Statement of Holly Felder Etlin

American Bankruptcy Institute Commission to Study the Reform of Chapter 11

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I am a managing director with AlixPartners LLP, a major crisis management and turnaround consulting firm. I have over 30 years of experience providing advice to underperforming and distressed businesses, primarily in the areas of retail, consumer products and media. I hold the professional designations of CIRA (Certified Insolvency and Restructuring Advisor) and CTP (Certified Turnaround Professional), both of which require documented expertise and passage of comprehensive examinations. I am a former Chairman of the Turnaround Management Association, and former board member of ABI, AIRA and TMA. In working with my clients I have held the titles of CFO, CRO and CEO. I offer this statement as my own opinion, and it does not reflect the views of AlixPartners or our clients.

The process for saving a troubled business has not changed much over the years: you minimize the negative cash flow in order to buy time to properly diagnose the problem, determine whether the business is viable in its current form and move to a solution. Once the business is 'fixed' then you can address an appropriate capital structure to support that business going forward. Depending on the nature of the problems, it may take anywhere from 3-12 months to address the underlying operating issues and show sufficient results such that stakeholders have confidence in the restructured business. Bankruptcy has traditionally been used to allow the management team and stakeholders the time to accomplish this. However, as the code and practice have evolved over the past 20 years, this time has become ever shorter, resulting in Chapter 11 being used to bless a quick sale or recapitalization process, rather than a more comprehensive solution to the business problem. The company post transaction is rarely operationally stronger, often still laden with too much debt, and more likely to make a return trip to the bankruptcy court in short order. In addition, the truncated process often results in lower overall returns for stakeholders than if the company had been allowed to better demonstrate its viability. An examination of how this has happened might produce some suggestions for bankruptcy reform. Following are some examples from my own experience which may prove useful in this discussion.

BAPCPA: or when is 210 days really 90?

Every change to the bankruptcy code has well-meaning proponents. However, the change to the lease assumption/rejection timelines which was intended to level the playing field between landlords and debtors has instead had some significant unintended consequences. Debtor-in-Possession (DIP) lenders are highly adverse to any potential pre-petition claim becoming a postpetition priority claim. Post BAPCA, DIP agreements routinely require a full resolution to the case or rejection of any lease not consensually extended by the 210^{th} day. In the case of a retailer, whose business is naturally lease intensive, the lender takes into account the normal liquidation timeline and requires this ‘full resolution or rejection’ in time to perform any required store liquidations by 210^{th} day---effectively shortening the timeline to reorganize the company to generally only 120 days and sometimes as short as 90 days. In order to resolve a retail case under this timeline, management is faced with a real quandary. They can either focus all their efforts on trying to get consensus with the landlords to formally extend the 210 day period and hope they make it in time to avoid a forced sale or liquidation, immediately start a sale process, or immediately file a Plan of Reorganization to comply with the provisions of their lender. None of these activities are focused on fixing the operational issues that brought them to bankruptcy court in the first place, or on re-building trust with vendors so they can successfully regain trade credit and work on emerging. In fact, this shortened effective period has had the opposite result on liquidity, causing more vendors to remain on the sidelines unless an imminent sale is announced at the commencement of the case. The resulting liquidity crunch further exacerbates the operational issues in the company and shortens the restructuring timeline further by artificially constraining liquidity.

A case in point is the recent bankruptcy of Borders, Inc. The company commenced efforts on its real estate on three fronts the day it filed. Their first focus, to obtain extensions of the 210 day period, second to close underperforming store with no hope of revival and finally to obtain economic concessions on over market leases. This effort involved no less than 10 company people and over 20 outside real estate consultants in order to try to address these issues with the proscribed timeframe. Landlords of high performing stores demanded and received substantial lease modifications in order to waive the 210 day rule. Yet, even with all this effort there were still landlords of approximately 20% of the go-forward locations who would not consent. Taking these stores out the mix meant dramatically less EBITDA for the company, and effectively shortened the time the company could take to restructure its business. In addition, the major vendors to the company remained on the sidelines through this short case, waiting to see if there would be a sale before granting credit. In addition to all of this, management needed to execute on an operational turnaround plan with no time to show any real results before they ran out of time. The company liquidated because they just did not have enough time within the process to show the company was viable to the stakeholders. Thousands of people lost their jobs, and recoveries to unsecured creditors were dramatically less than they would have been in a successful reorganization.

When this process is translated to a middle market company, it becomes almost impossible to do anything but ‘run to a sale’ in order to save the business. Middle market companies just do not have either the management or financial resources necessary to attempt to remain in

Chapter 11 long enough to reorganize. Since BAPCA, most retailers with sales less than $1B who file for Chapter 11 protection have liquidated. Many which were sold under this shortened timeframe made a return trip to court within a few years and liquidated then. So, for retailers of all sizes Chapter 11 no longer provides a safe haven for restructuring their businesses.

KERP vs. KEIP

Another issue which negatively affects the debtor's ability to focus on their reorganization process is the change in how employee retention and severance plans are structured in Chapter 11. The BAPCPA changes were intended to focus on the perceived excesses in senior executive programs, many of which attracted substantial press coverage in bankruptcies like WorldCom. However, in crafting these provisions, a number of inherent facts of business were not taken into account. First, the definition of insiders sweeps in large groups of employees by title and does not recognize the 'title inflation' inherent in American business today. In the Borders case, over 300 employees were potentially subject to this insider definition by virtue of 'Director' or 'Vice President' titles, something which was clearly not intended by the law. These limits not only modified their incentive compensation, but the company's ordinary course severance policies. These employees were of long tenure, with families to support, and it presented a true challenge to management to keep these people focused on the work to be done.

KERP plans should always be subject to review and discussion with the company's stakeholders, but the expanded provisions cause these programs to become an extended negotiation which can often take the majority of the period of a shortened case timeframe. The second issue with the BAPCPA changes is the convoluted calculation provisions intended to limit the divergence between the policies applied to 'senior management' versus rank and file employees. Companies with low turnover are particularly disadvantaged by these provisions, which require the use of averages from actual recent historic experience. Even excluding senior management from the initial process does not seem to solve the problem. Employees in middle market companies understand the inherent risks associated with the Chapter 11 process, and need to know their 'safety net' is properly in place in order give their full attention to the reorganization efforts. At a minimum, the BAPCPA provisions should be made more general to allow discretion to the parties involved to craft something appropriate to the circumstances.

BAPCPA and Financial Contracts

The final area I wish to comment on is the exclusion of certain forms of financial contracts from the automatic stay. Many companies now have financing in the forms which are excluded from any protections under the bankruptcy code. While the pre and post BAPCPA provisions are necessary for financial markets to function, they did not properly take into account their use as financing vehicles. When the principal lender to a business has the absolute ability to liquidate the assets subject to their agreement, the company is DOA on the steps of the bankruptcy court. Companies such as mortgage lenders who use re-purchase agreements to finance their businesses are essentially foreclosed from any opportunity to reorganize. Lending practices have evolved in a way not contemplated by BAPCPA, and this has resulted in much legal controversy and protracted litigation long after the company has liquidated. While the professionals in these cases have benefited greatly, the true stakeholders have seen their recoveries diminished as the litigation dissipates assets which might have been available for distribution.

Financial instruments can be 'melting assets', particularly in periods of market downturn, but allowing a company some limited period of protection under the automatic stay would provide an opportunity for all stakeholders to work for a consensual resolution rather than favoring those which find the exit ramp first. As we have seen in many recent cases, the activity of parties lunging to liquidate their holdings has actually caused more loss of economic value than if cooler heads had prevailed.

I want to thank the Commission for allowing me the opportunity to offer my comments, and for their efforts on behalf of entire industry in pressing for needed reforms in the Chapter 11 process.