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What Does Chapter 11 Really Cost?

BY KENNETH A. ROSEN

In the world of bankruptcy, where working capital is in short supply, litigation can materially decrease the likelihood of a successful reorganization. But, litigation is just one of Chapter 11's costs that must be considered when comparing an out-of-court restructuring with commencing a Chapter 11 case or when considering litigation versus settlement.

The other costs for debtors? Their own legal and financial advisor fees. Fees for turnaround consultants (increasingly common). Fees for attorneys and financial advisors retained by creditors' committees and the professionals of secured lenders. And, if there is an indenture trustee, payment of the trustee's fees also may be required. Finally, there are fees payable to the United States Trustee (part of the Department of Justice), which oversees the administration of bankruptcy cases.

Fees for retained professionals have administrative status, meaning they get paid ''off the top'' after satisfying the claims of secured creditors, but generally ahead of claims of pre-bankruptcy creditors. Money spent on professional fees reduces the pot of money otherwise available for unsecured creditors. Professional fees are justified if their benefits (increasing asset values, increasing the dividend for unsecured creditors, resolving disputes, reducing claims, etc.) outweigh the costs.

It has been estimated that the direct costs of bankruptcy in Chapter 11 are about 1-2 percent the value of a debtor's assets in larger cases and 4-5 percent in smaller cases. Selecting professionals based upon hourly rates is not an answer because less seasoned professionals may not be as efficient or skilled.

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Debtors request relief by application or court motion, a process that is relatively more expensive for smaller debtors. Debtors must also pay the professionals from the creditors' committee and bank's professionals who review the application or motion. Consequently, a debtor can pay more to obtain the relief than the relief is actually worth in smaller cases. The length and detail of a motion or application in a small or middle-market case should be ''sized'' to the amount of the debtor's assets and liabilities. And, counsel should aggregate motions and applications to minimize court appearances.

The concept of ''debtor-in-possession'' is that the debtor serves as its own trustee. Management continues to operate the business, subject to the Bankruptcy Code's requirements for Court approval. Some examples of actions requiring approval: rejecting leases, terminating a collective bargaining agreement, authorization to obtain financing, sales of assets outside the ordinary course of business, approval of settlements and compromises of contested or litigated matters and approval of the plan of reorganization.

Dealing with issues that come up each day in a bankruptcy case can be time consuming for management and can detract from management's focus on operations and rebuilding the business. Assume that management's hourly rate is the same as senior bankruptcy professionals. And, assume that one-half of management's time is spent on the bankruptcy case for the first several months after the petition date. This indirect cost may not be invoiced to the debtor, like accounting or legal fees, but it nevertheless must be considered in evaluating the cost of Chapter 11.

Once the Chapter 11 case begins, disputes, contested matters and adversary proceedings will arise. Some of the best advice that I received is that, in bankruptcy, the debtor should aim for what is reasonably acceptable, even though it may be painful, and then move on with the reorganization. Time and litigation cost money. Management should not get caught in the weeds of a case. Keep focused on the long-term goal of emergence from Chapter 11. Settlement may be painful; but, does it avoid more professional fees and enable you to move forward?

Inquire as to tax benefits — especially in real estate cases. If a taxing authority is effectively subsidizing a

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sale or a settlement, the less-than-stellar price obtained may be more tolerable.

In Chapter 11, cash is king and life is all about liquidity and redeployment of assets. Debtors are expected to dispose of assets not necessary to an effective reorganization. Being too wed to an asset at the expense of having the liquidity to reinvest or pay down excessive debt is short-sighted.

Defaulting on debt and filing a Chapter 11 petition hurts the value of a debtor's business. The mentality of buyers of a bankruptcy estate's assets is to base the purchase price offered on cost or liquidation value; not, based on a multiple of earnings. Going concern value evaporates. The value of intellectual property likely will be a fraction of the cost of its development. Before plunging in to Chapter 11, recognize the value erosion — while in Chapter 11, recognize the monetary benefit of promptly emerging from Chapter 11.

Scholars have estimated that the cost of defaulting on debt ranges from 10-45 percent of a debtor's value. Default costs vary by industry, the nature of a debtor's assets, the marketability of assets and degree of leverage, among other things. Value depreciation is key in evaluating the benefits of Chapter 11, refinancing, additional financing and out-of-court settlement. It has been estimated that indirect costs (lost sales due to the firm's uncertainty and its financial distress) can add up to 10-15 percent of the firm's value

For some businesses, Chapter 11 might not have a big effect on customers. For a retailer, the consumer may only care that the product that it wants is available at the right price when the consumer wants it. However, consumers may not be willing to buy products that could require future service, such as big-ticket items. If the debtor manufactures a product that requires a long lead time from date of order to date of delivery, customers often line up a secondary source of supply. Retailers prepare promotions and source goods several months in advance. It is not unusual for the buyer at a retailer to be concerned about a supplier's financial health and not want to risk embarrassment before his/her superior if the vendor fails to deliver. Think of Wal-Mart working on Christmas promotions months in advance not wanting to risk promoting a product that it is out of stock when the promotion hits. Also, think about the willingness of a customer to give a deposit to a Chapter 11 debtor for goods to be custom produced. I often hear from a debtor that a particular retail buyer is a close friend and never would take away the debtor's business. My response is ''Who is more important to the buyer? Your friendship or his job?''

Managers of a debtor company should realize they're in for a loss of control. Certain actions require court approval and the creditors committee is entitled to examine a debtor's finances and object to relief sought by the debtor — as can the bank. Financial and operational reporting is required by the creditor constituencies. Operation in Chapter 11 is supposed to be transparent – which restricts management's ease of movement.

On the other hand, Chapter 11 can create value that would not otherwise exist. Real estate leases that contain ''ipso facto'' clauses, which say that bankruptcy is a default, are unenforceable in bankruptcy. Also, companies can assign leases once they're in bankruptcy, overriding lease provisions. The value of the lease is the differential between the stated rent and the market rent for the remainder of the lease.

Chapter 11 also can create value because of the bankruptcy court's ability to enable assets to be conveyed ''free and clear'' – without liabilities attached to assets and with the debtor's liabilities attached to sale proceeds. The buyer receives the benefit of a court order decreeing assets to be free and clear at closing – which is even better than title insurance. Purchasers recognize the value of being able to convey assets pursuant to Section 363. They also recognize the value of the court's ability to set procedures that enable sales to close relatively quickly – certainly faster than would occur outside of bankruptcy.

Deleveraging the balance sheet is, perhaps, the greatest benefit of Chapter 11. But, the restructuring terms often are that debt holders exchange debt for equity in the reorganized company — which translates to loss of control and loss of ''upside'' from a successful turnaround. In Chapter 11, the Bankruptcy Code requires that creditors must receive at least what they would receive in liquidation under Chapter 11. This may be difficult for the debtor to achieve without secured lender(s) consent. And, if it only is achievable over time, the lenders may prefer liquidation over reorganization — which eliminates opportunities for value appreciation, growth, etc.

Chapter 11 (if possible) should never be a freefall case. A detailed case strategy should be determined pre-filing. What assets should be sold and when? What leases and contracts should be rejected and when? A strong business plan should be developed. Financing requirements for operation in bankruptcy and for exiting bankruptcy should be developed ahead of time.

Chapters 11s, unlike wine, do not get better with age. The best cases move quickly from deal to deal and settlement to settlement – always with an eye on the ultimate goal (emergence from Chapter 11), saving fees, tax benefits, benefits of cash now versus later, quickly rebuilding customer relationships and getting back in complete control.

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