

Bankruptcy Client Alert

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Extend and Pretend Meets The Great Deleveraging

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During the easy money days preceding the subprime mortgage crisis and the collapse of Lehman Brothers, many companies (as well as consumers and governments) took on too much debt. A great deleveraging is needed for consumers, companies and governments to reduce debt loads to sustainable levels. The great deleveraging appears to be partially underway. Consumers have been reducing debt and rebuilding their savings since the financial crisis began, but companies have not been as aggressive in deleveraging their balance sheets and addressing pension and health care obligations (and governments have actually been adding to already high debt levels). The failure of companies to deleverage the excesses of the bubble years appears to be at least partially attributable to the fact that some lenders, already burdened with defaulted loans, have been reluctant to declare further defaults unless the situation is dire. Instead, lenders have been amending loan documents to waive defaults and extend maturities. This phenomenon has sometimes been referred to as “extend and pretend” or “kicking the can down the road.”

Unfortunately, allowing companies in financial distress to remain on life support can be harmful for the company, its lenders and other constituencies. Bad situations rarely right themselves. They usually require the active (if not aggressive) participation by the parties with an economic interest. Moreover, during this limbo period, companies are likely to be starved of liquidity thereby impairing their ability to implement operational fixes and make capital improvements critical to the long-term viability of the business. And when interest rates eventually rise from these historic low levels, companies will be squeezed even harder.

The factors present in any particular distressed situation will necessarily vary, and extending maturities may buy time for the economy or industry to recover, thereby allowing the company to grow its way out of its problems, find a

buyer or raise new capital. It may also allow the parties to address the causes of financial distress at a more propitious time. For instance, declaring a default and running the risk of a fire sale at the bottom of an industry cycle or when the capital markets are in turmoil is not likely to lead to the maximization of value.

However, it is generally better to face the causes of financial distress head on than to let the situation fester in the hope that things may improve over time. In short, extending may make sense, but pretending never does. Moreover, if the directors of a company in financial distress do not deal aggressively with the situation when these problems first arise and are more manageable, they may be breaching their fiduciary duty.¹ At best, they run the risk that their company loses out to competitors who address problems sooner. An example of this may be American Airlines, which faced problems rampant in the airline industry but avoided chapter 11 until recently, while United, Continental, Delta, Northwest and other carriers entered chapter 11 years ago to reduce debt and renegotiate better deals with their unions. Likewise, GM and Chrysler struggled for years with unbearable pension and health care obligations before collapsing into acrimonious chapter 11 cases that were used to implement taxpayer bailouts. Addressing these critical issues earlier, before the situation further deteriorated, might have spared the parties substantial grief and produced better returns. And by delaying the day of reckoning for so long, GM and Chrysler were only able to survive with massive government assistance. Most companies will not be able to rely on their rich Uncle Sam to bail them out if they kick the can too far down the road.

In the tug of war between “extend and pretend” and the great deleveraging, the former has had the upper hand since the financial crisis began. The chapter 11 filing of Hostess Brands and other recent bankruptcy filings may be heralding a shift in attitudes that the time has finally arrived to address

long festering problems. When the parties decide to stop kicking the can down the road, they should consider a range of options to address balance sheet, operational and funding issues, including some combination of the following:

- reduce debt levels to right-size the balance sheet
- exchange existing debt for less onerous securities
- refinance existing debt
- seek lower cost financing
- reset loan covenants to reflect the new paradigm
- convert debt to equity
- strip down junior liens
- wipe out classes that are out of the money
- simplify the capital structure
- raise new capital
- conduct a rights offering
- sell the business as a going concern
- sell non-core assets
- overhaul the business plan
- streamline operations
- cut costs
- replace management
- reduce employee headcount
- renegotiate with labor unions to modify pay, pension, benefits and work rules
- if union negotiations fail, file motions to reject collective bargaining agreements and modify retiree benefits
- renegotiate or reject burdensome contracts and leases
- implement new strategies to grow revenues
- discontinue unprofitable lines of business, products or services
- refocus on the company's core competencies
- expand high margin product lines
- make needed capital improvements
- merge with competitors to achieve economies of scale
- if the business cannot be saved or sold, conduct an orderly liquidation

Some of these options can be done outside chapter 11, while others will require court supervision. Some of these options are mutually exclusive, while others can be done in tandem and indeed may be mutually reinforcing, i.e., a company that fixes its balance sheet and operations may be able to obtain better loan terms and attract new capital to

grow the business. Which of these options is employed will be a function of each company's particular circumstances, market conditions and the level of cooperation achieved with creditors and key constituencies.

A threshold question is whether the business should be reorganized, sold as a going concern or liquidated, and if sold or liquidated, whether that should be done in or out of chapter 11.² Whether the chosen measures are implemented in or out of chapter 11 will depend on factors such as whether new lenders insist on the protections of a DIP financing order, buyers insist on the protections of a 363 sale order or plan, the degree of creditor support, etc.³ Even if one or more factors necessitates invoking chapter 11, the parties will need to determine whether to proceed with a traditional chapter 11 case, a prepack, a pre-negotiated case or a 363 sale. While traditional chapter 11 cases have fallen out of favor for a variety of reasons,⁴ they are usually superior to a prepack if the company needs not only to right-size its balance sheet, but to also address serious operational issues.⁵

In the next couple of years we may witness "extend and pretend" begin to yield to the great deleveraging. This will present new challenges and new opportunities for all parties involved in the distressed arena. Throughout this process, companies in financial distress need to be upfront with lenders and other constituencies. To rebuild creditor trust, the board may need to hire a Chief Restructuring Officer or financial advisor and/or replace members of management. Importantly, companies in financial distress must be realistic. Creditors are likely to give honest management a second chance, but management that overpromises and underdelivers will soon lose creditor support.

Creditors and other constituencies also need to be realistic. For instance, if creditors do not realistically assess the value of the business, its future prospects and the level of debt it should be able to service after plan confirmation, further financial distress may soon be in the offing. Creditors and shareholders who are arguably out of the money have not had to defend their rights while the company was in limbo. If the can stops getting kicked, junior classes may suddenly be faced with the prospect of being wiped out unless they take action (and incur substantial costs) to defend their positions. Unions will likely be reluctant to make concessions concerning pension and health care plans that their members have relied on but which their employer finds burdensome. However, that may be the only way to save the company and assure continued funding of benefit plans, albeit at

reduced levels. Buyers of distressed assets and distressed securities may find more opportunities as lenders finally stop “pretending” and more companies that have been in limbo come into play.

For more information on how these issues may affect your rights, contact Nicholas F. Kajon at nfk@stevenslee.com or 212-537-0403. Mr. Kajon is a Shareholder of Stevens & Lee and a member of the Bankruptcy and Financial Restructuring Group practicing in the New York office.

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¹These duties run in favor of the company and its shareholders, but creditors have standing to bring a derivative action when the company is insolvent or in the zone of insolvency. For a general discussion of directors’ potential exposure to creditors, see *Zone of Insolvency Revisited: Delaware Supreme Court Further Restricts Ability of Creditors to Assert Claims for Breach of Fiduciary Duty*, available at http://www.stevenslee.com/news/bankruptcy/BreachFiduciaryDuty_0507.pdf.

²For a general discussion of distressed sales in or out of bankruptcy, see *Credit Crisis Limits Options for Troubled Companies: The Coming Rise in Distressed M&A*, available at http://www.stevenslee.com/news/bankruptcy/Distressed_M&A_0508.pdf.

³See generally *Friendly Foreclosure Sales and Other Alternatives to Traditional Chapter 11 Restructurings*, available at <http://www.stevenslee.com/news/bankruptcy/friendlyforeclosures.pdf>.

⁴These reasons include delay and uncertainty, as well as the increased costs and difficulty of reorganizing a company in chapter 11 since the Bankruptcy Code was amended in 2005. See generally *How the New Bankruptcy Code Will Accelerate the Trend To Conducting 363 Sales: Unsecured Creditors May Be Left With Crumbs*, available at http://www.stevenslee.com/news/bankruptcy/363_Sales_1005.pdf.

⁵See *Will the Increased Prevalence of Prepackaged Bankruptcies Lead to More Chapter 22s?*, available at http://www.stevenslee.com/news/bankruptcy/Chapter22_Dec07.pdf.