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Outside Counsel

Expert Analysis

Formal Composition Agreements: A Cost-Effective Option to Chapter 11

While it can be an effective tool, the price to file for bankruptcy is costly. Just the retainers for professionals in a small case could be substantial, as the debtor often needs both an attorney and financial advisor. The end result can easily be in the region of $500,000 to $1,000,000. There is also the emotional aspect of the owners appearing in court and publicly disclosing monthly financial information. In addition, the majority of companies filing Chapter 11 do not come out of Chapter 11 if they do not have an exit strategy, versus a pre-pack, whereby companies already have a plan and decide that it is best to consummate the plan with the protections Chapter 11 provides.

An alternative to Chapter 11 is a composition agreement, which is an out of court restructuring plan. Unlike Chapter 11, where voting creditors must cast a 51 percent vote in number and 67 percent in value to confirm a plan, the company determines the percentage vote it needs in order to have a successful reorganization. Having said that, it is not advantageous to the company to go for a low approval as explained further in the "Vote" section below. Otherwise, composition agreements typically adopt similar rules and regulations to a Chapter 11 proceeding.

There can be strong advantages to using a composition agreement in place of, or as a precursor to, filing for Chapter 11. Using a composition agreement often minimizes the expense and time of the restructuring, affords the principals the opportunity to retain equity of the company, and places less of a public spotlight on the company and its principals, which can minimize the stigma associated with the restructuring.

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Procedures

Today, a Chapter 11 filing is filed electronically. Attorneys and financial advisors prepare the necessary documents to immediately freeze all pre-petition debt and law suits against the company by law through the "automatic stay." With a composition agreement, however, there is risk with the absence of the automatic stay. Although it is quite rare, unsecured creditors can at any time during the process file an involuntary bankruptcy proceeding against the company. By the time the company decides on the composition agreement route, the creditors are/have already been pressuring the company for payment, so soliciting should come as no surprise. Their involvement is an out-of-court process to compromise the debt.

The formula for implementing a composition agreement is as follows. The company should:

• Have a concentration in accounts payable to help facilitate control over process, which will:
  - Ease communications;
  - Be helpful to obtain desired vote levels.

• Have favorable relationships with major creditors:
  - Have a positive EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) if past debt is frozen;
  - Retain a professional financial advisor for the company;
  - Retain a bankruptcy attorney for the company;
  - Be aware that there is full disclosure of all aspects of the business. This will be no different than if the company had filed Chapter 11. Creditors will want, and are entitled to a free flow of information concerning the company and its operations if their consent to the Composition Agreement is to be obtained.

Owners often retain separate counsel, as the bankruptcy attorney represents the company and not the individual, as there are often conflicts of interest. If there are secured lenders, they should be on board with the process, as their cooperation is needed for continued funding.

The Letter

Additionally, a letter should be sent to all creditors seeking to freeze payment of old debt as of a specific date. It is important to state that future purchases will be paid on a COD basis, and that their balances will not grow. Vendors can at their discretion decide if they want to continue giving terms.

The letter should come from either the company or the attorney, which will vary on a case-by-case basis (e.g., if there are numerous law suits against the company, then the letter may be better received from counsel). It should introduce the fact that a financial advisor has been retained and set a date for a meeting giving reasonable time for creditors to attend the meeting—at least two to four weeks is suggested. It also affords the company time to continue working on its turnaround.

The letter should provide a contact number for the creditor to express his desire to attend the meeting and invite creditors to call the retained financial advisor/turnaround specialist in advance of the meeting with any questions.

The Meeting

In preparation for the creditor meeting, the turnaround consultant should develop a presentation describing the history of the

company, ownership details, the latest financial statements, income statements and balance sheet, as well as why/how the company is in its present position.

The bankruptcy counsel will present options, namely:

- **File for Chapter 11 bankruptcy protection.** Counsel will advise that though current management will likely remain in control of continuing operations, secured lenders receive recovery first and therefore those who are unsecured will probably receive a small dividend, if anything.
- **File Chapter 7.** Company is handed over to an independent trustee for liquidation, where the unsecured creditors normally receive nothing.
- **Composition agreement.** The company believes they have an out-of-court process that is in the best interest of the unsecured creditors, i.e., receive the highest level of recovery among the options.

Once counsel, financial advisors and management have fielded all questions, the creditors will be invited to form an ad hoc committee. The largest creditors will traditionally serve. If the ad hoc committee is formed at the meeting and they have an attorney present, the company professionals will normally ask for a period (four to six weeks) to negotiate and present a plan, providing cash flows, income statements as well as the offer of compromise.

During a series of meetings negotiations will take place and the committee will report to the unsecured creditors. The committee will then either recommend or reject the company's offer. If it accepts the offer, all creditors will then vote on the composition agreement.

Additional Information

The classes of creditors are also important in achieving the company's objectives through a composition agreement:

- **Convenience Class:** It is not uncommon to dispose of all the small creditors at full value. The reason is obvious. If the company has 300 creditors, normally the top 20 percent represent 80 percent of the dollar value. However, it could be that a large number of creditors have small claims. If this is the case, a vote would probably be favorable in the value but fail in number. Therefore an analysis of the debt could show 150 creditors with claims smaller than $5,000 representing $150,000 out of $10,000,000. It would be wise to neutralize their ability to vote. Additionally, there can be substantial administrative cost savings in not soliciting the votes of very small creditors.
- **Remaining (Voting) Class:** Having established a convenience class, the company is left with fewer creditors to vote on the plan. The required percentage in number established by the company is achievable based on the company's knowledge of the vendor group, and the committee normally has the ear of the larger creditors who support the plan.

The Vote

During the vote, attorneys for both sides will prepare a "full disclosure" document which will be mailed to all creditors in the remaining (voting) class. It is normal for smaller companies to ask for a very high percentage in dollar value. This may be as high as 90 percent, although they would only need 67 percent in Chapter 11. The reason is that the company does not want to have to deal with the 33 percent creditors who do not vote for the plan.

Simply explained, if the total debt is $10 million, 67 percent vote for the plan, the remaining 33 percent represents $3.3 million and is normally too large a number to be supported by the company's cash flow, hence asking for a 90+ percent vote in favor. A company this size does not have $3.3 million liquidity to manage law suits and satisfy potential judgments that would flow from the 33 percent not in favor.

> With composition agreements, there is a high chance that owners will maintain majority ownership of the company and not have to give up equity.

Full Disclosure to Creditors

Full disclosure means full disclosure because if, for example, the company sought a 90 percent vote in favor (in dollar value), yet only received 80 percent in favor, the company can still go to court and use the Chapter 11 process to approve the plan. In this case it becomes a pre-pack.

At this stage, the costs are not as high as a traditional Chapter 11, as long as there has been full disclosure. If the bankruptcy judge feels there has been inadequate disclosure to creditors, the court will request additional disclosures resulting in excessive professional fees and reduce the potential amount available for distribution to creditors.

Potential Disadvantages

There are a number of potential risks in navigating through the process to consummate a composition agreement. The following are some potential disadvantages:

- **Concern for Involuntary Bankruptcy.** There is the danger of unhappy creditors filing an involuntary bankruptcy at anytime during the process, though this risk is mitigated by the company's unfettered ability under the Bankruptcy Code to convert to a voluntary Chapter 11.
- **Alternative Offers.** The committee could come up with an offer better than proposed and the owners could lose control of the company. Shareholders may well be diluted as the creditors might opt for equity.
- **Potential Lack of Clarity in Process.** From the attorney's perspective, the process for a composition agreement is not always as definitive as in bankruptcy. For example, in a retail business with multiple landlords, it is difficult to get agreement on lease concessions without the clear cut rules for assumption and rejection of executor contracts available to a debtor in Chapter 11.

Potential Advantages

The potential advantages of a Composition Agreement are:

- **Expense.** Composition agreements are often cheaper than a Chapter 11 process, providing higher recoveries to creditors. Composition agreements are particularly successful when the voting creditor body is small in number and comes from a close-knit business sector where pressure from the ad hoc committee may result in recalcitrant creditors agreeing to the terms of the composition agreement.
- **Time.** It is less time consuming, customers are not impacted and the company may avoid bad press.
- **Equity.** There is a high chance that owners will maintain majority ownership of the company and not have to give up equity. The owners may also avoid the stigma of "bankruptcy."
- **Effective Prelude to Chapter 11.** Should the creditors not agree to the percentage goals set by the company for the composition agreement, the Chapter 11 process may be shortened and better received by the court, should it become necessary to file for bankruptcy.

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