Monday, November 21, 2005

New York Law Journal

CORPORATE RESTRUCTURING AND BANKRUPTCY

ALM

Leveraged Transactions In Changing Terrain

New law's provisions, such as shortened time periods,are noteworthy for investors.

BY JOHN D. FERRELL

THE ACT TO REFORM the bankruptcy law, which wended its way through the Congress for years, was finally enacted into law in the spring. Most of the media attention has been focused on the consumer provisions of the law, which are regarded as a great benefit to credit card companies. Although these consumer provisions should indeed benefit credit card companies (providing a means to force consumer bankruptcies out of Chapter 7 liquidations and into Chapter 13 "pay-over-time" arrangements), there is much more to the recent changes than that.

ART BY NEWSCOM

Many provisions concerning business bankruptcies affect all classes of creditors and all varieties of debtors. Some of these, however, are especially noteworthy for investors in leveraged buy-outs (LBOs) for two principal reasons. First, some of these create greatly shortened periods for actions to be taken by or on behalf of a debtor in a chapter 11 proceeding. Because private equity investors will be attempting to effect a work-out of the financial difficulties (either through the existing management or through a specialized work-out team), they will need time up-front to try to work through the problems. Shortening certain periods so that as a practical matter the problems cannot be worked out only hastens the death of the business.

Second, some of the new provisions favor non-lender creditors (such as landlords and utility creditors) at the expense of lender creditors and the debtor company. Because of the difficulties that are raised by that result, the private equity sponsor in an LBO will have greater difficulty in securing the full cooperation of lender creditors to keep the business going.

Several key points regarding the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

John D. Ferrell *is a partner at Sheppard, Mullin, Richter & Hampton, in the New York office.*

should be of interest to private equity firms and LBO lenders:

1. Dramatic enhancement of a commercial lessor's position.

The Commercial Law League of America expressed its comments on the amendments regarding commercial leases succinctly:

> …in business cases of all sizes the Act jeopardizes the value of the bankruptcy estate, and therefore, the potential recovery by creditors, by conferring a benefit on a party of interest, the commercial landlord. Already preferred under the [Bankruptcy] Code, commercial landlords are given the power to force a debtor's decision regarding assumption or rejection of a commercial property lease before it is possible for the debtor and other parties to know which is more appropriate to the circumstances. The creditor body ultimately pays for premature decisions, either in value lost from rejected leases that should have been retained or in administrative expense involved in maintaining a lease that only later proves to be burdensome to the estate. (Letter dated March 15, 2005, to the House Judiciary Committee.)

This would be a very strong argument to think about carefully before choosing a sale/leaseback transaction for factory buildings or other real property in a leveraged acquisition, versus a secured loan.[1] Although the effective imputed interest costs can often look very attractive for a sale/leaseback deal, to give so much power to the lessor in a leveraged situation where things might become difficult would probably swing the balance of benefits over to that of a secured lending arrangement.

2. Utility Creditors.

A similar point is the substantially improved position of utility creditors. The amendments to Section 366 of the Code allow a utility to "alter, refuse, or discontinue utility service if…the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility."

Ordinarily, the claim of a utility creditor for utility service rendered would qualify for treatment as an administrative expense of the estate, entitled to priority treatment. This treatment, however, will not now constitute "adequate assurance of payment" for the purposes of Section 366. The only things that will so qualify are a cash deposit, letter of credit, certificate of deposit, security bond, prepayment of utility consumption, or "another form of security that is mutually agreed on between the utility and the debtor and the trustee."

Shortening certain periods so that as a practical matter the problems cannot be worked out only hastens the death of the business.

Many times one of the biggest worries in an LBO bankruptcy is just keeping the lights on and the machines going. Now the utility has the whip hand and can shut everything down unless there is a complete cash assurance of payment—even if there has been a perfect record of timely payments before the bankruptcy.

3. "Fast track" Chapter 11 procedures for small business debtors.

Section 438 requires the court to confirm a plan of reorganization in a small business case not later than 45 days after the plan is filed. Other limits are imposed on the exclusivity period for filing a plan, and on the time for filing a plan. These deadlines can be extended only for a "reasonable time" at the end of which confirmation of a plan will result.

Under the new provisions, a reorganization is less likely because the debtor would not have the time needed to improve its financial position. Generally speaking, the bankruptcy filing itself will generate a fall-off in business; consequently, it will take some time for the debtor company to build its business back up. "Fast-tracking" for such a company simply means death of the business, resulting in a loss, or a greater loss, to at least certain of the creditors. It will also usually mean a total wipe-out for the equity-holders, whereas with time under Chapter 11 some value could have been returned to them.

4. "Forum-shopping" for bankruptcy courts.

The Code continues to permit corporate bankruptcies to be filed in the debtor's state of incorporation even if the business has no other connection with that state. Permitting a bankruptcy filing in a far-off forum effectively precludes many creditors—especially those who are most vulnerable such as consumers, workers, retirees or small trade creditors—from participating in the bankruptcy process because of their inability to afford the travel expenses.

For a private equity fund specializing in purchasing distressed companies, to permit filings in distant forums is to run the risk that the acquisition target will

squander its goodwill with workers and small trade creditors. Filing with a local forum means that, right or wrong, workers, retirees, and small trade creditors will have a chance to have their say, and perhaps impact the proceedings. The result may be that more of the intangible value of the company will be preserved for the subsequent purchaser.

5. Exclusivity periods for a plan of reorganization.

Before the recent change, a party in interest could seek to shorten or enlarge the 120-day period within which the debtor has the exclusive right to submit a plan of reorganization, and 180-day period within which the debtor must obtain acceptances to its proposed plan of reorganization. The debtor could continue to seek extension after extension so long as the requisite cause was shown each time.

The act adds a new paragraph to Section 1121(d), which limits the debtor to a 14-month extension in the case of both the exclusivity and plan solicitation periods. The 120-day period may not be extended beyond 18 months after the Order for Relief, and the 180-day period may not be extended beyond 20 months after the Order for Relief. These revisions will have the most serious impact on the larger, more complex Chapter 11 cases, and may induce creditors to hold up a debtor-proposed plan in order to get the right to file a competing plan.

These limitations on the debtor's right to seek extensions naturally draw power away from the debtor—and the private equity investor—and toward a variety of classes of creditors.

6. Retention Bonuses.

In the past, when LBO deals ran into trouble, private equity sponsors found it necessary to provide for substantial "retention bonuses" to induce key management employees to stay with the debtor company and work things out. This was generally done through Key Employee Retention Programs (KERPs).

The new act has essentially killed KERPs. Section 331(c) now provides that nothing shall be allowed or paid to "an insider of the debtor for the purpose of inducing such person to remain with the debtor's business" unless the court finds three requirements have been met:

(1) it is essential to retain the person "because the individual has a bona fide job offer from another business at the same or greater rate of compensation;"

(2) "the services provided by the person are essential to the survival of the business," and

(3) the amount of the bonus is not greater than 10 times the amount of bonuses of a similar kind that were given to nonmanagement employees.[2]

Since this means that each key management employee must have received another job offer, which he will take if there is no KERP, the standard can almost never be satisfied, and KERPs are essentially dead.

Conclusion

As is so often the case, significant changes to the Bankruptcy Code being proposed found little attention from creditors' rights attorneys until it was too late for anything to be done about the proposed legislative action. Congress will now be asked to rectify changes made in the Code which did not receive significant attention from the legal community, and the private equity community, while the proposed changes were making their way through Congress.

Private equity investors are by nature usually optimistic and very skilled at seeing the upside in an investment situation. At the same time, everyone in the business recognizes that minimizing losses in any portfolio company is at least as important as seeing the upside at the beginning. The economics of the business change meaningfully when investors are prevented from using their management skills to minimize losses—either because of shortened time periods to effect work-outs, or favored treatment of certain classes of non-lender creditors, or the inability to offer portfolio company management an adequate incentive to perform.

1. Section 404 of the new law would amend Section 365(d)(4) to read as follows:

(A) Subject to the subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of —

(i) the date that is 120 days after the date of the order for relief; or

(ii) the date of the entry of an order confirmed a plan.

(B) (i) The Court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

2. If no bonuses were given to non-management employees, then the limit is 25 percent of the management employee's bonus in the last year.

This article is reprinted with permission from the November 21, 2005 edition of the NEW YORK LAW JOURNAL. © 2005 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact, ALM Reprint Department at 800-888-8300 x6111. #070-12-05-0002