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A crowded off ramp

Something weird happened in 2009 in what was perhaps the worst year in history when it came to bankruptcy filings—companies also *exited* in record numbers.

Bankruptcy professionals think that trend will only continue this year for several reasons. They point to the growing number of prenegotiated and prepackaged Chapter 11 filings, the increased use of Section 363 of the U.S. Bankruptcy Code for court-supervised asset sales and friendlier credit markets for those seeking exit financing. While some say more bankruptcies are leading to a higher number of exits, others believe a drop in filings is going to bring the same result.

Following 2009's act will be tough. The 339 exits for the year was by far the most in the decade, and maybe of all time, according to pipeline.thedeal.com. It also represented a significant leap from the 207 in 2008 and 169 in 2007. Concomitant with that rise was the proliferation of corporate bankruptcy filings. Pipeline.thedeal.com tracked 5,521 corporate U.S. and non-U.S. filings in 2009, compared with 4,128 in 2008 and 3,180 fiilings in 2007.

"I think the primary driver [to more exits] is that there were simply more cases filed," says Terrence Corrigan of **Abacus Advisors Group LLC** in New York.

He also believes that companies are now spending less time in bankruptcy, due to the rise in prenegotiated Chapter 11 filings. So as bankruptcy stays shorten, the number of exits within a year will rise as bankruptcy filings do.

"With more prenegotiated filings, there are companies now exiting in 30 days to 45 days, since they are now arriving in Chapter 11 with a broad outline on their reorganization and with agreements with creditors on what a plan will look like," Corrigan says. "When the [federal bankruptcy] laws were changed [in 2005], reducing the time a debtor has to assume or reject leases, that accelerated the process."

He adds, "Historically, retail companies especially found it advantageous to stay in bankruptcy for 12 to 24 months, to have a controlled environment to revise a business plan to operate."

Douglas J. Brickley, managing director of the restructuring practice at global consulting firm **LECG LLC**, believes, however, that the uptick in 2009 filings, including the jump in prepacks, isn't enough to explain all the exits. He asserts that there may have also been a lot of other cases lingering around from previous years that finally resolved their issues during the year.

Others agree. "I think the 2009 exits were based on the 2008 and 2009 filings," says Mark Dalton of **Halsey Lane Holdings**, a New York restructuring firm. "The 2010 exits will more than likely be the result of 2009 flings, so if there's more [filings] in 2009, there will be more [exits] in 2010."

As a result, even if bankruptcy filings start to fade in 2010—and data from pipeline.thedeal.com shows this year is already lagging 2009's pace—the amount of exits could still increase.

"Toward the end of 2009, many projected that at the beginning of 2010, there would be more bankruptcy filings. This has not really come about," Abacus' Corrigan says. "At least what I see, there is not a big uptick in bankruptcy filings in 2010. There's a growing sentiment that it's better to reorganize out of bankruptcy than in it."

Especially since some bankruptcy professionals believe the credit markets have thawed. "With the opening of the capital markets, there could be less companies coming out in late 2010 and into 2011," Halsey Lane's Dalton says. "Defaults are being avoided because of refinancing."

LECG's Brickley feels that better credit markets will also benefit debtors seeking exit financing. Indeed, according to pipeline.thedeal.com, there were already 28 exit financings proposed through Wednesday, totaling $6.2 billion, compared with eight for $459 million for the same period in 2009.

As the number of prepacks jump, and the incentive to drag out bankruptcies wanes, another alternative has rapidly gained favor: asset sales conducted under Section 363 of the Bankruptcy Code, which requires that certain auction rules be followed.

"A trend that I'm seeing is that there are more and more companies filing for bankruptcy that conduct 363 sales," Corrigan says. "By selling assets in a Section 363 sale, you can do it relatively quickly and confirm a plan quickly, rather than staying in and doing a traditional reorganization."

Again, bankruptcy reform has been a key factor here.

"It's very difficult to confirm a plan, especially with recent changes in bankruptcy law," David Warfield of **Thompson Coburn LLP** in St. Louis says. "For example, creditors who ship goods to the debtor within 20 days of the filing are entitled to an administrative priority claim, which has to be paid at confirmation in full in cash. A lot of companies can't do that, so they conduct a 363 sale. The speed and expense of a sale is so much lower."

Fast exits, of course, can backfire on debtors. Companies often rush out of Chapter

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rate on those defenses.)

Debevoise's Wiles thinks preference issues will only become more prevalent as more and more value becomes available to junior creditors.

"Creative bankruptcy lawyers are always trying to push the envelope," he notes.

Especially when there are fewer crumbs available. Paul Hasting's Chesley says creditor recoveries in 2010 will likely decline.

"It's a tough market," he says, "and people are going to have to be nimble and creative to achieve their results in bankruptcy." ■

—Carolyn Okomo

NEXT CHAPTER LOOK AHEAD

Movie Gallery views Chapter 11 again

Too much debt and increasing competition have led **Movie Gallery Inc.** to script a sequel to its October 2007 bankruptcy filing.

The Wilsonville, Ore., movie rental chain filed for Chapter 11 protection on Feb. 3 in the U.S. Bankruptcy Court for the Eastern District of Virginia in Richmond, less than 21 months after emerging from its first bankruptcy on May 20, 2008. It noted in court papers that it would immediately move to close 746 of its roughly 2,600 locations, and likely many more, as it once again attempts to reorganize. Movie Gallery shuttered about 1,700 stores during its earlier bankruptcy.

Chief Judge Douglas O. Tice Jr. of the Richmond court gave the company permission to hire **Gordon Brothers Retail Partners LLC** to liquidate the 746 stores later on Feb. 3 and also gave it permission to use cash collateral.

While online alternatives and DVD kiosk machines are encroaching on the market share of movie rental retailers, Movie Gallery's Oct. 16, 2007, bankruptcy was ultimately the result of an ill-fated $1.25 billion acquisition of rival Hollywood Entertainment Corp. that saddled the company with an enormous debt load. Movie Gallery financed the acquisition in part by raising $870 million in senior secured debt and issuing $325 million in 11% senior unsecured notes.

Second-lien debtholder **Sopris Capital Advisors LLC** funded Movie Gallery's exit from bankruptcy by providing $100 million in exit financing and committing $50 million in new equity by backstopping a rights offering to noteholders.

The New York private equity firm swapped its $72 million in second-lien debt for equity in the company, and holders of Movie Gallery's 11% senior subordinated notes due 2012, owed about $325 million, did the same. But about $624 million of first-lien debt, as well as roughly $117 million in second-lien debt, remained on Movie Gallery's balance sheet upon its exit from Chapter 11.

Moreover, the company did not alter its business model in any meaningful way to compete with mail delivery video rental services offered by **Netflix Inc.** and even **Blockbuster Inc.**, the largest movie-rental chain. Worse still, aside from competitors that offer home delivery of movies, Movie Gallery faced increased competition from **Redbox Automated Retail LLC**'s DVD dispensing kiosk machines. And now **Apple Inc.**'s iTunes platform, **Google Inc.**'s YouTube and an array of cable providers offer on-demand and streaming videos that erode the market share of traditional brick-and-mortar video retailers.

As a result, Movie Galley's revenue declined from about $2 billion in 2008 to about $1.4 billion in 2009, court filings show. The company suffered a $129.3 million operating loss in the fourth quarter of 2009, compared with an $84.8 million loss for the same period a year earlier.

Movie Gallery moved to improve its capital structure by retiring a total of about $246 million in first-lien debt last year. The company swapped $158 million of the debt for equity and purchased $88 million in first-lien debt from its lenders at discounts ranging from 35 cents to 59 cents on the dollar, court filings show.

Nevertheless, Movie Gallery has continued to have liquidity problems and, by the beginning of last year's fourth quarter, faced looming defaults under its loan agreement covenants, filings show.

As of its bankruptcy filing, Movie Gallery has about $394.4 million in outstanding first-lien debt and $146.3 million in outstanding second-lien debt on its balance sheet.

The debtor also owes the full amount of its $100 million exit financing revolver.

Chief restructuring officer Steve Moore of **Corliss, Moore & Associates LLC** said in an affidavit filed with the bankruptcy court that by the beginning of the fourth quarter of 2009, more than half of Movie Gallery's stores were operating at negative cash flow.

"Absent the filing of these Chapter 11 cases and the corresponding ability to exit a substantial number of underperforming stores and further deleverage its capital structure, the company likely would not be able to continue as a going concern," Moore said in the affidavit.

Court filings show Sopris holds at least 11.45% of Movie Gallery's equity. ■

—John Blakeley

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11 still larded with lots of debt and find themselves having to file again. Case in point: **Movie Gallery Inc.** on Feb. 3. It had $800 million on its balance sheet when it left its first bankruptcy on Mary 20, 2008. (See above.)

"If this is going to be a double-dip recession, meaning another drop in the economy, which a lot of people think is a possibility, then you will see a lot of companies come out into a tough economic environment to operate in," Brickley says.

Brett Miller, a partner with **Morrison & Foerster LLP** in New York, does not rule out the possibility of Chapter 22 filings by recent reorganized debtors. "I think it's possible for companies that came out prior to [the recession], those may be companies that are on the watch list, because [financial] projections made back in May 2008 may be very different from the projections in May 2009," he says.

Not to mention that while the economy is recovering, it's hardly inspiring. Unemployment still borders 10%, and worries linger about a commercial real estate meltdown and the fiscal woes of the federal government on down to local ones. So companies that do exit this year may want to heed the conditions they are emerging into.

"The companies that will be exiting from Chapter 11 this year, there's a chance they will be back in," Corrigan says. "It's just a fact that not all companies that reorganize out of bankruptcy will be successful." ■

—Kevin Fung