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Turnaround Topics

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For Better or Worse, Prepackaged and Pre-Negotiated Filings Now Account for Most Reorganizations

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There's not much that's distinctly new or novel about prepackaged, pre-negotiated and pre-arranged bankruptcy filings (collectively referred to herein as "pre-filings" by the authors) in recent years, except their growing numbers — and that is a story in itself. Today, pre-filings account for a majority of cases that emerge from chapter 11 via a confirmed reorganization plan.

Prepacks have been around for a long time. Business usage of the term "prepackaged bankruptcy" can be traced back nearly 30 years. There are articles and academic literature that refer to prepacks dating back to the early 1990s, notably "Business and Law: Prepackaging a Bankruptcy"[1] and "The Economics of Prepackaged Bankruptcy."[2] The "Business and Law" article references Crystal Oil Co., which filed a chapter 11 petition along with a solicited reorganization plan in October 1986 and emerged 91 days later, as one of the first recognized instances of a large prepack filing. Prepackaged filings increased in frequency in the early-to-mid 1990s in the wake of the original leveraged buyout (LBO) bust, but then faded as corporate capital structures became increasingly complex, only to make a comeback since the end of the 2009 recession, as concentrated debt holdings by large distressed-investor groups have made prepacks and other pre-filings a bit easier to negotiate and implement.

Prepacks often are viewed as being akin to out-of-court debt exchanges while also availing a debtor of the remedies of chapter 11, either to bind holdout creditors and/or to take advantage of specific provisions of the Bankruptcy Code, such as the rejection of executory contracts. Required-consent thresholds and the specific negative-covenant language contained in the legal documentation of a debtor's bonds and loans, along with the particular composition and concentration of debt-holders, will largely determine whether an out-of-court debt exchange or prepackaged filing is the more feasible route. When key creditor holdouts have a blocking position that precludes a prepackaging filing around a proposed plan that otherwise has substantial creditor support, then a pre-negotiated filing is the likely result.

A pre-negotiated filing is generally understood to be a case in which the debtor has had substantial negotiations with select creditor groups prior to a filing and has reached a consensus on key restructuring provisions with some *bloc* of creditors, which are documented either in a term sheet or a plan support agreement (PSA), also known as a restructuring support agreement (RSA). Large creditors might sign binding lockup agreements in support of an RSA, but there is no reorganization plan submitted with the chapter 11 filing, nor has there been a formal solicitation of creditors prior to filing.

The RSA often serves as the basis for key provisions of an eventual reorganization plan. A pre-negotiated filing is far from a "done deal," having yet to obtain the requisite creditor support for a plan. Post-filing negotiations pertaining to an RSA or its implementation can still become contentious, especially in large and complex cases, as occurred in the case of *Caesars Entertainment Operating Co.* or the protracted (and recently resolved) dispute between Claire's Stores and a large holder of its second-lien notes. However, pre-negotiated filings usually facilitate a path forward and pave the way for a reorga-

1 *The New York Times* (1990).
2 *Journal of Applied Corporate Finance* (1991).

nization plan that typically gets confirmed and implemented more quickly than a freefall filing.

What has changed about prepacks and pre-negotiated plans in recent years are their sheer numbers, which have increased appreciably. Is this a favorable development for debtors, creditors and the reorganization process? The answer is neither obvious nor definitive. Pre-filings tend to produce a more-streamlined chapter 11 reorganization process, fewer unpredictable outcomes, shorter case lengths, and fewer case-related expenses for the debtor than a conventional filing. These features generally are viewed favorably by bank lenders, trade creditors and the distressed-investing community.

However, there are drawbacks emanating from a reorganization process that is done as a pre-filing. A primary criticism leveled at pre-filings is that they are often shortsighted in their ambition and scope, and accomplish little more than financial reengineering without adequately addressing operating deficiencies and implementing substantive remedies, thereby leaving a reorganized company less leveraged but likely "unfixed" and still susceptible to subsequent failure. However, it would be premature to evaluate the legitimacy of these concerns given the relative recency of the pre-filing surge.

Pre-Filings by the Numbers

In order to assess the impact of pre-filings on case lengths, the authors analyzed large (those with liabilities greater than $50 million at the time of filing) chapter 11 cases that emerged from bankruptcy via a confirmed reorganization plan from January 2010 through June 2018. There were 434 relevant filings that emerged during this nearly eight-year period. Filings that were resolved via a sale of the debtor or substantially all its assets were excluded. The analysis supports the general observation that pre-filings have increased in recent years, and also identifies several factors that have contributed to their growing share of reorganizations.

Pre-Filings Have Accounted for a Larger Share of Reorganized Companies Since 2015

- *Forty-four percent* of cases that emerged from chapter 11 in 2010-18 (191 of 434) were pre-filings (that is, either prepackaged or prearranged/pre-negotiated), accounting for nearly one-half (47 percent) of all pre-filings over this period.
- However, 65 percent of cases that emerged after 2015 (71 of 109) were pre-filings, compared to 37 percent (120 of 325) from 2010-15 (as shown in Exhibit 1).

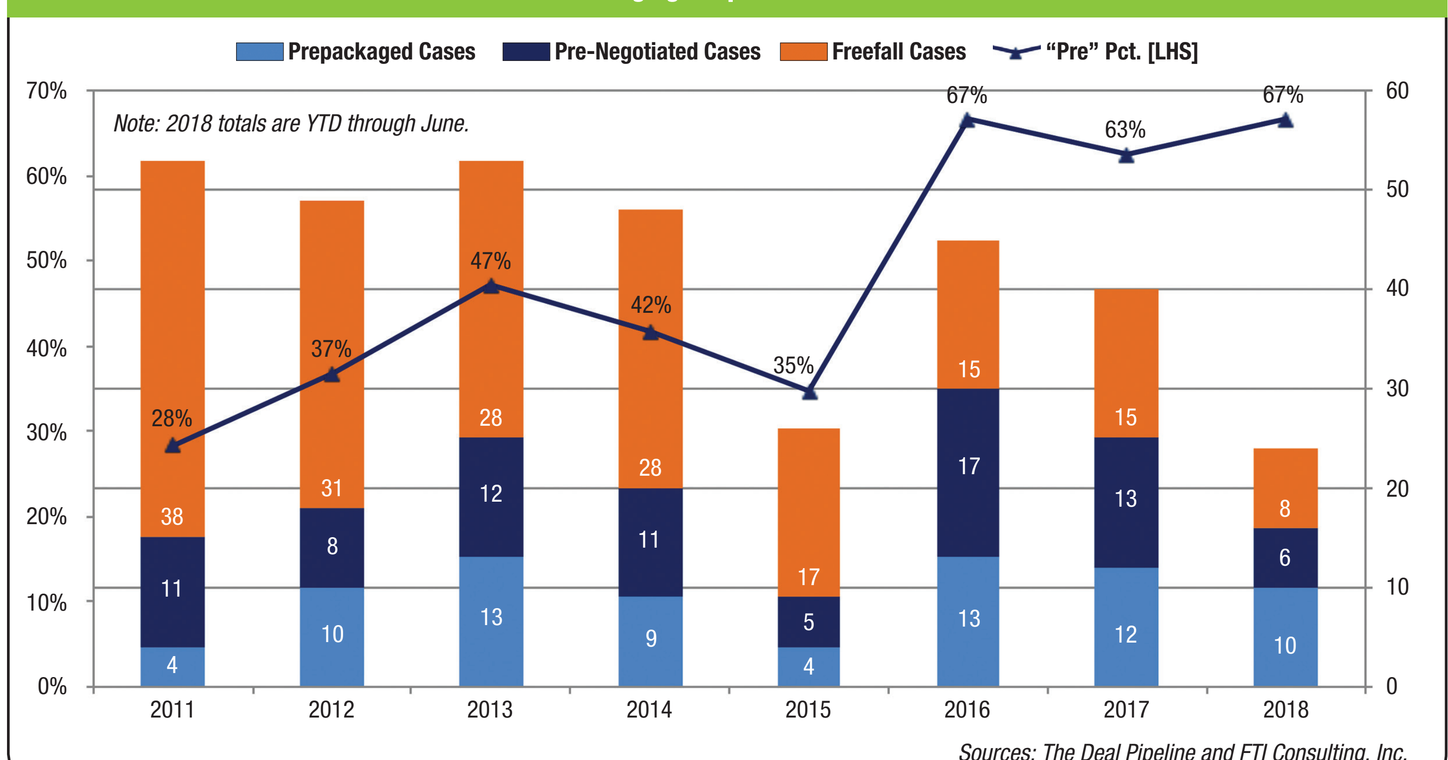
Pre-Filings and Private-Equity Ownership

- Reorganizations of companies owned by private-equity (PE) sponsors were much more likely to be pre-filing cases than non-PE owned companies, owing to the pressing need to quickly de-lever businesses, many of which were still operationally profitable at filing. As the share of chapter 11 filings attributable to companies owned by PE sponsors increases, which it has in recent years, the proportion of pre-filings likewise has increased.
  - Companies owned by PE sponsors accounted for 27 percent of reorganized companies, yet accounted for 38 percent of all pre-filings.
  - In all, 63 percent of filing companies owned by PE sponsors were pre-filing cases (73 of 116), compared to 37 percent for non-PE owned companies (118 of 318).

Pre-Filings and Debtor Size

- Reorganizations of larger companies were much more likely to be pre-filing cases than those of smaller companies.

Exhibit 1: Emerging Chapter 11 Cases via a POR



– Companies with liabilities at filing in excess of $1 billion accounted for 29 percent of reorganized companies, yet accounted for *38 percent* of all pre-filings.

– In all, 58 percent of companies with liabilities at filing in excess of $1 billion were pre-filing cases (72 of 124), compared to 38 percent for companies with liabilities at filing of less than $1 billion (119 of 310).

Pre-Filings and Industry Sector

• Reorganizations in certain industry sectors, primarily energy and media, were more likely to be pre-filing cases. This makes sense, as companies that are asset-rich or whose enterprise value is derived largely from asset values are often better candidates for pre-filings than those that are asset-light and in need of extensive operational restructuring.

– The energy sector accounted for a disproportionate share of pre-filings. In all, 56 percent of energy sector companies that reorganized were pre-filings (45 of 80), compared to 44 percent across all industry sectors. Most of these occurred after the onset of the energy bust in late 2014.

– The media sector also accounted for a disproportionately large share of pre-filings. In all, 62 percent of media sector companies that reorganized were pre-filings (21 of 34), compared to 44 percent across all industry sectors. Media companies tend to be more levered than other industry sectors, so the prevalence of pre-filings in this sector is not surprising.

Pre-Filings by Venue

• Reorganizations outside the court venues of the District of Delaware, Southern District of New York and Southern District of Texas were much less likely to be pre-filings.

– Filings in Delaware accounted for 42 percent of all filings, but accounted for 54 percent of all pre-filings. In all, 57 percent of cases filed in Delaware were pre-filings (104 of 182), versus 44 percent across all venues.

– Filings in the Southern District of New York accounted for 17 percent of all filings, but accounted for 20 percent of all pre-filings. In all, 52 percent of cases filed in this district were pre-filings (38 of 73), versus 44 percent across all venues.

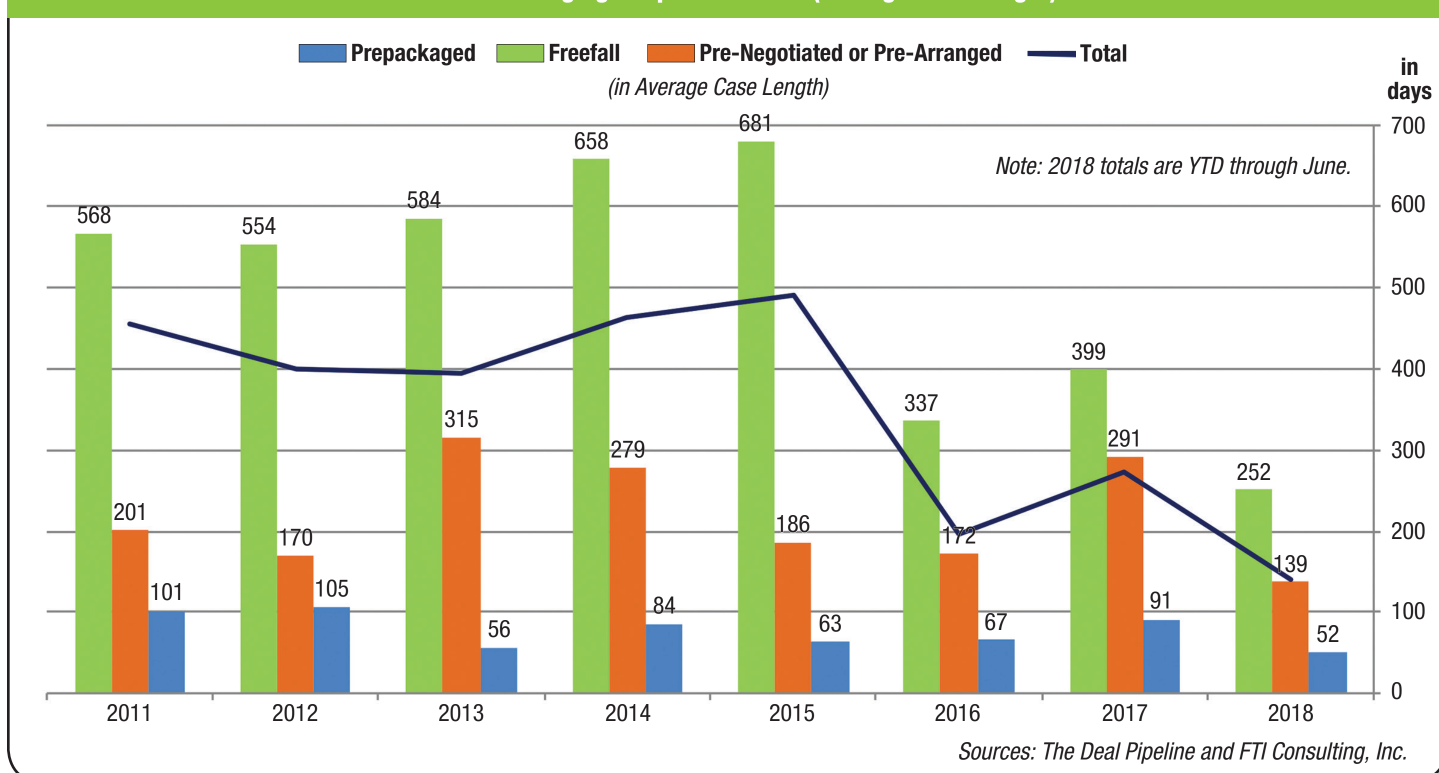
– Filings in the Southern District of Texas accounted for 6 percent of all filings, but accounted for 9 percent of all pre-filings. In all, 69 percent of cases filed here were pre-filings (18 of 26), which is likely attributable to the high percentage of filings by energy companies in that venue.

– Filings in all other venues accounted for 35 percent of all filings, but accounted for just 16 percent of all pre-filings. In all, only 20 percent of cases filed in all other venues were pre-filings (31 of 153), versus 44 percent across all venues.

Impact of Pre-Filings on Case Lengths and Outcomes

Most restructuring professionals recognize that the duration of a typical chapter 11 case from filing to emergence has become shorter in recent years. A primary driver behind these shorter case lengths is the prevalence of pre-filings. Consequently, the average duration of chapter 11 reorganizations fell by nearly one-half in 2016-18 compared to 2010-15, to 212 days from 401 days. Exhibit 2 shows a breakdown by category. The average case length of pre-filings did not change materially over this multi-year period; there were just a lot more of them in 2016-18. Prepackaged filings were consistently within a range of 50-100 days from filing to emer-

Exhibit 2: Emerging Chapter 11 Cases (Average Case Length)



Sources: The Deal Pipeline and FTI Consulting, Inc.

gence, averaging nearly 80 days, while pre-negotiated filings took about 216 days, on average, to emerge.

However, it was not just the increasing frequency of pre-filings that drove down average case length; the duration of freefall cases contracted sharply, to 344 days in 2016-18 from 545 days in 2010-15. This recent contraction might have been influenced by small sample size and case-specific randomness, as there were only a total of 38 freefall cases that emerged in 2016-18, compared to an average of 28 per year from 2011-15.

The impact of shorter case lengths on debtors' reorganization outcomes is not as easy to discern, and there are varying opinions on the issue. A prevailing belief is that a pre-filing is a "cheaper" alternative for a debtor than a conventional filing because it saves the estate substantial sums in professionals' fees. Related expenses can be a spurious argument, as many of the costs pertaining to negotiations with creditors around an RSA or plan are incurred prior to a filing rather than avoided, as are some other bankruptcy-associated expenses that once were primarily incurred post-filing. Moreover, a prepackaged filing that is consummated in 80 days is certainly going to incur fewer reorganization-related expenses than a freefall filing that takes a year or more to emerge, but these undertakings are likely to be dissimilar in work scope. Can a 90-day prepack filing accomplish in scope and substance what a 250-day conventional filing could have, all other things being equal? It is not likely, but it is possible, depending on the man-hours and resources devoted to the effort.

The common criticism that a pre-filing is a less-rigorous reorganization that does not give the debtor sufficient time to plan and implement needed operating changes can be a misleading argument, as substantive business reforms can still be accomplished in an abbreviated time frame. For example, the authors' firm recently advised Southeastern Grocers LLC, which filed for bankruptcy in late March with a prepackaged reorganization plan. It emerged from chapter 11 in 65 days with a plan that equitized more than $500 million of debt (40 percent of its pre-petition debt), secured exit financing, closed 94 stores (and related lease rejections), planned remodels for nearly 100 stores and completed several M&A transactions in this short period of time. It was an impressive accomplishment by the debtor in only two months. Many of these actions were anticipated and planned out prior to filing.

Lastly, the concept of reorganization (either a pre-filing or conventional filing) as a comprehensive process to rehabilitate broken or uncompetitive businesses has often been an unrealistic ambition in many cases since the Great Recession. This is largely attributable to aggressive event milestones and liquidity constraints often imposed by debtor-in-possession (DIP) lenders, which no longer afford debtors the luxury of a lengthy reorganization.

Such lender constraints are not arbitrary; they often reflect a debtor's lack of unencumbered assets at the time of filing, as leveraged borrowers increasingly have relied on first-lien secured debt in recent years compared to the pre-recession period. This reality has limited financing options available to debtors during the pendency of a case. In instances where distressed investors will become majority owners of a debtor, they are also likely to favor an expedited reorganization process. Such time urgency is an aspect of most large cases today, whether or not the filing was a conventional one.

> **[P]re-filings should be judged by their future failure rates compared to their similarly situated peers, out-of-court workouts and other debtors that have reorganized around conventional chapter 11 filings.**

It Is Too Soon to Evaluate the Lasting Efficacy of Pre-Filings

The prevalence of prepackaged bankruptcies and other pre-filings with negotiated RSAs/PSAs that become the basis of a reorganization plan is a trend that is not likely to abate anytime soon, and will continue to impact case lengths and the scope of work in reorganizations. Whether these reorganization efforts ultimately "fix" a debtor and provide more than a salve of debt relief remains to be seen, as a large majority of these cases have emerged only within the last couple of years, which is typically too soon for re-failure to occur.

The ultimate effectiveness of pre-filings should be judged by their future failure rates compared to their similarly situated peers, out-of-court workouts and other debtors that have reorganized around conventional chapter 11 filings. Within the next few years, sufficient time will have passed to better assess these outcomes and judge their success in a more statistically rigorous way. The authors would expect that bankruptcy academicians will study these outcomes, as has been done for distressed-debt exchanges and "chapter 22" filers. Until then, expect a few premature victory laps by some debtors who will be back in a courthouse sooner than they expected. abi

Editor's Note: *For more on this topic, purchase* A Practitioner's Guide to Pre-Packaged Bankruptcy: A Primer, *available in the ABI Store (store.abi.org). Members must log in first to obtain reduced pricing.*

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