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Avoiding the Prepack Steamroller

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Prepackaged bankruptcy filings (referred to as "prepacks") have been increasing in use the last several years because they allow a company to swiftly emerge from Chapter 11, thereby saving time, sparing expense and reducing the risk of damage to its business. The growing use of prepacks provides significant benefits to distressed companies, their senior lenders, customers, suppliers, employees and other stakeholders who support the prepack. On the other hand, junior classes of debt and equity are often wiped out because they appear to be out of the money when the prepack is confirmed. By having a plan accepted before Chapter 11 is even filed, the debtor achieves tremendous momentum and is usually able to steamroll junior classes. However, if junior classes are vigilant, they can take steps to preserve the value of their positions and avoid getting flattened by the prepack steamroller. The looming threat of the steamroller facing the junior classes could create opportunities for hedge funds to buy positions at steep discounts and then try to salvage value instead of getting flattened.

How Prepacks Work

Prepacks have grown in popularity ever since revisions to the Bankruptcy Code in 2005 made Chapter 11 more expensive and difficult.[1] In a prepack, the company solicits acceptances of the plan of reorganization before filing Chapter 11. Outside of bankruptcy, creditors who do not support the restructuring will have to be paid off at par. However, once a plan of reorganization is confirmed by the Bankruptcy Court, then the deal is binding on all classes of claims and interests, whether or not they voted to accept the plan. The momentum a debtor achieves by having the plan accepted by enough creditors to enable confirmation before the bankruptcy case is even filed creates a steamroller effect that wipes out dissenting creditors. Assuming the requisite acceptances are obtained, the company can file Chapter 11, skip most of the preliminary and intermediate steps of the Chapter 11 process, and request the immediate scheduling of a hearing on confirmation of the plan. There will be no need to conduct a separate hearing on the adequacy of the disclosure statement accompanying the plan. Instead, at the confirmation hearing, the plan proponent will request that the court find that either (1) the solicitation of acceptances was in compliance with applicable non-bankruptcy law, e.g., the securities laws; or (2) the pre-petition disclosure statement contained "adequate information."[2] Pre-negotiated bankruptcy filings are similar to prepacks, except either the company did not solicit votes pre-petition, or did not obtain the acceptance of all impaired classes whose acceptance was required. In any event, the essential terms of the deal have been agreed by all major constituencies, who also usually execute a plan support agreement. Speed is the essence of both prepackaged and pre-negotiated bankruptcy filings.

Problems for Junior Classes

The speed that makes prepacks popular with companies in financial distress and the creditors who support the prepack naturally creates problems for those junior classes of claims and equity who are out of the money because they will either get wiped out or receive a nominal return. These stakeholders will have far less time to effect a more favorable outcome or mount a challenge to plan confirmation. Moreover, the enterprise value of complex businesses that languish for years in Chapter 11 sometimes increases dramatically as a result of a turn in the business cycle or other favorable exogenous events affecting the company or its industry. That is far less likely to occur in a prepack, where the duration of the Chapter 11 is often measured in weeks if not days. Thus, in a prepack, creditors and shareholders who are out of the money as of the petition date are unlikely to find themselves in the

money by confirmation. This effect may be exacerbated by management's control over the timing of the filing of the prepack. For example, management and/or creditors enjoying relative seniority may have an incentive to file a prepack before business prospects improve, so that lower levels in the capital structure can be wiped out and senior creditors enjoy all of the upside as business conditions improve. In fact, the holders of the fulcrum security – the level in the capital structure that is partially in and partially out of the money – may get a windfall as business prospects improve and values increase. Moreover, creditors and shareholders who are dissatisfied with their distributions will not have much time to shop the company. Similar ramifications are inherent in pre-negotiated bankruptcies, although dissenting classes and disgruntled members of accepting classes will generally have a little more time and leverage to enhance their recoveries.

Solutions

Disgruntled creditors and shareholders should take steps early in the process to organize and try to join up with other similarly situated creditors to pool resources and spare expenses. This would primarily be to spread the costs of attorneys, financial advisors and other experts. Getting well armed will put these stakeholders in the best position to take aggressive action well before the petition is filed and avoid the steamroller effect of the confirmation process inherent in a prepack. Junior classes who are unsatisfied with their recoveries under the prepack should consider various strategies including:

Alternative Transactions

Find an alternative transaction that creates more value to enhance their recoveries, e.g., a new investor or buyer who will issue securities that allow junior classes to share in any potential upside, rather than being wiped out at the bottom of the market.

Alternative Recovery Sources

Investigate alternative sources of recovery such as litigation claims against officers, directors, shareholders, professional advisors, senior lenders and other parties, and insist that such claims be transferred to a litigation trust for the benefit of junior classes.

Involuntary Petition

Consider the filing of an involuntary petition before the pre-petition plan solicitation process can be completed.

Target the Board of Directors

Consider bringing an action against the borrower's board of directors for breach of fiduciary duty to dissuade the directors from going ahead with a prepack that unfairly wipes out junior classes and gives too much value to senior classes.

Blocking Position

Try to buy a blocking position in the fulcrum security or any other class that is impaired under the plan if the plan proponent needs the acceptance of that class.[3]

Sell Out

Sell their position to a distressed investor who is better able to bear the risks and costs of a fight.

Object to Confirmation

Mount a valuation fight at the hearing on confirmation of the plan. Junior classes should also consider pursuing other potential confirmation objections including that the disclosure statement did not contain adequate information, plan classification was improper, the plan was not proposed in good faith, the junior class is receiving less than liquidation value, the plan is not feasible, the plan discriminates unfairly and the plan is not fair and equitable.

Negotiate for Modest Recovery

If it appears that junior classes are significantly underwater, try to negotiate for a relatively insignificant security such as way out-of-the-money warrants. A variation on this would be to give junior classes the right to purchase warrants.[4]

Which of these strategies should be employed will of course depend on the circumstances of each case, including the enterprise value and capital structure of the company in financial distress, its business prospects, market conditions and a detailed analysis of the legal rights of the disgruntled stakeholders.

Conclusion

In short, junior classes who are unsatisfied with a prepack will have to move aggressively and take action at an early stage to maximize their chances of recovery. Investors in distressed securities may find trading opportunities as those unable or unwilling to bear the risks and expense of trying to stop the prepack steamroller sell their positions to those willing to bear such risks to garner an enhanced recovery.

About the Authors

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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. Stevens & Lee, P.C. is a professional services firm with 180 lawyers and 40 business and consulting professionals located in 15 offices throughout the Mid-Atlantic region.

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[1] Kajon, Prepackaged Bankruptcy Filings: A Harbinger of Practice Under the New Law, Debt³, July/August 2006, Vol. 21, No. 4. Also available online at: http://www.stevenslee.com/news/NFKArticles/prepackaged_bankruptcy.pdf.

[2] 11 U.S.C. § 1126(b) (validating pre-petition plan solicitation provided one of the two tests is satisfied). "Adequate information" is defined in 11 U.S.C. § 1125(a).

[3] A majority of creditors holding two-thirds of the debt are required for a class of claims to accept a plan. 11 U.S.C. § 1126(c). If an impaired class votes to reject a plan (and provided at least one impaired class of claims has voted to accept the plan), the plan proponent can seek to have the plan "crammed down." 11 U.S.C. §§ 1129(a)(10), 1129(b).

[4] Mr. Buchwald's firm, Buchwald Capital Advisors LLC, is presently developing a technique to facilitate a rights offering for warrants.

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