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The economics of prepackaged bankruptcy

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INTRODUCTION

A new kind of bankruptcy has emerged in the last few years. It can be thought of as a "hybrid" form—one that attempts to combine the advantages (and exclude the disadvantages) of the two customary methods of reorganizing troubled companies: workouts and bankruptcy.

In a workout, a debtor that has already violated its debt covenants (or is about to do so) negotiates a relaxation or restructuring of those covenants with its creditors. In many cases, the restructuring includes an exchange of old debt securities for a package of new claims that can include debt, equity, or cash. Informal reorganizations take place outside the court system, but typically involve corporate officers, lenders, lawyers, and investment bankers. And though such negotiations are often contentious and protracted, informal workouts are widely held to be less damaging, less expensive, and, perhaps, less stressful than reorganizations under Chapter 11.[1]

Recently, however, a number of firms that have had most or all of the ingredients in place for a successful workout outside the courtroom have filed for bankruptcy anyway. In such cases, the distressed firms file a plan of reorganization along with their filing for bankruptcy. And largely because most creditors have agreed to the terms of the reorganization plan prior to the Chapter 11 filing, the time (and presumably the money) actually spent in Chapter 11 has been significantly reduced.[2]

Kroy, Inc., an Arizona-based maker of low-tech office labeling equipment, is a good example. After undergoing a leveraged buyout in 1986, the company suffered a slump in sales and profit margins that left it unable to meet its debt obligations. The company's primary lenders were the Minneapolis First Bank and Quest Equities Corporation. Both were receptive to a pre-negotiated bankruptcy reorganization. With a pre-negotiated plan in place, the company filed its plan of reorganization along with its bankruptcy petition on May 15, 1990. The company emerged from bankruptcy proceedings 89 days later. Such an untraditional reorganization has been dubbed "prepackaged bankruptcy."[3]

The appearance of this new mechanism for corporate reorganization gives rise to a number of questions: How are they structured? Are they motivated by real economic gains and, if so, what are the sources of such gain? What are the particular circumstances in which a prepackaged bankruptcy is more sensible than an informal reorganization outside the courts? What does the future hold for prepackaged bankruptcy reorganizations?

In this article, we explore prepackaged bankruptcies and arrive at the following conclusions:

- A prepackaged bankruptcy should be viewed as an administrative extension of an informal reorganization. It is not likely to be useful in resolving complex, litigious disputes among hundreds of creditor groups with sharply divergent interests—the kind we often see in a traditional, highly contentious Chapter 11 reorganization. (For example, cases involving extensive claims held by trade creditors are not likely to lend themselves to this new method).

[1] Arguments along these lines have been made by Haugen, Robert, and Lemma Senbet. 1978. "The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure." *Journal of Finance* 33, 383-93 and Jensen, Michael C. 1989. "Active Investors, LBOs and the Privatization of Bankruptcy." *Journal of Applied Corporate Finance* 2, 35-44. Gilson, Stuart C., Kose John, and Larry H.P. Lang. 1990. "Troubled Debt Restructurings: An Empirical Study of Private Reorganizations of Firms in Default." *Journal of Financial Economics* 27, 315-53, provide evidence that stockholders are better off when debt is restructured privately.

[2] Section 1126 of the bankruptcy code allows a debtor to negotiate with its creditors for a restructuring of its debt obligations before filing for Chapter 11 protection.

[3] Strategic aspects of prepackaged bankruptcy are discussed by Salerno, Thomas J., and Craig D. Hansen. 1991. "A Prepackaged Bankruptcy Strategy." *The Journal of Business Strategy*, 36-41.

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- The benefits of a prepackaged bankruptcy are essentially these:
  1. Prepackaged bankruptcies can alleviate problems with creditor holdouts who interfere with informal reorganizations.
  2. A prepackaged bankruptcy can preserve the integrity of creditor claims that could be invalidated (in large part because of the recent Lifland ruling in the LTV case) following an informal reorganization in which not all creditors participate.
  3. In some cases, tax benefits can be secured under a prepackaged plan that are not available under an informal reorganization.

AN EXAMPLE

The first major corporation to undergo a prepackaged bankruptcy reorganization was Crystal Oil Company, an independent crude oil and natural gas exploration and production company headquartered in Louisiana. The company filed for bankruptcy on October 1, 1986 and emerged less than three months later, its capital structure completely reorganized. The total indebtedness of the firm was reduced from $277 million to $129 million. In exchange for giving up their debt claims, debtholders received a combination of common stock, convertible notes, convertible preferred stock, and warrants to purchase common stock. Little time was spent in Chapter 11 because most major creditors had already agreed to the plan of reorganization.

The original reorganization proposal had been presented to creditors three months before the Chapter 11 filing. It was accepted by all classes of public debtholders. Within each class, more than half of the debtholders, representing more than two thirds in value of the outstanding debt, accepted the proposal. The initial plan was not accepted, however, by Crystal Oil's most senior creditors: Bankers Trust and Halliburton Company. Both of these creditors' claims were securitized by a lien on the company's oil and gas properties. Bankers Trust accepted a revised plan, but Halliburton never gave in.[4] Eventually, the bankruptcy court "crammed down" the revised plan on Halliburton.

Since its reorganization, Crystal Oil has returned to profitability and it has been able to further reduce its debt burden and continue its operations on a smaller scale.

THE BENEFITS OF PREPACKAGING

Solving the holdout problem

Why does a firm that has most of the ingredients in place for a successful informal reorganization file under Chapter 11? First, it should be recognized that Chapter 11 is an administrative procedure designed to facilitate the successful reorganization of temporarily distressed, but otherwise economically viable, businesses. As such, the code provides certain advantages to the distressed firm that are not available under an informal reorganization.

Perhaps chief among these advantages is the smaller fraction of creditors required to approve the reorganization plan. Under most bond indenture agreements, a significant majority of the holders— typically 90% or more—must approve any change in the terms of the agreement in order for the change to become effective. This means, for example, that if one investor owns 11% of a bond issue, that investor can effectively block any relaxation of the terms of the agreement.

Alternatively, the firm can propose an exchange of some of its old debt obligations for new debt or a combination of new debt and other securities. The problem with such an exchange offer is that it may strengthen the position of bondholders that do not participate relative to those who do participate. This leads to the well known "holdout" problem. In brief, each individual bondholder has an incentive to reject any restructuring of his claim even though the restructuring collectively benefits all bondholders.

The same phenomenon is at work among other creditors who own an entire loan rather than a fraction of a single bond issue. Suppose that a firm has loans with four different banks, all of which have claims of equal priority, and that three of the four banks agree to a restructuring of their loans that reduces the principal owed by 25%. If the fourth bank does not agree to the plan, its claim to the assets of the firm remains intact and that lender gains at the expense of the other banks. Thus, each bank has the incentive to hold out, even if the reorganization would benefit all banks acting in unison.

This holdout problem can be mitigated by choosing a prepackaged Chapter 11 filing. Under Chapter 11, a plan of reorganization can become effective if it is approved by 50% of the creditors by number in each class and two thirds by dollar amount. Thus, a plan of reorganization can be forced upon a set of recalcitrant creditors who could have effectively blocked an informal reorganization.

For example, Republic Health Corp. filed a prepackaged reorganization plan under Chapter 11 on December 15, 1989 after the firm had been unable to persuade a sufficient fraction of its debtholders to reorganize out of court. The prepackaged plan was approved by 86% of Republic Health's debtholders. The firm entered bankruptcy with total debt of $645 million and came out of Chapter 11 on May 1, 1990 with this amount pared to $379 million.

Similar circumstances prevailed in the case of JPS Textile Group. JPS was formed in November 1988 when a group of investors led by Odyssey Partners acquired the assets of J. P. Stevens and Co., a leading textile maker, in a leveraged transaction arranged by Drexel Burnham. In mid-1990 it became apparent that JPS could not meet the interest payments on the $579 million of debt outstanding. Management attempted to reduce the company's debt burden through a voluntary exchange offer in which equity and low coupon debt would be exchanged for the then outstanding high yield bonds. The offer was conditional on 95% of the bondholders agreeing to changes in certain debt covenants. After sweetening and extending the offer seven times, management withdrew the offer

[4] The revised plan did not alter the exchange offer to the public debtholders. It simply altered the distribution of cash flows allocated to service the private debtholders.

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because an insufficient number of bondholders had tendered their securities.

JPS continued to negotiate with bondholders and, in February 1991, the company filed a prepackaged plan of bankruptcy reorganization. Prior to the filing, the company announced that nearly all creditors had approved the plan. News accounts indicate that the bankruptcy petition was filed to ensure that all creditors participated in the reorganization.

Preserving the integrity of creditors' claims

In much the same fashion as it resolves holdout complications, a prepackaged Chapter 11 reorganization can be used to preserve the integrity of creditors' claims that might be diluted in an informal reorganization. Assume, as often happens in an informal reorganization, a subset of creditors agrees to reduce the principal amount due under their loan agreements, but not all creditors participate. In such a case, those creditors who participate have reduced their claim to the firm's assets.

This problem has become more troublesome as a result of a January 1990 court ruling in the LTV bankruptcy case. Prior to filing for bankruptcy in 1986, LTV had negotiated a swap with some of its creditors. In the swap, bondholders received bonds with market value substantially below face value. The courts ruled that the bondholders who participated in the swap could value the bonds for purposes of a bankruptcy claim only at their discounted value, not their face value. Had LTV undergone a prepackaged bankruptcy in 1986 instead of an informal reorganization, and had all creditors been forced to participate on a *pro rata* basis, the relative market value of each claimant would have been preserved.

The LTV ruling is likely to cause more debtholders to hold out in informal reorganizations because, if they participate, their claim in any further bankruptcy proceedings will be substantially diluted.

Thus, to the extent the holdout problem is exacerbated by this ruling, prepackaged bankruptcies are likely to become an even more attractive tool for corporations considering informal reorganization.

Tax benefits

Taxes can also play a role in encouraging firms that would otherwise have undergone an informal workout to file a prepackaged Chapter 11 reorganization. Two aspects of the tax law require particular attention.[5]

First, net operating losses are treated differently in bankruptcy than in a workout. In an informal reorganization, if debtholders exchange their debt for equity claims such that the old equityholders hold less than 50% of their original ownership, the company forfeits its net operating losses. For companies that have accumulated losses over a large number of years, the loss of these carryforwards can have a significant effect on future cash flows of the firm. In bankruptcy, by contrast, firms do not lose their carryforwards and thus could conceivably file for bankruptcy simply to keep the net operating losses intact.[6]

On the other hand, carryforwards are not lost in an informal workout if the firm is deemed by the courts to be "insolvent." A firm is considered legally insolvent if the market value of its assets is less than the face value of its liabilities.

The second aspect of the tax law favoring use of Chapter 11 is the treatment of cancellation of indebtedness (COD). For example, in an informal workout, if debt with a face value of $1000 is exchanged for debt with a value of $500, the reduction of $500 in the firm's debt is considered to be income for tax purposes. If, however, a similar exchange is executed through a formal bankruptcy filing, it does not lead to an income tax liability.[7] Thus, the elimination of COD income taxes that occurs in Chapter 11 appears to provide a powerful incentive for firms to file for Chapter 11 after a reorganization plan has already been approved by creditors.

By eliminating some of the ambiguity surrounding the exact method of computing COD income, recent tax changes have made prepackaged filings even more compelling. Prior to the 1990 Tax Act, COD income was determined as the difference between the face value of the old and the new debt. Before the 1990 Tax Act, companies could exchange $1000 face value debt with an interest rate of 5% for $1000 face value debt with an interest rate of 15% without creating COD income. The 1990 Tax Act provided that the market value of the new debt should be used in this computation. Thus, if the new debt is valued at $700, the firm will be taxed on $300.

To avoid income taxes on the $300, the firm must either claim insolvency or undergo a prepackaged bankruptcy.

A GLITCH IN THE SOUTHLAND CASE

One potential problem that can arise when a firm initiates a prepackaged bankruptcy can be illustrated with the case of Southland Corporation. In 1987, Southland, the firm that operates the 7-Eleven convenience stores, underwent a leveraged buyout to thwart a hostile takeover attempt by Samuel Belzberg. By 1989, the company could not service its $4 billion of debt and sought to restructure these claims. After 9 months of unsuccessful negotiations with creditors, Southland management concluded that the company would have to reorganize through the bankruptcy process. A prepackaged bankruptcy was proposed to resolve the impasse and Southland sent solicitations to its debtholders in early October. The bankruptcy petition was filed on October 24. Southland claimed that a sufficient number of debtholders had accepted the plan for confirmation by the court. The voting procedure, however, was challenged by a number of debtholders who were not satisfied with the outcome. Three basic objections to the voting process were raised: (1) the debtholders did not

[5] For greater detail, see Witt, Fred T., and William H. Lyons. 1990, "An Examination of the Tax Consequences of Discharge of Indebtedness." *Virginia Law Review* 10, 1-112 and Sherck, Timothy C. 1990. "Restructuring Today's Financially Troubled Corporation Taxes," 881-905.

[6] But if this motive appears compelling on the surface, we have been unable to identify firms that have undergone a prepackaged bankruptcy [simply?] for the purpose of retaining tax loss carryforwards. The primary reason for lack of such evidence is that the companies that have undergone prepackaged bankruptcies to date have not had large loss carryforwards.

[7] Once again, though, if the firm is legally insolvent, COD income taxes can be avoided even in an informal workout. However, the firm has the responsibility to argue for insolvency.

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have sufficient time to cast their votes; (2) brokers often voted for their customers; (3) votes were not counted properly. The judge ruled in favor of the dissidents and the voting process was invalidated.

The Southland case illustrates that a prepackaged bankruptcy always entails the risk that dissident creditors will challenge the legitimacy of the voting process. But such challenges are not necessarily a major obstacle to prepackaged bankruptcies. Southland later sweetened its offer, which was then accepted by the majority of the debtholders. The company ended up emerging from bankruptcy in March of 1991 after a stay of only four months.

THE FUTURE

Prepackaged bankruptcy can facilitate a successful, and relatively low-cost, reorganization by forcing holdouts to accept the plan of reorganization. It also provides a means of circumventing two relatively new obstacles that have substantially dampened out-of-court exchange offers: the LTV ruling and the change in the tax code penalizing debt forgiveness.

To make use of this new "hybrid" form of bankruptcy, however, a significant fraction of creditors must be able to reach agreement outside of the court. A prepackaged bankruptcy cannot be forced on a significant number of reluctant creditors. Nevertheless, given the possibility of a pre-negotiated bankruptcy reorganization, a greater fraction of creditors may be willing to agree to the plan precisely because holdouts can be forced to participate by filing Chapter 11.

This new development has in some sense been anticipated by financial economists. Reviving and expanding upon an argument presented by Robert Haugen and Lemma Senbet in the late 70s, Michael Jensen recently suggested that the bankruptcy process can be expected to undergo a "privatization." According to this line of thought, because private reorganizations are likely to be much less expensive than formal bankruptcy, workouts can be expected to replace bankruptcies—that is, barring major tax and legal obstacles.

Although economists did not foresee the new obstacles to workouts, the rise of prepackaged bankruptcies can be viewed as evidence in support of this privatization argument. As we suggested earlier, firms that have succeeded in prepackaging their bankruptcies have most of the elements in place necessary to reorganize successfully outside of court. Indeed, several of the prepackaged bankruptcies, including those of Republic Health and JPS, were filed after first achieving considerable progress toward an out-of-court settlement. Based on these and a growing number of other "success stories," it seems likely that prepackaged bankruptcies will significantly speed up the process of reorganization— but, again, provided that a reasonable degree of creditor consensus can be reached informally.

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