

Alternatives for the Financially Distressed Business?

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This chapter is for a business that is in a financial distress. We will deal with what alternatives are available, when and under what circumstances to file bankruptcy, and what types of bankruptcy filings are appropriate for the situation.

The Warning Signs

One of the first and most important points in dealing with this difficult situation is to emphasize the need to face up to the business problems and dealing with them earnestly and early will provide more options and will make the process less painful. Too often entrepreneurs adopt a “head in the sand” approach and cannot recognize the urgency of the financial distress or their responsibility in permitting it. While it is inevitable that situations will occur which are truly outside the control of the entrepreneur, in the vast majority of cases, management bears the responsibility for the financial condition of the business.

Sometimes financial problems arise because the entrepreneur is out doing what he/she does best: selling and building the business and may either not be getting the right financial information or may be getting the information but not paying close enough attention. It is crucial to make sure that you as the owner get good information about how the business is performing, and that the information is reviewed. This may sound as stating the obvious, but getting credible information and taking the time to understand it and what it means to the business is something that is too often taken for granted.

As an example, the entrepreneur should be watching the status of accounts payable and accounts receivable. You don't want to see too late that your business is behind on paying bills or that receivables are lagging. A warning sign that the business is headed for financial trouble would be a call from the bank saying that the financial ratios of the businesses are out of compliance or that loan covenants are not being complied with. Another more obvious warning sign is the filing of a lawsuit or a writ of attachment from a creditor or vendor. (A writ of attachment is an application to the

court to freeze assets pending the outcome of a trial and it can significantly hamper operations of a business.) Another more subtle warning sign is significant or sudden turnover of management staff. The managers may be closer to the day to day activities and they may experience stress or see that the business is not performing well and thus leave for greener pastures.

A serious sign of a looming financial crisis is the set off or freezing by the bank of the business bank account, due to a delinquency in the loan. If the business has gotten to a point where the bank account has been frozen, this is a sure sign that you have waited too long and unfortunately, not taking action earlier will likely limit available options at this point. The option of moving away from the existing bank lender to a more flexible asset based lender or accounts receivable finance lender may not be possible at this point. This underscores the importance of taking action early when options are still available.

Case Examples – The importance of acting early

A couple of case examples show the importance of addressing a company's financial problems early.

In the first case, our client was a sign manufacturer who realized his business was in trouble so he immediately engaged a bankruptcy attorney and a turnaround consulting firm to help him work through his issues. The turnaround team was in time able to pacify the bank, get the books and records in order, appease the vendors and creditors, and help get the business get back on track. The entrepreneur was a critical and integral part of this process. By getting the professionals involved early the entrepreneur was able to keep his focus on business operations and leave the legal issues and dealing with the bank and creditors to professionals who have experience in this area. After the turnaround, the business was sold, and the bank debt that the owner had guaranteed was paid off. If the owner had not acted when he did, the business likely would have continued its downward slide, not been sold but likely ended up being liquidated.

In another case, a company was involved in litigation which if adversely decided would have resulted in the assets of the company being seized. The company called us in during the litigation to help them plan so that they

would still be able to operate if the litigation was successful. As it turned out, the litigation was resolved successfully, but this was a case where the entrepreneur understood the importance of pre-emptive planning.

Hiring of a Consultant

When the business is in trouble, one of the first things is to hire a good turnaround consultant. Too often the business owner's reaction to the hiring of a consultant is that the owner knows the business best since he/she often has started the business and believes that someone else surely cannot direct the business at its most critical hour. While that may be true, almost invariably the entrepreneur does not have experience in how to deal with the issues surrounding financial distress. The turnaround consultant may not know the company, but what he/she brings to the table is an understanding of the issues that need to be addressed when a company is in financial distress. Certainly the consultant needs to learn the business, but understanding the mechanics of financial distress, and how it affects the balance sheet of the company and its creditors, and more importantly how to address these effects, become pivotal.

As one example, one of the first things a turnaround consultant will do is to look at whether the inventory is overstated on the books. This happens to be a common problem with financially distressed companies, and one that business owners are not accustomed to looking at. A consultant will also have considerably greater experience in understanding how to approach a bank whose loan may be in default, the creditors who may be clamoring for payment, and the employees who likely are nervous about losing their jobs, allowing the entrepreneur to continue to focus on the business itself. This in and of itself is often an important ingredient contributing to the success of a turnaround.

It is typical that when a business is in financial distress, banks, creditors and vendors take it out on the entrepreneur blaming him or her, whether fairly or not, for the liability created to that creditor. An important contribution from a turnaround consultant is the credibility that a qualified turnaround consultant can bring to the business's creditors, who may have lost confidence in the entrepreneur and/or his management team. The turnaround consultant may be able to get vendors to continue to supply

product on credit or may even be able to get additional financing from the company's bank based in part on his/her credibility. Typically a bank will move a defaulted loan from the regular loan officer to a "special assets" officer. These bankers tend to be much more hard nosed than the entrepreneur may expect from the bank. The special assets bankers are however accustomed to working with turnaround consultants. Often the bank will welcome the engagement of a turnaround consultant, and indeed in some cases will recommend a turnaround consultant to the business owner. This is because the bank knows that the turnaround consultant will be truthful and accurate about current events in the business. This is not to say that banks and creditors do not trust the business owner, but often it is the entrepreneur who is regarded by the creditors as having caused the business's demise, and so is viewed with some level of skepticism.

A turnaround consultant will also be valuable if the business ultimately has to file bankruptcy, since the experienced turnaround consultant will have expertise in the bankruptcy court process. They will be able to anticipate the procedural issues that arise in a bankruptcy, are able to "talk the language" with attorneys and creditors, and can help prepare the many necessary financial documents needed for and during a bankruptcy filing, all the while allowing the owner to remain focused on the business operations.

The Importance of Candor

The natural inclination for the entrepreneur when a business is in trouble, is to keep quiet about it, not to tell the bank, creditors, even the employees. However, the information inevitably does come out and the bankers typically lose confidence if they learn about untoward business events from third parties rather than directly from their own borrowers.

While we advocate being candid, the way one communicates information to creditors is crucial. If vendors and creditors have been calling without return calls, their natural tendency is to think the worst. Getting back to them with a response is important. This is where a turnaround consultant can be particularly helpful. They lend credibility and usually some level of confidence simply by being involved. The consultant will usually establish contact with suppliers, creditors and lenders which is essential to a turnaround.

It is also important to determine with which employees and/or managers the information needs to be shared. In many cases, the management team is already aware that the business is having trouble and may be worried about their own jobs. If they are not already aware, they will quickly become aware when lenders and business consultants begin to look at the books and ask questions. Being candid and upfront in a tactical way helps engender support from employees as opposed to allowing them to dwell on the fear of the unknown. Enlisting employees “buy-in’ to the turnaround process is essential. Letting employees know that professional help has been engaged and that the turnaround program is underway, goes a long way toward preventing employee attrition and production fall off.

Case Example – The Downside of Not Getting Help

Our firm was engaged by a business that rented durable medical devices such as wheelchairs that patients needed on a long term basis. The owner was having financial problems, but he refused to acknowledge that any of the financial difficulties were attributable to his management. He viewed all the problems as being caused by someone else. Even though at our urging he hired in a team of turnaround professionals to help him with the situation, he would not give the members of the team the authority to do what they needed to do or to disclose the information that should have been provided to creditors and lenders. Largely as a result of this, when the company filed for bankruptcy, the consultants were not able to implement the necessary changes and the judge felt he was not being given accurate information. The owner also had little credibility with the lender and creditors. The bankruptcy was later converted from a Chapter 11 reorganization to a Chapter 7 liquidation. If the entrepreneur had allowed the team to do what they were hired to do, the business could have been sold (there was a buyer in the wings) rather than having to be liquidated. In addition, the entrepreneur had to file personal bankruptcy because he had personally guaranteed the bank debt.

Case Example – How Getting the Right Help Can Result in a Turnaround

In another example, we represented a client in the food distribution business. The owner of the company brought us in early and we brought in

turnaround consultants. The company ultimately filed bankruptcy because of financial problems that could not be resolved without a bankruptcy, but the company was able to reorganize, pay most of what was owed to the creditors and continue in business. The reason we were successful is because the owner understood the need for dealing with the issues, dealing with them early, openly and honestly with full disclosure. The creditors recognized that they were dealing with an honest person and were willing to work with the company to give it an opportunity to correct its problems.

Typically when an entrepreneur is forthright in dealing with a bank about the financial problems of a business, the bank will work with business to permit the business to keep operating to the extent that the bank believes the owner is being straightforward and that the business has the ability to succeed. Too often the entrepreneur believes that disclosure of the financial problems of the business to the bank will necessarily result in the bank taking untoward action against the company. While that is always a legitimate concern when a bank's loan is in jeopardy, a bank is more likely to give accommodations to the business in a turnaround whether it be to help the owner reorganize, sell the business, or even find a new lender, provided that the borrower has been forthcoming in the initial disclosure of the issues and kept informed as the turnaround proceeds.

Building Your Turnaround Team

When a business is in a difficult financial situation and the owner needs to hire professionals to help, where does one start? First, call your accountant or your attorney. However, ensure that your attorney specializes in business restructuring. This is different from an attorney that works with personal bankruptcy, or a business attorney who deals with other aspects of business. Experience with bankruptcy laws and other turnaround methodologies is critical. If you do not know someone like this, you may be able to get a referral from your regular attorney or accountant.

An attorney who has been certified as a business bankruptcy attorney by the American Bankruptcy Institute is usually a good choice. This designation requires that a certain portion of the lawyer's practice be in the business bankruptcy area and that he/she takes continuing legal education to be re-certified on a regular basis. There are also several professional

organizations, including the Turnaround Management Association and the American Bankruptcy Institute whose members specialize in this area. Also check whether the attorney is a member of the State Bar of the state in which he/she practices and specifically of the section of the state bar which focuses on bankruptcy.

If you hire someone who has been in the community where the business is located for a while and has experience with turnaround situations, the attorney would probably know many of the lawyers, accountants, appraisers and other professionals that will be involved. The importance of hiring someone who is known in the community is that such an attorney can accomplish much more in a short period of time, simply because of being known and respected by other professionals are involved. Typically a business turnaround will involve several different professionals. In addition to the attorney for the business, there is typically an attorney representing the bank, often an attorney representing the unsecured creditors, and there may also be attorneys representing other interested parties in the matter. If your attorney knows some of the other professionals, your attorney may have additional credibility in their eyes thus enabling the process more than otherwise would be available.

The turnaround consultant is another critical member of the team. The consultant may be recommended by your own attorney or accountant. There are turnaround consultants who work with large national firms, and solo practitioners. If you do not have a recommendation from your attorney or accountant, turnaround advisors who have the CIRA (Certified Insolvency Reorganization Advisor) designation, is usually a sign of experience.

Another member of your team may be a public relations consultant that deals with crisis management. For a larger company or one in which public perception is key, this may be a necessary role. Again relying on a recommendation from one of your existing advisors to the right professional here is best.

Directors and Officers Liability

The slide of a company from a solvent business to the “zone of insolvency” (described further below), has an important effect on the duties of the directors.

The duty of loyalty requires directors and officers to perform their duties in good faith and in a manner that they reasonably believe to be in the best interests of the company. The duty of loyalty generally mandates that the best interests of the corporation and its shareholders take precedence over any interests possessed by a director, officer, or controlling shareholder and not shared by the stockholders generally. The duty of care requires directors and officers to act with the care an ordinarily prudent person in a like position would exercise under similar circumstances. A director or officer who fails to exercise appropriate diligence may violate the duty of care, even if such officer or director did not realize any personal gain from the transaction at issue. However, directors (as well as officers) are generally protected by the “business judgment” rule from liability arising from negligent acts (as opposed to intentional or grossly negligent misconduct).

The “zone of insolvency”

In general, directors and officers do not owe a fiduciary duty to creditors. However if the corporation’s financial condition deteriorates to the point of insolvency or the “zone of insolvency,” a director’s fiduciary duties expand to include the protection of corporate creditors. Courts have not clearly defined when a company is in the “zone of insolvency.” A company is insolvent when its liabilities exceed its assets. Most courts apparently presume a business is on the brink of insolvency if the questioned action by the directors would or reasonably could render the corporation insolvent in fact, or that there is the risk that creditors will not be paid.

Implications of the Duty to Creditors

Outside insolvency or the “zone of insolvency” directors and officers owe a fiduciary duty to shareholders. Directors of an insolvent corporation have a fiduciary duty to creditors. It is unclear whether the duty to creditors supplants the directors’ duty to shareholders. The duty has been described as the duty as to protect the contractual and priority rights of creditors. If directors cause

their business to incur debt they may be in breach of duties enforceable by creditors if, for example, the directors cause the business to incur unnecessary debt to or for the benefit of shareholders or otherwise divert assets from legitimate business uses.

When Bankruptcy is the Only Option

Kinds of Bankruptcies

If it is ultimately determined that bankruptcy is your only option, there are three types of bankruptcy that are relevant to the business person: a Chapter 7 liquidation; Chapter 11 reorganization; and Chapter 13 individual repayment program . While Chapter 7 and 11 filings are normally voluntary (i.e. the company makes an affirmative decision to file), they may be involuntary and forced on a business which is delinquent in payment of its creditors. If the business has three or more unsecured creditors whose claims exceed \$10,000 and whose claims are not in dispute, and the business is not paying its debts as they become due, then the business may be the subject of an involuntary bankruptcy filing. The company then has a choice to either consent to the involuntary filing which for all purposes thereafter proceeds as though it were a voluntary filing, or protest and challenge the filing. If the latter, the court will make a determination whether the standards have been met.

A business should only consider a Chapter 7 liquidation if the business is going to cease to operate. The purpose of filing a Chapter 7 is to wind up a business and put the final liquidation of the assets in the hands of a trustee. In a Chapter 7 bankruptcy, a trustee is appointed by the bankruptcy court. Trustees are usually lawyers or accountants whose job it is to collect all the assets of a company and liquidate them for the benefit of creditors.

Unlike in a Chapter 7, in a Chapter 11 management of the business remains in place as a debtor in possession (“DIP”). No trustee is appointed unless the DIP has engaged in inappropriate conduct or other fraudulent acts, in which event a trustee might be appointed. A Chapter 11 is very flexible; it allows a company to either liquidate under the control of the DIP, sell the assets, or reorganize. More often than not, management (often with

professional assistance) is in a better position than a trustee to maximize the return on the asset liquidation.

The Chapter 11 process does, however, require that there be existing management available or that funding is available to hire appropriate expert personnel to manage the company through the Chapter 11. In addition, the out-of-pocket cost to the lender/investor of a Chapter 11 tends to be significantly more expensive than in a Chapter 7. This additional out-of-pocket cost, however, is often justified by the greater return that can be obtained from a sale or liquidation of the assets under the control of management in a Chapter 11.

The bankruptcy code has a priority scheme for the payout of creditors as follows: secured creditors, administrative creditors (which include the cost of the bankruptcy, wages, taxes, deposits on goods not delivered, and certain other items), unsecured creditors and finally, equity holders. There is no discharge of the business's liabilities in a Chapter 7 liquidation, nor is the businesses automatically dissolved in the Chapter 7. In other words, even though the assets of an entity may be liquidated through a Chapter 7 bankruptcy, those liabilities are not legally discharged. Accordingly, the principals of a company would never use that entity as a vehicle for further operations even though it might have been through a Chapter 7 bankruptcy, because the debts still remain in existence (unless they have been fully paid through the Chapter 7 liquidation).

The principal benefits of a Chapter 7 liquidation include the fact that it brings some finality to the cessation of the business. A notice is sent to creditors by the bankruptcy court indicating both that the company has filed a Chapter 7 bankruptcy and whether or not assets are available for distribution. In the event that assets are available for distribution, creditors may file claims in the bankruptcy case and receive a pro rata distribution of the assets available. The receipt of a Chapter 7 bankruptcy notice also tends to flush out creditors. In other words, not only will creditors file their proofs of claim, but if they believe they have any claims against the officers or directors of a company, the notice often initiates those proceedings promptly. This allows the directors and officers of a company to "close the books" of the company after the Chapter 7 has been concluded. Another principal benefit of a Chapter 7 is that the assets are delivered to a Chapter

7 trustee whose responsibility it is to conduct the liquidation and disposition of the assets. This is important if the company either has no remaining management or does not have the finances available to hire somebody to conduct the wind down of the business.

Chapter 7 bankruptcies also tend to require less out of pocket costs to the lender/investor. Normally the legal costs for filing a Chapter 7 bankruptcy are significantly less than those for a Chapter 11 or other kinds of liquidations. On the other hand, this benefit is often overshadowed by the principal detriment of a Chapter 7 bankruptcy; if the intention is to preserve any vestige of going concern value of the business; Chapter 7 is not the appropriate vehicle. This is because the Chapter 7 trustee is not allowed to operate a business in a Chapter 7 without specific court permission and more importantly, Chapter 7 trustees act slowly. Even though they have the ability to engage in a quick sale of the remaining assets, they rarely do. Usually the tangible assets of a business which is no longer in operation are sold at a fraction of the value otherwise attributable to asset sold as part of an operating business.

A Chapter 13 bankruptcy is a repayment plan for *individuals* who have *regular* income. (Note: This option is only available to unincorporated businesses; therefore, corporations and limited liability companies- the most common form of businesses- are not able to file this type of bankruptcy.) “Regular” income for the purposes of filing a Chapter 13 means an income that is sufficiently regular that it can support a repayment program. If you own an unincorporated business and your unsecured debts are less than \$336,900 and secured debts are less than \$1,010,650, you may file a Chapter 13. In this case, a trustee will be appointed and you will need to file a plan of reorganization. The plan of reorganization provides that all of your excess income be paid to you creditors over a 3 – 5 year period.

Reasons for Chapter 11

A Chapter 11 is a business reorganization. The purpose of a Chapter 11 is to allow a business which is financially distressed to get a breathing spell and an opportunity to modify its financial structure. The reasons for the filing of a Chapter 11 are many. Typical reasons include:

-the inability to pay debts;

-if creditors are filing lawsuits against the business, a Chapter 11 provides a stay of litigation and a stay of actions against the company. The stay is broadly interpreted in that it actually stays any action that could have been brought against the company prior to the bankruptcy filing. With limited exceptions, it stays all proceedings, giving the business a breather.

-if a secured creditor is seeking to foreclose, the automatic stay also applies. Say for example, the business lender has filed a lawsuit and is preparing to seize the company's bank account to partially satisfy the debt, or for example, if the company has real estate, the real estate lender may be proceeding with a foreclosure, the filing of a Chapter 11 will cause a stay of any of the above actions.

-as a way to coordinate litigation, for example if the company is involved in several lawsuits related to product liability

- to terminate a lease agreement. As an example, if a retail business has various locations some of which are not prospering, if the company simply walks away from the leases that are not doing well, landlords will likely sue the business the result of which may be significant damages that put the company out of business. However, if the company files a bankruptcy, there is the ability to "reject" a lease agreement,. In this case, the landlord's damages become part of the creditors' unsecured claims in the bankruptcy case.

The mechanics of Chapter 11 filing

Upon the filing of a Chapter 11 bankruptcy, a separate estate, referred to as a bankruptcy estate, is created. At this point, the books and records of the business are started anew as of the date of the bankruptcy filing. Any assets created by sales occurring post petition become part of the bankruptcy estate.

As noted above, during the course of the Chapter 11, typically the pre-bankruptcy management of the company remains in control of the business and becomes what is called a "debtor in possession." A trustee may be

appointed by the court to run the business in a situation where the pre petition acts of the current management have been fraudulent. The management or debtor in possession focuses on reorganizing the business instead of battling with creditors in various courts.

In most chapter 11 cases a creditors committee is appointed. The creditors committee is usually between 3 to 7 of the largest unsecured creditors of the company. The creditors' committee role is to monitor the operations of the chapter 11 company. The company's management will usually keep the committee closely involved in the decisions that company makes, and on occasion the company and the committee may disagree, in which event the disagreement is resolved by the court.

If the chapter 11 company has a pre existing secured loan, then bankruptcy law requires that the lender either consent to, or the court approve, the use of "cash collateral" during the course of the chapter 11. "Cash collateral" is the proceeds generated from the security held by the lender. For example rents generated by real estate security held by a lender are "cash collateral." Also receivables generated from inventory security held by a lender are "cash collateral". The company is not allowed to use the cash generated from receivables if a lender has a security interest in the company's inventory and "accounts" (i.e., receivables.) In order to use the cash collateral, whether by agreement with the lender, or without the lender approval by order of the court, the company needs to prepare a budget showing the specific sources and uses of the cash that it intends to use. Usually to get the approval of the lender or the court, the budget will need to show that during the course of the chapter 11, that cash usage will not result in the asset base dwindling and lender being ultimately wiped out.

In addition to the use of "cash collateral" in the preparation for a Chapter 11 typically the attorney and turnaround consultant will evaluate the need for and availability of Chapter 11 financing, called "DIP" or debtor in possession financing. Many businesses need additional financing to make it through the Chapter 11. This type of financing also requires court approval, Chapter 11 financing may often be provided by the company's existing lender, if the lender is satisfied that providing the company with additional financing will resolve the company's problems and hasten its exit from Chapter 11. The

turnaround consultant and the attorney are usually integrally involved in helping the company make this case to the bank.

Although the filing of the bankruptcy creates an automatic stay precluding creditors from pursuing the company's assets, creditors are not stayed indefinitely. Typically, secured creditors can seek relief from stay by asking the courts to allow them "for cause" to pursue their pre-bankruptcy remedies. The court will evaluate the cause on a case by case basis by balancing the needs of the company that has filed with the impact of the stay on the creditor. For example, assume the business has a \$1,000,000 secured loan and was making \$5,000 monthly payments to the bank, which it stopped making in the months preceding the filing of the Chapter 11. Assume as a result that the lender is seeking to foreclose on the company's assets. Assume also that the company has assets that secure the loan that are worth \$2,000,000. In this case the court would not likely allow the lender relief from stay to foreclose on the assets at least initially in the Chapter 11 case. The analysis of the court in a case like this is usually that even if the company does not pay the lender for several months although the lender is delayed in receiving its monthly payments, ultimately the lender will not be harmed since even if the company failed the lender could reach assets that would more than pay its claim together with accrued but unpaid interest. But on the other hand, if the company only has \$500,000 in assets securing a \$1,000,000 loan, each month that the business does not pay the loan interest will increase the lender's debt, which the lender will not be able to recover if the company fails. In this case, unless the company continues after the bankruptcy filing to pay the lender, the court is likely to allow the lender to pursue its remedies so that the lender's debt does not continue to grow during the bankruptcy proceedings.

A typical Chapter 11 filing for a middle market company takes about 12 – 15 months. This is the amount of time the court typically will give the business to start showing progress on the reorganization and turnaround. Even though a Chapter 11 can provide a "legal cocoon" around the business to allow the business time to reorganize, the fact is that the business must ultimately be viable.

While the benefits of a Chapter 11 can be wide ranging, the Chapter 11 process is expensive. Depending on the size of the company filing, the aggressiveness of the creditors and the location of the business, a Chapter 11 can cost \$100,000 or more just for professional help needed for the filing. The Company will also need to accumulate cash for operational purposes. If a company has been used to using the “float” from its bank i.e. writing checks on funds that have been deposited but not yet cleared, after the filing the bank can no longer allow the company to write checks without having cleared funds in its bank account. This often causes an acceleration of cash needs of the company. Also, it is likely that vendors will shut off credit that may have been offered prior to the filing and require payments to be COD.

Plan of Reorganization

Ultimately the objective any Chapter 11 is to reorganize either through the filing of a Chapter 11 plan of reorganization or by selling the assets (dealt with below.) If the reorganization is approved by the court, it is essentially a contract that is approved by the court which becomes binding on both the company in bankruptcy and all of its creditors. The plan of reorganization divides the creditors into various classes, which follow a certain order of priority. Secured creditors are first, priority creditors are next, unsecured creditors then follow and finally equity is at the bottom. All creditors in the same class of creditors must be treated the same way.

Generally, secured creditors are entitled to get paid in full (unto to the value of their collateral) or to get their collateral back.

Unsecured creditors often get partial payments, but they all have to be dealt with the same way. For example, if the plan calls for the unsecured creditors to get 50 cents on the dollar in monthly payments over a two year period, they must all be given the same terms. The calculation of how much will be paid to unsecured creditors will often be the result of negotiation with the creditors committee taking into account how much the company can reasonably be expected to set aside in the future to pay creditors after paying expenses for operations.

In a smaller business the equity owners are usually dealt with providing that they continue to own the business after the chapter 11 plan of reorganization is approved by the court. However, there is a rule called the “absolute priority rule” which provides that unless the unsecured creditors are paid in full, the equity holders cannot participate and retain their ownership of the company. There are a few ways to deal with this. First as a practical matter, the creditors of a smaller company are usually not interested in operating that company and if they stand any hope of seeing a recovery after the chapter 11, it typically will be because the current ownership continues ownership and operation of the company after bankruptcy. Creditors do however often use this “absolute priority rule” as leverage to make sure that the company pays them the most that can reasonably be expected as part of the reorganization plan that is negotiated by the parties and approved by the court. If the creditors elect not to negotiate with the company owners on a plan and want to exercise their “absolute priority rule” rights, then the owners have the right to put in “new value” into the company and repurchase their shares which are cancelled in the chapter 11 plan. The amount of new value that equity has to pay to acquire their post chapter 11 equity ownership will depend on the case and the value of the company at the time of plan confirmation. If the company will have a positive cash flow following the chapter 11, then the valuation of the company will likely require that the new shares be purchased for their present value which often will be at a discount of the future cash flow of the company.

Section 363 Sale

Often it is evident that a company cannot survive the Chapter 11 process either because it cannot obtain financing or for other strategic reasons. The company’s assets may however have value to a third party buyer. Buyers however are often very cautious about buying the assets of a troubled business because of the concern that the company’s creditors could pursue the acquired business on various legal theories including “successor liability.” The sale through a chapter 11 bankruptcy offers the buyer a means to acquire the assets without concern that a creditor of the seller will pursue the buyer. It also offers the creditors of the seller a way to maximize the value of the assets by selling them to a buyer rather than simply

liquidating the company. Such a sale is called a “section 363” sale, as the process takes place under section 363 of the Bankruptcy Code.

In a section 363 sale the assets which may be subject to bank and other judgment liens can be sold free and clear of liens so that the buyer receives the assets lien free. The cash proceeds paid by the buyer for the assets then attach to the liens in the same order and priority as the liens previously attached to the assets. This process allows the assets to be sold for the maximum price, leaving the disputing parties to litigate over the cash paid.

One of the principal drawbacks from a buyer’s perspective of a “section 363” sale is that it is subject to overbidding. While this is theoretically in the best interests of the bankrupt debtor company, it does expose the buyer to the risk of overbidding and loss of the transaction. Various devices are employed by buyers to minimize this possibility. One such way is that if a buyer is found, the buyer is often referred to as a “stalking horse”. The stalking horse buyer enters into the purchase and sale agreement with the company in bankruptcy. That sale agreement is then filed with court for approval. Other parties usually have the right to overbid the price of the stalking horse at the sale hearing. If they do so, the stalking horse bidder will usually be entitled to a “break up fee” for his costs and expenses of investigating and documenting the agreement.

Recovery rights in Bankruptcy

Preferences

A trustee in a chapter 7 bankruptcy and the debtor in possession in a chapter 11 bankruptcy has what are called “avoidance powers” to recover moneys paid out prior to the bankruptcy. One of the purposes of bankruptcy is to treat creditor of the same class equally. Sometimes when a business is in trouble and is about to file bankruptcy, it pays to creditors who scream the loudest, or those creditors whom the owner has personally guaranteed. These payments may be considered a “preference.” While a preference is not illegal, the payment may be recoverable in the bankruptcy. Since the bankruptcy system is designed to treat creditors fairly and equally, if one creditor has been preferred, the funds may be recovered and divided among all like creditors.

A payment is considered a preference if:

- there is a transfer by the company, whether voluntary such as a payment to an creditor, or involuntary such a judgment obtained by a creditor;

- it is made within 90 days prior to the bankruptcy, or in the case of a payment to an insider (such as a relative or a director), it is paid within one year prior to the bankruptcy;

- it is paid on account of antecedent debt (i.e. a debt that is not current.) So for example, payment of a current bill even if paid within 90 days is not a preference. The result may be different is the bill is past due.

- paid while the company is insolvent (liabilities exceed the assets);

- as result of the payment the recipient creditor receives more money that it would have as a result of a liquidation of the company in a chapter 7.

There are several defenses to a preference, including that the payment was made in the ordinary course of business of the company; or that the payment is for a contemporaneous exchange for new value, for example a COD payment and delivery of goods.

Fraudulent Transfer

One of the other frequently used avoidance powers is a fraudulent transfer recovery. It sometimes occurs in the life of a business that is in financial distress that there are transactions by which the owner either intentionally caused the business to transfer asset in order to remove the assets from the grip of creditors (called an intentional fraudulent transfer), or where assets are transferred but without “reasonably equivalent” value (called a constructive fraudulent transfer). In both these cases the trustee in bankruptcy or the creditors committee can seek to recover such assets which are transferred within 4 years prior to the bankruptcy.

Other Alternatives

An assignment for benefit of creditors (“ABC”) is a state law alternative to a Chapter 7. Under an ABC, all of the assets of the company are assigned to an independent third party “assignee” who then has the responsibility to liquidate those assets for the benefit of the creditors of the company. The assignee can sell the assets either in a public sale or in a private transaction.

One of the principal benefits of an ABC over a Chapter 7 is greater flexibility. Very often the assignment of the assets from the company is implemented in conjunction with the assignee’s agreement to sell the assets to a pre-selected third party. This private sale procedure is available provided that the assignee is satisfied that the private sale is commercially reasonable and at least equal to the fair value of the company’s assets. In this way, the lender/investor will often realize a greater return than that occurring from a delayed sale in a Chapter 7 liquidation. Further, an ABC is often less expensive than a Chapter 11.

The principal drawback of an ABC is that it is a creature of state statute. Accordingly, if the assets to be disposed of are located in different states, the ABC will not necessarily carry legal weight in other jurisdictions. In addition, an ABC is a device simply not as well as known as a sale of assets under a section 363 sale. Accordingly, buyers often are more skeptical about the benefits of this approach and thus sometimes are not willing to adopt this as an acceptable method.

Fast Five

Be alert- watch the financial metrics of your business so that you don’t find yourself on the eve of financial disaster without even being aware of where the business is heading.

Be proactive- don’t wait until the last minute before you run out of cash or are shut out of your premises. Statistically companies that are proactive in addressing their financial problems have the greatest likelihood of surviving.

Be forthcoming- It is of critical importance when the business is in financial distress that the owner is honest and forthcoming with the people who need

to know about the situation and those who can help. This includes lenders, endors, shareholders, some or all of your employees, management and the team of people hired to help. That is not to say one needs to reveal a doomsday scenario, but rather an honest assessment of the situation placed in the best light possible.

Be savvy- don't just rely on the professionals. Make sure you ask your attorney and turnaround advisor all the alternatives available.

Be open- too often business owners cannot accept that their company is in financial distress and expect-unreasonably-that by continuing what they have done in the past will resolve the situation. Be open to the fact the while the entrepreneur undoubtedly knows the business best, almost invariably the entrepreneur has not had the experience of dealing with a business in financial distress. Be open to advice from the professionals and be open to changing the way things are done.