Chapter One

# An Out-of-Court Restructuring or a Chapter 11 Case: When and How to Choose[1]

Mark S. Chehi[2]
Corali Lopez-Castro[3]
Sarah E. Pierce[4]
Mindy Y. Kubs[5]

## OVERVIEW

Every financially troubled company has unique factual, legal, and business circumstances and exigencies that shape and determine what restructuring alternatives and strategies are available to its decision makers and stakeholders. Often the most important consideration is the company's *liquidity*: what cash resources does the company have, how much cash does it need to operate in the ordinary course and satisfy current liabilities, and when will it run out of cash? A company's liquidity situation dictates whether it has time to pursue, negotiate, and effectuate a successful out-of-court financial restructuring.

If a company's cash position is poor and liquidity shortfalls are imminent, and if no lenders or stakeholders are willing to provide additional funding on an

1. Special thanks to Simeon Gold, Jacqueline Marcus, Catherine T. Dixon, and Daniel S. Holzman of Weil, Gotshal & Manges, LLP, for their contributions to earlier editions of this chapter.
2. Skadden, Arps, Slate, Meagher & Flom LLP.
3. Kozyak Tropin Throckmorton, LLP.
4. University of Pennsylvania Law School.
5. Kozyak Tropin Throckmorton, LLP.

out-of-court basis, the company may have no choice but to commence a voluntary chapter 11 case to obtain "debtor-in-possession" (DIP) financing needed to preserve its business operations and going concern value. In chapter 11, under the protection of the Bankruptcy Code, a financially distressed company will have some opportunity and exclusive rights to propose and seek confirmation of a chapter 11 plan-based restructuring of its financial affairs and liabilities. Sophisticated or opportunistic financial creditors may support (or restrict) a company's liquidity in order to avoid (or accelerate) a chapter 11 filing.

If a company's liquidity resources are substantial and will last for many months or longer, the company and its advisors should have ample time to negotiate a possible out-of-court financial restructuring. However, out-of-court financial restructurings typically require unanimity or near unanimous consent of creditors whose legal rights are to be modified and restructured. An out-of-court financial restructuring strategy may fail if one or more significant creditors do not agree to proposed out-of-court terms.

Bankruptcy may be the best or only viable strategy for restructuring a company when dissenting creditors are unwilling to agree to out-of-court terms. In short, the chapter 11 process binds dissenters by imposing chapter 11 plan terms and outcomes on minority dissenting creditors if requisite creditor majorities have accepted the bankruptcy plan and it satisfies Bankruptcy Code confirmation requirements.

A lengthy traditional chapter 11 case may not be required to bind dissenting creditors. A "prepackaged" chapter 11 case of short duration may overcome obstacles posed by dissenting minority creditors. Prepackaged chapter 11 plan terms are negotiated and fully documented out-of-court with creditor acceptances solicited before a chapter 11 case is commenced. A prepackaged plan may be confirmed within weeks or little more than a month following commencement of a prepackaged chapter 11 case.

A confirmed prepackaged plan will bind minority dissenters who do not provide their consent prior to bankruptcy. Sometimes, prebankruptcy proposal of a prepackaged plan will cause "holdout" dissenting creditors to agree to a nonbankruptcy restructuring (without need for any chapter 11 process) because the dissenters know they will be defeated by the prepackaged plan if a chapter 11 case is commenced.

"Prearranged" or "prenegotiated" chapter 11 cases effectuate prebankruptcy restructuring agreements with outcomes that require impairment of creditor (or equityholder) rights, when acceptances of a chapter 11 plan cannot be solicited or obtained prior to bankruptcy for practical or legal reasons. While not as certain or quick as a prepackaged chapter 11 restructuring, a prearranged chapter 11 case advances prenegotiated terms and outcomes that cannot be attained without commencing a chapter 11 case.

## WHEN AN OUT-OF-COURT RESTRUCTURING STRATEGY WORKS BEST

### Balance Sheet Restructurings

An out-of-court restructuring is typically best suited for a balance-sheet restructuring of funded debt that deleverages or relaxes a company's financial debt obligations. Refinancings, exchanges of new debt (with different terms and amounts) for existing debt facilities, extensions of financial debt maturity dates, changes in interest rates, covenant amendments, and other financial accommodations that deleverage a company or improve its financial condition may be negotiated and effectuated in an out-of-court restructuring. In a balance-sheet restructuring, the financially troubled company and its advisors negotiate deleveraging transactions with funded debt creditors (and perhaps equityholders) to improve the company's financial picture.

An out-of-court balance-sheet restructuring of financial debt will be subject to existing contractual terms and applicable nonbankruptcy law (including securities laws if applicable). A company's out-of-court restructuring will be consummated only when all agreements, consents and/or tenders are received that are required by existing contractual terms and applicable nonbankruptcy law.

A purely out-of-court restructuring of "debt-for-money lent" is free from judicial oversight—and, therefore, does not alter, change, impair, or prejudice the legal rights of (and continuing obligations owed to) holders of trade debt and litigation claims, employees, counterparties under commercial agreements, landlords, taxing authorities, and the like. Typically, nonfinancial creditors are not implicated in an out-of-court balance-sheet restructuring, and they have no forum or opportunity to participate in (or object to) out-of-court restructuring negotiations and outcomes. However, an out-of-court restructuring that improves a company's balance sheet and liquidity should improve company relationships with vendors, suppliers, customers, and other commercial counterparties and may lead to increased trade credit for the company.

An out-of-court refinancing or restructuring of a traditional credit agreement can be accomplished with a negotiated amendment of the credit agreement. The restructuring of a traditional credit agreement is not subject to securities laws, and credit agreement amendments and refinancings may be accomplished by private contracting among the parties. Maturity date extensions, the elimination or relaxation of restrictive covenants, provisions for additional borrowings, and other amendment terms can be achieved by reaching agreements with the requisite lenders whose consents to such amendments are required under prevailing credit agreement terms. An out-of-court restructuring of existing indebtedness may also involve agreements

and arrangements permitting additional new financings or equity infusions by existing stakeholders or third parties.

The restructuring of a company's obligations to holders of its public debt securities may be more complex. Public debt restructurings are generally subject to securities laws and their solicitation rules. Restructuring options available for public debt securities may include cash tender offers, exchange offers, individually negotiated purchases or exchanges, and cash redemptions.

An out-of-court restructuring avoids unnecessary bankruptcy risks to a business and its value. Bankruptcy may impair the value of secured lender collateral and result in uncertain, diminished returns for financial creditors. Bankruptcy risks include business interruption risks; loss of trade credit; negative effects on management, employees, and vendors; the significant costs and expense of chapter 11; bankruptcy litigation risks inherent in the chapter 11 process; and usually dismal outcomes for equityholders when their company ends up in bankruptcy.

Bankruptcy risks and outcomes (that may materialize if out-of-court negotiations fail) inform workout negotiations and drive parties to reach agreement on out-of-court restructuring terms. Although no bankruptcy case is involved in an out-of-court restructuring, bankruptcy risks and outcomes are considered in workout negotiations because bankruptcy outcomes are baseline alternatives.

Boards and senior management of financially distressed companies are well advised to pursue out-of-court solutions if their company has time and liquidity, and if its primary concerns are deleveraging the company's balance sheet and addressing upcoming debt maturities. An out-of-court deleveraging of the company is usually the best strategy when there is sufficient time for an out-of-court process and there is no need to restructure liabilities associated with commercial contracts, trade creditors, pending or threatened litigation, and other nonfinancial obligations.

## Need for Organized Creditors and Other Stakeholders

An out-of-court financial restructuring is difficult to accomplish if financial debt (which may consist of numerous competing classes or tranches of debt claims) is widely held by numerous unorganized holders. In order to reach a successful out-of-court restructuring, a financially troubled company must be able to negotiate with its financial creditors, and they should be represented by sophisticated counsel and financial advisors.

The presence of organized and well-represented financial debtholders permits negotiations and the making of proposals and counterproposals for restructuring terms and transactions that might ultimately be acceptable to financial creditors. While a company and its advisors must engage with its debtholders in a manner that does not run afoul of securities laws that prohibit paid solicitations of holders

of public equity and some debt securities, negotiations between a company and its financial debtholders are expected and necessary if an out-of-court restructuring is to be achieved.

Often, sophisticated holders of financial debt self-organize by forming ad hoc committees represented by their own counsel and financial advisors. If financial creditors remain unorganized, a company may need to hire professionals who can identify the holders of debt to be restructured.

If financial debtholders are not well represented, an out-of-court restructuring strategy may be fruitless. Organized creditors may demand—and a financially troubled company typically agrees to reimburse (pay)—professional fees incurred by ad hoc creditor committees in order to induce them to retain sophisticated legal and financial advisors and to engage with the company.

### Benefits of Out-of-Court Restructurings

Restructuring a company's debt through an out-of-court restructuring (instead of with a traditional chapter 11 bankruptcy process) has numerous benefits.

An out-of-court restructuring avoids bankruptcy consequences for all creditors and other stakeholders, including the Bankruptcy Code's section 362 automatic stay of payments to creditors, and possible material damage to a company's business operations and going concern value that might be caused by the "bankruptcy stigma" of a chapter 11 case.

An out-of-court restructuring avoids the high costs of traditional chapter 11 cases, including professional fees incurred by the company and creditor representatives, costs of bankruptcy-related litigation, distractions to management, the attendant costs of complying with bankruptcy reporting requirements, and judicial oversight. Chapter 11–related costs can be enormous, especially if the chapter 11 process is contentious and litigated.

Another fundamental benefit of an out-of-court restructuring is that its consensual nature reduces restructuring uncertainties and closing risks. Consensual restructuring terms that have been agreed to by creditors are highly likely to be accomplished on the agreed-upon terms. Differently, a traditional (i.e., non-prepackaged, non-prearranged) chapter 11 case poses outcome uncertainties because a chapter 11 case is inherently litigious. Bankruptcy is a forum for all creditors and parties in interest to contest and object to (and litigate) nearly all nonordinary course transactions and restructuring initiatives that a chapter 11 company might propose, including chapter 11 plan terms.

An out-of-court financial debt restructuring is typically limited to the restructuring or refinancing of certain specified debt facilities. Such a restructuring is beneficial because it does not generally implicate or impair a company's business operations and nonfinancial creditors. An announced out-of-court financial restructuring that

improves the company's balance sheet and liquidity should reduce anxiety among employees, suppliers, other trade creditors, and customers.

Shareholders have significant incentives to support a consensual out-of-court debt restructuring that avoids bankruptcy because equity interests are typically extinguished in bankruptcy. Shareholder stakes and other equity interests often survive a balance sheet debt restructuring, unless equityholders agree to terms that modify their rights or existing equity is diluted by new equity issued in an out-of-court exchange offer or similar transaction.

Out-of-court financial restructurings may give controlling shareholders significant input and opportunity to maintain their positions and current ownership structure. Controlling shareholders may influence or dictate the company's negotiations with its financial creditors. Controlling shareholders may have previously guaranteed debt being restructured, or they may be asked to provide new personal guarantees or additional equity contributions in order to convince financial creditors to support out-of-court restructuring terms.

In an out-of-court process, incumbent management continues to manage and control the company as well as the restructuring process, unless creditors demand new or replacement management as a condition of out-of-court debtholder concessions. It is not uncommon for creditors participating in an out-of-court restructuring to require appointment of a chief restructuring officer (CRO) acceptable to financial creditors. A CRO may give financial creditors greater assurance that company business operations and performance will improve and that financial creditors will have better access to information and management.

## Limits on Out-of-Court Restructurings

Out-of-court restructurings have limited utility if one or more dissenting minority holdout creditors will not agree to restructuring terms agreed to by the majority. Minority dissenters may withhold consents in an attempt to extract special value for themselves by having their debt holdings purchased at a premium price by other creditors (who want the out-of-court restructuring to go forward) or by retaining their existing repayment rights under their bonds or notes, thereby "free riding" on restructuring concessions agreed to by majority consenting creditors. Out-of-court exchange offers may be blocked by dissenting noteholders if an out-of-court exchange offer is conditioned on a high level of acceptances (i.e., acceptances by nearly all noteholders).

Out-of-court restructuring terms may help discourage dissenters, holdouts and free riders. Terms may include both "carrots" and "sticks." As carrots, exchange offer terms may encourage acceptances by offering new debt securities having a greater market value (than the securities to be tendered in the exchange), higher interest

rates and shorter maturity dates, improved security compared to original security rights, more restrictive covenants on the company issuer, and an increased equity position in the issuer. As sticks, restructuring terms may provide that nonexchanging dissenters retain debt securities that become junior or otherwise subordinate to the new securities issued to exchanging holders, or that exchanging holders will grant "exit consents" to indenture amendments that strip out borrower covenants and other debtholder-favorable indenture terms governing the securities that will be retained by dissenting, nonexchanging holders.

There may be circumstances other than the holdout problem that force a financially troubled company to look toward bankruptcy strategies. For instance, an out-of-court strategy will not suffice if the company lacks the liquidity and time needed to negotiate an out-of-court solution; if recalcitrant or opportunistic dissenting creditors want to force a company into bankruptcy; if the company's financial restructuring needs go beyond limited balance-sheet changes (e.g., there is a need to impair or extinguish junior creditor or equityholder rights); or if an insolvent company requires a broader operational restructuring, needs to sell assets, or requires bankruptcy court protection against pending or threatened litigation claims.

## WHEN A PREPACKAGED CHAPTER 11 CASE STRATEGY WORKS BEST

Bankruptcy is a judicial process intended to bind all creditors (including dissenters) to chapter 11 plan terms that meet Bankruptcy Code plan confirmation standards. Prepackaged bankruptcies are an effective strategy to bind minority dissenting and holdout creditors to financial restructuring terms that have strong majority creditor support.

In a prepackaged chapter 11 restructuring, a financially distressed company commences a chapter 11 case and simultaneously files a complete chapter 11 reorganization plan with terms that already have been accepted by the majority of its creditors whose rights would be adjusted by the chapter 11 plan. The terms of the contemplated restructuring are embodied in the prepackaged chapter 11 plan. The plan has been negotiated in detail and fully drafted before bankruptcy. Before the prepackaged chapter 11 case is commenced, the company solicits acceptances of the chapter 11 plan from the creditors whose rights will be adjusted by the plan. Usually, the company has all the necessary votes it needs to confirm its prepackaged plan before it commences its chapter 11 case.

Instead of unanimous or near 100 percent creditor agreements and consents required to effectuate a successful out-of-court restructuring, confirmation of a chapter 11 plan requires only majority creditor acceptances of the plan by each

voting creditor class (meaning acceptances by both a majority in number of claims voting and two-thirds in amount of claims voted in a class).

A prepackaged strategy works best when the debt being restructured does not include public debt securities. If public debt securities are involved, then the solicitation of acceptances must follow stringent securities laws solicitation rules.

A prepackaged plan may be confirmed in a short period of time over the dissents of holdout creditors. Typically, the bankruptcy court hearing to confirm a prepackaged plan will occur 30 to 60 days or less after the chapter 11 case is commenced.

If the company anticipates a holdout problem when it negotiates out-of-court restructuring terms, it may simultaneously pursue both out-of-court and prepackaged bankruptcy strategies: The company may combine a "backup" prepackaged chapter 11 plan with its primary out-of-court restructuring transaction documents. With a fully documented backup prepackaged chapter 11 plan included in its creditor solicitation materials, the company simultaneously solicits acceptances and consents to both its proposed out-of-court restructuring transaction and the prepackaged chapter 11 plan itself (which incorporates the essential terms of the company's out-of-court transaction proposal). If the company does not receive sufficient creditor acceptances to effectuate its financial restructuring outside of bankruptcy (due to minority dissenters and holdouts), the company can use majority acceptances of the prepackaged chapter 11 plan to effectuate the equivalent financial restructuring by commencing a chapter 11 case and seeking rapid confirmation of the prepackaged chapter 11 plan, which will be binding on all creditors, including dissenters.

With proper messaging to employees, customers, and trade creditors, a prepackaged chapter 11 case should pose few adverse business effects. The quickness of a prepackaged case provides certainty to all stakeholders that the chapter 11 restructuring will be accomplished promptly without unnecessary "bankruptcy stigma," business disruptions, or negative impacts on nonfinancial creditors. In a prepackaged case, the claims and rights of employees, customers, trade creditors, and other nonfinancial creditors usually "ride through" the bankruptcy unaffected. A prepackaged plan may provide for the cancellation and extinguishment of equity interests.

Not least important, a prepackaged chapter 11 strategy is much less expensive and litigious when compared to a traditional non-prepackaged chapter 11 case. If general unsecured creditors are left unimpaired by a prepackaged plan, appointment of an official creditors committee usually is not required.

## WHEN A PRENEGOTIATED BANKRUPTCY STRATEGY WORKS BEST

A prearranged or prenegotiated chapter 11 case seeks to effectuate restructuring terms and outcomes that have been negotiated and partially documented before commencement of a chapter 11 case. Unlike a prepackaged case, there is no prebankruptcy solicitation of votes on a plan before the prenegotiated case is commenced. The company's finalization of a chapter 11 plan, the bankruptcy court's approval of a disclosure statement, and the solicitation of votes of acceptance of the plan all take place during the chapter 11 case.

A fully documented chapter 11 plan usually does not exist when a prenegotiated case is commenced. However, a company may have "lockup" or restructuring support agreements (RSAs) from key stakeholders, including organized holders of financial debt. RSAs obligate parties to support and advance particular restructuring terms that will be incorporated in a contemplated chapter 11 plan.

Prenegotiated chapter 11 cases are often used when public debt is to be restructured and no securities law exemption applies to prebankruptcy solicitations of debt securityholders, when needed acceptances of a plan cannot be solicited prior to bankruptcy for other practical or legal reasons, or when the company has simply "run out of time" and liquidity needed to complete an out-of-court or prepackaged restructuring.

Prenegotiated chapter 11 restructurings are more time-consuming and riskier than prepackaged chapter 11 cases because (unlike prepackaged cases) votes of acceptance of the plan are not certain and the solicitation of plan acceptances may ultimately fail. In a prenegotiated case, the plan confirmation process takes more time because any solicitation of acceptances must await bankruptcy court approval of a disclosure statement. Litigation and objections asserted by dissenting parties in interest, including an official creditors committee, may lead to uncertain and unexpected results. However, confirmation of a prenegotiated plan may be accomplished in as little as 90 to 120 days if the proposed plan and disclosure statement are filed soon after the prenegotiated case is commenced.

A prenegotiated chapter 11 restructuring is well suited to effectuating significant strategic transactions with third parties that may be key elements of a company's restructuring strategy. For example, during the prebankruptcy period, an insolvent company may seek buyers for the sale of a significant asset (or substantially all of the company's assets) to be effected during bankruptcy pursuant to section 363 of the Bankruptcy Code. Such a value-maximizing sale requires the commencement of a chapter 11 case, which may be prenegotiated with the company's financial debtholders and include the terms of a liquidating chapter 11 plan.

# WHEN A TRADITIONAL CHAPTER 11 CASE MAY BE REQUIRED

## Traditional Chapter 11 Process

A traditional chapter 11 case results when an insolvent company has no out-of-court options for preserving its business and restructuring its financial affairs. Traditional chapter 11 cases are commenced without well-developed restructuring agreements with key creditors—other than agreements with senior secured lenders about debtor-in-possession financing that is needed to fund ongoing business operations and the costs of a lengthy bankruptcy process.

At the start of a traditional chapter 11 case, the company typically lacks a clear strategy or plan for emerging quickly from bankruptcy. Instead, the company is focused on stabilizing its business; reassuring its employees, suppliers, and customers; obtaining court approval of DIP financing; retaining professionals; and complying with DIP reporting obligations imposed by the Bankruptcy Court and applicable rules.

A traditional chapter 11 case may adversely impact a company's business and enterprise value. Bankruptcy distracts management from its ordinary course of business responsibilities. The company's employees, vendors, suppliers, customers, and commercial counterparties usually remain concerned about the company's bankruptcy, resulting in downward business results and diminished trade credit.

It takes months (and sometimes more than a year) for a chapter 11 company to develop, negotiate, and propose a chapter 11 plan to creditors and the bankruptcy court. Formulation and negotiation of a reorganization plan may require development of a new business plan with projections that withstand creditor scrutiny. An experienced, independent CRO may be needed to evaluate the business and develop a new business plan and give creditors confidence in management's projections. All this takes significant time before the company can propose and confirm a chapter 11 plan.

Bankruptcy-related litigation may delay progress in a traditional case because all parties in interest (including creditors large and small) and an official committee of unsecured creditors have standing to object to and contest (litigate) any of the chapter 11 company's restructuring initiatives and nonordinary course activities. The official committee will hire legal and financial advisors who will be paid by the company's bankruptcy estate to investigate the company, its management and board, and the events leading to the chapter 11 filing.

In short, the costs of a traditional chapter 11 case are very high, and it poses numerous risks for a company's business and stakeholders. Usually, there is no easy, expeditious path to confirming a chapter 11 plan.

Company-specific circumstances will always dictate whether a traditional chapter 11 case strategy is the best (or only) available restructuring strategy. The following sections discuss circumstances that frequently require commencement of a traditional chapter 11 case.

### Loss of Liquidity

Lack of liquidity is most often the precipitating cause of a traditional chapter 11 filing. When a company exhausts its liquidity and no lender is willing to advance additional funds outside bankruptcy, the company has little choice but to commence a chapter 11 case. Chapter 11 provides opportunity to obtain DIP financing from existing lenders or third parties. Lenders require a chapter 11 filing because bankruptcy court orders that approve DIP financing terms can give existing secured lenders "adequate protection" rights and give new DIP financing lenders super-priority liens and claims that are higher in priority than the repayment rights of other creditors.

### Sudden Catastrophic Developments

A company may be forced to file a traditional chapter 11 case following unpredictable catastrophic events that quickly eliminate the company's ability to continue doing business and borrow money in the ordinary course. The following are examples of catastrophic developments that force a company into an emergency chapter 11 filing: discovery or disclosures of fraud or criminal activity involving the company and its management; explosions, accidents, and other acts of nature that destroy critical production facilities; government-ordered recalls of company products or other sudden regulatory actions that preclude the company's ability to operate in the ordinary course; and sudden unexpected changes in market conditions.

### Need for Operational Restructuring

If fundamental business problems are the cause of a company's financial distress, a traditional chapter 11 case may be required to give management the time it needs to reorganize and right-size the business. It may take months to devise and initiate an operational restructuring that transforms or discontinues significant business operations. The company may need to use the Bankruptcy Code to reject or otherwise adjust burdensome agreements, such as contracts, real property leases, and collective bargaining agreements. Complex retail business may need chapter 11 protections to close and wind up unprofitable divisions and locations,

reject leases, and reduce footprint and workforce. Manufacturing businesses may need to undertake wholesale transformations requiring new resources and capital investments to return to profitability. Such operational restructurings give rise to significant liabilities and needs for new financial resources that can only be managed in a traditional chapter 11 case.

### Pending or Threatened Litigation

A traditional chapter 11 case is often necessary when a debtor confronts significant threatened or pending litigation that is expected to result in large or ongoing liabilities that the company cannot pay. Such litigation might be commercial in nature, arise as a result of mass torts, or be securities fraud class action litigation. Commencement of a chapter 11 case automatically stays such litigation, and the chapter 11 process may be the best venue for resolving such litigation in a cost-effective manner without unnecessary depletion of the company's limited financial resources.

Commencement of a traditional chapter 11 case also protects the company against continued litigation against its codefendants. If the company has indemnified its codefendants against significant liabilities, continued litigation against the company's codefendants may impose liabilities on the company. Although the automatic stay under section 362 of the Bankruptcy Code will automatically stop litigation against the filing chapter 11 debtor company, it does not automatically stay litigation against the debtor's principals, affiliates, or other third-party codefendants, and the litigation can move forward against the nondebtors notwithstanding the stay of litigation against the debtor company. This can be problematic for the chapter 11 debtor if litigation against the debtor's principals interferes with their efforts to reorganize the chapter 11 company or if the principals are entitled to indemnification from the debtor should a judgment be entered against them. Ongoing litigation against nondebtors may require substantial discovery from the debtor, including depositions of key employees and responses to large document requests. Even if the chapter 11 company is no longer a defendant, it may feel compelled to monitor and participate in litigation proceedings to ensure it will not be prejudiced by adverse judicial findings. For these reasons, a debtor company may commence bankruptcy and quickly ask the bankruptcy court to extend the section 362 automatic stay to nondebtor codefendants or enter a section 105 equitable injunction to stay litigation against codefendants until the chapter 11 company's reorganization is complete.

### Failure of Out-of-Court Negotiations

Sometimes, out-of-court restructuring negotiations fail simply due to good faith lack of consensus, and then the company has no alternative but to file a traditional

chapter 11 case when its liquidity is lost. However, out-of-court restructuring negotiations sometimes fail because opportunistic financial creditors want to gain control and equity ownership of the company through a chapter 11 process. Such creditors will force a traditional chapter 11 case by refusing to agree to out-of-court terms that would address the company's liquidity needs. When the company has to commence chapter 11 to obtain needed funding, such creditors use DIP financing terms to impose case milestones and other strictures that advance the creditors' objective of converting their financial debt claims into controlling shares of the company pursuant to a chapter 11 plan.

### Springing and Exploding Guarantees

The existence of springing guaranties executed by a company's principals can be a significant factor in determining whether an insolvent company will pursue an out-of-court restructuring or bankruptcy strategy. A springing guaranty is a guaranty—usually executed by the borrowing company's principals—that becomes effective upon the happening of a triggering event such as insolvency, bankruptcy, and other actions commonly referred to as "bad boy acts" (e.g., fraud, misallocation of funds, willful misconduct). The purpose of a springing guaranty is to render the borrowing company "bankruptcy remote," and these guaranties have become increasingly more commonplace in the area of real estate finance. Exploding guaranties are similar to springing guaranties, but the triggering event is usually tied to the borrower's bankruptcy proceeding. For example, a guarantor's liability may be triggered if the guarantor contests the lender's rights in bankruptcy, such as objecting to a lender's motion for relief from the automatic stay.

The existence of springing or exploding guarantees may be a circumstance favoring either an out-of-court restructuring or a chapter 11 case. By commencing a chapter 11 case, a company may be able to influence those who are subject to guarantees to make significant financial contributions to fund a chapter 11 plan.

## CONCLUSION

Practical and legal constraints and strategic considerations influence (and sometimes dictate) whether a financially distressed company has sufficient opportunity and time to achieve a successful out-of-court restructuring or, alternatively, whether it must proceed with a prepackaged, prenegotiated, or traditional "free-fall" chapter 11 bankruptcy case. Generally, an out-of-court restructuring is preferable to chapter 11 and should be elected if it can accomplish the desired outcome.

A company's liquidity situation often dictates whether it has time to propose, negotiate, and accomplish an out-of-court restructuring. Absent sufficient liquidity and time, a company and its decision makers may have little choice but to commence a traditional in-court chapter 11 process without any agreements or plan for emerging from chapter 11. Likewise, a chapter 11 filing may be the only viable strategy when dissenting or opportunistic creditors, the terms of existing indentures and credit agreements, or applicable securities laws, rules and regulations are obstacles to an out-of-court solution.

If circumstances dictate that a chapter 11 restructuring is inevitable, a well-conceived prepackaged or prenegotiated case strategy will be more cost effective and provide greater certainty of outcome for a company and its stakeholders than will a traditional chapter 11 process. However, if a broad operational restructuring is required, or the company needs immediate borrowings that are unavailable outside chapter 11, or other complex or emergency issues require immediate judicial relief, then a traditional chapter 11 case may be the best available strategic alternative.