

UNIVERSITY OF PENNSYLVANIA  
WHARTON SCHOOL  
SNIDER ENTREPRENEURIAL RESEARCH CENTER

BANKRUPTCY BASICS: A Chapter 11 Primer

Michael A. Bloom, Esq.  
Morgan, Lewis & Bockius LLP

April 3-4, 2006

# INTRODUCTION AND OVERVIEW



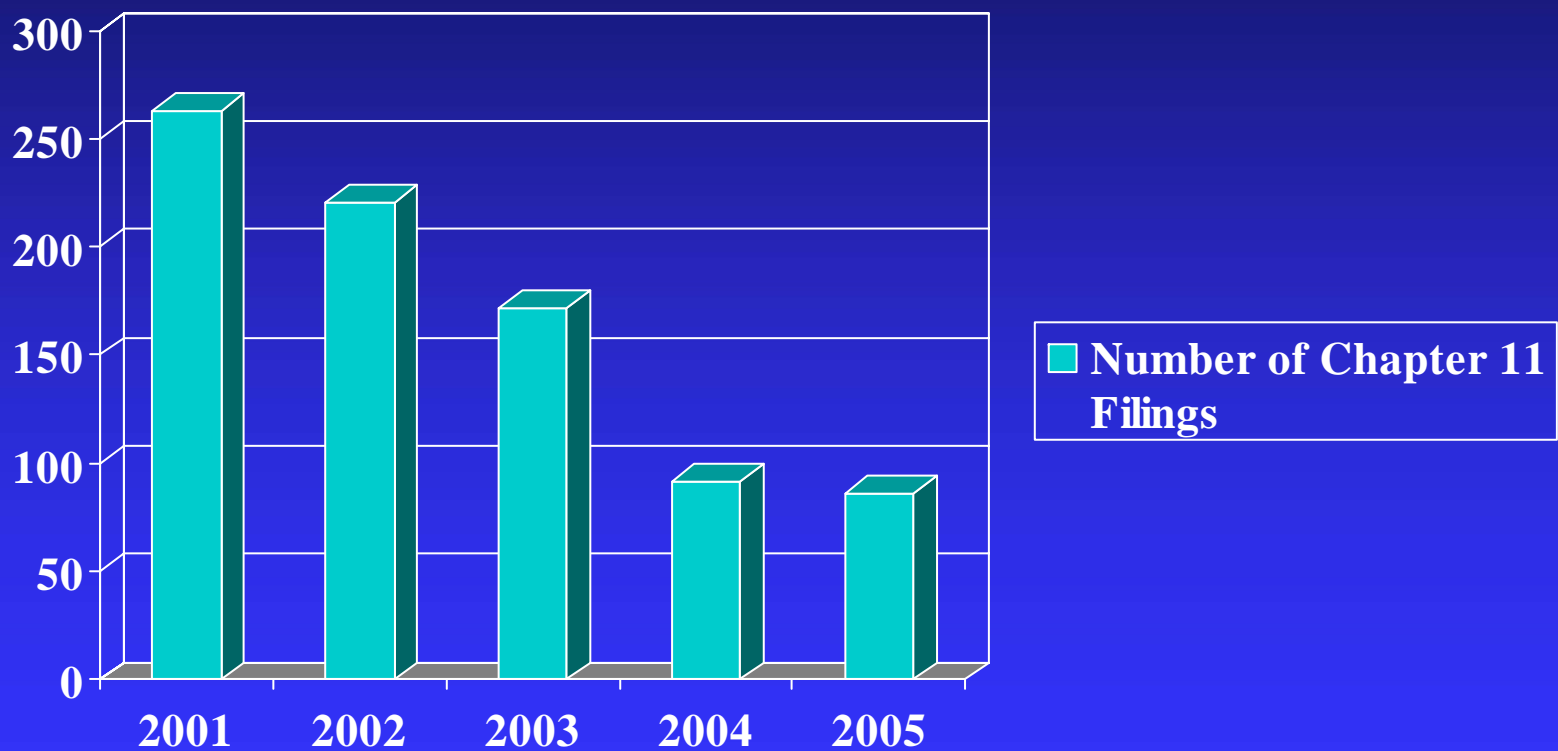
# TRENDS IN BANKRUPTCY

How many companies are filing?

Who is filing?

Why are they filing?

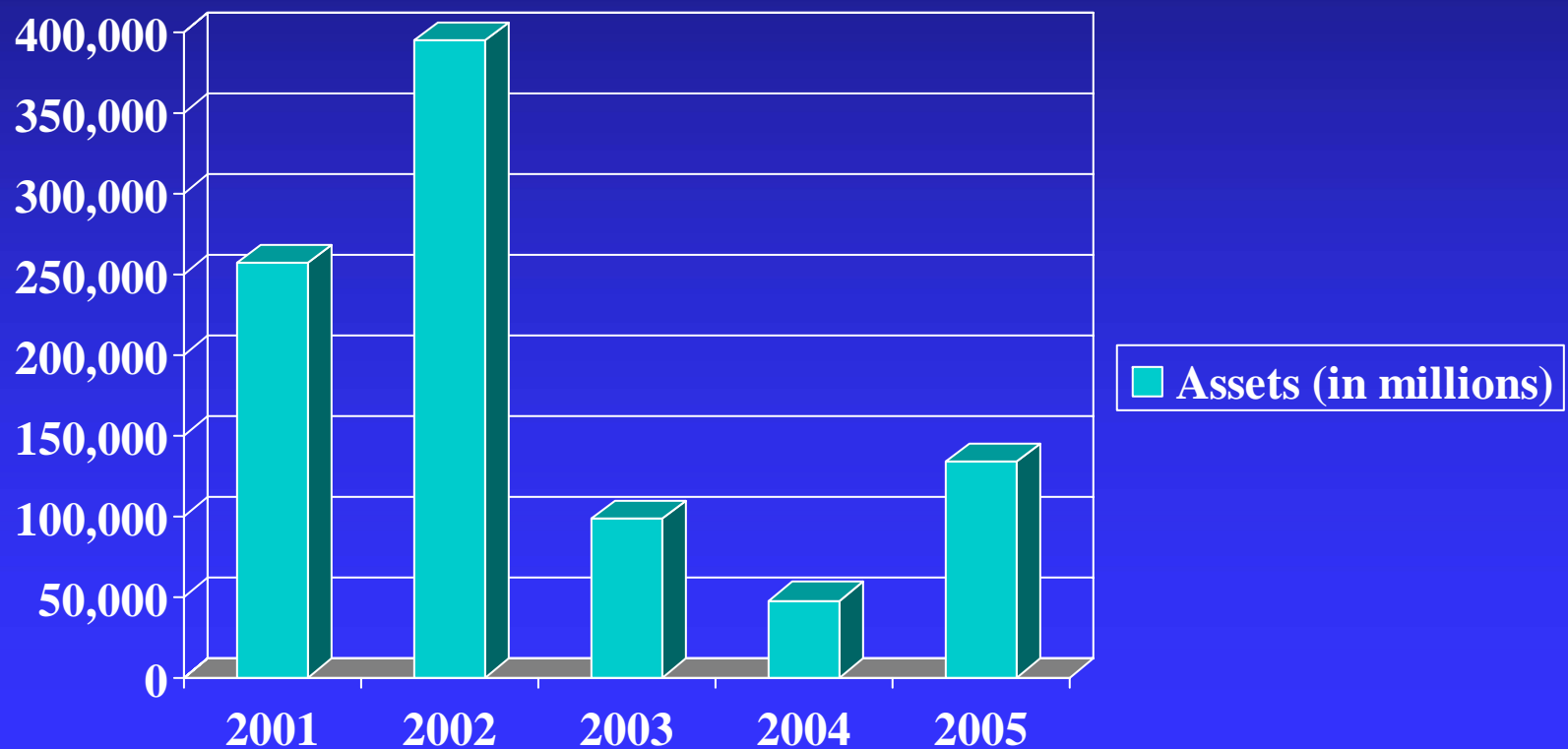
# NUMBER OF U.S. PUBLIC COMPANY CHAPTER 11 FILINGS IS DECLINING STEADILY



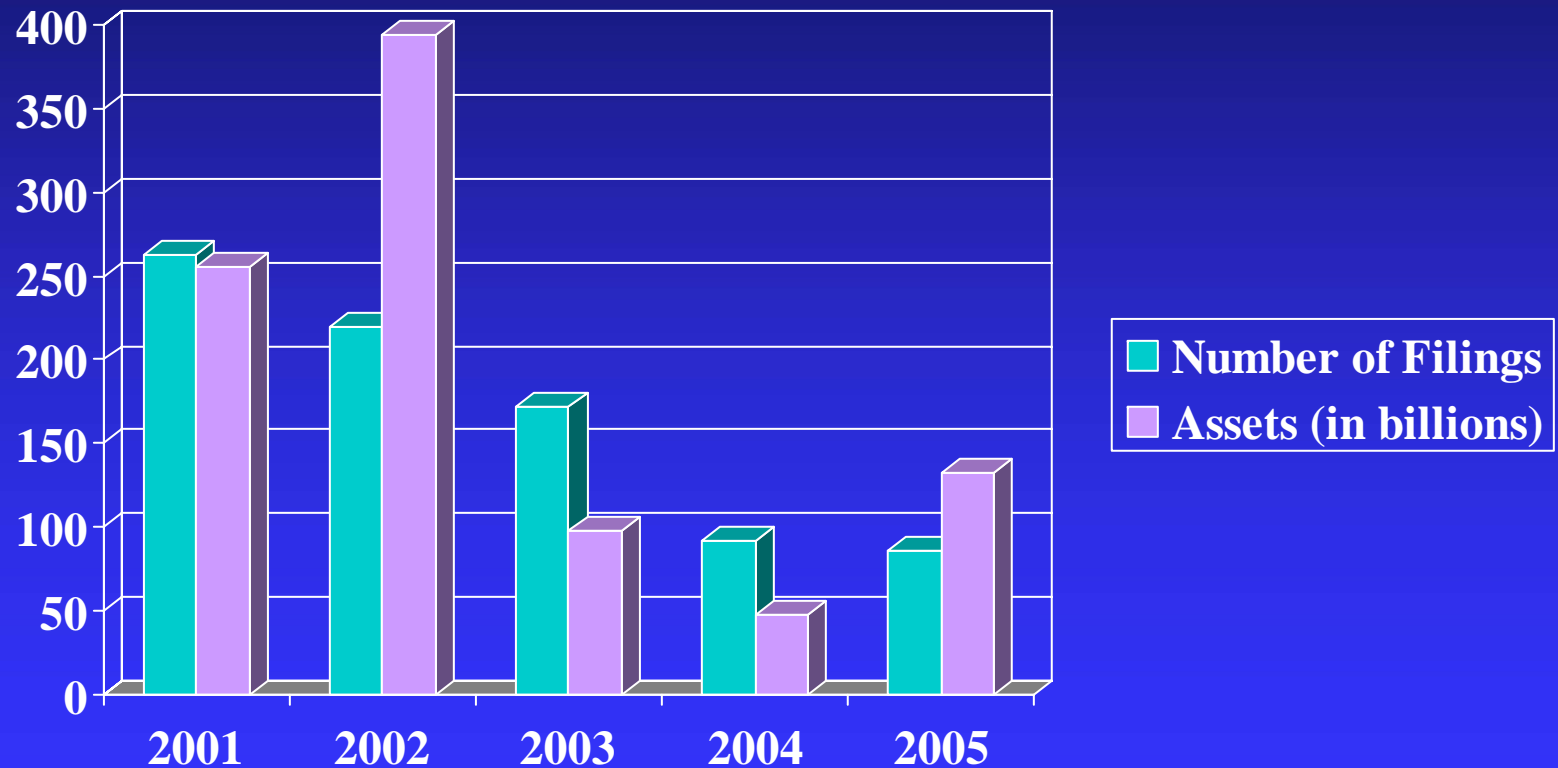
Source: Bankruptcydata.com

© 2006 Morgan, Lewis & Bockius LLP

# HOWEVER, THE TREND REGARDING ASSETS IN BANKRUPTCY IS NOT AS CLEAR



# COMPARING NUMBER OF FILINGS TO DOLLAR VALUE OF ASSETS



# WHO IS FILING FOR CHAPTER 11

**Then (2001/2002)**

**Now (2004/2005)**

Telecom Companies:

Worldcom - \$104 billion  
Global Crossing - \$30 billion  
Adelphia Communications - \$21 billion  
XO Communications - \$8 billion  
Williams Communications - \$8 billion

Energy Companies:

Enron - \$63 billion  
PG&E - \$13.2 billion

Others:

UAL Corp. (United Airlines) - \$25 billion  
Kmart (retail) - \$16.3 billion  
The FINOVA Group (financial services) -  
\$14 billion  
Federal Mogul Corporation (auto)- \$10  
billion

Airlines:

Delta Airlines - \$21 billion  
Northwest Airlines - \$14 billion  
US Airways Group - \$8 billion  
Atlas Air Worldwide - \$2 billion  
ATA Holdings - \$870 million

Automotive Companies:

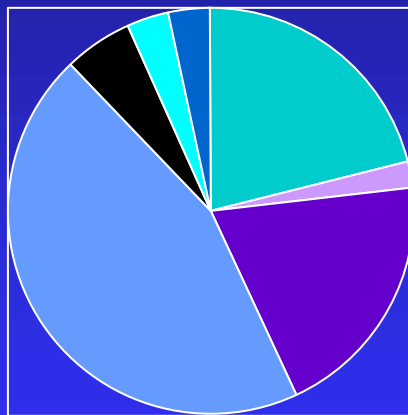
Delphi Corp. - \$16 billion  
Collins & Aikman Corp. - \$3 billion  
Tower Automotive - \$3 billion

Others:

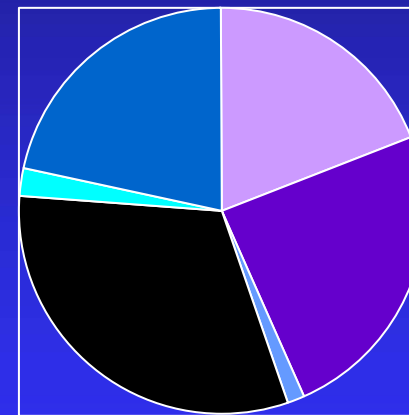
Refco Inc. (financial services) - \$33 billion  
Winn Dixie Stores (grocery retail) - \$2.6  
billion

# WHO IS FILING FOR CHAPTER 11? (CONT'D)

Then (2001/2002)



Now (2004/2005)



# WHAT CAUSED THE DECREASE IN FILINGS?

## THEN (2001/2002)

- Economic slowdown
- Profits declined while leverage increased (S&P 500 firms showed a 49% decrease in 3Q profits in 2001)
- September 11, 2001
- Tightened credit standards by large lenders

*In short:* Businesses were overleveraged and unable to generate cash flow due to a general economic slowdown, tightened credit standards and a decrease in consumer spending and confidence.

## NOW (2004/2005)

- Economic upturn
- Declining interest rates mean more money available for borrowing and capital expenditures
- Insatiable appetite for high yield debt issuances (i.e., bonds) means more cash available for mergers, acquisitions and other funding needs

*In short:* Businesses are able to borrow money at lower interest rates, raise funds through bond issuances and benefit generally from increased consumer spending and confidence.

Source: Alan Deaton, Bank Trends, published by the FDIC, No. 02-01, Jan. 2002

Capital Eyes, published by Bank of America, June 2005 (<http://www.bofabusinesscapital.com/resources/capeyes/a06-05-286.html>)

# WHAT IS ON THE HORIZON?

- Higher energy prices have created weakness in particular industries (e.g., airlines, automotive).
- M&A has flourished, meaning that leverage has increased.
- Second lien loans are being underwritten on a cash flow, rather than an asset-backed, basis. In a distressed situation, this may leave second lienholders “out of the money”.
- Rising interest rates affect:
  - Consumer spending (for example, decrease in the housing market means home improvement industry may be at risk); and
  - Companies’ ability to pay off debt or use excess cash for capital expenditures.
- *In short:* There is a current glut of credit and available cash in the market. A downturn in the economy could lead lenders and other financiers to tighten credit standards and decrease lending obligations. Accordingly, companies that already are over-leveraged or close to it may not be able to service their debt in the coming years, leading to cash flow crises and increased bankruptcy filings.

Source: Capital Eyes, published by Bank of America, June 2005 (<http://www.bofabusinesscapital.com/resources/capeyes/a06-05-286.html>)

© 2006 Morgan, Lewis & Bockius LLP

# How Do Business People Protect Their Investors?

- Establish a Liquidity Buffer.
- Plan for Distress.
- Know Your Creditor Constituencies.

Source: Capital Eyes, published by Bank of America, June 2005 (<http://www.bofabusinesscapital.com/resources/capeyes/a06-05-286.html>)

© 2006 Morgan, Lewis & Bockius LLP



# To File or Not To File... The Ultimate Decision

- Why do companies file?**
- Who is part of the decision making process?**
- What do these constituencies consider?**
- What should the company do?**

# WHAT CAUSES AN ENTITY TO SEEK CHAPTER 11 RELIEF?

- Over-leveraged
- Poor performance:
  - Diminished revenues
  - Failure to make a profit
- Poor management
- Poor products or services
- Obsolescence (e.g., the typewriter)

# WHO ARE THE CONSTITUENTS OF THE TROUBLED ENTITY?

- Directors and Officers
- Employees
- Creditors/Suppliers
- Customers
- Shareholders

# WHO IS MAKING THE DECISION ABOUT SEEKING BANKRUPTCY PROTECTION?

**YES**

**NO**

**MAYBE**

Directors

Customers

Shareholders

Officers

Employees

Creditors

# WHAT ISSUES DO THESE CONSTITUENTS FACE?

- **Directors and Officers** (Part of the decision making process)
  - To whom does the troubled company owe a duty?
  - Does this duty change as the entity approaches the “zone of insolvency”?
- **Employees** (Not part of the decision making process)
  - Should employees fear whether their next paycheck is in jeopardy?
  - What about health benefits? 401(k) benefits? Incentive bonus programs?
- **Creditors/Suppliers** (Sometimes part of the decision making process)
  - Is the creditor secured or unsecured (primary lender, other secured creditors, unsecured trade creditors)?
  - Should these parties continue to provide credit and/or goods and services to the trouble entity? Should they require cash in advance on goods shipped?
  - What are their remedies in the event they are not paid before the company files for bankruptcy?
- **Customers** (Not part of the decision making process)
  - Should customers start looking elsewhere for the goods and services previously provided by the troubled company?
  - How will a bankruptcy filing affect the customer’s ability to operate its own business?
- **Shareholders** (Sometimes part of the decision making process)
  - To sell or not to sell, that is the question!
  - Who has “inside information”?
  - What is the likelihood of a recovery if the entity seeks bankruptcy protection?

# WORKOUT ISSUES (OR, DO YOU NEED A “PLAN B”)?

- Short term cash flow analysis
- Identifying operational needs
- Evaluating management.
  - Strengths and weaknesses
- Evaluating assets and liabilities:
  - Balance sheet analysis vs. “Real world” analysis
  - Intellectual property rights
  - Existing executory contracts

# ARE YOU INSOLVENT?

- Balance sheet test
- Inability to pay obligations as they come due



# NOW WHAT? (EXAMINING THE OPTIONS)

- Out of Court Restructuring
- Out of Court Liquidation
- Bankruptcy Protection
  - Chapter 11
    - Reorganization
    - Liquidation
  - Chapter 7 Liquidation

# HYPOTHETICAL TROUBLED CORPORATION

MUSIC AND VIDEO ENTERTAINMENT, INC.

# Music and Video Entertainment, Inc.

## Balance Sheet

(\$ in 000s)

### Assets

Cash and Cash Equivalents	\$ 4,148
Inventory	304,120
Other Current Assets	<u>9,803</u>
Total Current Assets	318,071
Net Fixed Assets	41,375
Goodwill & Purchase Reserves	--
Other Long-Term Assets	7,486
Total Other Assets	<u>48,861</u>
Total Assets	<u>\$ 366,962</u>

### Liabilities and Equity

Accounts Payable	176,465
Other Current Liabilities	53,894
Gift Card Liability	<u>72,170</u>
Total Current Liabilities	299,529
Revolving Line of Credit	100,243
Other Long-Term Liabilities	27,243
Liabilities Subject to Compromise	--
Capital Stock	1,196
Retained Earnings (Deficit)	<u>(61,279)</u>
Total Equity	<u>(60,083)</u>
Total Liabilities and Equity	<u>\$ 366,962</u>

### Operations:

- Retail chain specializing in music, movies and video games.
- 830 retail stores (all leased)
- Industry trends such as digital music delivery, on demand movie formats (TiVo, Netflix), lower consumer demand and lower price points by mass merchandisers (i.e., Target, Wal-Mart) are causing declining sales.

## PRE-FILING CONSIDERATIONS: THE BALANCE SHEET - ASSETS

- What are the Debtor's assets?
  - Balance sheet
  - Off balance sheet
    - Are leases an asset or a liability?
    - What about goodwill?
      - What is “going concern” value?

# PRE-FILING CONSIDERATIONS: THE BALANCE SHEET - LIABILITIES

- What are the Debtor's liabilities?
  - Balance sheet
  - Off balance sheet
    - Pension obligations
    - Long-term leases
    - Contingent and unknown  
(environmental, products liability, etc.)

# PRE-FILING CONSIDERATIONS: IS THE DEBTOR INSOLVENT?

- Balance sheet test
- Inability to pay obligations as they come due

# PRE-FILING CONSIDERATIONS: LABOR AND EMPLOYMENT ISSUES – WILL A REDUCED WORKFORCE SOLVE THE PROBLEM?

- Layoffs (When? How?)
  - WARN Act Liability
    - When does it apply?
    - When must notices be given?
    - Effect of chapter 11 on failure to provide proper notice?
  - Severance and Retention Issues
  - Existing Employment Contracts
  - Other Issues

# PRE-FILING CONSIDERATIONS: OUT OF COURT OPTIONS

## Debt Restructuring

- Out of court debt restructurings are useful for companies that have limited debt issuances (both in tranches and in number of holders).
- Out of court debt restructurings are useful for companies that can afford to pay their other creditors in full.
- Companies with complicated debt structures, widely held debt issuances or that cannot afford to pay their unsecured creditors after the restructuring will find this option unappealing.

# PRE-FILING CONSIDERATIONS: OUT OF COURT OPTIONS

## Liquidation

- State liquidation laws, including bulk sale transfer laws, will apply.
- Absent an assignment for the benefit of creditors, piecemeal liquidation and entity dissolution under state law may be burdensome and cost prohibitive.

# PRE-FILING CONSIDERATIONS: OUT OF COURT OPTIONS

## Sale of Assets

- Timing of the sale: before, during or after bankruptcy?
- Selling substantially all of a company's assets through a bankruptcy proceeding has particular advantages.

## OTHER PRE-FILING CONSIDERATIONS

- Threat and impact of an involuntary petition.
- The need for a business plan/exit strategy.
- Venue choices:
  - Delaware
  - New York
  - Other
  - New trends in filing patterns

# OPERATING AS A DEBTOR AND DEBTOR IN POSSESSION: WHOSE OPINION MATTERS?

- The Court
- Senior Lenders
- Management
- The Official Committee of Unsecured Creditors
- Ad Hoc/Informal Committees
- The United States Trustee
- The Shareholders
- Others



# OPERATING AS A DEBTOR AND DEBTOR IN POSSESSION: FINANCIAL CONSIDERATIONS

Which unsecured creditors get paid at the beginning of and during the chapter 11 case?

- “Critical Vendors”
- Employees
- Reclamation Creditors
- Administrative Creditors
  - Professionals (debtor, committee, other)
  - Suppliers who supply post-petition goods and services
  - Landlords
  - Personal property lessors (after 60 days)



*If the company can afford to pay all these entities, why is it in chapter 11?*

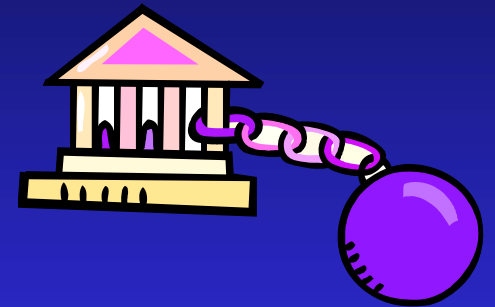


(or, why chapter 11 does not mean a company is out of cash)

# OPERATING AS A DEBTOR AND DEBTOR IN POSSESSION: FINANCIAL CONSIDERATIONS (cont'd.)

## DIP FINANCING

(borrow new money)



VS.



## CASH COLLATERAL

(use existing cash flow)

Who will lend?

On what terms?

Is cash flow sufficient to cover expenses?

# OPERATING AS A DEBTOR AND DEBTOR IN POSSESSION: THE AUTOMATIC STAY



- “Breathing Room”
  - Litigation
  - Collection Actions

# EMERGENCE FROM BANKRUPTCY

- Who is benefiting from the filing?
  - Shareholders (are they “out of the money”?)
  - Creditors
  - Senior Management
  - Employees
  - Customers
- Financial/Business Considerations:
  - Capital Structure
  - Business Plan
  - Pro Formas
  - New Management
  - Adequacy of Capitalization and Financing (“Feasibility”)
- Timing Considerations

# CONCLUSION

