

Morgan Lewis

Managing an ESOP Company in  
Challenging Economic Times

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# Workout Situations and Bankruptcy: Things You Need to Know to Survive

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# Introduction

- Introduction
- Focus of Presentation
  - **Anatomy of a Workout**
  - **Bankruptcy Basics**
  - **Additional ESOP Compliance Matters in a Workout**

# The Players

- **Board of Directors**
- **Officers**
- **ESOP Trustee**
- **Independent Financial Advisor**
- **ESOP Committee**
- **Senior Lender**
- **Mezzanine or Subordinate Lenders**
- **Former Seller(s)**
- **Private Equity**
- **Other Creditors**
- **Bankruptcy Court**

# Warning Signs of Trouble

- **Violation of Loan Covenants**
- **Delays in Financial Reporting**
- **Lack of Needed Capital Investment**
- **Running Out of Cash**
- **Slow Inventory Turnover**
- **Store Closings**
- **Loss of Key Relationships**
- **Avoiding Contact with Bank, Trustee**

# Lender Options

- **Workout: Loan modification/forbearance**
- **Workout: Orderly liquidation or turnover/sale of assets outside bankruptcy**
- **Claims trading**
- **Foreclosure; receivership**
- **Bankruptcy**

# Considerations in Workouts

- **Why** – What was the cause of the problem? Is the Company viable?
- **Who** – Who is involved and what are their incentives?
  - *One lender vs multiple lenders – is it a manageable process?*
  - *Commercial lenders vs workout group*
  - *Management – is management trustworthy and competent?*
  - *Guarantors – do they have a stake or are they tapped out?*
  - *Subordinated creditors – do they have an incentive to cooperate?*
  - *ESOP Trustee*
  - *Other Shareholders*
- **What** – What do the parties have and what can they bring to the table?
  - *Capital*
  - *Collateral*
  - *Services and relationships*
  - *Forbearance*
  - *Additional advances*
- **When** – When to take action, when to monitor
- **Where** – Consider the impact of state and federal laws/state of incorporation

# Phases of a Workout

- **Default or other notices**
- **Initial discussions**
  - **Pre-negotiation agreement or reservation of rights agreement**
  - **Information gathering (incl. cash flow projections)**
  - **Possible hiring of workout consultant**
- **Loan modification or orderly liquidation agreement**
  - **Forbearance or waiver of defaults**
  - **Revision of loan terms: interest, amortization, fees, equity kicker**
  - **Additional capital infusions (equity or subdebt)**
  - **Additional guaranties or other credit enhancement**
  - **Modified financial covenants**
  - **Waiver of defenses and release of lender**
  - **Obtaining approvals**

# Zone of Insolvency

- General rule: Board and officers owe fiduciary duty solely to shareholders and the Company.
- But when Company is insolvent or even near the “zone of insolvency,” an additional fiduciary duty arises that requires Directors and Officers to maximize and preserve assets for benefit of creditors.
- Duty to creditors can often be adverse to duty to shareholders.
- Query: If ESOP holds majority or 100% of stock, what duties, if any, are owed to creditors by ESOP in “zone of insolvency”?

# Pros and Cons of Out of Court Workout vs Chapter 11 Bankruptcy

- Out-of-court workout can be faster and cheaper, and avoids “stigma” and/or bad press of a bankruptcy.
- But no “stay” of creditors; no court oversight of bad behavior; need 100% or other minimum consent to bind; inability to sell “free and clear” of liens or to override anti-assignment provisions in contracts and leases.
- Bankruptcy has all of these benefits, but is often slower and more expensive and can have a negative stigma/effect on business. Some businesses do poorly in bankruptcy due to customer/vendor perceptions (restaurant chains, service providers, etc.).
- Bankruptcy also has mandatory disclosures and creation of a Creditors Committee – paid for by Company.

# Phases of Typical Chapter 11 Bankruptcy Case

1. *Filing and "first day orders"*
2. *Stabilization period*
  - DIP loan is obtained to fund the chapter 11 case and debtor sells some non-core assets
  - Rejecting burdensome leases/contact
3. *Negotiate exit strategy and propose a plan of reorganization, including:*
  - new capital and debt structure/cancellation of old stock
  - business plan
  - classification and treatment of creditors
  - post-bankruptcy funding
  - other issues

# Effect of Chapter 11 on Stockholders

- Shares still trade.
- Corporate governance generally remains in place (Board, By-laws, etc.).
- However, DIP does not need shareholder approval to take any action – only court approval.
- “Absolute priority” rule mandates that existing shareholders must not receive or retain any stock or other consideration until every class of creditors is paid in full plus interest (secured claims, administrative claims, priority claims and unsecured claims all must get 100% before any shareholder gets to keep its stock or receives any distribution).

# Effect of Chapter 11 on Stockholders (cont'd)

- Therefore, in most Chapter 11 cases, all existing stock is cancelled under any reorganization or liquidation plan.
- “Cram down” rule allows Company to get its Plan approved despite a vote by stockholder class rejecting the Plan.
- Stockholders thus have few rights: seek a trustee, consider derivative or class action suits or fraudulent conveyance suits, but these are risky, slow, fact-intensive and expensive.

# ESOP Trustee's Responsibilities

- **Fiduciary Loyalty**
  - **Participant, not employee**
  - **Company and ESOP – not individual participants**
- **Investment Judgments**
  - **Trustee purchases of shares when value has declined**
  - **Carrying on debt repayment where stock value has declined**
  - **ESOP's role in a bankruptcy**

# ESOP's Role in a Layoff

- **ESOP effect on employment:**
  - **Participation and employment are separate relationships**
  - **ESOP fiduciary must be loyal to the plan participant not employee**
  - **Company and ESOP as a whole – not individual participant**
- **Fiduciary requirements**
  - **Business judgment is controlling factor**
  - **No obligation to rehire as a result of ESOP ownership**

# Partial Termination

- **Identifying a Partial Termination:**
  - **What is a partial termination?**
  - **Who's an active participant?**
  - **Who's counted as a termination for this purpose?**
  - **How is the percentage calculated?**
- **Results of a Partial Termination**
  - **Accelerated vesting**

# Considerations Related to Distributions

- **Unworkable Distribution Policy:**
  - **What does your plan require?**
  - **What is the weight of precedent?**
  - **What changes are allowed and when must they be adopted?**
- **Fiduciary Considerations:**
  - **In general, a fiduciary's responsibility is to the ESOP as a whole, not individuals**
- **Actions to Take:**
  - **Review current policies and plan necessary changes**
  - **Consult advisors as to implications of any changes**
  - **Communicate changes as soon, fully, and straight-forwardly as possible**

# Questions?

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