UP/CLOSE

Business Finance & Restructuring Q&A Series

Scott L. Baena

Partner, Business Finance & Restructuring Chair

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"I've long said that capitalism without bankruptcy is like Christianity without hell. But it's hard to see any good news in this."

Former Eastern Airlines Chairman Frank Borman on the high failure rate of U.S. companies in 1982.

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For 40 years, Scott L. Baena, a senior partner of Bilzin Sumberg and chair of the firm's Restructuring and Bankruptcy Group, has witnessed drastic changes in the practice of bankruptcy law. It has emerged, he recently told a group students, from a "small arcane undesirable practice" to a sophisticated subset of the legal profession where specialists navigate a matrix of rules designed to give debtors and creditors a level playing field to resolve their financial disputes.

Over time, Baena and the firm successfully counseled clients in such high-profile cases as Fontainebleau Las Vegas, Tousa, Cenvill Development and U.S. Gypsum. He also saw involvement in airline cases involving carriers including Air Florida, Atlas Air, Braniff, Eastern and Pan Am.

Since the 1980s, Baena recalled, the bankruptcy process evolved into a system where the interests of economic stakeholders have been balanced "in the interests of rehabilitation and reorganization of a distressed business."

Yet, since the recession of 2008, Baena now argues, bankruptcy has become a very unpredictable play for real estate developers who failed to complete projects before the crash, for companies that failed to achieve new financings and for retailers who saw a significant erosion of their customer base. As debtors in these and other categories have sought bankruptcy court protection, successful trips to reorganization have become less certain. In short, Baena notes, there is no longer a "Playbook" to successfully navigate the process.

The following discussion examines a number of factors that have complicated the bankruptcy process. It also offers a look at how out-of-court restructurings might be a more viable course for distressed business owners to take.

Unpredictability in bankruptcy: what are the causes?

1 Absent consent where payment in full is made for all creditors, equity can't retain their interests unless they provide new value and that value is market tested. It's not so clear who walks away with the reorganized debtor if there will be one, and it has made bankruptcy a very unfavorable argument for equity.

2 363 sales are no longer the quick and process that they formerly were. Bankruptcy courts now feel constrained to make the process transparent and to encourage a robust process. And the consequences of that is they take longer, more people can show up and it's unpredictable what the outcome is going to be.

3 363 process has recently been undermined once more in terms of efficiency by a couple of decisions which suggest that credit bidding can be limited … so now, even secured creditors don't know what the outcome is going to be. Their right to a credit bid might be limited by the bankruptcy court.

4 The revisions that occurred in the last five or six years to the Bankruptcy Code with respect to single asset real estate cases, which essentially say to the debtor, 'fish or cut bait. You've got 90 days to put forth a plan of reorganization which has a reasonable prospect of confirmation or you start paying your secured debt. Otherwise your case gets dismissed or converted.'

5 The dynamics of most bankruptcy cases today, in particular the sociology of those cases because there are more players in the mix: first lien lenders, second lien lenders, mezzanine lenders … we've got general unsecured creditors, we've got retirees and current employees. All of them have different agendas because their rights are different. How those agendas get exercised and resolved creates an exceedingly complicated and unpredictable puzzle.

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Why are the costs increasing to file for bankruptcy?

Question: At a distressed investing conference in Las Vegas, Nevada earlier this year, several practitioners voiced concern that the increased cost of filing for bankruptcy has risen to the point where the process is no longer an effective tool for ailing companies to use. Do you agree and where do these increased costs lie? Are rising professional fees and protracted creditor-debtor combat contributing to the increased costs?

Scott L. Baena: There is no question that the transactional cost of bankruptcy has increased. In bankruptcy the debtor is nonetheless expected to pay for the costs and when it can't, it will frequently look to its lenders to provide the grist for that mill. The proliferation of the costs is very easy to trace – first is the advent of more players in the process. We now have CROs and financial advisors and accountants, lawyers. The bankruptcy code contemplates the establishment of official committees which are also entitled to have financial advisors, investment bankers, accountants and lawyers. All of this is paid for by the estate. The other dynamic that impacts cost is duration of the case. In the salad days, if you will, immediately after the recession, cases were getting filed and concluded pretty quickly. Now they're dragging again and obviously there is a linear relationship between the duration of the case and the cost of the case since most of these fees are incurred on an hourly basis.

The other element is that more frequently than in the past, some bankruptcies have been litigations in drag – just a place to have a quick fight for some strategic purpose, but those quick fights turn out to be long battles with an extra layer of appellate review … all of which serves to extend the duration of that litigation.

Not only does bankruptcy litigation engender one more appeal, but there's also this ever constant controversy today about the jurisdiction of the bankruptcy court to hear things in the first instance, and whether it has constitutional authority to determine certain actions which are related to the bankruptcy but not be regarded as being within its constitutional authority. And the consequence of that is some matters related to the bankruptcy must be resolved elsewhere – principally the district court or state court and the duration of the litigation is far longer than if that litigation can be addressed by the bankruptcy court. From the debtor's perspective, therefore, the rude awakening is every 120 days they get bills from professionals that have to be paid or those folks won't serve anymore. It isn't exactly relationship building and can interfere with the process of reorganization.

What kinds of companies benefit most from out of court restructuring?

Question: What industries are more likely to benefit from out-of-court restructurings? Are there some classes of businesses that are more likely to succeed without court assistance than others?

Scott L. Baena: When you're dealing with bankruptcy or restructurings out of court, there are few 'one-size-fits-all' solutions or game plans. The fit depends on circumstance, not on industry or business. By way of example, it doesn't matter whether you're making widgets or selling real estate, if judgments are being entered against the debtor and none of the judgment creditors has any interest in forbearing from exercising their rights to execute, bankruptcy may be the only viable way of imposing a stay to sort things out.

Having said that such a debtor may have profited by recognizing and dealing with causes for its extremis before it becomes the subject of prolific litigation claims by engaging creditors and stakeholders in restructuring negotiations and discussions outside of bankruptcy.

How late is too late to restructure a company's debt?

Question: Is there a point of no return for a management to complete a restructuring? If the team is unable to do a deal with leading creditors, what does it do next? In many instances, creditors may seek to attach assets in state or federal court and force a Chapter 11 petition. What can a debtor do to avoid being forced into such a position?

Scott L. Baena: At the risk of oversimplification, the prospects for a successful restructuring are marginalized, I think, when creditors obtain and exercise rights against the borrower and they're unwilling to forebear even to see if there is a nonjudicial solution that is viable.

Many times the sense of urgency and unwillingness of creditors to abate is a systemic problem. Not everybody is willing to sit down. It's the so-called race to the court house. That phenomenon disables a meaningful dialogue. Clearly, it's best to anticipate the advent of litigation and try to avert or at least delay than it is to try to respond to litigation that's occurred in which the debtor has been unsuccessful.

> *"At the risk of oversimplification, the prospects for a successful restructuring are marginalized, I think, when creditors obtain and exercise rights against the borrower and they're unwilling to forebear even to see if there is a nonjudicial solution that is viable."*

The quintessential creditor that deems itself empowered is the one with a judgment and a clear path to enforcing, that's the most difficult person at the table.

The word to the wise is that you create that environment as a borrower. It's up to you to create the environment in which you resolve your distress. It is strategic and it is tactical. It all is related. Your recalcitrance is related to outcome. Your willingness is related to outcome. Failure to do anything is related to outcome. Even a cooperative creditor can become wholly uncooperative if you mistreat them.

How effective are pay cuts or layoffs? Are they necessary?

Question: One key consideration for managements to undertake is a top-to-bottom inward look at labor force expenses and output. Should this step occur early in the process? Do lenders consider measures such as pay cuts, layoffs, job eliminations and consolidations as prerequisites to refinancing?

Scott L. Baena: My thematic answer to each of these questions is "no playbook." Particularly for lenders in this regard. If an oversized, over compensated and unproductive workforce is the root issue … lenders will obviously expect that to be addressed as part of any meaningful restructuring or workout. Otherwise, labor costs are just another element of expense that deserves everyone's attention, but not the driving force in most restructurings. It's excessiveness that makes it a driving force. Management expense is almost always undertaken particularly in smaller, more closely held companies or in middle market companies like we have down here, where insiders may be quick to seek debt service adjustments but are unwilling to right size comp and perks paid to insiders. Sharing of the pain is order of the day. Tactically the issue may arise differently in each restructuring.

It might be good for the debtor to put its best foot forward before any recriminations are served upon it, or in some instances, to keep that close to the chest recognizing that it is something they are going to have to do something about, but rather than bidding against oneself let that become part of the discussion. My experience is that you can't be past due and thin-skinned. A borrower -- a debtor -- needs to be willing to have that discussion in a constructive and open dialogue. Often times we'll look to third party sources to assist us in providing a framework for whether or not compensation in a company is consistent with norms.

> *"In some instances, the reduction in force or the reduction in benefits that may lead to the flight of human capital may be adverse to the interests of creditors because you will not be able to meet your business plan."*

A reduction in force or a reduction in benefits to an existing any work force have to be put through a filter. This is looking at it from the perspective of the debtor or the lender. That filter is, just what is required to meet a going-forward business plan? In some instances, the reduction in force or the reduction in benefits that may lead to the flight of human capital may be adverse to the interests of creditors because you will not be able to meet your business plan. Other than in instances of clear excessive compensation structures and undue duplication of workforce, the principal driving force is what does your business plan require?

What about pensions? How can companies alleviate the financial pressure?

Question: In both the public and private sectors, employers face substantial short- and long-term pension obligations for past and present employees.
--In the municipal venue, the typical path for modifying or eliminating these obligations has been through a Chapter 9 bankruptcy filing. What are the probabilities for accomplishing this outside court, and what are the steps to be taken?
--On the private sector side, what avenues are available for corporations to alleviate the financial pressures from burdensome pension costs?

Scott L. Baena: GM had 500,000 U.S. retirees and 150,000 family members. The prospects of getting to 'yes' in the restructuring of those obligations alone with a sufficient critical mass outside of bankruptcy were slim to none. Outside of bankruptcy you're talking about virtual unanimity. Awfully hard to get in a circumstance like that. Even in smaller settings, the restructuring of pension liabilities is a daunting task outside of bankruptcy because of the federal regulatory landscape that essentially limits your ability to adjust your workforce and their benefits unilaterally, absent consent. So if the restructuring objective is to shed or vastly reshape pension liabilities in the public or the private sector, bankruptcy may be the only game in town.

In bankruptcy, the process of rejecting collective bargaining agreements or modifying employee benefits … comes down to either demonstrating the modifications are fair and equitable and necessary to permit reorganization or, secondly, consent. It always entails what the Bankruptcy Code refers to as the balancing of the equities – a wholly nebulous concept that gives both side plenty of room to argue.

Ultimately it is a new collective bargaining initiative that engenders the solution. You've got to always remember that retiree benefit issues could become a zero sum game for the retiree, eliminating any incentive to consent. These are people who have nowhere else to go to fill the void created by the modification in their benefits. Nowhere else to go. We've seen in those circumstances this turn into a game of chicken where everyone dies.

The classic example is from right here -- Eastern Airlines – where the unions said 'no' right through the last day of the sale of the last asset of Eastern Airlines. They never got to 'yes.'

It's a highly charged and emotional experience in large part, as well as an economic one … largely because you're taking something from people that they can't get back. Their horizon never changes. This remains the other side of the deal. Oddly enough the only pension liability nobody has to worry about is the pension provided by the United States Government. Everything else is up for play.

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Can you reject a lease without going into bankruptcy?

Question: While the Bankruptcy Code provides avenues for rejecting leases in court, the process appears to be more challenging outside court. What are the probabilities that managements can successfully reduce the burden of unwanted leases without the benefit of bankruptcy court assistance?

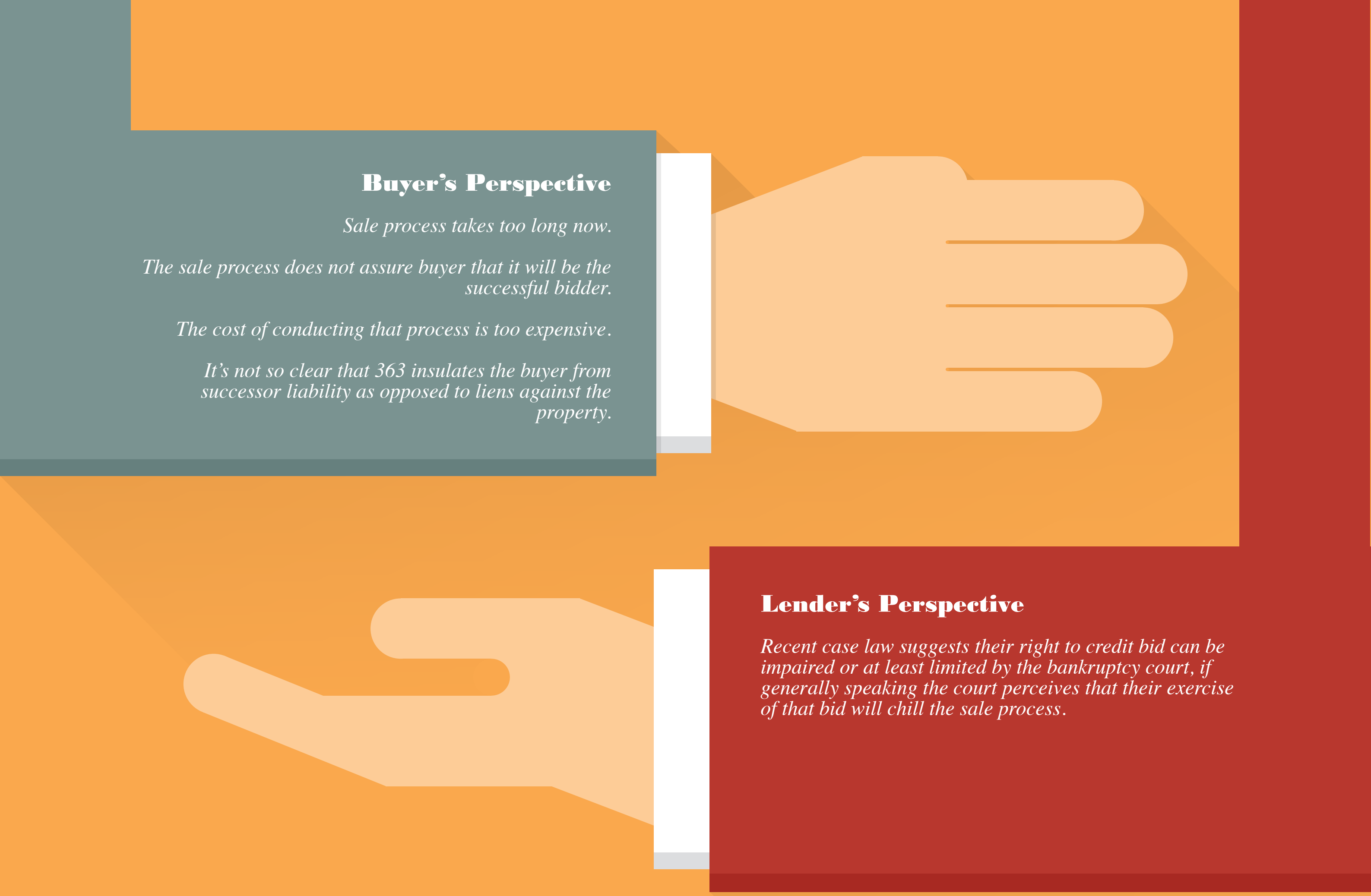
Scott L. Baena: There are instances where the keystone of the subject restructuring is downsizing physical space. That's most often the case in retail restructurings: Circuit City, Linens & Things, Borders. Those cases were all about downsizing the physical space and therefore leaseholds that debtors occupied. Bankruptcy clearly serves a useful purpose in those kinds of cases because it does permit tenants as well as landlords the opportunity to shed unfavorable leases. But the right to do so in bankruptcy comes at a price. In the case of a lessee's rejection of a lease for a property it's occupying, the landlord is entitled to the greater of one year of rent or 15 percent due under the remaining term of the lease. That limitation on the landlord's damages does provide the salutary effect of providing a framework for out of court restructurings because they know what their upside is. And hearkening back to the discussion about transactional costs of bankruptcy, they also have a sense of what it costs to get there.

> *“From my viewpoint, there isn't a landlord who doesn't get this and there isn't a landlord that should resist having that discussion in negotiation outside of bankruptcy, because they can do better. The fact you're not incurring transactional costs on both sides of the table creates currency in that negotiation.”*

In bankruptcy non-residential leases you have until confirmation to reject them. So the landlord can be sitting there in this unpredictable situation for a long time not knowing whether or not that space is going to be occupied at the end of the day and being told, ‘eh, well, here's a year's worth of rent which I'm going to pay you as a general unsecured claim at 15 cents on the dollar.'”

The only time a landlord has an advantage in bankruptcy is when you want to keep the lease. Because in that instance you've got to cure all of your arrearages and so they get paid in full. That's the big advantage to them. But when they want to get rid of a lease, we're just talking about liquidating the amount of their damages – the code does that -- and you then suffer the bankruptcy discount just like every other unsecured creditor that gets pennies on the dollar in many cases.

From my viewpoint, there isn't a landlord who doesn't get this and there isn't a landlord that should resist having that discussion in negotiation outside of bankruptcy because they can do better. The fact you're not incurring transactional costs on both sides of the table creates currency in that negotiation.



Hard asset sales and the increasingly problematic 363 sale.

Question: The sale of company headquarters and other real estate, as well as inventories and equipment seem to have become key elements in raising cash and reducing expenses. What should be the timing of these types of asset disposals?

Scott L. Baena: First, in the prototypical case, those assets are likely the subject of liens and claims and thus the liquidation of those assets has to be part of the larger discussion with the creditors that hold those liens and claims about restructuring their claims against you generally. And so the disposition in the out-of-court restructuring is necessarily tied to the overall restructuring process.

Buyers of those assets – particularly real estate assets – from distressed entities require some form of assurances that can only be provided by a bankruptcy court under Section 363 of the Bankruptcy Code. They get the benefit of a court order cutting off any claims or liens in the property they are acquiring, and essentially they get clean title.

Having said that, as I suggested earlier 363 sales have become problematic. Oddly enough the principal complaint about 363 sales comes from buyers themselves. While they were anxious to get those cleansing orders, they now complain that the bankruptcy courts are so focused on transparency and eliminating any perceived barriers to entry into the sale process, that the sale process takes too long now, the sale process does not assure that buyer that it will be the successful bidder and the cost of conducting that process is too expensive.

Add to that, now it's not so clear that 363 insulates the buyer from successor liability as opposed to liens against the property, there's some amelioration of the sense of urgency about getting a 363 sale behind you from the buyers' perspective.

From the lenders' perspective, they're getting skittish, too, about 363 sales because of recent case law suggesting their right to credit bid can be impaired or at least limited by the bankruptcy court, if generally speaking the court perceives that their exercise of that bid will chill the sale process. So while it's impossible to really measure, it seems that filing bankruptcy just for the sake of conducting a 363 sale process may be diminishing. It may not be the same exciting prospect it formerly was.

Can illiquid assets, like limited partnership interests, be used as bargaining chips?

Question: If push comes to shove, can illiquid assets become chips in the bargaining process with lenders? These assets might include limited partnership interests, drug royalties, future licensing revenues, legal claims or minority equity positions. What are the probabilities that creditors might accept these?

Scott L. Baena: When one is in the zone of insolvency, everything is on the table. Let's not forget, the goals of most restructurings precipitated by monetary defaults in obligations to creditors are extend or modify payment terms, forebear or forgive. That's it. That's the whole repertoire. Those objectives usually require the borrower to give something up because of the consideration it's seeking to extract. What it gives up could be money or other property.

Of property, everything is in play. In the final analysis, value is the driver. The benefits obtained by the borrower are really the coefficient of the value it's giving up, as well as the prospects for its success. Illiquid assets are currency in the event you have nothing else to give in exchange for a concession, when the creditors perceive it possible that you can execute on your plan.

Note exchanges when severely distressed.

Question: Many companies, particularly utilities, have sought to secure relief from high interest rates and narrowed maturities by soliciting note-holders to exchange old notes for new ones. What is the likelihood this route would be accepted when it is obvious that the company is under severe distress?

Scott L. Baena: Theoretically, and as a matter of good common sense, no one should continue to endure high rate obligations in a period when there is abundant low-cost funds. You don't have to be an MBA to figure that out. That's not to say there is stupid money out there these days that anyone can get. That's not the case. If you can't access lower cost funds, you're compelled to seek relief from your existing creditors. Their willingness to oblige is once again a function of your circumstances, as well as their own, and your ability to execute.

Consider the concessions that were given over the past 10 years to commercial real estate borrowers, largely because the lenders were just as anxious as the borrowers to avert the classification of loans as being in default, because that would have occasioned large reserve requirements for the lenders. So it is that there is the opportunity for exchanges … but you just can't help yourself to them because there's a low interest rate environment.

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