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A Strategic Perspective on Bankruptcy

For the managers of a company with obligations to claimholders that exceed its ability to fulfill them, the choice between out-of-court reorganization and a court-supervised reorganization under Chapter 11 of the U.S. Bankruptcy Code involves complex economic, legal, and ethical considerations.

Over the five-year span that began in 2007, 619 public companies in the U.S. representing more than $2.0 trillion in combined assets entered Chapter 11 bankruptcy proceedings (see **Exhibit 1**).[1] While fifteen years earlier managers had reluctance to damage their reputations by taking a company into bankruptcy,[2] it is now a more frequent path for companies in financial distress. Nevertheless, reorganizing the obligations and operations of a distressed company remains a time-consuming, complex process with uncertain timelines, numerous hazards, and unknown outcomes.

The Challenges of Reorganizing under the Bankruptcy Code

The proximate cause of bankruptcy, and the most reliable warning flag to stakeholders, is a company's inability to pay debts because of a disruption in cash flow. This scenario is usually preceded by visible signals that may include changes in financing conditions or the competitive landscape, problems in product development processes, disruptions to sales and customer relationships, or a sudden flood of tort litigation.

Entry The decision of whether to file for relief with a bankruptcy court lies with management (i.e., "voluntary bankruptcy") or a company's creditors (i.e., "involuntary bankruptcy"). The Bankruptcy Code is federal law, and U.S. bankruptcy courts are specialized divisions of U.S. district courts. The primary way a creditor initiates an involuntary bankruptcy is after a company has failed to pay debts when they become due. Yet when courts seek to apply this standard, they do not use balance sheet or equity definitions of solvency; instead they consider the totality of the circumstances.[3] Involuntary bankruptcies are rare.

Companies can find that the threat of a voluntary bankruptcy filing—a "take-it-or-get-nothing" threat for suppliers, employees, or creditors—is an effective bargaining tool when negotiating with claimants. A large and specialized industry of legal and financial professionals can advise management on the advance negotiation of a reorganization plan. Such "pre-packaged" filings can reduce time under court supervision from twelve months to three.

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Procedure When reorganizing under court supervision, public companies are subject to the procedures established by the Bankruptcy Code. These procedures were designed to organize and encourage consensual bargaining among the several classes of claimants on the company's cash flows (see **Exhibit 2** for a process outline). In court, the company gains time in which to make decisions, take action, and propose a resolution. Debt service and legal proceedings are subject to an automatic 120-day stay, which may be extended. Tort litigation can be halted, consolidated, and moved from regular courts into bankruptcy courts, which some view as more sympathetic to management.[4]

If management elects to reorganize out of court, it enjoys more freedom of action because the operational calendar remains under management control. However, there is also less certainty with regard to the actions and priorities of creditors, employees, and shareowners. This uncertainty makes it difficult for management to establish a future date when the crisis will be resolved, and also increases uncertainty for claimholders and customers alike while increasing the likelihood of defection.

During a court-supervised restructuring, extraordinary demands are placed on management. Devoting the proper attention to continuing operations is a challenge even during out-of-court proceedings. Under court supervision, the automatic stay and the requirement to negotiate and approve a restructuring plan within a specified time period fix the calendar for management. Moreover, under court-supervised reorganization, disclosures and reorganization plans are public record. Potentially sensitive information may be exposed to competitors.

Cost Out-of-court restructuring is generally less expensive in terms of professional fees than in-court restructuring. While specialized consulting and advisory firms exist to advise distressed companies, management retains discretion over engaging outside services. During court-supervised proceedings, discretion is reduced, and fees in major public bankruptcies can run into tens of millions of dollars.

The costs of retaining professional advice and special cash compensation programs[a] for management during court-supervised restructuring may be offset by the potential financial benefits to the company of eliminating interest payments and halting debt and supplier payments. Operating costs during distress are increased as credit becomes scarcer and terms of payments are tightened up; suppliers frequently require cash payments for parts or inventory shipments during both in-court and out-of-court restructurings.

Coordinating claims A company that is deemed at risk of bankruptcy faces an acute challenge when coordinating several constituencies' claims on the company's assets without the supervision of the court. The challenge is increased when a company has multiple creditors because the company must reach consensus with its creditors, and the incentive for any single creditor to hold out is high.

In court, claims are subject to a strict precedence and resolution framework. The Bankruptcy Code defines the hierarchy of claims in court-supervised bankruptcy proceedings (see **Exhibit 3**). A majority of creditors and two-thirds of the value of claims in each class must approve a proposed reorganization. If a majority in a class cannot agree, the court can force claimants to accept a reorganization plan.

[a] Guaranteed cash compensation for key employees is often dramatically increased during court-supervised restructuring, since only contractual compensation is a priority claim (see **Exhibit 3**).

The court often requires a liquidation value to be submitted that reflects the current market value of the assets if they were sold. Book value is often discounted to reflect disposal of the assets in a short time frame, often at auction. When compared to the hierarchy of claims, each creditor class can evaluate their potential recovery under this alternative which can be used as a basis for negotiations.

While the intent of the code is to encourage consensual bargaining, the opportunity remains for bad-faith negotiation. Parties must weigh their strategic options as they decide whether to push for acceptance of a plan or hold out for more favorable treatment. "In a bankruptcy, the level of cooperation you get in negotiations is at the level of the least reasonable person involved," observes Jeff Werbalowsky, managing director of Houlinah, Lokey, Howard & Zukin.[5] Observers also cite a wide variance among the courts; some judges and courts are viewed as more sympathetic to management interests, while others are thought to favor creditors. Courts that favor management are more likely to grant extensions to the 120-day stay to allow management more time to craft a successful reorganization plan.

Market for corporate control All companies in distress encounter a volatile market for corporate control. The uncertainty of negotiating reorganization proposals is further complicated by the uncertainty of market movements in the ownership of various claims. While the stay under Chapter 11 halts payments and legal proceedings, the market for a company's debt and equity continues. This volatility is greater under court supervision, where the strategic value for so-called "vulture investors" of holding various quantities of a company's different obligations is subject to information asymmetries and coordination problems of their own. Not infrequently, claimholders acquire claims within other classes in order to gain influence in restructuring negotiations.

Continuing operations The survival of a distressed company depends on its ability to restore operating cash flows to a sustainable level. Under court supervision, companies commonly find easier access to credit because any new obligations are often given priority over all other debt obligations. This cash infusion can be vital to the company's ability to continue to operate its business.

Continuing operations under court supervision face unique challenges. First, management actions are subject to court scrutiny. Under Chapter 11, management may be permitted to retain control of the company under the theory that management knows more about the business and is therefore more likely to turn it around successfully. In the case of alleged fraud or management misconduct, however, the court will appoint a trustee to oversee operations. Yet even in cases without a trustee, management must seek court approval for any major decision, including the securing of new credit, employing professionals to work on the bankruptcy, and disposing of assets outside the normal course of business. While bankruptcy courts often will allow companies to reject executory contracts,[a] other obligations are hard to break. For example, management must persuade the court that there is no alternative plan under which the company could successfully emerge from bankruptcy before underfunded pension obligations can be transferred to the federal Pension Benefit Guarantee Corporation. Likewise, before rejecting a collective bargaining agreement, the debtor usually has to demonstrate to the court a good-faith effort to renegotiate the contract privately.[6]

Second, commitment of employees, partners, and customers suffers under court supervision. This has been observed in cases of companies that depend on highly skilled employees, strategic business

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[a] Executory contracts are characterized by an unfulfilled mutual obligation for future performance. Leases usually fall in this category because a landlord provides services as necessary over time and lessors pay over time. In the case of a business loan, on the other hand, the creditor has fulfilled its obligation at inception while the debtor fulfills its obligation over time.

partnerships, or long-term customer relationships. While it may be appealing to relinquish burdensome obligations and generate immediate cash savings, the effect of the consequent loss of goodwill should be carefully considered in light of the future value of the affected relationships. Transaction-based businesses—notably airlines and retail—have established histories of frequent recourse to court-supervised reorganizing, while relationship businesses—for example, financial services, business technology, and durable goods—are notably absent. Restructuring in this class may be more likely to be conducted out of court or through the sale of all or part of the business.

Social cost When management attempts to shed its obligations to improve a company's position, the burden of the foregone claim falls elsewhere. Investors, creditors, suppliers, employees, and retirees have varying abilities to absorb the costs of a failed claim; few stand any chance of being made whole under court-supervised bankruptcy. The various players have different avenues available to absorb their losses, but even government guarantee programs are at risk. Recourse to the federal Pension Benefit Guaranty Corporation for the spin-off of unfunded pension obligations has strained the resources of the tax-funded body and may increase political pressure to rewrite statutes.

The exercise of the most drastic restructuring tools has consequences for firms and for the social compact on which the conduct of business rests. Firms and institutions alike face the long-term loss of goodwill with the public and regulators. This arises in part because of the frequency with which court-supervised restructurings have been perceived as tactics used to circumvent obligations to customers (e.g., product liability), employees (e.g., contracts, pensions, health care) and the public (e.g., environmental cleanups). While the stigma of a court-supervised restructuring may be less severe today among executives and boards of directors, the stain persists among other stakeholders in a firm.

Two Different Paths

While in-court and out-of-court reorganizations face the same sources of uncertainty, the differences in their treatment yield sharply contrasting paths and outcomes:

- In out-of-court restructurings, and under volatility caused by investors' uncertainty, the challenge of coordinating creditors is far higher than under court supervision. However, the goodwill of customers and employees is less threatened, the company controls its calendar, critical company information, and management attention, and the company has the potential to restore value for the holders of its equity.

- In court-supervised restructurings, on the other hand, the company gains the ability to selectively extract assets in a 363 sale, unilaterally alter leases and employee contracts and suspend payments to creditors. However, the ultimate outcome is highly unpredictable and may negatively impact the company's competitive position due to the vagaries of the particular court, the maneuvers of vulture investors, the mandatory disclosures of further financial and operating information, and the loss of goodwill from customers, employees, and the public.

Exhibit 1 Largest Public Bankruptcies by Revenues (before 2012)

Company	Bankruptcy Filing Date	Last FY Revenues ($ millions)
General Motors Corporation	06/01/2009	$148,979
Enron Corp.	12/02/2001	100,789
Chrysler LLC	04/30/2009	66,225
Lehman Brothers Holdings Inc.	09/15/2008	59,003
Kmart Corporation	01/22/2002	37,028
WorldCom, Inc.	07/21/2002	35,179
Texaco, Inc.	04/12/1987	32,591
Yukos Oil Company	12/14/2004	28,867
Delphi Corporation	10/08/2005	28,622
Lyondell Chemical Company	01/06/2009	28,603
AMR Corporation(American Airlines)	11/29/2011	22,170
Pacific Gas and Electric Co.	04/06/2001	20,820
Washington Mutual, Inc.	09/26/2008	19,489
UAL Corporation(United Airlines)	12/09/2002	16,138
Fleming Companies, Inc.	04/01/2003	15,628
Delta Air Lines, Inc.	09/14/2005	15,002
Lear Corporation	07/07/2009	13,571
SemGroup, L.P.	07/22/2008	13,200
Circuit City Stores, Inc.	11/10/2008	11,744
Northwest Airlines Corporation	09/14/2005	11,279
Nortel Networks, Inc.	10/01/2001	10,948
Winn-Dixie Stores, Inc.	03/04/1996	10,633
Visteon Corporation	08/27/1996	9,544
Calpine Corporation	10/05/2000	9,230
Dana Corporation	01/15/1990	9,056
Great Atlantic & Pacific Tea Co.	03/09/1989	8,814
EOTT Energy Partners	06/16/2000	8,609
CHS Electronics, Inc.	12/29/2000	8,546
Southland Corp., The	08/20/2001	8,352
US Airways Group, Inc.	01/08/1991	8,253
Conseco, Inc.	12/18/2002	8,108
Pilgrim’s Pride Corporation	12/01/2008	7,599
LTV Corporation, The	07/17/1986	7,582
AmeriServe Food Distribution	01/31/2000	7,421
Smurfit-Stone Container Corp.	01/26/2009	7,420

Source: New Generation Research, *The 2012 Bankruptcy Yearbook & Almanac,* 22nd ed. (Quincy: 2012), p. 56.

Exhibit 2 Outline of Events in a Business Bankruptcy

- A company comes into a situation of present or perceived future financial distress. Usually, the company incurs excessive losses, or expects future losses, from causes including poor sales, mismanagement, excessive debt, lawsuits and product liability, fraud, labor costs and labor disturbances, etc.
- The company defaults on its debt or otherwise appears to be incapable of continuing to meet its obligations.
- Restructuring negotiations are held with creditors and other interested parties (e.g., employees, stockholders, etc.).
- When it is determined that bankruptcy is unavoidable, the company files a bankruptcy petition under Chapter 11 (bankruptcy with intent to reorganize and continue operation). Creditors may file an involuntary petition to force the company into Chapter 11. Alternatively, if there is no hope for reorganization, the company, or its creditors, files a petition for Chapter 7 (bankruptcy with intent to liquidate the company). In either case, an automatic stay takes effect to prevent creditors from seizing property or prosecuting actions against the company.
- The business continues to operate under the control of the existing company management (the company is called debtor-in-possession). However, the bankruptcy court may appoint a trustee to run the company if conditions warrant. A trustee is usually appointed in Chapter 7, and usually not in Chapter 11.
- Interested parties, including creditors, stockholders, employees, retires, etc., form committees to negotiate their claims against the company.
- A plan (or plans) of reorganization is submitted by the company or other interested parties (e.g., creditor's committees). For the first 120 days of the Chapter 11 bankruptcy, the company has the exclusive right to submit a plan of reorganization. Thereafter, any interested party may submit a plan, unless the bankruptcy court grants an extension of the exclusivity period.
- A disclosure statement is produced that contains information on the company and its plan of reorganization. The disclosure statement must be approved by the court.
- After the disclosure statement is approved by the court, the disclosure statement and associated plan of reorganization are submitted to a vote by all impaired creditors and stockholders. (If the plan is rejected, new plans are submitted or the bankruptcy is converted from Chapter 11 to Chapter 7.) Generally, each class of creditor must approve the plan by a majority in number and two-thirds in value of that class. If a plan is not accepted by all parties, the sponsor of that plan can request that the bankruptcy court issue a cram-down. In a cram-down, the court confirms the plan or reorganization over the objections of one or more classes.
- The plan of reorganization is confirmed by the bankruptcy court.
- The company emerges from Chapter 11 when the conditions of the plan of reorganization have been satisfied. Alternatively, if no plan or reorganization can be agreed upon, the bankruptcy can be converted from Chapter 11 to Chapter 7. In Chapter 7, a trustee is appointed and the company assets are sold, usually by auction. Proceeds from the sale compensate the parties involved and the company ceases to exist.

Source: Compiled by casewriter from New Generation Research, "Outline of Events in a Business Bankruptcy," pp. 501-502, in *The 2012 Bankruptcy Yearbook & Almanac,* 22nd ed. (Quincy: 2012).

Exhibit 3 Hierarchy of Claims in Chapter 11

1. Secured claims
2. Superpriority claims (e.g., debtor-in-possession financing)
3. Priority claims
   a. Administrative expenses (including legal and professional fees incurred in the case)
   b. Wages, salaries and commissions
   c. Employee benefit claims
   d. Claims against facilities that store grain or fish produce
   e. Consumer deposits
   f. Alimony and child support
   g. Tax claims
   h. Unsecured claims based on commitments to a federal depository institutions regulatory agency
4. General unsecured claims
5. Preferred stock
6. Common stock

Source: Stuart C. Gilson, 2009, *Creating Value through Corporate Restructuring*, p. 63, Wiley, 2010.

Endnotes

[1] New Generation Research, *The 2012 Bankruptcy Yearbook & Almanac*, 22nd ed. (Quincy: 2012), p. 32. This note considers only filings under Chapter 11 of the Code—i.e., filings with the intent to reorganize a business. Filings under Chapter 7 of the Code (filings with intent to liquidate) and substantially similar filings do not pose the same operating questions for management. (See **Exhibit 2**.)

[2] Robert I. Sutton and Anita L. Callahan, "The Stigma of Bankruptcy: Spoiled Organizational Image and Its Management," *Academy of Management Journal*, Vol. 30, No. 3 (September 1987): 405-436; Gregg Wirth, "Dancing with the Devil: Bankruptcy Pays Off," *Journal of Business Strategy* (November/December 1995), p. 54.

[3] *Collier On Bankruptcy* (Lawrence P. King, editor.-in-chief, 15 ed. rev.), pp. 303–22; Timothy A. Luehrman and William A. Teichner, "Note on Bankruptcy in the United States," HBS No. 292-062 (Boston: Harvard Business School Press, 1991).

[4] For more on the ways that bankruptcy courts are viewed to act in management or creditors' favor, see Stuart C. Gilson, "Investing in Distressed Situations: A Market Survey," *Financial Analysts Journal* (November–December 1995), p. 10.

[5] Quoted in Wirth, op. cit.

[6] Luehrman and Teichner, op. cit.