Is Chapter 11 Still a Viable Option — Or Has High Cost Rendered The Process Unaffordable?

BY JEFFREY A. WURST, ESQ.

Companies emerging from Chapter 11 as reorganized debtors as we used to know them have become rare. Attorney Jeffrey Wurst explains that middle-market companies generally cannot afford or withstand the high cost of a Chapter 11 in today's environment and notes that alternatives will become even more popular.

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Several years ago I attended a continuing legal education program sponsored by the bankruptcy committee of a local bar association. A number of sitting bankruptcy judges from that district were on the panel. When we finally got around to Q&A, I raised my hand to ask a question of the panel and stated, "Once upon a time a company would file a voluntary petition pursuant to Chapter 11. It would work out an arrangement with its pre-petition lender for a DIP facility, then it would set out to reach accommodations with its landlords and with its creditors. It would then file a plan of reorganization, together with a disclosure statement, fine tune both, confirm the plan and emerge as a reorganized debtor." Before I could complete the question, one judge commented, "Well I've been on the bench for ten years, and I haven't seen that."

Companies emerging from Chapter 11 as reorganized debtors as we used to know them have become rare. In 2008, Judge Robert Gerber wrote: "Liquidating Chapter 11 cases, for better or worse, have been the rule and not the exception in this Court and others over the last decade, if not longer." *In re Applied Theory Corp.* (Bankr. S.D.N.Y. Apr. 24, 2008) (Gerber, J. Case No. 02-11868 (REG at 11). Thus, the bankruptcy court is most often utilized to effect a transfer of the debtor's assets — sometimes as the result of a failed attempt to restructure sometimes *under duress* — sometimes using the court to seek a buyer — sometimes using the court to cleanse the assets in what would otherwise have been an arms length transaction outside of bankruptcy.

There are a number of reasons why traditional reorganizations have been sparse. Amongst them are: 1.) the high cost of professional fees; 2.) uncertainty as to the outcome; 3.) lack of availability of unencumbered assets that otherwise may be utilized to secure a DIP lending facility or to fund post-petition obligations under a plan of reorganization; and 4.) alternatives such as out-of-court restructurings and assignments for the benefit of creditors.

We studied a sample of Chapter 11 cases filed in the Bankruptcy Court for the Southern District of New York during 2010. This amounted to approximately 60 cases after administrative consolidation. Eleven of those cases converted to Chapter 7. In the two to three years since the beginning of our sample period, very few of the 2010 cases had reached conclusion, and it appeared that only one of those 11 cases was a *traditional reorganization*.

OMC, Inc. (OMC) was organized in 1986 and provides commercial heating, ventilation and air conditioning subcontracting services in the Bronx, NY. OMC filed a voluntary petition pursuant to Chapter 11 on September 10, 2010 and confirmed a plan of reorganization on January 25, 2012. The disclosure statement projected a 20% distribution to unsecured creditors payable over a four-and-a-half-year period which, if realized, would aggregate approximately $900,000. The professional fees approved (excluding fees for claims objections) approximated $263,000 and the equity of the reorganized debtor vested with the pre-petition shareholders. Just like the *old days*.

At the opposite extreme, we consider a large case that resulted in liquidation of the debtors. Saint Vincent Medical Centers (St. Vincent) operated hospitals and related facilities in New York City and neighboring areas, including a 732 bed hospital that served the Greenwich Village section of New York City for over 150

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years, a 600 bed facility in Westchester County, a home health agency, a cancer center, hospice facilities, geriatric care facilities and more. In 2005, St. Vincent filed its first bankruptcy case, which resulted in a confirmed plan of reorganization in 2007. After applications for professional compensation and expenses approached $80 million (including compensation for the CRO and his colleagues of over $15 million) that success, however, was short-lived. Despite efforts to revitalize the hospital and its system, a subsequent bankruptcy was filed in April 2010 to effect an orderly closing of the hospital and the sale of its assets. The process took approximately two and a half years and cost in excess of $40 million in professional fees and expenses to substantially complete. By virtue of the nature of the debtor's business, an expedited "shut down" was not possible even if it had been desirable. The recovery for the benefit of unsecured creditors is not yet known; however, the liquidation analysis submitted with the disclosure statement approved in connection with the liquidating plan estimated a recovery ranging from 1.8% ($19.9 million) up to 7.7% ($85.5 million).

In 2010, few cases were filed on behalf of small to middle-market companies (under $750 million in annual sales), creating the impression that Chapter 11 may no longer be a viable option for small and middle-market companies. The shockingly low number of cases during a challenging economic period may indicate that distressed businesses are turning to alternatives to Chapter 11.

Of the bankruptcies filed in the Southern District of New York during 2010, many were pre-arranged, pre-packaged or to facilitate a quick sale. Some companies determined that it was more feasible to arrange a sale of assets outside of bankruptcy, but reserved the option to utilize the bankruptcy process to "cleanse" the assets so that a purchaser could obtain title "free and clear of all liens and encumbrances." Even in those cases, sales may only have raised an amount sufficient to pay the secured lender and unsecured creditors were left to wait for a distribution, if ever, from a liquidating trustee pursuing avoidance actions.

One significant reason why the traditional Chapter 11 may be too costly is due to the high cost of professional fees. Those costs may have a crippling effect on a debtor's ability to reorganize as a going concern. In our sampling, we found that professional fees for the middle-market Chapter 11 cases typically approached or exceeded $1 million, while sales of assets pursuant to §363 of the Bankruptcy Code, coupled with a structured dismissal, resulted in significantly lower fees, especially in those cases where the sale was conducted very early in the proceedings.

Attorneys historically representing middle-market Chapter 11 debtors have reported that they often sought and obtained more cost effective alternatives to Chapter 11. Out-of-court restructurings have become a more favorable alternative by streamlining the restructuring process allowing cost savings to be passed down to the creditor body. Sophisticated creditors recognize that even when a reasonable return may not be attainable, there may still be an opportunity to continue to do business profitably with a reorganized entity.

Of course, when a company's assets are insufficient to provide a dividend to unsecured creditors, the secured lender may foreclose on its collateral, without any necessity of judicial proceedings. A purchaser of assets may be willing to purchase the assets from the lender in a private or public secured party sale or the lender may arrange to have a public auction conducted to dispose of its collateral.

Another manner in which small and middle-market companies have avoided bankruptcy is as a result of pressure placed on commercial banks to dispose of underperforming assets. As a result, when banks sell off underperforming loans at a discount, the loan purchaser is often able to provide additional financing to enable the borrower to effect a turnaround without incurring the costs of a Chapter 11. A loan sale may result in a secured party sale, where the subordinated secured creditors receive little or no distribution and unsecured creditors receive nothing.[1]

Compositions are another low cost alternative to Chapter 11. A composition is an out of bankruptcy reorganization effected through a written agreement entered into amongst the company and its creditors whereby the debts are restructured. Often, composition agreements provide for the filing of a pre-packaged bankruptcy in the event sufficient creditors approve the composition but holdouts prevent the composition from being effective. In order for the *pre-package* option to work, there must be sufficient financial disclosure to satisfy the bankruptcy court (should the *pre-package* option be exercised) that the consenting creditors were provided with adequate information. Even if the composition alone is insufficient and the pre-package becomes necessary, the cost savings are substantial.

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Assignments for the Benefit of Creditors (ABC) are also on the rise as another cost effective alternative to §363 sales in Chapter 11. In these instances, a debtor surrenders its assets to the assignee of its choice who, in turn, sells the assets to a third party (sometimes made up of former owners of the defunct company). The purchaser obtains the assets and continues the operations as if the company had been sold as a going concern under §363 of the Bankruptcy Code. The cost of this approach is usually a fraction of the cost of a §363 sale in Chapter 11 and a structured dismissal.

A number of jurisdictions, including New Jersey, have amended their ABC statutes to provide a true state court alternative to the bankruptcy process. However, in New York the Debtor & Creditor Law has not been modified in decades and has many features that vary significantly with the Bankruptcy Code — specifically with respect to preferences and priority claims. As a result, where New York (specifically the Southern District) leads the country in major Chapter 11 proceedings, it has lagged behind in legislating for cost effective alternatives to the costly Chapter 11 process.

When Congress enacted the Bankruptcy Code in 1978 and made amendments thereafter, the objective was to make Chapter 11 an expeditious proceeding. This is borne out by the debtors' exclusive period to file a plan and the rules created for small debtors. If the bankruptcy bench and bar would adhere with the original intent and effect quick Chapter 11 cases for the small and middle-market debtor, it is possible that the cost of the Chapter 11 proceedings would be substantially less and result in a return to *traditional* Chapter 11 reorganizations. Middle-market companies generally cannot afford or withstand the high cost of a Chapter 11. Alternatives remain available and those alternatives have become and will become even more popular as the cost of the process renders Chapter 11 unaffordable. abfj

[1] This analysis does not include any information resulting from Chapter 11 cases converted to Chapter 7, or voluntary or involuntary Chapter 7 cases.

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