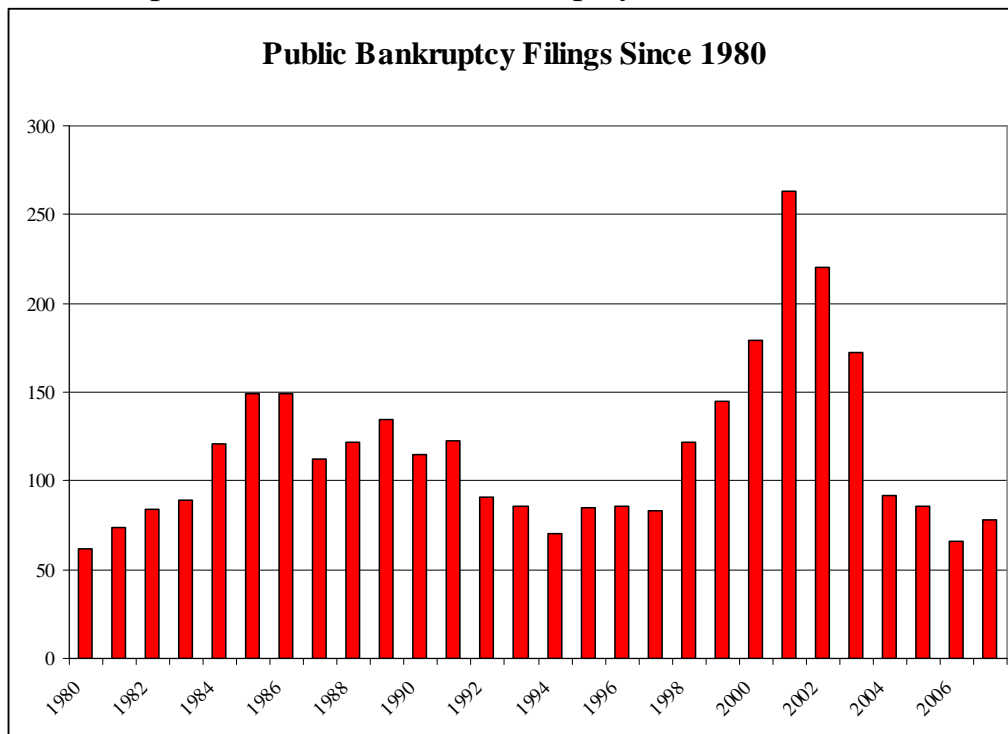


**FUNDING INVESTMENTS**  
**FINANCE 238/738, Spring 2008, Prof. Musto**  
**Class 9 – Corporate Bankruptcy**

**Today:**

- I. Chapter 7 - Liquidation**
- II. Chapter 11 - Reorganization**
- III. Violations of Absolute Priority**
- IV. Economic Role of TIA**

A corporation always has the option to file bankruptcy. We recently saw a boom in filings, peaking in 2001. Now the filing rate is much lower, though it ticked up a bit in 2007 (from bankruptcydata.com):



*Largest Filings in 2007:*

<u>Company</u>	<u>Filing Date</u>	<u>Assets</u>
New Century Financial Corporation	04/02/07	\$26BB
American Home Mortgage Investment Corp.	08/06/07	\$19BB
HomeBanc Corp.	08/09/07	\$7BB
Delta Financial Corporation	12/17/07	\$7BB
NetBank, Inc.	09/28/07	\$5BB
Movie Gallery, Inc.	10/16/07	\$1BB

*Largest Filings Ever:*

<u>Company</u>	<u>Filing Date</u>	<u>Assets</u>
Worldcom, Inc.	07/21/02	\$104BB
Enron Corporation	12/02/01	\$63BB
Conseco, Inc.	12/18/02	\$61BB
Texaco, Inc.	04/12/87	\$36BB
Refco Inc.	10/17/05	\$33BB
Global Crossing Ltd.	01/28/02	\$30BB
Pacific Gas and Electric Co.	04/06/01	\$30BB
Calpine Corporation	12/20/05	\$27BB
New Century Financial Corporation	04/02/07	\$26BB
UAL Corp.	12/09/02	\$25BB

The option to file is obviously an important element of the credit risk of corporate bonds, and raises several questions

- What exactly is Chapter 11?
- How does it compare to Chapter 7 bankruptcy?
- Why do these firms find it advantageous?
- What actually happens in Chapter 11?

## **I. Chapter 7 - Liquidation**

In most countries, filing for bankruptcy leads straight to

- Liquidation of assets
- Distribution of proceeds to creditors, by seniority

In this country that's Chapter 7

- Most filings are Chapter 7; it's only the big companies filing 11

The date a company files bankruptcy is called the *petition date*. Everything that occurred before this date is referred to as *pre-petition*, and everything after is *post-petition*. In the pre-petition period

- Creditors are trying to collect debts with threatening letters, phone calls, and legal action to seize assets

The immediate effect of Chapter 7 is an *automatic stay of creditor claims*

- Creditors have to stop trying to get paid, and the debtor has to stop paying them

This has several purposes

- Prevent the piecemeal liquidation of assets, that would intuitively fetch a bad price
- Allow for the orderly winding up of the company's business
- Address creditors' concerns that other creditors are getting value ahead of them

Another process that commences immediately is the *reversal of preferences*

- Creditors (with some exceptions) that received value from the debtor in the 90 days before the filing date must pay the value back into the bankrupt estate
- The idea is that these payments are preferences – the company gave some creditors preference over others by paying them off before filing, and thereby letting those creditors avoid taking a haircut like all the other creditors
- Also looking for *fraudulent conveyances* – value paid out of the firm before bankruptcy to keep it out of creditors' hands. Can't do that!
- Sometimes, a company's *creditors* will file the bankruptcy petition (known as *involuntary bankruptcy*), and the motive is often but not always the reversal of preferences

## Recent involuntary bankruptcy: Earth Biofuels

### Alternative Investment News

August 3, 2007

LENGTH: 405 words

HEADLINE: Funds Strike Back At Earth Biofuels

A group of 11 investors led by Sandell Asset Management that participated in a \$53 million club deal for Earth Biofuels are striking back at the company for allegedly deceiving them. Five hedge funds in the group, which also include RG Capital Management and Ramius Capital Group, have filed an involuntary Chapter 7 bankruptcy petition against the company that distributes biodiesel fuel bearing the name and likeness of country music legend Willie Nelson, to collect past due debt, according to the filing.

Days before the hedge funds signed their agreement with the company last summer it provided warrants to another investor, Greenwich Power, allegedly without disclosing their existence to the hedge funds, according to documents filed with the Securities and Exchange Commission. This diluted the funds' positions. The company claimed to not have technically violated the deal because its holding company, Apollo Resources International, provided the warrants to Greenwich, said one hedge fund manager involved in the deal. This explanation was not accepted by the investors in the club deal. "A lot of investors [in the club] were really, really upset with that," he added.

The Sandell-led group spent the past year renegotiating with the company but ultimately decided to file an involuntary bankruptcy petition to protect its investment from Earth Biofuels' management, which it no longer trusts, the manager said. The funds were concerned that Earth Biofuels' management would unwisely sell off assets that were securing the financing, he added. By filing the bankruptcy petition, the creditors are trying to get the court to intervene to protect the assets from being squandered, the manager noted. The company's equity has quickly eroded, as its market-cap was once around \$450 million, he added. It's now less than \$15 million.

If the funds are successful with their involuntary petition, then Chapter 7 liquidation will begin. Once the petition is filed, the company has the choice of fighting it or transferring the case to Chapter 11, which involves reorganization. The company has yet to file a response with the bankruptcy court. A spokeswoman for Earth Biofuels said the company believes the recently filed petition was unnecessary and it would continue on with its operations. She declined to comment regarding the specific allegations. Officials at the funds either declined to comment or did not return calls.

Creditors who file involuntary bankruptcy can be liable for damages if the debtor successfully argues that the suit was unwarranted

One of the exceptions to the preference-reversal rule is payments made on a Cash on Delivery, or COD basis

- If you ship dresses to Macys and they pay you COD then file the next day, you don't have to give the money back

Another exception is offsets by banks

- Suppose a company owes \$10M to a bank, *and* has \$5M on deposit there
- The bank can seize the \$5M deposit, and announce that the company now owes it only \$5M
- If the company files bankruptcy the next day, the bank (generally) does not have to pay the money back
- This is known as the *right of offset*

*A bank does not have unlimited rights to offset loans. Unless it can show just cause it can be sued under lender liability laws.*

- *If a bank disrupts your company by calling a loan without proper justification, you can hold the bank liable for the disruption*

Creditor claims are put on hold while the trustee collects together the value of the estate, and then distribution begins according to a strict rule of priority, which goes like this:

- Secured debt
  - A secured creditor has a senior claim to principal *and* interest up to the value of the asset backing his loan
    - If a company owes you \$1M principal and \$0.5M interest on a loan secured by property worth \$2M, then you will get your full \$1.5M in Chapter 7. But if the value of the property has dropped to \$0.75M, then you will get \$0.75M principal back, have an unsecured claim to the remaining \$0.25M principal, and you will not get the interest
- Post-petition expenses, such as rent, wages, lawyers, *etc.*
- Involuntary gap claims (*claims that date to the involuntary gap*)
- Employee wages
- Employee benefits
- Customer claims
- Taxes
- Unsecured debt (principal, no interest)
  - Senior
  - Junior
- Preferred Equity
- Common Equity

The trustee is encouraged to collect and disburse as much value as possible with a fee that increases proportionately with the amount disbursed.

That's it! The company is gone.

## II. Chapter 11 - Reorganization

Most large corporations file Chapter 11 first. The hope is to emerge from bankruptcy as a viable corporation, but some filings convert to Chapter 7. Chapter 11 shares some features with Chapter 7

- Automatic stay of pre-petition claims
- Reversal of preference payments and fraudulent transfers

It is potentially important, though, that the debtor can keep paying some pre-petition debt if the judge gives permission

Consider the case of Kmart, which filed January 2002:

- Upon filing, Kmart requested and received permission to immediately pay in full \$300MM of pre-petition debts owed to 2330 vendors
- The idea is, all creditors can theoretically benefit
  - They know the business will die if suppliers stop shipping or if employees or customers lose faith

In the Kmart bankruptcy, the judge stated that critical vendors are those “necessary to keep the business going as a going concern”

When PSC (an Oregon firm that makes bar-code scanners) filed in 2003,

The Bankruptcy Court ... required PSC to differentiate between “critical” and “noncritical” vendors. Both types will be paid under normal terms for trade debt PSC incurred *after* the bankruptcy filing. But only *critical* vendors will be paid immediately on *pre*-bankruptcy debt; *non*-critical vendors will have to wait until the bankruptcy process is over...

(*The Register Guard*, 1/27/03)

However, the critical-vendors exception came under attack

- In April 2003, a district judge responded to a complaint by other creditors by ordering Kmart’s critical vendors to pay what they got *back* to Kmart
- This was upheld on appeal by the 7<sup>th</sup> Circuit in 2/04, and in 12/04 the Supreme Court did not take up a further appeal, so the current authority on this point is the 7<sup>th</sup> Circuit decision which states that if critical-vendor payments are ever justifiable, the debtor would have to *show*
  - Critical Vendors would cease delivering w/o full payment on pre-petition claims, *and*
  - *Non*-critical vendors are at least as well of as in Ch. 7

## Critical Vendor exception still happens; for example, Butch Parker Oil:

### Daily Deal/The Deal

August 15, 2007 Wednesday

HEADLINE: Butch Parker Oil can pay vendors

BYLINE: by Jamie Mason

HIGHLIGHT: The gas and oil company won an important vendor motion despite protest.

Butch Parker Oil Co. has been cleared to pay its main vendors during its bankruptcy.

Judge Robert Jones of the U.S. Bankruptcy Court for the Northern District of Texas in Lubbock City approved the critical vendor motion Aug. 9 despite objections.

Parker Oil, a distributor of gasoline and diesel products, filed for Chapter 11 protection Aug. 7.

The approval of the vendor motion will allow Parker Oil to pay Exxon Mobil Oil Corp. its \$70,000 unsecured claim and H.J. Garrison Oil Co. its \$214,718 unsecured claim.

The Plainview, Texas-based company was forced into bankruptcy after it signed a bad lease agreement for its Amarillo, Texas, store, said single practitioner debtor counsel R. Byrn Bass Jr.

Nakamura Family LP, the lessor of the Amarillo store, filed an objection to the motion, claiming it was unclear if Exxon and Garrison qualified as critical vendors.

The objection was overruled, said Bass.

"Unless all prepetition amounts owed Exxon and Garrison are paid, Exxon and Garrison will no longer do business with Parker Oil. If either, much less both, cease doing business with Parker Oil, Parker Oil will have no inventory, will be out of business and therefore have no chance to successfully reorganize," said the motion.

Nakamura filed a suit March 21 in the U.S. District Court in Texas for breach of a lease agreement for Parker Oil's failure to pay its rent, said documents.

Parker Oil, which operates service stations throughout Texas, does not plan to seek cash collateral or debtor-in-possession financing, said Bass.

The service stations are in Lubbock, Amarillo, Odessa, Sweetwater, Memphis, Comfort, Canyon, Alpine, Fort Davis, Presidio and Marda, Texas, documents said.

Parker Oil has one secured creditor, Aurora Loan Services LLC, which is owed around \$150,000, said Bass.

Parker Oil's petition listed its assets and liabilities at \$1 million to \$100 million.

The largest unsecured creditor, Nakamura Family Ltd. of Burlingame, Calif., has a disputed claim of \$1,410,697. The other unsecured creditors have trade debt claims; Fred Garrison Oil Co. of Plainview, Texas, has a \$5,391 claim, and Coastal Transport Co. of San Antonio holds a \$4,648 claim.

### *Debtor-in-possession*

Management does not lose control of the company when they file Chapter 11 so the firm is called the *debtor in possession*. Upon filing, the company gains access to *Debtor-In-Possession* (DIP) financing

- New credit can come in senior to pre-petition debt
  - Judge can even let new debt come in senior to *secured* pre-petition debt. This is called *super-priority* DIP financing
    - Judge has to conclude that the secured claims aren't impaired
- Easy to see why it is important for the new debt to be senior
  - Suppose you said to a bank "we have all this debt we can't pay, and we'll pay off your new loan with whatever is left after paying them off." There won't be any new loan.
  - The potential for access to new loans is a powerful incentive to file

## Here's a typical example, *Hancock Fabrics*:

### Daily Deal/The Deal

June 11, 2007 Monday

HEADLINE: Judge OKs Hancock Fabrics DIP

BYLINE: by John Blakeley

HIGHLIGHT: The specialty fabric retailer's total of postpetition financing is now \$122.5 million.

A Delaware judge decided Hancock Fabrics Inc. is fit for a second debtor-in-possession loan, raising the Baldwin, Miss., specialty fabric retailer's total of postpetition financing to \$122.5 million.

The most recent DIP is a \$17.5 million term loan from Ableco Finance LLC.

When Hancock filed for Chapter 11 on March 21 in the U.S. Bankruptcy Court for the District of Delaware in Wilmington, it had already secured a \$105 million postpetition facility from prepetition lender Wachovia Bank NA, and said it was working on securing additional financing.

Judge Brendan Linehan Shannon approved the Ableco DIP in an order dated June 8.

Hancock said it will use the Ableco facility for working capital. The term loan is priced at the debtor's choice of the Adjusted Eurodollar Rate plus 5% or Prime plus 200 points, court filings show.

The Wachovia DIP, meanwhile, is priced at the prime rate plus 25 basis points or LIBOR plus 175 basis points. The financing carries a 0.35% unused line fee, a 1% letter-of-credit fee, a 1.75% standby letter-of-credit fee and unspecified closing and servicing fees.

Shannon approved the Wachovia DIP on April 19.

Both DIP lenders have a superpriority administrative claim on their loans, court filings show.

Hancock, which touts itself as a specialty retailer for fabric enthusiasts and home decorators, will use the financing to operate its business as it sheds more than 130 underperforming stores and looks to reorganize around slimmed-down operations.

The company tapped liquidation firm Great American Group to conduct the going-out-of-business sales in February.

Shannon already gave Hancock the necessary approval to begin closing 134 stores, and more could be included. Hancock had already closed 70 of its roughly 400 stores before filing for bankruptcy.

Hancock's troubles began in 2005, when it determined its method of accounting for promotional fabric inventory was inaccurate.

A tedious year-long inventory recount in all of its stores contributed to a nine-month delay in the company's 2005 audited financial statements. Hancock said the delay caused its trade creditors to tighten their credit lines, causing the company to increase its borrowing under its facility with Wachovia to merchandise.

Wachovia eventually declared Hancock in default of the loan after the borrower failed to comply with a financial covenant within that required it to have at least \$25 million of excess capital in the credit line.

As of its petition date, Hancock owes Wachovia \$56.1 million on the prepetition loan plus \$8.8 million in letters of credit, filings show.

Robert J. Dehney at Morris, Nichols, Arsht & Tunnell LLP is debtor counsel.

Houlihan Lokey Howard & Zukin is the debtor's investment banker.

## Here's an example from Delphi:

TROY, Mich., Oct. 27 / PRNewswire-FirstCall/ -- Delphi Corp (OTC:DPHIQ) announced today that it has received final court approval of a \$2 billion senior secured debtor-in-possession (DIP) financing facility being provided by JPMorgan Chase and Citigroup Global Markets Inc. and final approval of an adequate protection package for the Company's \$2.5 billion prepetition secured revolver and term loan facilities. The final financing package includes provisions that the Court determined also adequately protect customers and suppliers with allowable set-off and recoupment claims and permits them to continue ordinary course business relationships with Delphi.

## Pre-petition lenders complained:

HedgeWorld Daily News  
November 7, 2005

NEW YORK (HedgeWorld.com) – When Delphi Corp., the Troy, Mich., auto parts company that spun off from General Motors in 1999, filed for Chapter 11 protection on Oct. 8, it appears to have caught several event-driven hedge funds, painfully, by surprise.

After an event-filled month in Manhattan's bankruptcy court, it appears that hedge funds, many of them organized into what they're calling an "ad hoc committee of prepetition lenders," seek to return the favor by contesting Delphi's motion for postpetition financing.

They aren't alone in this. A variety of parties – creditors, customers, and suppliers – have filed objections to the "debtor in possession" motion by Delphi, a more-or-less routine motion designed to allow a company to continue doing business while the reorganization proceeds.

One of the first parties to object, though, was the committee of hedge fund lenders, a committee that consists of funds and managed accounts controlled by DK Acquisition Partners LP, Latigo Partners LP, Quadrangle Master Funding Ltd., Cyrus Capital Partners, Canyon Capital Partners, Concordia Advisors LLC, Avenue Capital Group, Special Situations Investing Group Inc., D.E. Shaw Laminer Portfolios LLC, Longacre Fund Management LLC, Springfield Associates LLC, and Kensington International Ltd.

Committee members have a combined economic interest in the prepetition debt of Delphi in excess of US\$443 million.

Because it can be difficult to find lenders who will extend financing to an already bankrupt firm simply in order to stand in line behind the prepetition creditors, and because Congress has deemed it in the public interest to keep some companies operating while reorganization moves forward, the bankruptcy code provides for superpriority and so-called "priming" liens, subject to the bankruptcy court's approval, if a debtor can't obtain credit otherwise.

That "if" is exactly what is at issue here. The hedge fund group of prepetition lenders contend in their brief that the Delphi debtors "through the DIP Motion seek to violate the constitutionally protected property rights of the Prepetition Lenders through a priming lien rather than obtaining more expensive alternative financing that is available to them on a junior basis."

## On 11/24/05, the Daily Deal reports:

Delphi also has an unusual \$2.58 billion portion of the DIP that emerged after a committee of prepetition lenders objected to being primed by the postpetition financing.

The prepetition lenders, including funds managed by DK Acquisition Partners LP and Latigo Partners, agreed to let their estimated \$2.58 billion in loans be primed by the DIP in return for getting immediate interest payments and other considerations.

**It would appear that the prepetition lenders won a concession.**

### *Reorganization Plan*

The way out of bankruptcy is a *plan of reorganization*, a document that enumerates the company's claimants, and what they will get in return for their claims. This could be cash, but it could also be new debt or equity. Three issues are especially relevant to getting a plan of reorganization approved

(1) Voting rules. Two ways for a plan to get approved

- Usual way – the plan is approved by each class of claimant. A class approves a plan if the vote within the class for the plan is
  - $\frac{1}{2}$  of the creditors by number, *and*
  - $\frac{2}{3}$  of the face value of the class
  - unless the class is common equity, in which case approval must come from  $\frac{2}{3}$  by value of equity (*i.e.*  $\frac{2}{3}$  of shares)
- Cram-down – the plan is approved by at least one class but *not* approved by at least one class. The judge must determine that the plan treats those classes fairly and equitably. The judge is cramming the plan down their throats.
  - If a plan is crammed down on an objecting class receiving less than full restitution, no *junior* class can receive *anything*

(2) Creditors have the right to receive what they *would* have received in Chapter 7, if that had been filed instead.

- Proponents of a plan will provide a description of what members of the different classes would have gotten in Chapter 7, showing that they would have gotten less
- Creditors can provide an alternative valuation showing that they would get more in Chapter 7 than under the plan. Then the judge has to choose between the valuations

(3) Management has the exclusive right to propose a plan in the first 180 days after the petition date.

- The judge can extend this exclusivity period. In the infamous Eastern Airlines bankruptcy, the exclusivity period was extended repeatedly, for years.
- This is a meaningful source of bargaining power over creditors
  - If they don't like a management plan, they have to wait – maybe for a long time – before getting a chance to vote on their own
  - Meanwhile, their claims are not accruing interest

United Airlines had its exclusivity period extended for its entire stay in bankruptcy (from 12/9/02 to 2/1/06)

- However, under the revised bankruptcy law that went into effect 10/17/05, there is an 18-month limit on the period of exclusivity, so this source of power over creditors may be less significant now.

## Creditors of Fruit of the Loom:

[00005] UNOFFICIAL LIST OF THE DEBTORS' LARGEST CREDITORS

Entity	Nature of Debt	Amount of Claim
Bank of America, N.A., as Administrative Agent	Prepetition Bank Group	Up to \$660,000,000
The Chase Manhattan Bank, as Trustee	Synthetic Lease Obligation	Up to \$87,500,000
Senior Bondholders	7% Northwest Notes due 2011	Up to \$125,000,000
Senior Bondholders	6.5% FTLI Notes due 2003	Up to \$150,000,000
Senior Bondholders	7-3/8% FTLI Notes due 2023	Up to \$150,000,000
NationsBank, N.A. and Credit Suisse First Boston	Farley Loan Guarantee	Up to \$65,000,000
Unsecured Bondholders	8-7/8% FTLI Notes due 2006	Up to \$250,000,000
Staple Cotton	Unspecified	Unknown
Calcot Ltd.	Unspecified	Unknown
DuPont Akra.	Unspecified	Unknown
Dystar LP	Unspecified	Unknown
Raytex Fabrics, Inc.	Unspecified	Unknown
Compuware Corporation	Unspecified	Unknown
Warwick Baker O'Neill, Inc.	Unspecified	Unknown
Parkdale Mills, Inc.	Unspecified	Unknown
Hohenberg Bros. Co.	Unspecified	Unknown
Elastic Corporation	Unspecified	Unknown
Tubular Textile Machinery Manhattan Associates	Unspecified	Unknown
US Label Corp.	Unspecified	Unknown
Rosner & J. Coweb Logistical SRV	Unspecified	Unknown
Bertling Logistics, Inc.	Unspecified	Unknown
Ameritx Yarn LLC	Unspecified	Unknown
Coats American, Inc.	Unspecified	Unknown
Atwood Richards, Inc.	Unspecified	Unknown
ECOM USA	Unspecified	Unknown
GE Capital First Factors	Unspecified	Unknown
Vanguard Supreme	Unspecified	Unknown
Seyer Graphics	Unspecified	Unknown
Interstate Packaging	Unspecified	Unknown
Crowley American Transport	Unspecified	Unknown
Intermec Technologies Corp.	Unspecified	Unknown
MSAS Global Logistics	Unspecified	Unknown
Magnolia Manufacturing Co.	Unspecified	Unknown
Norrell	Unspecified	Unknown
Clark Container, Inc.	Unspecified	Unknown
Dart Transit Company	Unspecified	Unknown
Civitas Bank	Unspecified	Unknown
Scholler, Inc.	Unspecified	Unknown
Avondale Mills	Unspecified	Unknown
RL Stowe Mills, Inc.	Unspecified	Unknown
CIT Group/Commercial Svcs.	Unspecified	Unknown
Industrial Cartonera Dominicana, S.A.	Unspecified	Unknown
Farmers National Bank	Unspecified	Unknown
Yorkshire America, Inc.	Unspecified	Unknown

## And Global Crossing:

<http://f1.findlaw.com/news.findlaw.com/hdocs/docs/globalcrossing/glblx012802ch11pet.pdf>

The breakdown of creditors into different classes is not completely predetermined.

- A reorganization plan groups creditors into classes for voting purposes. A different plan could group them differently
- This gives the plan's proponents some latitude to gerrymander – to group creditors who will resist the plan with enough creditors who will support the plan so that the total vote of the class is positive

Notice that there is no necessary relation between the reorganization plan and absolute priority

- Only connection is that creditors can insist on getting at least what they would have gotten in Chapter 7, where absolute priority is obeyed
- This can be a weak connection if the company is worth much more as a going concern than in liquidation
  - Suppose a company owes 80 to senior debt, and 60 to junior debt, and is worth 50 in liquidation and 100 as a going concern. Reorganization plan calls for giving 70% of firm's equity to the senior debt, and 30% to the junior debt
    - Senior debt gets value=70, and Junior debt gets 30
    - Senior debt is not getting paid in full ( $70 < 80$ ), but Junior debt is getting value anyhow
    - Senior creditors can complain, but in liquidation they would get 50 so the judge would not disallow the plan
- The right to get what you would have gotten in Chapter 7 is most useful to secured creditors, who get 100 cents on the dollar plus interest in Chapter 7, provided their collateral is worth it

### III. Violations of Absolute Priority

So a reorganization plan *can* violate absolute priority, but why *would* it?

The obvious possibility is that management wants to buy the approval of junior creditors

- Paying only a small amount to a class runs the risk that it will vote against the plan
- In that case, the plan goes through only if the judge determines that the plan is fair
- Junior creditors can drag out this proceeding, imposing a cost on everybody who would benefit if the company got out of bankruptcy court

It may be better to give the junior creditors enough value that they'll cooperate.

Another reason occasionally cited for paying claimants out of order is the tax benefit that can accrue, under certain complicated conditions, from giving the old equity holders some of the equity in the reorganized firm

- Essence of the story is that
  - Bankrupt firms have almost always lost a lot of money
  - These *net operating losses* are a valuable property – they can be subtracted from future profits before calculating income tax
  - In its reorganization, a firm wants to make sure that it will have access in the future to the tax benefits of its NOLs
  - Tax code makes it easier to retain the tax benefits if the ownership of the firm changes little
    - The idea being, these owners are the ones who lost the money, so they should get the future tax benefits of those losses

For example, on 11/23/05:

FLYi, Inc. (FLYIQ) and its operating entity, Independence Air, a low-fare airline, and their respective subsidiaries filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. In conjunction with the filing of the petitions, the Company filed a variety of "first day motions" to help ensure a smooth transition into the Chapter 11 reorganization case. Among the first day motions was one that would require notices from and restrict the transfer of FLYi's claims by or to any person or entity that beneficially owns at least \$30 million in claims. The Company sought this order in order to preserve to the fullest extent possible the flexibility to develop and implement a plan of reorganization that maximizes the use of their net operating losses for U.S. income tax purposes.

## *And Interstate Bakeries:*

The Kansas City Star

March 4, 2006 Saturday

HEADLINE: Judge refuses to limit trading of bakery stock

BYLINE: Jennifer Mann, The Kansas City Star, Mo.

Mar. 4--U.S. Bankruptcy Judge Jerry Venters on Friday denied a motion by Interstate Bakeries Corp. to restrict trading activity by large shareholders.

Interstate filed the motion Tuesday and asked for an emergency hearing, hoping for an interim order that would create a process under which it could object to certain stock sales and the conversion of debt to equity.

Interstate's goal was to preserve millions of dollars in net operating loss tax credits that could be possibly used to offset future taxable income. Thus far, Interstate said, it has generated about \$90 million in NOLs.

The wholesale baking company, which filed for Chapter 11 in September 2004, said that if a change in ownership control occurred through the sale of stock, Internal Revenue Service rules could limit the amount that could be used as tax credits.

The company argued that the NOLs were a valuable asset because it anticipated generating taxable income if it successfully emerged from bankruptcy.

Interstate argued for creating a process whereby holders of 4.5 percent or more of the stock -- equal to 2,042,851 shares -- would file disclosures with the court. Under the proposal, Interstate could then file objections to limit the transfers of equity and convertible debt.

...

The exact connection between giving new shares to old equity and keeping NOLs is complicated. Suffice to say, it has been a reason to violate absolute priority.

### *So What Happens?*

That is the question Lawrence Weiss is addressing in *The Bankruptcy Code and Violations of Absolute Priority* by collecting a sample of bankruptcies, and analyzing the payments made to different classes in the reorganization plan

He finds this:

- Absolute priority is almost always followed for secured debt
  - They are paid in full before anybody junior gets anything
- Absolute priority is rarely followed for unsecured debt
  - Equity usually gets something even when unsecured debt did not get 100 cents on the dollar

This is consistent with what we've been saying

- Can't underpay secured debt if their collateral is worth enough
- Easier to underpay unsecured debt

Here's a representative reorganization plan at [bankruptcydata.com](http://www.bankruptcydata.com)

<http://www.bankruptcydata.com/PlanSamp2.htm>

Note that the senior and secured creditors are all paid in full, the junior debt is impaired but equity still gets something.

### A more recent example: *Owens Corning*:

**The Blade (Toledo, Ohio)**

September 19, 2006 Tuesday

HEADLINE: Judge favors OC's plan to exit from bankruptcy

BYLINE: Gary T. Pakulski, The Blade, Toledo, Ohio

Sep. 19--PITTSBURGH -- After a four-hour hearing yesterday, a bankruptcy court judge signaled that she is ready to sign off on Owens Corning's Chapter 11 exit plan.

"Congratulations," Judge Judith Fitzgerald told company lawyers and creditors.

She made the comment shortly after dismissing the second of just two remaining objections to the Toledo Fortune 500 company's plan for distributing \$8.6 billion in cash and stock to thousands of asbestos victims and other creditors.

It was a crucial moment in OC's six-year bankruptcy odyssey.

While the judge didn't indicate when she will officially "confirm" the so-called plan of reorganization, all sides anticipate quick action.

The company and its lawyers are racing against the clock to avoid a \$30 million penalty in connection with financing arrangements if it fails to exit Chapter 11 by Oct. 31.

"What happened today made me very confident about that date," Owens' Chief Executive Dave Brown said in a telephone interview.

The CEO of the building-products maker in downtown Toledo monitored the hearing in U.S. Bankruptcy Court in Pittsburgh by telephone link from the firm's headquarters.

"We think it's an important day for our company," he said. "It's an important next step in our emergence from bankruptcy."

Once Judge Fitzgerald approves the plan, a U.S. District judge in Philadelphia will consider whether to sign off.

Before OC can exit Chapter 11, however, it must then wait 30 days to give creditors a chance to object. Even if objections are filed, the firm would likely take court action to try to prevent a delay, bankruptcy experts said.

Banks will receive full recovery under the plan and other creditors will receive between 49 cents and 58 cents for each dollar owed. Existing stock will be canceled, but shareholders will get an opportunity to buy new shares at pre-determined prices.

The hearing was held just days after the company reported that 99 percent of ballots cast by or on behalf of 600,000 asbestos-injury claimants favored the plan.

Officials had earlier announced that other creditors had voted for the plan by lopsided margins.

### *Getting out of leases*

After filing Chapter 11, a firm has to make a decision about each property it is leasing. It can either

- Continue the lease – keep making lease payments, and using the property, *or*
- Reject the lease – stop making payments, and the owner repossesses the property
  - Owner can sue for damages, which are capped at the maximum of a) one year's rent, and b) 15% of the remaining rent for a maximum of three years
- Or *sell the lease rights to someone else*

When Kmart filed, it cited the opportunity to “cancel unfavorable leases” as a major motivation

- And in the Tower Records bankruptcy (from the Sacramento Bee):  
*Trans World is a \$1 billion-a-year retailer that has become the self-proclaimed "last man standing" in the dwindling business of music retailing. The Albany, N.Y., chain bid unsuccessfully to buy all of Tower at the retailer's Oct. 6 bankruptcy auction, losing to Great American. In a separate real estate auction held in November, Trans World won the lease rights for five of Tower's stores, including Broadway and Watt. Sullivan said Trans World is still going ahead with plans to take over Tower locations in Torrance, Philadelphia and Nashville, Tenn.*

### Another:

#### **Business Wire**

December 20, 2007 Thursday 9:50 PM GMT

HEADLINE: Buffalo Wild Wings, Inc. Announces Intent to Purchase Eight Restaurant Locations from Avado Brands, Inc.

DATELINE: MINNEAPOLIS

Buffalo Wild Wings, Inc. (Nasdaq:BWLD), today announced that it has reached an agreement to acquire certain leases and other assets of up to eight "Don Pablo's Mexican Restaurant" locations from Avado Brands, Inc. and its related companies. Buffalo Wild Wings, Inc. agreed to pay, in the aggregate, approximately \$1,200,000 in cash for the lease rights and other assets.

The eight Don Pablo's Mexican Restaurants are located in metropolitan areas of Illinois, Minnesota, New York, Ohio, Texas, and Virginia. The locations range in size from 6,500-9,800 square feet. Buffalo Wild Wings, Inc. anticipates the locations will be renovated and reopened as Buffalo Wild Wings Grill and Bar restaurants, and three of the restaurants will be relocations of existing Buffalo Wild Wings restaurants.

The Avado Brands, Inc. entities have filed a Chapter 11 bankruptcy petition in Delaware and the purchase and sale of these assets will be subject to both bankruptcy court approval and satisfactory completion of due diligence before January 31, 2008. It is anticipated that the transaction would close sometime in the first quarter of 2008.

Those are the major features of corporate bankruptcy. To understand their significance to corporations, it is useful to consider the problems a firm encounters when trying to restructure *outside* of bankruptcy.

- Recall we said last time that a debtor can not change the principal, interest or maturity of a creditor's bond without the creditor's approval
- The debtor might try to get the creditor to exchange his bond voluntarily, but this runs into what is known as a *buoying-up* problem

Suppose a distressed firm is worth \$100M, but has \$200M in debt maturing soon

- 5 creditors each hold \$40M face value of the bond

The firm decides to restructure with an equity-for-debt swap

- Each creditor can exchange his bonds for 20% of the firm's equity
- If all exchange, then each has 20% of a firm worth \$100M, or \$20M, and the firm does not go into bankruptcy

Now suppose one of the creditors believes that all the *other* creditors will exchange. Should he exchange or not?

- If he *does* exchange, he gets \$20M
- If he *doesn't* exchange, then he is the *only* creditor, with face value \$40M, of a firm worth \$100M
- The firm can easily pay \$40M, so he gets \$40M

The creditor wins by holding out when all others exchange. The debt relief from the other creditors voluntarily exchanging has buoyed-up the value of his own claim.

- The value of being the one creditor who doesn't exchange encourages everybody to hold out, making voluntary exchanges difficult
- They aren't entirely impossible, though – more on that next time

Compare this scenario to the process of voting on the reorganization plan of a firm that has filed Chapter 11

- If you vote against a plan, and it is approved anyhow, the plan applies to you even though you voted against it
- Benefit of holding out is greatly reduced

*TIA is a doomsday machine*

The Trust Indenture Act creates the holdout problem by requiring each bondholder's consent for changing principal, interest or maturity, making it much more likely that distressed firms will land in bankruptcy than work out privately. This, according to some market participants, is the virtue of the TIA. The logic is like the logic of the doomsday machine in Dr. Strangelove

- Soviet computer that automatically destroys the world if the USSR is the victim of a nuclear attack
- Idea is, nobody is willing to destroy the world. If the Soviets threaten to destroy the world if they are attacked, it will be an empty threat because everybody knows it isn't in the Soviets' interest to destroy the world
- Can attack them and know that they won't do it
- By *automatically* retaliating, the machine solves this problem. The Soviets' unwillingness to pull the trigger is no longer a problem. A nuclear attack on them will destroy the world, even though the Soviets wouldn't want to destroy the world.
- Result is, nobody attacks.

Now imagine a firm that can pay off its junior bonds, but tells its bondholders *we didn't hit our numbers, and can't pay you face value. Why don't you take 80 cents on the dollar, that's more than you'll get in bankruptcy if you insist on the full 100 cents, which we haven't got.*

- Bondholders might vote for the 80 cents, preferring it to the small amount they would get in bankruptcy
- Some bondholders might vote against it, but maybe not enough to defeat it, and everybody gets 80 cents on the dollar

The bondholders problem is, they are in a weak bargaining position; it is very risky for them to demand full payment, because they do badly if bankruptcy results. This is where the TIA comes in handy. When the issuer says *take 80 cents or it's Chapter 11* bondholders can say *You need 100% approval to pay less than you owe, and you'll never get 100%, so you better just pay up.*

- TIA gives bondholders a credible threat to force bankruptcy, and this helps them extract full payment.

The unfortunate side effect to making it difficult for a solvent company to underpay is that it makes it difficult for an insolvent company to underpay.