

RENAISSANCE

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SECURING VALUE IN UNDESIRABLE CIRCUMSTANCES: WHY CHAPTER 11 MAY BE THE BEST OPTION FOR LIQUIDATION

By Domenic Pacitti, Partner, Klehr, Harrison, Harvey, Branzburg & Ellers, LLP

These days, many companies that face financial challenges are experiencing more reluctance than ever from their lenders when they attempt to extend maturities, renegotiate terms or increase borrowing availability. Rather than allow a company the time it would need to restructure financially or operationally, creditors often see liquidation as their most favorable option.

Often, by the time management has finally concluded that additional liquidity or other financial support is unavailable, the company's financial condition is so dire that a typical reorganization under the U.S. Bankruptcy Code is impossible or so costly that it is not in the company's best interest. Consequently, many lenders are now adding stipulations to financial accommodations that require companies to sell assets and wind down their affairs in these types of situations.

The liquidation of a business can take many forms depending on the nature of the business and the willingness of lenders to support the process. These options include state court receiverships, assignments for the benefit of creditors, sales under the Uniform Commercial

Code, Chapter 7 bankruptcy and Chapter 11 liquidations. While the traditional objectives of Chapter 11 are to reorganize a company and exit as a going concern,

Chapter 11 is a viable option to liquidate assets and maximize value, and liquidations in Chapter 11 have become quite normal. Courts have almost uniformly held that approval of a proposed sale of assets before the confirmation of a plan of reorganization is appropriate if the transaction represents a reasonable business judgment on the part of the company. In fact, some argue that the use of Chapter

11 results in a more orderly liquidation that increases the ultimate return to creditors, thereby satisfying a company's duty to achieve the greatest overall benefit possible. Recent examples of Chapter 11 liquidations include Whitehall Jewelers, Linens 'n Things, Friedman's Inc., Drug Fair Group, Inc., JEVIC Transportation, S-Tran Holdings, Inc., The Sharper Image and Mervyn's.

A significant advantage of using Chapter 11 bankruptcy as a liquidation method is that it affords businesses the ability to retain management and employees necessary to business operations during the liquidation process. This allows a



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RENAISSANCE

FROM THE DESK OF
Jim Ross

Since 1980, MorrisAnderson has been working with stakeholders to steer more than 1,500 underperforming companies toward operational and financial success. With an average of 25 years of real-world line management success, executives in finance, manufacturing, distribution and logistics, marketing and information systems are working in virtually every economic sector to maximize enterprise value.

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WHICH WAY IS UP?

By Jim Ross, Principal at MorrisAnderson
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Many are confident that the economic free-fall we have seen over the previous four quarters has slowed. But the question of the moment is, "How fast will the economy grow and when

will growth start?" I don't believe third-quarter '09 growth statistics are a true measure of the current economic trends. The effect of stimulus spending and the statistical volatility that generally occurs in periods of changing trends will give misleading results. Real, sustainable growth in the domestic economy is still to be seen.

A lot of conflicting forces are at play in the economy now. Trillions of dollars of asset value has been lost at both the individual and business level. Some of these losses will not be recouped for years. Unemployment is still rising and will likely hit its peak in the first or second quarter of 2010. Estimates of what that peak will be range from 10 percent to 11 percent, but underemployment may max out at closer to 20 percent. The consumer engine will find it hard to recover quickly if the numbers are that high. And, of course, Wall Street still appears to be disconnected from Main Street. While the apparent quick recovery of the stock market may indicate an overall economic recovery, most experts agree this is not a reality. In the long term, the deficit, a weak dollar and interest rate movement will affect the recovery.

Our recommendation to middle-market businesses is to be prepared to deal with a long, slow recovery period. If your financial strength is dependent on a quick recovery in the next 12 to 18 months, you must continue the restructuring efforts and conserve cash. It will likely be a long road back and you will have to be prepared to stay the course.

Securing value in undesirable circumstances: Why Chapter 11 may be the best option for liquidation, continued from page 1

company to stabilize its operations and provide the ability and expertise needed to shut down unnecessary facilities, marshal assets for disposition and provide time and marketing necessary to avoid “fire sale” prices. When liquidations are accomplished through Chapter 11, going-concern sales, piecemeal asset sales, going-out-of-business sales and/or auctions help keep monetary losses to a minimum.

To determine if Chapter 11 is the best liquidation route for you, it is important to weigh the relative cost of the process against the estimated return on the asset sales in the Chapter 11 (as compared to estimated returns from other alternatives). In cases where assets can be sold for significantly more through a Chapter 11 liquidation, lender support through the use of cash collateral or debtor-in-possession financing is often available. In cases where values are thin and costs uncertain, Chapter 11 may not be the best option.

A potential downside to continuing operations in Chapter 11 is increased administrative costs and the challenge of deciding whether to liquidate as planned or convert the case to Chapter 7. If, however, the company and its lenders work together to analyze the options and relative costs, potential challenges can be avoided. Specifically, it is imperative for the company to budget appropriately for the Chapter 11 process when negotiating the use of cash collateral or a debtor-in-possession loan. By working through the options and process, creditors and company management often conclude that the structured, streamlined process of asset sales in Chapter 11 maximizes value.

To determine if Chapter 11 is the best liquidation route for you, it is important to weigh the relative cost of the process against the estimated return on the asset sales in the Chapter 11 (as compared to estimated returns from other alternatives).

Liquidation of the major assets of a business is the first step to streamlining the company and winding down the company's affairs in an orderly fashion. During the process, management can take comfort in the fact that most, if not all, additional activities to settle the company's remaining affairs are organized, court-approved functions. These include rejection of contracts and leases, providing notice of business closure to employees under federal and state statutes, the termination and asset distribution of 401(k) plans and the monetization (via settlement or litigation) of collateralized self-insured components of workers' compensation or liability insurance programs.

Once the assets of a business are liquidated and its affairs substantially wound down, the debtor or the creditor's committee will typically propose a plan to make distributions to creditors. A Chapter 11 liquidating plan often includes provisions for the establishment of

liquidation or litigation trusts into which all remaining assets are transferred and pursued on behalf of the estate.

The number of business liquidations associated with Chapter 11 is steadily increasing. If lenders, the company and their advisors work together to formulate a strategy geared toward maximizing value, and remain mindful of the costs associated with the process, a successful liquidation is likely. Any troubled businesses that are contemplating liquidation and those doing business with companies that may be forced into liquidation are advised to seek the advice of restructuring professionals regarding the various methods of liquidation available.

Domenic Pacitti

Domenic Pacitti is a Partner of Klehr, Harrison, Harvey, Branzburg & Ellers, LLP in Wilmington, Del. He concentrates his practice on bankruptcy, restructuring and workouts, representing debtors, creditors' committees, secured creditors, unsecured creditors and acquirers of distressed assets and companies. Pacitti was named one of "America's Leading Lawyers in Bankruptcy" by Chambers USA, America's Leading Lawyers For Business, The Client's Guide 2006 through 2009.

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Dan Dooley, Chicago-based Principal and COO of MorrisAnderson, was a panelist for the Chicago Bar Association's event on Nov. 17 at the CBA headquarters. The panel discussed, "Distressed Business Issues for the Non-Bankruptcy Attorney." Dooley was also a panelist at the NCBJ Conference in Las Vegas on Oct. 20, where the panel discussed "Employment Issues in Chapter 11," and at the ABI Midwestern Bankruptcy Institute in Kansas City, Mo., on Oct. 2, where the panel discussed "Financing a Chapter 11 — Pre, During and Exit." He was also interviewed by the *ABF Journal* for the roundtable article, "In Troubled Times, Turnaround Professionals Bring Skilled Expertise to the Ring," for the September/October issue.



Ken Yager, Chicago-based Principal of MorrisAnderson, was a panelist on Sept. 16 for the 5th Annual Southeastern M&A Forum sponsored by West Legalworks and the Business & Finance Section of the Atlanta Bar Association. The panel discussed distressed mergers and acquisitions. Yager's responsibilities as principal at MorrisAnderson have expanded to include managing MorrisAnderson's consultants, client projects and marketing in the Southeast.



Chicago-based Consultant **Ray Neihengen** was a participant in the Executive Panel at the 2nd Annual Middle Market Commercial Banking Symposium in Chicago on Oct. 19. The

panel discussed insights into key drivers of success for middle-market banking.



Steve Agran, Consulting Manager with the New York office, has been promoted to the position of Managing Director. He has been with MorrisAnderson for two years and has worked in the turnaround consulting industry for 20 years. Agran has particular expertise in trucking and consumer products. Agran was also presented with his certified insolvency and restructuring advisor (CIRA) certification at the Association of Insolvency & Restructuring Advisors' (AIRA) annual dinner earlier this year.



New York-based Managing Director **Lance Miller** received his certified turnaround professional (CTP) designation from the Turnaround Management Association (TMA) in September. MorrisAnderson now has a total of 13 CTPs and one CIRA.



Alpesh Amin, Consultant with the Chicago office, has been promoted to Consulting Manager. He has been with MorrisAnderson for two years and has worked in the turnaround industry for 10 years. He is currently managing a sizeable project in the hardware distribution industry.



Robert Aquilino has joined MorrisAnderson's Charlotte office as a Managing Director. His experience in the consumer products industry further strengthens MorrisAnderson's expertise in that important industry segment. Before joining MorrisAnderson, Aquilino was president of SpinVox, Inc., and led the reshaping of the company's North American sales and marketing organization. Other experience includes leading turnarounds at several mid-cap acquisitions in consumer products and business-to-business technology products. He also played a leadership role in the marketing and sales departments of several big-name, international brands, including Pepsi, Frito-Lay, Kidde and Invisible Fence, Inc.

John Weber has joined MorrisAnderson's St. Louis office as a Consultant. Weber brings more than 20 years' executive operations experience to MorrisAnderson and will supplement MorrisAnderson's long-established reputation as an "operations"-focused practice. He is well-versed in several operations functions, including merger integration, manufacturing and distribution efficiency and outsourcing, performance improvement, and back-office processes. He has worked with clients in a variety of industries, including pharmaceuticals, consumer goods, printing, food-service distribution, biotech, agricultural services, printing and more. Before joining MorrisAnderson, Weber held executive positions at Summit Street Advisors, Huron Consulting Group and Remington Financial Group.

NEW MORRIS ANDERSON ENGAGEMENTS

Automotive Components Assessment

We will assess a \$250 million auto parts manufacturer that just assumed \$50 million of transfer work from a bankrupt competitor.

Expert Witness Litigation

We are assisting a liquidating trustee in pursuing a multimillion-dollar contract-damages claim.

Accuride Unsecured Creditors' Committee

The Unsecured Creditors' Committee for Accuride, a \$560 million truck parts manufacturer, chose us as financial advisor.

Acquisition Due Diligence

We are evaluating facilities for potential cost take-outs and facility consolidation plans for a Department of Defense electronics manufacturer.

Defense Instrument Manufacturer

We performed a viability assessment of this \$20 million business with liquidity issues.

HVAC Distributor

We are engaged in a turnaround of a \$30 million ESOP-owned business.

Burr Oak Cemetery Chapter 11

We have been appointed COO in this high-profile Chicago bankruptcy.

Dime Building Expert Witness

We are an expert witness in a Detroit Chapter 11 that involves the feasibility of a proposed plan of reorganization (POR) for this historic building.

Consumer Products Distributor Wind-Down

We have been appointed CRO in the out-of-court wind-down of a \$35 million artificial flowers distributor.

FormTech Unsecured Creditors Committee

The Unsecured Creditors' Committee for FormTech, a \$150 million steel forging foundry, chose us as financial advisor.

Military Apparel and Tactical Gear Distribution

We are assisting this \$40 million distributor in its efforts to find a buyer.

Arclin Unsecured Creditors Committee

The Unsecured Creditors' Committee for Arclin, a \$400 million Canadian and U.S. chemical products company, chose us as financial advisor.

Sante Fe Cattle Company Chapter 11

We acted as CRO and investment banker for this \$60 million casual restaurant chain with the 363 sale closing in October.

IFC Credit Corporation Chapter 7

We are acting as financial advisor to the Chapter 7 trustee for this equipment leasing company with \$100 million of secured debt.

Automotive Components Assessment

We are doing an assessment of a \$150 million automotive components manufacturer.

Credit Card Manufacturer Assessment

We are doing an assessment of a \$70 million credit card manufacturer.

SAI Holdings Expert Witness

We are an expert witness in a multimillion-dollar lawsuit involving a Toledo Chapter 11.

TRANSACTIONS COMPLETED

- Sale of Drivesol Sweden, a tier-one automotive pedal manufacturer
- Debt restructuring and lease renegotiations for Granite City Food & Brewery, a 26-store casual restaurant chain in Minneapolis
- Sale of an injection molding business in Oxnard, Calif.
- Section-363 sale of 12 restaurants owned by Santa Fe Cattle Co. (TN Chapter 11)
- Reorganization plan for Renova Energy, an ethanol producer and distributor (WY Chapter 11)

GUSHER OF DISTRESS IN OIL AND GAS!

By Jeff Beunier and Tim Shaffer, Consultants at MorrisAnderson, jbeunier@morrisanderson.com; tshaffer@morrisanderson.com

The independent domestic oil and gas industry is seeing a gusher of trouble and woe. Extreme volatility in prices creates unmanageable revenue streams, strained operating margins, restricted free cash flow and impaired balance sheets. Smoothing volatility means matching energy supply to demand, which is a slow process.

In an environment of falling oil and gas demand, leasing stops, drilling rigs and “dumb iron” go to the scrap yard, and skilled employees are laid off. Projects previously committed, but not fully funded, are extremely difficult to manage. New risk dollars are elusive. The question today is one of survival, not simply downsizing.

“Upstream” (resource holding) companies drive the domestic energy sector. In 2007, they drilled 54,300 wells, investing more than \$243 billion and paying landowners \$30 billion in royalties. To sustain viability, these companies focus on the incremental increase of their mineral reserves. Therefore, all midstream and service firms depend on the drilling activity and oil and gas throughput of the upstream companies. When upstream companies get the sniffles, the whole energy sector gets sick.

When demand falls, these companies experience the dark side of leverage. Revenue and collateral value decline, placing existing debt out of balance. In certain cases, entire fields become uneconomic and are shut in. Revenues drop while holding costs accrue and debt payments are demanded.

The speculative frenzy of years past resulted in reserves with a high-cost basis. Over the last 12 months, oil and natural gas prices have cratered by as much as 75 percent. Free cash flow has been crushed and the debt-to-asset-value ratios of many upstream companies are drastically impaired. Say “goodbye” to dividends, distributions and equity!

Exploration is the engine that drives the train, and rig demand is a key indicator of the engine’s power. The number of operating drilling rigs has declined by approximately 45 percent since mid-2008.

These issues trickle down to service and midstream companies. Every well drilled is supported by 10 to 30 service companies. For the “down-hole” companies that provide services such as cementing, logging and testing, a 50 percent reduction in drilling activity is nearly terminal. Most service equipment is not cross-functional, and requires skilled personnel. Anyone want to buy a used, radioactive logging tool? They make great bug zappers.

Midstream companies focus on the transportation, storage, refining and distribution of oil and natural gas. Government regulation of rates, maintenance, environmental concerns and safety standards provides little flexibility to control costs. Without continued drilling, existing reserves become depleted. Less production means less volume, which translates to less revenue.

For energy companies, traditional turnaround management practices most likely will not be appropriate. Crisis-management techniques will be required to effectively address earnings and capital structure. Reappraising project and operational economics is mandatory and requires companies to face brutal realities. Cutting costs and shedding marginal assets may not be enough. Due to the credit crisis, traditional remedies such as merging with an industry partner, refinancing with a more aggressive lender or issuing equity or long-term debt are not readily available. Most likely, a financial restructuring will have to take place if companies are to survive. Debt renegotiation in or out of court is often the only option.

Upstream companies must conduct a critical assessment focused on improving EBITDAX¹

margins. In the near term, unhedged, gas-centric companies will face a difficult redetermination period as gas prices near seven-year lows. Oil-centric firms should escape the redetermination period unscathed. Companies should seek out trustworthy joint venture partners to share costs and optimize acreage positions. Undeveloped assets must contribute to earnings rather than protect proven reserves. Limited lending availability will result in marginal reserve replacement. Low-cost producer standards need to be implemented and high-cost operations need to be sold or abandoned.

For service companies, crisis management and “hard-truth” analysis is critical. Adjusting to the tumultuous decline in drilling activity requires drastic de-levering measures. Expect in-court solutions to be the preferred norm. Oil-centric service companies can expect to find a more stable environment, as the recent rebound in oil prices has stemmed the plummet in rigs drilling for black gold.

On the other hand, natural gas-centric service companies face a bitterly cold winter as gas prices have fallen below production costs, and continue to remain unseasonably low. At the same time, storage is near capacity and demand is declining. Expect liquidations to increase in this subsector. Survivors would be wise to redeploy assets to serve the large gas-producing shale fields that still provide relatively attractive returns.

When orchestrating oil and gas restructurings, professionals need to understand the unique characteristics and pitfalls of the industry, such as leasehold rights, royalty obligations and triggers, hedging strategies, lien priorities, regulatory compliance and production metrics. Survival is the only avenue to success. Live today to drill tomorrow.

¹EBITDA and Exploration (X)

THE EVOLUTION OF BANKRUPTCY

By Robert M. Fishman, Member of Shaw Gussis Fishman Glantz Wolfson & Towbin, LLC



Robert M. Fishman

I began practicing in the insolvency/bankruptcy world in 1980. Then, the firms involved were largely smaller specialty practices. The cases generally involved small, privately owned companies

with liquidity problems, obsolete products or management in over their heads. In the 1980s, some larger cases began to appear and the larger firms took a more active interest in the area. The insolvency/bankruptcy area continued to grow, and eventually became a mainstay practice area for most major firms. Today, bankruptcy cases are prevalent and substantial. They affect commerce in an undeniable way.

The evolution began with the adoption of the U.S. Bankruptcy Code of 1978 (the "Code"), which applied to cases filed starting in the fall of 1979. The Code was a more user-friendly, efficient and effective legal (and strategic) tool than its predecessor, the Bankruptcy Act of 1898. The number of cases filed under Chapter 11 of the Code increased with time, as companies found it an effective way to manage creditors' claims; obtain financing or the use of cash collateral during the operation of the case; rehabilitate a business and reorganize its debts and equity into a viable product; or even liquidate a business or its assets.

Naturally, creditors also learned to use the new process. Initially, creditors and debtors clashed over the new provisions of the Code. They filed numerous motions and objections, testing the boundaries of the Code sections and the limits to which they, and the judges interpreting them, could be pushed.

Some lenders tried the tactic of maximum resistance against any effort by a borrower to reorganize under Chapter 11. This was an attempt to deter the use of the Code as a way to avoid repaying obligations in full. This resulted in numerous expensive and time-consuming legal battles, which were detrimental to all parties and the entire process. Over time, case law made it clear that the resistance-at-all-costs approach would not be successful. Boundaries evolved and certain outcomes, even over the vehement objection of the secured creditor, became predictable and ordinary.

The lending community's approach also evolved. More and more lenders realized that merely being resistant was not going to be a successful strategy. Lenders started to accept the reality of the Code and borrowers' rights. It became easier to negotiate cash collateral orders, adequate protection provisions and plan terms with lenders. Eventually, this evolution progressed to out-of-court deals as an alternative to bankruptcy cases, which were quicker and more cost-effective than formal Chapter 11 cases. Over time, out-of-court workouts, with sophisticated provisions and substantial protections for the benefit of all parties, became the norm, and filings decreased.

Bankruptcy court increasingly became a destination for liquidations and sales. There were numerous good reasons to use Chapter 11 of the Code as a vehicle for orderly liquidations. The automatic stay prevented haphazard litigation from dismantling an enterprise before a thoughtful disposition could take place. Lenders were much more comfortable financing a liquidation under Chapter 11 than they were with the same liquidation outside of bankruptcy, due to the protections lenders have under debtor-in-possession financing orders; the ability

to impose enforceable deadlines for the accomplishment of milestones; the availability of a court to resolve disputes; and the ability to sell free and clear of liens, claims and encumbrances provided under the Code. All in all, a well-run sale process in Chapter 11 created a positive environment for attempting to maximize asset value, to creditors' benefit.

Use of Section 363 of the Code to sell the assets of a debtor apart from confirmation of a plan, is now generally acceptable. The acceptability of this approach depends upon sound business judgment, although the loudest creditor with the most leverage in the case (typically the secured creditor) is often able to encourage this approach. Continued reliance on Chapter 11 (and specifically Section 363) to liquidate the collateral of secured creditors has led to numerous questions about the appropriateness of using Chapter 11 solely to benefit the secured creditor, a topic which is still pertinent in bankruptcy court.

Over time, Chapter 11 has become a haven for many cases that Code drafters did not envision. Nowhere is that more evident than in the case of mass tort cases, such as those that focus on asbestos and medical products. The extent to which Chapter 11 has become a financial planning tool, to address union contracts, burdensome leases, the cost of appellate bonds and other narrow issues, rather than a destination of last resort to address global financial difficulties, has increased over time.

Today, we are in the midst of the craziest credit environment of my lifetime. The challenges of the bankruptcy system are substantial, as securing exit financing to allow viable companies to complete plans is difficult. The tolerance of lenders to write off debt, defer interest or extend loan maturities has been adversely affected by the lending regulatory climate, and amendments to the Code (relating

Continued on page 8

The Evolution of Bankruptcy, continued from page 7

As the holiday season approaches,
we find ourselves reflecting on
the past year and on those who have
helped to shape our business in a
most significant way.
We value our relationship with you
and look forward to working with
you in the coming year.

We wish you a very happy
holiday season and a new year filled
with peace and prosperity.

*Dan Dooley, Alan Glazer, Larry Hennessy,
Howard Korenthal, Jim Ross, Ken Yager, Domenic Aversa
and the entire MorrisAnderson team*

to non-residential leases, pre-filing trade claims, pension claims and other issues) have complicated the process and made plan confirmation much more difficult and unlikely. With the increased pressure on business entities to achieve profitability and the increased pressure on lending institutions to make objective and sound business decisions respecting loan extensions, forbearance and concessions (as determined under the current regulatory climate), it seems that complex and challenging times lay ahead for those practicing in the insolvency world. As the ancient Chinese saying goes, "May you live in interesting times." I think we are there.

Robert M. Fishman

Robert Fishman is the Co-Chair of the Bankruptcy, Reorganization and Creditors Rights practice at Shaw Gussis. His practice is concentrated in the areas of debtor-creditor relations, insolvency and bankruptcy, representing a wide range of clients in business cases throughout the United States.

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