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**WORKOUT TACTICS AND OTHER STRATEGIES  
TO AVOID CHAPTER 11 BANKRUPTCY**

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## **Introduction**

The topic of declining bankruptcy filings has been on the minds of bankruptcy practitioners for quite some time. Over the past four years, the number of business bankruptcy filings has decreased by about 25 percent.<sup>1</sup> But chapter 11 filings generally have decreased by only about 14 percent.<sup>2</sup> This suggests a greater decline in business chapter 7 cases versus a smaller decline in business chapter 11 cases. And that makes sense. There is no practical alternative to a traditional chapter 11 reorganization. More specifically, there is no alternative way to cram down an uncooperative creditor. But there is more than one way to liquidate a business. Whereas the only alternative means of reorganization is a cooperative workout, known as a composition of creditors, a business can liquidate through dissolution, receivership, or an assignment for the benefit of creditors.

## **Workouts and Compositions with Creditors**

Workouts and compositions are similar in that both are intended to restructure debts of distressed business. Typically, the goal of both is to avoid the termination of operations. A workout is a more generic term and generally refers to any debt-related settlement arrangement. A composition, however, is a contractual agreement between a debtor and two or more assenting creditors under which the creditors agree to accept less than the full amount of their claims, typically on a *pro rata* basis.<sup>3</sup> It is noteworthy that the composition is not just an agreement between the debtor on the one hand and its creditors on the other. It is also a binding agreement between the creditors *inter se*.<sup>4</sup> The creditor parties are "bound to the exercise of good faith in preserving the equality of payment of the debts of the [debtor] which the terms of the agreement contemplate[] ...."<sup>5</sup> Workouts and compositions with creditors will likely fail if the participating creditors lack confidence in the debtor's management team or believe that the debtor is not being forthright about its finances or operations.

Another unique aspect of a composition is that "a composition contains the consideration for the agreement within itself ...."<sup>6</sup> "The consideration for a composition of creditors is the mutual covenant of each creditor to accept the settlement."<sup>7</sup> "Such an agreement, if entered into

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<sup>1</sup> United States Courts, June 2018 Bankruptcy Filings Fall 2.6 Percent (July 24, 2018), *available at* <http://www.uscourts.gov/news/2018/07/24/june-2018-bankruptcy-filings-fall-26-percent>

<sup>2</sup> *Id.*

<sup>3</sup> See 17 Tex. Jur. 3d Creditors' Rights and Remedies § 60.

<sup>4</sup> See *P.J. Willis & Bro. v. Morris*, 63 Tex. 458 (1885).

<sup>5</sup> *Id.*

<sup>6</sup> 17 Tex. Jur 3d § 61.

<sup>7</sup> *Cadle Co. v. Int'l Bank of Commerce*, No. 04-06-00456-CV, 2007 WL 752260, \*3 (Tex. App.—San Antonio March 14, 2007).

by a debtor with a number of his creditors, each acting on the faith of the engagement of others, will be binding on them, for each in that case has the undertaking of the rest as a consideration for his own undertaking."<sup>8</sup> This characteristic distinguishes a composition from an accord and satisfaction, which requires additional consideration.<sup>9</sup> Thus, lack of consideration probably will not apply as a defense to enforcement of a composition.

Texas state cases discussing compositions with creditors were somewhat common in the first half of the twentieth century, especially considering it was a time before modern word processing. But there are almost none after the 1970s. The decline of compositions therefore appears to coincide with the rise of modern bankruptcy law. Just as Congress was enacting the Bankruptcy Code, one Texas Court even described Chapter XI of the former Bankruptcy Act as "provid[ing] a quick efficient method of implementing a composition among the debtor's general creditors with minimal court involvement."<sup>10</sup> Modernizing federal bankruptcy law might have caused debtors to abandon old fashioned state-law remedies.

That is not to say, however, that compositions are necessarily a thing of the past. But there is an obvious impediment. Any bankruptcy practitioner knows that creditors are reluctant to consent to anything. When a single undersecured creditor's claim is secured by all of the debtor's assets, including cash, there is little to negotiate from that creditor's perspective. Likewise, from the perspective of the same debtor's general unsecured creditors, the debtor has little to offer. A composition requires more than one creditor's assent, so these creditors' diametrically opposed positions leave almost no room for compromise. As the cost of chapter 11 increases, however—especially because that cost is borne by creditors—it is possible that the cost will rise enough to bring everyone back to the negotiating table.

#### *Advantages of Workouts/Compositions to Bankruptcy*

- Typically less expensive
- Done out of court and thus generally less damaging to the reputation of the business
- Less disruption to operations
- Better control over the process
- Allows for more flexibility and creativity

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<sup>8</sup> *Cade Co.*, 2007 WL 752260 at \*3 (quoting *Texarkana Nat'l Bank v. Hubbard*, 114 S.W.2d 389, 392 (Tex. App.—San Antonio 1964)).

<sup>9</sup> 17 Tex. Jur. 3d at 61.

<sup>10</sup> *Valley Int'l Props. V. Los Campeones, Inc.*, 568 S.W.2d 680, 685 (Tex. App.—Corpus Christi 1978).

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