtor's need to retain key management, especially in light of the large administrative claims that may result from assumption. From the perspective of the bankruptcy court, the compensation sought by senior management may seem astronomical, particularly faced with the possibility of a distribution to unsecured creditors that may be a fraction of their respective claims.

Consequently, at a time when the debtor needs great stability, and management needs to know that it can put its own individual interests aside and operate in the best interests of all creditors, it may be exceedingly difficult to obtain bankruptcy court approval of a management compensation and retention program. If it is not possible, the debtor is vulnerable to having key members of management cherry-picked by the competition, further exacerbating the debtor's problems.

Exclusive Right to File a Chapter 11 Plan

In the past, repeated extensions of the debtor's exclusive period for filing a plan have been commonplace. Lengthy extensions have been granted due to the size

and complexity of the debtor's estate, the unresolved status of major litigation, and the seasonality of the debtor's business, among other things.[54] More recently, however, lengthy extensions of exclusivity have become less common. Courts commonly note that sheer size alone will not justify extension of a debtor's exclusive period for filing a plan.[55]

Although a large debtor is still likely to obtain at least one extension of exclusivity, it cannot rely on having adequate time within which to effectuate a turnaround. This lack of certainty has made chapter 11 a much more difficult environment, and one in which a debtor has less control over its own fate.

Appointment of a Trustee, Examiner, or Mediator

The Bankruptcy Code provides for the appointment of a trustee for cause or in the best interest of creditors.[56] The Bankruptcy Code also contemplates the appointment of an examiner; an examiner is a person usually charged with certain investigatory powers.[57] Two recent trends have impacted on the debtor's ability to manage the chapter 11 process. The first is the recent tendency of bankruptcy courts to appoint "an examiner with expanded powers." The concept is to appoint someone to perform more than a merely investigatory function, yet not go so far as to appoint a trustee and oust management. The expanded powers are generally enumerated by the bankruptcy court's order. For example, in the *Public Service of New Hampshire* case, an examiner was appointed to mediate negotiations aimed at arriving at a consensual plan of reorganization and to report to the court on the status of negotiations.[58]

The other recent trend, following a trend prevalent in other litigation contexts, is the appointment of a mediator, either to mediate a particular dispute or to broker a deal on a reorganization plan among the debtor and competing groups of creditors. Although there does not at first blush appear to be a downside to nonbinding mediation from the debtor's perspective, the risk for the debtor is that the bankruptcy court will view an impartial mediator as the voice of reason and view the debtor's refusal to accede to the mediator's view as unjustified intransigence.

Dubious Survival of the New Value Corollary

The Bankruptcy Code contemplates the confirmation of a consensual plan of reorganization. Pursuant to a consensual plan, creditors and stockholders may agree among themselves, within certain limits, as to how to share distributions under a reorganization plan. The Bankruptcy Code also provides for the confirmation of a nonconsensual or cram-down plan.[59] In the cram-down context, however, the "absolute priority" rule must be satisfied. Under the absolute priority rule, no junior class may receive any distribution under a reorganization plan until all senior classes have received property having a value equal to the allowed amount of their claims. Consequently, equityholders would ordinarily not be entitled to any distribution unless all creditors have received distributions equal to the full amount of their claims.

The so-called new value corollary was developed by courts under the former Bankruptcy Act. It provided that former equityholders may exchange "new value" for equity in the reorganized debtor, even though some creditors will not

be repaid in full under the plan. The judicially established criteria for application of the new value corollary are that the capital to be contributed by old equity must be (1) new, (2) substantial, (3) money or money's worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the value of the property that old equity is to retain or receive. Although the Bankruptcy Code incorporates the absolute priority rule, the Bankruptcy Code and its legislative history do not indicate whether the new value corollary continues to be available.

Courts of appeal have split over whether and to what extent the new value corollary survives the enactment of the Bankruptcy Code.[60] The key distinction in the conflicting cases is whether an existing equityholder that provides tangible new value is receiving anything "on account of" its equity interests. Those courts that have upheld application of the corollary have held that the new equity is being distributed on account of the new investment. Conversely, those courts that have strictly interpreted the corollary have held that, unless investments are solicited from third parties, existing equityholders impermissibly would be receiving something on account of their former equity—the exclusive opportunity to invest in the reorganized entity. The split among the courts of appeals should be resolved shortly, inasmuch as the Supreme Court has recently granted certiorari and will review the Seventh Circuit's decision in *In re 203 North LaSalle Partnership*.

If the Supreme Court adopts the position of those courts that have adopted a strict interpretation of the new value corollary, chapter 11 will be fraught with even more uncertainty from the perspective of the debtor's equityholders. In order to obtain confirmation of a new value plan, the debtor may have to demonstrate that third-party investors were solicited. Such solicitation, however, may result in the equity being outbid; that is, a third party may be willing to make a greater investment for the same portion of new equity. Former equityholders may lose any interest in the reorganized debtor or have to increase the amount they are willing to pay therefor.

All of the foregoing demonstrate that actual practice under the Bankruptcy Code has proceeded far afield from what the legislators contemplated when the Bankruptcy Code was enacted. While the norm in chapter 11 often assumes that management is expected to remain in place and run the debtor's operations and its restructuring, there appears to be less likelihood than ever that the DIP will be able to orchestrate its chapter 11 case and shepherd its reorganization plan to confirmation.

Expense of Restructuring in Chapter 11

As is the case with respect to out-of-court restructurings and other remedial proceedings, a chapter 11 case may be expensive to administer. The structure of chapter 11, with the imposition of statutory committees and the U.S. Trustee, necessarily elevates costs. The addition of any significant litigation likewise will materially add to the cost of administration. However, many of the cost items would be incurred despite the chapter 11 case. That factor should not be ignored. In any event, the use of cash to meet the costs of professionals, experts, and the

like hired by the debtor and, beyond its control, by statutory committees may be very substantial.

Chapter 11 also extracts a huge toll in soft costs—the amount of time devoted by senior members of management to complying with the chapter 11 process rather than operating the business. Similarly, the delay occasioned by the need for bankruptcy court and statutory committee approvals may preclude the debtor from taking advantage of business opportunities. The debtor's employees are invariably affected by the commencement of a chapter 11 case; many employees will leave the debtor to pursue other opportunities, and those that remain may have poor morale in light of the uncertain futures.

DEVELOPMENT OF A RESTRUCTURING STRATEGY

The optimal restructuring scenario for most debtors is to take advantage of the extraordinary remedies available in chapter 11, but to do so in a controlled process, the outcome of which is all but assured (i.e., a prepackaged or prearranged chapter 11 case). Chapter 11 offers debtors a wide panoply of tools with which to effect a restructuring of both their financial status and their operations. On the other hand, a traditional chapter 11 case can be time consuming, expensive, and unpredictable. For some debtors, the incremental benefits available in chapter 11 may be outweighed by the risks attendant thereto. Thus, if the debtor's primary problem is overleveraging, but there are some provisions of chapter 11 that might confer some minimal additional benefit, commencement of a case under chapter 11 may not be appropriate. Conversely, if a debtor can obtain a restructuring of an amount of indebtedness outside of chapter 11 sufficient to allow it to continue its business without impairment, commencement of a chapter 11 case may nevertheless be warranted in order to correct debilitating operational problems. As previously noted, the circumstances require the debtor's business managers to review and evaluate:

- How extensive a restructuring is necessary?
- What is the threshold of debt or other relief the debtor must achieve if it is to avoid chapter 11?
- Regardless of the magnitude of concessions made by its creditors, is the debtor's resort to chapter 11 necessary or appropriate because of pressing litigation, avoidance claims, or other reasons?
- Are the primary creditor constituencies fully secured or undersecured, and does their concern over their potential recoveries in chapter 11 give the debtor negotiating leverage?
- How much can the debtor afford to give up to creditors in the form of additional collateral?
- Will the pledge of additional collateral obviate the possibility of a successful chapter 11 case, should chapter 11 ultimately prove unavoidable?
- How does the seasonal nature of the debtor's business affect the timing of

commencement of restructuring discussions and, if necessary, a chapter 11 case?
- Are there impending debt defaults, required public filings, or other external considerations that affect timing?
- Does the debtor require a freeze of creditor rights to attempt an operational turnaround?
- Is the payment in full of trade claims, a typical feature of prepackaged cases, a feasible option that is likely to be acceptable to the senior creditors?
- What will be the impact on the business if the commencement of restructuring discussions becomes public?
- Can the debtor withstand the possible contraction of trade credit?
- What unilateral measures, if any, can the debtor take during the period of negotiation and documentation to reduce its operating expenses?
- Are there any outstanding obligations for "trust fund taxes" for which "responsible officers" may be personally liable, and what arrangements, if any, have been made for satisfaction of such obligations?
- Has the debtor failed to pay any outstanding corporate or other business taxes that may lead to the commencement of a chapter 11 case?
- If the debtor has one or more pension plans, are they fully funded, overfunded, or underfunded, and what impact does their status have on restructuring discussions?
- Does the debtor face any environmental liabilities that may not be discharged in chapter 11?
- Does the debtor have sufficient cash on hand or projected to be received to support its efforts to negotiate an out-of-court restructuring or a prepackaged or prearranged bankruptcy?

After consideration of all factors and evaluation of the benefits and risks of chapter 11, unless the debtor requires immediate relief under the Bankruptcy Code, the distressed debtor should formulate an initial restructuring proposal and commence negotiations with its major creditors to obtain what relief is necessary. The debtor must maintain its credibility, and it will have to provide financial data to justify the concessions and changes it requests.

Unless the debtor has significant unencumbered assets to offer to creditors in an out-of-court restructuring, the debtor's only leverage in the restructuring negotiations is the commencement of a traditional chapter 11 case. Of course, by virtue of the absolute priority rule, creditors, and particularly distressed debt traders, recognize that the debtor's equityholders are vulnerable to having their equity eliminated if the debtor is insolvent or is in the vicinity of insolvency. Nevertheless, creditors may believe that the bankruptcy court tends to favor debtors, at least initially, and fear the delay and risks attendant to a chapter 11 case thereby extending some leverage to the debtor. Distressed debt traders may fear that in chapter 11 the debtor will be put "in play," increasing the price such traders would have to pay to obtain control of the reorganized entity.

CONCLUSION

Although out-of-court restructuring negotiations may not go as planned, and the debtor should remain flexible, it is essential that the debtor's policy makers and management not allow the momentum of the workout strategy to overtake them. In fact, the ideal course is for the debtor to conduct restructuring negotiations at the same time it prepares for commencement of a chapter 11 case. Two purposes are served by pursuing parallel courses. First, creditors will recognize that the prospect of a chapter 11 filing is not an idle threat by the debtor. Second, the debtor's policy makers and senior management will continue to focus on chapter 11 as a viable option.

There are many different avenues to a successful restructuring. The only approach that is obviously doomed to fail is for the debtor to agree to the terms of an out-of-court restructuring that provides the debtor with only a piecemeal, short-term reprieve from its financial difficulties.

NOTES

1. *See* Commission on the Bankruptcy Laws of The United States Report, H.R. Doc. No. 93-137, 93d Cong., 1st Sess., pt. I, at 237-48 (1978).
2. *In re Johns-Manville Corporation, et al.*, Chapter 11 Case Nos. 82-B-11656 through 82-B-11676 (BRL) (Bankr. S.D.N.Y. 1982).
3. *In re Continental Airlines Corporation, et al.*, Consolidated Chapter 11 Case No. 83-04019-H2-5 (Bankr. S.D. Tex. 1983).
4. *See*, *e.g.*, Bankruptcy Code §§ 365(b)(3), 1113, 1114, 362(c)(3), 362(e), 363.
5. *See*, *e.g.*, Bankruptcy Rule 4001.
6. *See*, *e.g., In re Southland Corporation*, 124 B.R. 211 (Bankr. N.D. Tex. 1991).
7. *In re Consolidated Hydro, Inc.*, Chapter 11 Case No. 97-1924 (SLR) (D. Del. 1997).
8. *In re G. Heileman Brewing Company, Inc.*, *et al.*, Consolidated Chapter 11 Case No. 91B-10326 (FGC) (Bankr. S.D.N.Y. 1991).
9. *In re R.H. Macy & Co., Inc.*, Case No. 92 B 40477 (BRL) (Bankr. S.D.N.Y. 1992).
10. For example, *Texaco, Inc.* and its affiliates, which commenced their chapter 11 cases on April 12, 1987 (Chapter 11 Case Nos. 87 B 20143, et seq. (HS) (Bankr. S.D. N.Y.)).
11. Bankruptcy Code, § 362(a)(1).
12. Bankruptcy Code, § 362(a).
13. *See*, *e.g.*, *In re Little Creek Development Company*, 779 F.2d 1068 (5th Cir. 1986) (court of appeals remanded case to bankruptcy court for further evidence regarding bankruptcy court's decision to grant secured creditor relief from automatic stay based on statements of debtor's counsel that petition was filed in order to escape the necessity of posting a bond in a state court proceeding).
14. Bankruptcy Code, § 364.
15. Bankruptcy Code, §§ 364(b), (c).
16. Bankruptcy Code, §§ 364(a), (b), (c), (d).
17. *See*, *e.g.*, *In re Snowshoe Co.*, 789 F.2d 1085 (4th Cir. 1986) (although the debtor is not required to seek credit from every possible source, the debtor must establish that it has made reasonable efforts to seek other sources of credit under sections 364(a), (b) and (c)).
18. Bankruptcy Code, §§ 363(a), 363(c)(2).
19. For example, in *In re Food Barn Stores, Inc.*, Case No. 93-40012-2-11 (Bankr. W.D. Mo.) the

trade vendors requested (and received) a carve-out from the DIP lender's post-petition liens in the amount of $2 million. *See also F&M Distributors, Inc.*, Case No. 94-52115 (Bankr. E.D. Mich.) (trade vendors received a superpriority administrative expense and lien on inventory *pari passu* with lien granted to DIP lenders).

20. Bankruptcy Code, § 365(a).

21. *See* discussion, *infra*.

22. Bankruptcy Code, § 1113.

23. Bankruptcy Code, § 1114 (enacted in 1988).

24. *See*, *e.g.*, *In re Continental Airlines Corp.*, 901 F.2d 1259 (5th Cir. 1990).

25. Bankruptcy Code, §§ 502(b)(6) (lease rejection) and 502(b)(7) (employment contracts). The ability to reject contracts and unexpired leases will not provide any benefit to a debtor if the debtor's obligations thereunder have been guaranteed by a non-debtor entity; the relief afforded by sections 365 and 502(b) is only available to a debtor under the Bankruptcy Code.

26. Bankruptcy Code, § 365(f).

27. In the case of a shopping center lease, adequate assurance has certain particular requirements as to tenant mix, percentage rent and other matters. Bankruptcy Code, § 365(b)(3).

28. Bankruptcy Code, § 365(k).

29. *See*, *e.g.*, *In re R.H. Macy & Co., Inc.*, 170 B.R. 69, 76 (Bankr. S.D. N.Y. 1994); *In re Ames Department Stores, Inc.*, 136 B.R. 357 (Bankr. S.D. N.Y. 1992).

30. Bankruptcy Code, § 363(f).

31. Bankruptcy Code, § 363(h).

32. Bankruptcy Code, § 1126(c).

33. Bankruptcy Code, § 1129(b).

34. Bankruptcy Code, § 502(c).

35. *See Kane* v. *Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988) (affirming confirmation order in appeal by asbestos claimant who challenged, *inter alia*, the voting procedures).

36. *In re Eagle-Picher Industries, Inc., et al.*, 189 B.R. 681 (Bankr. S.D. Ohio 1995).

37. Bankruptcy Code, §§ 548, 544(b).

38. Bankruptcy Code, § 108.

39. Bankruptcy Code, § 547.

40. 26 U.S.C. § 108.

41. 26 U.S.C. § 108(a), (b), (d).

42. 26 U.S.C. § 108(a)(1)(A), (a)(2).

43. Bankruptcy Code, § 1146(c).

44. *California State Board of Equalization* v. *Sierra Summit, Inc.*, 490 U.S. 844 (1989).

45. *In re Jacoby-Bender, Inc.* (*City of New York* v. *Jacoby-Bender, Inc.*), 758 F.2d 840 (2d Cir. 1985).

46. *In re Jacoby-Bender, Inc.*, 40 B.R. 10 (Bankr. E.D.N.Y. 1984), *aff'd*, 758 F.2d 840 (2d Cir. 1985).

47. *See*, *e.g.*, *In re Jacoby-Bender*, 758 F.2d 840 (2d Cir. 1985); *In re Smoss Enterprises Corp.*, 54 B.R. 950 (E.D. N.Y. 1985); *In re Permar Provisions, Inc.*, 79 B.R. 530 (Bankr. E.D. N.Y. 1987).

48. Bankruptcy Code, § 1145(a).

49. Bankruptcy Code, § 1121(b). In addition, if the debtor files a plan within such time period, it is given an additional 60-day period during which to solicit acceptances of its plan. Bankruptcy Code, § 1121(c)(3).

50. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 233-34 ("[A] standard that led to too frequent appointment [of a trustee] would prevent debtors from seeking relief under the reorganization chapter and would leave the chapter largely unused except in extreme cases. One of the problems that the Bankruptcy Commission recognized . . . is that debtors too often wait too long to seek bankruptcy re-

lief. Too frequent appointment of a trustee would exacerbate that problem, to the detriment of both debtors and their creditors.")(footnotes omitted).

51. *See*, *e.g.*, Bankruptcy Code, § 1104(b) (providing that within 30 days after the bankruptcy court orders appointment of a trustee, the U.S. Trustee shall convene a meeting of creditors for the purpose of electing a trustee).

52. Bankruptcy Code, §§ 341, 1103(c); Bankruptcy Rule 2003.

53. Bankruptcy Code, § 363(b)(1).

54. *See*, *e.g.*, *In re Manville Forest Products Corp.*, 31 Bankr. 991, 995 (S.D. N.Y. 1983) (affirming bankruptcy court's order granting the debtor's fifth extension of its exclusive periods even though the debtor was solvent, faced no liability for asbestos claims and had operations which were separate from those of Manville and its other subsidiaries, the court held that "[t]he sheer mass, weight, volume and complication of the Manville filings undoubtedly justify a shakedown period.").

55. *See*, *e.g.*, *In re Public Service of New Hampshire*, 88 B.R. 521, 537 (Bankr. D.N.H. 1988).

56. Bankruptcy Code, § 1121(a).

57. Bankruptcy Code, § 1121(c).

58. 99 B.R. 177 (Bankr. D.N.H. 1989). *See also In re Ionosphere Clubs, Inc.*, Case Nos. 89 B 10448 and 10449 (Bankr. S.D. N.Y. 1989) (Eastern Airlines, Inc.) (court ordered appointment of examiner with expanded powers and engendered a quasi-official offering of the debtor's business to the world at large).

59. Bankruptcy Code, § 1129(b).

60. *Compare In re 203 N. Lasalle Partnership*, 126 F.3d 955 (7th Cir. 1997), *cert. granted*, 118 S. Ct 1674 (1998) (upholding confirmation of the debtor's new value plan); *Bonner Mall Partnership* v. *U.S. Bancorp Mortgage Co.,* 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681 (1994), *appeal dismissed as moot*, 512 U.S. 18 (1994)(same), with *Coltex Loop Cent. Three Partners, L.P.* v. *BT/SAP Pool C Assocs., L.P.*, No. 96-5140, 1998 U.S. App. LEXIS 2662 (2d Cir. Feb. 19, 1998), as corrected Mar. 3, 1998 (adopting a very limited interpretation of the corollary and holding that "if old equity's new interest under the plan results in any significant way from its old status, the plan may not be confirmed.") and *Travelers Insurance Co.* v. *Bryson Properties XVIII*, 961 F.2d 496 (4th Cir. 1992) (same).