

Bankruptcy Client Alert

STEVENS & LEE
Understanding Your Business Is Our Business

September 1, 2010



Friendly Foreclosure Sales and Other Alternatives to Traditional Chapter 11 Restructurings

Nicholas F. Kajon
nfk@stevenslee.com
212-537-0403

In a traditional chapter 11 case, a company in financial distress utilizes the tools provided by the Bankruptcy Code to restructure both its business and its balance sheet, and it emerges under a chapter 11 plan as a going concern. Sophisticated players, however, have become concerned that the uncertainties, costs and delays inherent in chapter 11 (especially in light of additional burdens imposed by the 2005 amendments to the Bankruptcy Code), undermine reorganization prospects and erode recoveries. Thus, parties have been exploring alternative methods to sell or restructure viable businesses in an attempt to avoid the vagaries of the chapter 11 plan confirmation process. Because chapter 11 provides procedural safeguards for all constituencies, parties seeking to wipe out junior classes of secured lenders who appear to be out of the money may prefer an alternative mechanism such as a foreclosure sale, rather than a risky and expensive cramdown battle. The uncertainty, delays and expense of chapter 11 may also have adverse consequences for the viability of the business, as suppliers, customers, employees and other important constituencies lose faith in the company's ability to survive. Alternative mechanisms may achieve the desired result quicker, with more certainty and with less expense.

Historically, the most popular alternatives to a traditional chapter 11 have been out-of-court restructurings, distressed debt exchanges, prepackaged bankruptcy filings (referred to as "prepacks"), pre-arranged or pre-negotiated bankruptcy filings and section 363 sales. A sixth method that has been under-utilized but may be worth consideration is the "friendly" foreclosure sale. A friendly foreclosure sale entails an agreement among the borrower, senior lender and a buyer pursuant to which the lender will foreclose its liens and transfer its collateral – the assets comprising the business – to the buyer with the cooperation of management. This works so long as the collateral consists entirely of personal property (*i.e.*, everything other than real estate owned by the borrower), so that the lender can utilize the streamlined foreclosure procedures under Article 9 of the Uniform Commercial Code.¹ The optimum situation for use of a friendly foreclosure sale is where there is a significant amount of junior lien debt that appears to be out of the money, which can be wiped out with minimal risk of litigation claims alleging commercial unreasonableness, fraudulent transfer, successor liability, breach of fiduciary duty, etc.

This article will compare a friendly foreclosure sale to its closest relative – the section 363 sale – as well as four other alternative methods for restructuring a business in financial distress. Broadly speaking, any of the three alternatives that do not involve a bankruptcy filing entail forsaking the benefits of bankruptcy in exchange for avoiding the burdens associated with a bankruptcy. These bankruptcy benefits include the automatic stay, the ability to bind dissenting classes of debt and equity, insulation of any buyer or funder from attacks by creditors, insulation of management and the board from breach of fiduciary duty claims, and other bankruptcy powers and rights. The disadvantages of bankruptcy include the necessity for court approval, uncertainty, public disclosure, delay, valuation fights, the possibility of being held up by constituencies who are out of the money, and extra expense. Bankruptcy also increases the odds that insiders will be investigated and possibly sued. Each of the alternatives to a traditional chapter 11 restructuring presents its own set of advantages and disadvantages for the various constituencies,² which can be summarized as follows:

Type	How it works	Advantages	Disadvantages
Foreclosure Sales	Under Article 9 of the UCC, after default, a secured party may sell, lease, license or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing, provided every aspect of the transaction is commercially reasonable	Faster and less expensive than a 363 sale, so leaves more value for an undersecured lender Wipes out all junior liens and borrower's right of redemption Lender can credit bid its debt to preserve its position Avoids stigma of bankruptcy	Difficult to do without management's cooperation No "free and clear" order, so lender exposed to risk of challenges to commercial reasonableness, and buyer exposed to risk of fraudulent transfer and successor liability claims

Type	How it works	Advantages	Disadvantages
Foreclosure Sales (cont.)	The disposition can be by public or private sale; the lender and borrower can agree to enter into an asset purchase agreement to sell the business assets to a third party or to the lender in a private sale; works well where going concern value exceeds the value of the assets but is still less than the amount of secured debt	<p>No need to provide notice to customers, suppliers and other business partners</p> <p>Avoids public disclosure of financial condition and deal terms</p> <p>While individual creditors may bring challenges, borrower and lender won't have to deal with a creditors' committee or trustee</p>	<p>Management and board not insulated from breach of duty claims</p> <p>Article 9 of the UCC doesn't apply to sales of real property, which are usually subject to far more cumbersome proceedings</p>
Section 363 Sales	Use chapter 11 to sell business as a going concern, rather than restructuring under chapter 11; debtor also usually assumes and assigns beneficial executory contracts and leases to buyer	<p>Gets the business into the hands of a stronger owner sooner, thereby avoiding risk and sparing expense</p> <p>Encourages competing bids to maximize value</p> <p>Allows assets to be sold free and clear of claims and liens, and insulates buyer from successor liability and fraudulent transfer exposure</p> <p>Executory contracts and leases can be assigned to the buyer notwithstanding third party consent provisions</p> <p>Can be consummated within a few weeks of a bankruptcy filing</p> <p>Business doesn't suffer while creditors are squabbling over allocation of value under a plan</p> <p>Preserves right of secured lenders to credit bid, whereas this right has been subjected to some limitations in the chapter 11 plan context</p> <p>If liens exceed the value of the collateral, secured lenders do better under a 363 sale because administrative expenses must be cashed out on confirmation of a plan</p> <p>More certainty for buyer, employees, suppliers, customers</p> <p>Management and board insulated from breach of duty claims</p>	<p>Fewer procedural safeguards for creditors than chapter 11, so value may not be maximized for all classes</p> <p>Less time for junior classes to find a better transaction</p> <p>Buyer may balk at having to submit the deal to competing bids</p> <p>Can't use the exemption in section 1146(a) to save the cost of transfer taxes because it is limited to sales under a plan</p> <p>Can't assume and assign licenses of intellectual property without licensees' consent; in contrast, under a plan the debtor could retain the license and the buyer could be issued stock in the reorganized debtor</p> <p>If assets are sold for less than the amount of secured debt, then there may not be anything left for junior classes other than litigation claims</p> <p>The risk of a transaction at the bottom of the market is exacerbated under a 363 sale because the sale consideration is likely to be cash and/or senior debt bid in at auction; in contrast, a plan is more likely to provide creditors with securities in the reorganized business, thereby enabling creditors to share in the upside</p>
Out-of-Court Restructurings	Negotiate restructuring with creditors without resorting to a bankruptcy filing	<p>Eliminates uncertainty, burden and expense of chapter 11</p> <p>Reduces debt to "right size" the balance sheet</p> <p>Reduces interest expense</p>	<p>Discount will not be binding on those who did not vote in favor, so creditors who hold out will have to be paid at par</p> <p>Likely to be dilutive to equity</p> <p>Inability to wipe out classes who are out of the money</p>
Distressed Debt Exchange	A type of out-of-court restructuring in which an issuer, whose outstanding debt is trading at a substantial discount, offers new debt instruments at more than market price but less than par in exchange for its outstanding debt	<p>Allows issuer to reduce the amount of debt on its balance sheet</p> <p>Reduces interest expense</p> <p>Provides holders of distressed securities with a premium over market prices</p> <p>Incentive for holders to accept to avoid being left with lower priority debt</p>	<p>New debt instruments are usually secured and are exchanged for bonds without collateral or with lower priority liens to entice creditors to make the exchange</p> <p>The enhanced collateral position of the new debt may hinder the issuer down the road if further restructuring is required</p>

Type	How it works	Advantages	Disadvantages
Prepacks	Negotiate the plan and solicit acceptances pre-petition; then file chapter 11 and schedule prompt confirmation hearing, at which plan proponent will have to demonstrate that pre-petition solicitation of acceptances was in compliance with applicable non-bankruptcy law or that the pre-petition disclosure statement contained adequate information	Only 2/3 in dollar amount and half in number needed to bind a class of claims Eliminates holdout problem Short stay in chapter 11 Greater certainty Less expense	Quick ride through chapter 11 makes it more difficult to address operational issues If unforeseen problems occur, the plan may need to be modified and acceptances may have to be re-solicited post-petition Junior classes who are out of the money or who are unsatisfied with their recoveries will have far less time to effect a more favorable outcome
Pre-Arranged Bankruptcy Filing	Similar to a prepack, but acceptances are solicited post-petition; the essential terms of the deal have been agreed by major constituencies, who also usually execute a plan support agreement	Less certainty than a prepack, but far more certainty than filing chapter 11 without the support of major constituencies	Longer stay in chapter 11 than a prepack, so more expense and more opportunities for something to go wrong

Conclusion

As adverse economic conditions continue to take their toll on corporate America, companies will continue to encounter financial distress and need to restructure. In connection with plan confirmation, senior creditors may have to provide some recovery to constituencies who are out of the money to avoid a costly valuation fight. Therefore, troubled companies and lenders concerned with the uncertainties, costs and delays inherent in chapter 11 may wish to consider the six alternatives to a traditional restructuring discussed above, including the under-utilized friendly foreclosure sale. Obviously, which of these alternatives works best will depend on the particular situation, the value and nature of the borrower's assets, the borrower's capital structure, business prospects, industry, whether creditors will cooperate or hold out, whether the borrower merely needs to fix its balance sheet or also needs to address operational issues, economic conditions, the state of the capital markets, tax and securities law considerations, and many other factors. Nevertheless, there will be times when one of these alternatives may be superior to a traditional restructuring under chapter 11.

For more information on how these issues may affect your rights, contact Nicholas F. Kajon at nfk@stevenslee.com or 212-537-0403. Mr. Kajon is a Shareholder of Stevens & Lee, P.C., and a member of the Bankruptcy and Financial Restructuring Group practicing in the New York office.

¹ UCC § 9-610.

² The columns headed "Advantages" and "Disadvantages" are to some extent arbitrary because an advantage for one or more constituencies may be a disadvantage for other constituencies. For example, the requirement of competitive bidding in connection with a 363 sale is beneficial to junior classes, but will not be popular with the buyer, who might prefer a private sale under Article 9 all other things being equal.

© 2010 Stevens & Lee, a Pennsylvania Professional Corporation

Richard J. Pinto and Harry A. Horwitz, shareholders responsible for the Princeton and Cherry Hill, New Jersey offices, respectively.

This material is provided as a general informational service to clients and friends of Stevens & Lee. It should not be construed as, and does not constitute, legal advice on any specific matter. The delivery of this material does not create an attorney-client relationship. This material may be considered ATTORNEY ADVERTISING in some states. Please note that prior results discussed in this material do not guarantee similar outcomes. Readers must not rely on this general information in making decisions about such things as structuring transactions or arbitrating, settling or resolving any dispute, contested or uncontested; professional advice should be sought as to any such specific situation.