Creditor Compositions: Overview

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A Practice Note providing an overview of creditor compositions. This Note addresses the process for conducting creditor compositions, including considerations when negotiating with creditors, preparing for creditor meetings, and reaching a creditor consensus.

Due to the costs, time, and uncertainty that a bankruptcy proceeding necessitates, professionals dealing with a financially distressed business often consider alternative schemes that can accomplish some of the same outcomes as in a bankruptcy proceeding, but in a simpler and more efficient manner. One of these alternatives is the creditor composition.

A composition is a contractual settlement between a debtor and its creditors that allows a business to restructure its debt obligations and continue as a going concern.

This Note addresses the process for conducting creditor compositions, including considerations when negotiating with creditors, preparing for creditor meetings, and reaching a creditor consensus.

For information on other non-bankruptcy alternatives, see Practice Note, Non-Bankruptcy Alternatives to Chapter 11 Restructurings and Asset Sales (W-006-9306).

WHAT IS A COMPOSITION?

A creditor composition agreement is a non-statutory, out-of-court arrangement in which a debtor negotiates and enters into a settlement of its unsecured liabilities with its vendors, landlords, and other large creditors to provide debt relief and a restructuring. As compared to an in-court proceeding, a composition agreement is much less costly. However, a composition agreement can be challenging because it requires the consent of substantially all major creditors.

TYPES OF DEBTOR USING COMPOSITIONS

Because a composition is contractual and voluntary on the part of creditors, it can be used by almost any corporate organization. Compositions are most useful when:

- The debtor has a relatively limited and known set of creditors with an interest in the debtor's ongoing survival.
- There is good relationship and high degree of trust between the debtor and the creditors and among the creditors.
- Individual creditors have not advanced any collection efforts that give any one creditor a substantial advantage over other creditors.

For these reasons, it is often helpful for creditors to form a committee, with several creditors serving as representatives.

In the right circumstances, a composition can be significantly faster and far less expensive than even a pre-packaged bankruptcy. Because a composition is entirely private, the risk of business disruption is also much lower from adverse publicity and market speculation.

Conversely, compositions are difficult when creditors have little stake in the ongoing business prospects of the debtor, such as secondary market claims buyers. A debtor considering a composition must begin the process well before collection efforts advance too far and debt changes hands.

NEGOTIATING WITH CREDITORS

A successful creditor composition enables a debtor to restructure its debt obligations by:

- Compromising or reducing creditor claims.
- Adjusting payment terms over a set amount of time.

To achieve a compromise, a debtor and its advisors must be skilled in negotiating and proficient in oral communication. Regardless, negotiating with creditors and gaining their acceptance of a compromise may be challenging because:

- Numerous one-off negotiations typically occur, which can be substantially time-consuming.

- Certain creditors, particularly those holding larger claims, hold greater leverage and may ask for:
  - their own terms and unique arrangements; and
  - different treatment than other creditors.

While creditors may promise to keep an individual deal confidential from other creditors, that rarely occurs. Therefore, it is crucial that the debtor treat all creditors equally, without exception, when negotiating the composition agreement. If one creditor receives special treatment, it may result in additional creditors seeking the same treatment, which can make it impossible to achieve global consent.

SELECTING A DEBTOR REPRESENTATIVE

Determining which of the debtor's representatives should conduct the creditor negotiations and represent the company is an essential consideration for a successful composition. The debtor must consider whether its senior executives are best suited to answer questions posed by creditors. It is often preferable that creditors communicate directly with the debtor's counsel, financial advisor, or chief restructuring officer to navigate the process. However, the debtor should:

- Ensure that one of its senior executives, for example a chief executive officer, chief financial offer, or chief operational officer:
  - attend any meetings with creditors, either in person or in a video conference (based on the latest health authority recommendations due to the 2019 novel coronavirus disease (COVID-19) pandemic); and
  - participate on calls during the compromise process.
- Select one senior executive or manager, to respond to individual creditor inquiries before and after creditor meetings and conference calls. Incoming questions should not be answered on an ad hoc basis by the debtor's employees, other than the designated employee assigned to this task. This enables control over the debtor-creditor dialogue and avoids conflicting or inconsistent messages. In responding to creditors, the lead employee should have a prepared list of frequently asked question and follow a script of answers that has been vetted by counsel.

MAXIMIZING CREDITOR CONSENSUS

A debtor's 20 largest unsecured creditors often hold approximately 80 percent of the debtor's unsecured trade debt. In that case, it may be cost efficient for the debtor to seek compromises only from its largest creditors. To accomplish this, the debtor should determine the dollar threshold for compromising creditor claims. Creditor claims falling below the dollar threshold can be part of an administrative convenience class of claims, which are paid in full at a slower rate.

SHARING FINANCIAL INFORMATION

Before providing information to creditors regarding the debtor's financial affairs, the debtor and its advisors should require that each creditor execute a confidentiality agreement or nondisclosure agreement (NDA). NDAs should be short, in plain English, and reviewed by counsel.

However, even when sharing financial information subject to an NDA, there is a risk that the information may be misinterpreted by the creditor or leaked to other parties not subject to the NDA. This may result in:

- Damaged relationships with customers and vendors.
- Competitors using sensitive information to take advantage of the debtor's financial situation for their own benefit.

Therefore, the debtor should ensure that:

- Financial information in written materials does not contain any excessive detail. For example, a debtor should present its balance sheet and income statement in a summary fashion, without a detailed breakdown or supporting schedules for each line item.
- Highly confidential information is only shared by telephonic, video, or in-person meetings if circumstances permit.

PREPARING FOR THE CREDITOR MEETING

Before the initial meeting with creditors, the debtor's senior management representative should reach out to each of the invited creditors and have a pre-meeting call to:

- **Provide a preview of the presentation.** The debtor may provide the creditor with a brief overview of its financial situation, which typically entails an explanation of strong business operations and recent cash flow problems. When providing this preview, the debtor should:
  - explain that it does not have the financial capability to pay all creditors in-full and on current payment terms; and
  - avoid discussing the debtor's liquidation analysis or recoveries under alternative restructuring scenarios. If the creditor inquires whether the debtor intends to seek a discount on the creditor's claim or alternative payment terms, the debtor may respond that it is seeking to avoid that scenario but is evaluating all options that are to be discussed at the meeting.
- **Assess the creditor's view regarding the proposed creditor compromise**. The debtor should explain that the purpose of the upcoming meeting is to reach consensus on a compromise that is fair to all creditors and garner the creditor's support in the pre-meeting call.

By individually approaching each creditor in advance of the larger meeting, the debtor may get an understanding of the creditor's sentiment and whether the creditor:

- Is hostile or supportive of the debtor's efforts
- Has specific concerns regarding a compromise.
- Intends to recommend the compromise to other creditors.

Understanding a creditor's position and questions in advance of the larger meeting enables the debtor to properly prepare for the meeting, anticipate the creditors' questions, and possibly avoid unforeseen issues during the meeting.

The debtor should also learn which of the creditor's representatives is attending the meeting because that may impact the creditor's position. If the creditor representative is:

- A salesperson, the creditor may be concerned that any reduction in the creditor's claim may directly impact its commission.
- A credit manager, the debtor's situation may be causing the creditor manager internal embarrassment.

After the debtor completes its pre-meeting conversations, the debtor should ensure that at least one creditor is present at the meeting to outwardly support the composition proposal. That creditor can influence other creditors at the meeting, both in the presence of the debtor and at the conclusion of the meeting when creditors talk among themselves.

MEETING LOGISTICS

The debtor must consider the format and logistics for conducting the meeting with its largest unsecured creditors. A debtor's options typically include holding the meeting:

- At its advisor's office.
- At its own office.
- By conference call.
- By video conference.
- In a hotel conference room near an airport or a convenient location for creditors traveling to the meeting.

A debtor's determination of the meeting format and location ultimately depends on:

- The geographic location of the largest unsecured creditors.
- The creditors' willingness to travel, which is often dependent on the size of the creditors' claims.

The COVID-19 pandemic has substantially impacted the ability of parties to travel and appear in-person due to shelter-in-place orders or other mandated restrictions. Therefore, until the COVID-19 pandemic subsides, debtors must adjust accordingly and conduct all creditor meetings by telephone or video conference.

IN-PERSON MEETINGS

If geography permits or creditors are willing to travel, in-person meetings (or video conferencing during the COVID-19 pandemic) are an optimal means of presenting the composition settlement. In-person meetings provide creditors with an opportunity to meet each other, compare notes, and determine a strategy of cooperation. However, in-person meetings also enable a hostile creditor to spread misinformation or negative sentiments to discourage a successful composition. The debtor must, therefore, weigh these possibilities when assessing whether to gather its largest creditors and their representatives for an in-person meeting.

When determining the venue for an in-person meeting, debtors should consider:

- Whether holding the meeting at the debtor's place of business would raise unnecessary questions or concerns for the debtor's employees, triggering an unnecessary and possibly damaging morale.
- Whether conducting the meeting at the debtor's advisor's office may:
  - intimidate creditors; or
  - cause creditors to bring their own attorneys to the meeting, who often alter the dynamic and control the negotiations.

TELEPHONIC MEETINGS

Conducting the creditor meeting by conference call is viable option when:

- In-person meetings are not feasible (for example, during the COVID-19 pandemic)
- A debtor prefers that creditors do not meet each other to avoid negatively influencing support of the composition.

Except for the presenter, the debtor should conduct the meeting with all parties placed in a listen-only mode. Creditors should be invited to email or text their questions to the presentation leader. This avoids interruptions and allows the debtor to prevent a disgruntled creditor from interrupting the presentation with a question that seeks to derail the debtor's efforts to create consensus.

MEETING SETUP

In preparing for the meeting, whether it is held in-person or telephonically, the debtor should be mindful to:

- Create a meeting environment that facilitates listening and conversation.
- Deliver the presentation by PowerPoint or similar program rather than distributing written presentation materials at the meeting or by electronic means. This avoids the risk that any printouts or handouts may find their way into the public domain, including the hands of competitors.
- Set a clear agenda, which begins with delivering the presentation uninterrupted, followed by a brief amount of time for questions.

INVOLVEMENT OF CREDITORS' COUNSEL

Creditors often engage counsel to represent their interests in negotiating the composition. If a creditor's counsel reaches out to the debtor in advance of the meeting, the debtor should take note whether counsel is friendly or hostile. Counsel and its client may not always share the same position. A creditor may be concerned about retaining future business and not alienating the debtor from issuing future purchase orders. Counsel, however, may be interested in being retained by other creditors to represent their collective interest, taking a more aggressive approach to attract a new engagement. A debtor should not hesitate to ask a creditor if its counsel's aggressive posture is reflective of its relationship with the debtor.

It is not uncommon for a creditor's attorneys to appear at the creditors meeting, either in-person or telephonically, to aggressively advocate for the creditor or position itself to be selected as counsel to an unofficial or ad hoc creditors' committee. If this occurs at the meeting, it is advisable for the debtor:

- To maintain composure and avoid appearing visibly disturbed.
- To continue with the presentation and defer any questions to a later point in the meeting.

Approaching an aggressive counsel in this manner may yield positive results from the meeting and move the parties further along the path of reaching a creditor compromise agreement.

When a creditor's counsel is friendly, a debtor may strategically prepare counsel on the upcoming creditors' meeting and garner its support for the composition. This may influence other creditors to support the proposed settlement at the meeting.

PRESENTATION TO CREDITORS

The debtor's presentation to creditors should include a liquidation analysis that:

- Demonstrates payment amounts to unsecured creditors under the debtor's proposed composition.
- Estimates the hypothetical recoveries that unsecured creditors may receive, after payment of secured creditor and other administrative claims:
  - from liquidation of the debtor's assets outside of a bankruptcy case;
  - under a Chapter 11 restructuring;
  - from a section 363 sale; or
  - under a Chapter 7 liquidation.

The presentation should also contain summary level cash flow and income projections that assume acceptance and implementing of the composition. The goal is to demonstrate that the unsecured creditors can:

- Realize a greater recovery from an out-of-court composition agreement as compared to a liquidation of the debtor's assets.
- Recover any short-term losses by continuing to do business with a going concern debtor.

If a debtor's cash flow permits, a successful composition is often achievable if the debtor proposes to pay creditors in full, over an extended period of time, without interest. The length of any proposed amortization schedule is also key for creditor support. For example, a balloon payment, or lump sum payment, made for the entirety of the outstanding loan before the maturity date may be a possible proposal, if feasible for the debtor. Creditors that are interested in a long-term business relationship with the debtor and engaging in new business may be more likely to forgive the balance at the end of the amortization period.

THE COMPOSITION AGREEMENT

The centerpiece of the composition transaction is the composition agreement itself, which the debtor provides to the creditors following the meeting and presentation. The hallmark of a composition agreement is its flexibility, so the structure of each agreement varies.

For example, a relatively simple composition agreement may contain some or all of the following provisions:

- An acknowledgement of the claims of the consenting creditors and a representation regarding the amount of all other claims.
- An extension of the payment due dates or the creation of a specific payment schedule.
- A minimum acceptance threshold for the percentage of creditors or claims signing the agreement as a condition to effectiveness.
- An initial cash payment by the debtor and an escrow agent to receive and distribute future payments.
- A provision for dealing with treatment of disputed claims or claim amounts with a reserve for distributions until the disputes are resolved (the provision may provide for mandatory mediation or arbitration).
- A "standstill" whereby creditors agree not to pursue their claims, including filing any collection actions or a bankruptcy proceeding if the debtor is performing under the composition agreement.
- Covenants relating to the operation of the business, including restrictions on non-ordinary asset sales or acquisitions, incurrence of debt, and financial reporting.
- Default provisions that include the right of creditors to have their full claim reinstated in the case of certain specified defaults.

If a creditor representative or committee has been formed, then that entity, together with the debtor, can help solicit consents to the composition and explain to creditors the benefits of pursuing a consensual composition rather than a bankruptcy proceeding, including:

- Avoiding the dissolution of the debtor.
- Continuation of the business.
- Potentially higher recoveries to creditors.

Because the composition agreement cannot bind non-consenting creditors, the composition must be agreed to with a high threshold of creditor support, either in number or dollar amount. Those creditors that do not participate continue to retain their full claims, creating financial risk for both the debtor and the consenting creditors.

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