Secrets of Successful Out-of-Court Workouts for Companies and Lenders

An alternative to Chapter 11 bankruptcy may prove to be the superior option for companies and their creditors.

A company can fall into financial trouble for many different reasons. Often, the gut reaction of its management is to file for Chapter 11 bankruptcy. In our practice, we consider bankruptcy a last-resort remedy, so we always try to keep our clients out of bankruptcy. The reason for this is that an out-of-court restructure or liquidation has the potential of achieving higher returns at a lower cost for all stakeholders.

Any type of company in any industry can fall into an adverse scenario with its creditors.[1] Typically, the process involves a bank lender with a lien on accounts receivable, inventory, equipment, and land, as well as trade creditors. If the business does not own real estate or equipment, there will be a landlord and some equipment lessors. These are small differences, and the principles discussed herein will apply regardless. Furthermore, though the bank loan may be current or just a payment or two behind, there are likely significant covenant defaults and payments to trade creditors that might be delinquent.

Despite a variety of scenarios, companies and creditors can consider several factors to arrive at a successful out-of-court workout.

Restructure or Liquidate?

When experiencing financial hardship, one of the first things a business must do is determine whether to continue operations or liquidate. This will depend largely on whether there is a sufficient market for the company's products or services. If there isn't, it is pointless to continue, and the decision will be for liquidation. In the event of a decision to liquidate, the company must then decide whether selling as a going concern – perhaps to a competitor – or shutting down immediately will maximize the value of the assets. Our firm often recommends that the client hire a competent turnaround professional to assist with this evaluation and the creation of a viable action plan. In addition to assisting in this regard, an independent turnaround professional provides the company with credibility when approaching creditors for concessions.

One might ask why the company cares about maximizing the value of the assets. The answer is that often the principals have personal guarantees that need to be satisfied. These guarantees act as a significant incentive for management to obtain the maximum value. Moreover, our experience is that most principals want to achieve the maximum recovery for all concerned and, in many instances, believe the assets are worth more than their appraised value. If the business can be sold as a going concern, it must be able to run at close to its cash flow breakeven point for at least 90 days. This will give management a chance to market the assets as a going concern. If this is not achievable, then the business must shut down.

The Business Plan

If there is a market for the business and the company can operate at close to its cash flow breakeven point, then it must come up with a reasonable business plan for going forward. The plan must provide at a minimum for the collection of enough revenue to cover the payment of ongoing business expenses such as payroll, taxes, rent, utilities, critical supplies, and transportation costs. Ordinarily, this means that the company will likely have to curtail payments on past-due loans, leases, and trade credit while the business operations are being turned around.

The business plan is often provided in two stages. The first stage is when the company is in crisis and it simply needs to eliminate a cash flow crunch. In addition to curtailing payments on past-due debts, the company usually reduces its head count and undertakes other cost-cutting measures in order to equalize the sources and uses of cash. Competent turnaround professionals are excellent at identifying areas where businesses can cut costs and become more efficient. The plan should include current and projected balance sheets, income statements, and cash flows.

The second stage of the business plan is developed at a later date. Hopefully, the company's efforts to cut costs and make operations more efficient have turned a negative cash flow situation positive. At this point, the company has the ability to negotiate out-of-court settlements with its creditors.

Creditor Negotiations

The bankruptcy attorney, the company, and the turnaround professional (if one is hired) work together to negotiate with creditors. There are typically two stages to these negotiations, and they mirror the stages of the business plan. The most important negotiation is with the bank that holds a lien on assets and therefore has the ability to foreclose. Contemporaneously with this process, the company should contact its unsecured trade creditors.

1 Bank Negotiations

Assuming the company has identified its problems early in the process, the bank is probably not aware that a crisis

[1] This article may not apply to certain types of high-tech companies that are primarily research and development vehicles funded by equity investors.

exists. The worst thing the company can do under these circumstances is attempt to continue to hide the crisis from the bank. Rather, the company must go to the bank and disclose the nature of the crisis and provide a plan for resolving it. This is perhaps the hardest principle for the client/company to accept. The client almost always believes that the bank will take immediate action to liquidate its collateral. This is almost never the case since the bank really does not want to own the collateral.

Also, the bank is often impressed with the honesty and integrity of the company in bringing the problem to its attention. Banks are not strangers to financial difficulties. This approach is even more effective if the company has hired a turnaround consultant who has reviewed the business operation and developed a plausible plan to stabilize the situation. Ideally, the meeting with the bank should be with the company, the turnaround consultant, and the bankruptcy attorney. The company should let the bank know that an attorney will attend the meeting so the bank will know to invite its bankruptcy attorney. The knowledge that an attorney will attend the meeting telegraphs to and prepares the bank to expect a problem.

The negotiations with the bank are going to depend on the facts and circumstances of each case. They can run the gamut from a simple request to waive a covenant default to a total forbearance. This depends on the cash flow situation and whether the company has decided to liquidate. If the company has decided to liquidate, then the bank will want to know the nature of the program for selling the assets, the costs of sale, and how the proceeds of the collateral will be transmitted to the bank. If the company has decided to continue operations, it will usually request some form of relief on debt service. The forms of relief can range from a total cessation of debt service for a short period of time while operations are being stabilized to an agreement to pay only interest for a certain period. Assuming the company is honest and has a reasonable business plan, it is a virtual certainty that the bank will enter into an agreement.

In the wake of Enron and other corporate fraud, banks are often suspicious and may believe their borrowers are bleeding money out of the company inappropriately. The best way to combat this problem is to volunteer to provide the bank and/or its auditors with complete access to company records.

2 Trade Creditors

The negotiations with trade creditors are less involved since the creditors ordinarily do not hold liens and the consequent power to shut down operations.

Typically, the company will create two lists of creditors. The first list will consist of noncritical vendors. These creditors will be sent a letter requesting a standstill for at least 60 days. In this letter, the company (or the bankruptcy attorney) will describe the extent of the financial crisis and the steps being taken to rectify the situation. If possible, the letter should include recent financial statements. The concluding sentence should promise to get back to the creditors before the end of the standstill period to provide a report and/or an offer to settle the debt. There are several purposes for this letter. First, it is simply a good business practice to notify your creditors about the situation. Often creditors with past-due debts will make collection calls, and company personnel will do any of the following: (i) duck the calls; (ii) promise to make payments the company really can't afford; or (iii) make phony excuses. These types of responses will only make the creditors mad. Second, the flow of information to the trade creditors will have virtually the same impact as providing information to the bank. That is, most trade creditors will agree to the standstill as an alternative to litigation. The purpose of this effort is to avoid the cost and expense of litigation. Moreover, if a creditor obtains a judgment, it can force the company to file for bankruptcy, thereby defeating the entire purpose of an out-of-court settlement.

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Critical vendors (i.e., those absolutely necessary for the business to survive) must be dealt with separately. In essence, these debts should be kept current. If the company cannot keep them current, then it must figure out a way to do business with these vendors on a cash-on-delivery basis.

Equipment lessors are often the most difficult set of creditors to deal with. In the situation where the company has leased equipment that is not being used, it should so notify the leasing company and invite the company to repossess it. Oftentimes, these letters will be ignored by the equipment lessor, and they will continue to demand payment. On at least one occasion we have sold equipment and given the proceeds to an equipment lessor that absolutely refused to repossess. If the equipment is being used in the business, then the company should make the payments, if possible, or try to reschedule them.

Second-Stage Negotiations

Once again, these are going to depend on the circumstances. In a reorganization, the best-case scenario is that the business has turned around and is now in a position to propose a restructure or refinance its bank debt and propose a payout plan to its trade creditors. Here again, turnaround professionals can provide assistance in presenting refinancing requests to asset-based lenders, factors, or investors who are less risk averse than are banks. Further, a second letter should be mailed to trade creditors offering either a discounted cash settlement or a payout of a larger percentage over time.

If the business has not turned around sufficiently to proceed in this manner, then the company should meet with the bank again to discuss the process and request an additional extension of time. A similar request should be made to the trade creditors.

In the event of a liquidation, the company should meet with the bank periodically to report on the status of the sale of assets. Similar reports should be issued to trade vendors. Sometimes trade vendors will demand to be paid something immediately. For example, in Texas the parties must note that once the company is in default under a secured bank loan, the diversion of collateral proceeds to third parties without bank consent is actually a crime called Hindering Secured Creditors, and it is a felony if the amount involved is in excess of $1,500. It is extremely rare for a bank to consent to such payments. This little-known fact can be used to dissuade trade creditors from taking collection action.

Better Return, Faster Payout

Assuming a company is honest and is trying to fulfill its fiduciary duty to its creditors, then there is no question that an out-of-court workout will produce a higher return to creditors and a quicker payout than will a bankruptcy filing. The parties can tell whether a company is honest if it provides information and access to records on request. The likelihood of a successful outcome is greatly improved by the employment of a competent and independent turnaround consultant because this lends credibility to the process.

Of course, a single creditor can interrupt the process by filing suit and obtaining a judgment. Such a creditor might think that it is jumping ahead of the crowd and gaining leverage to achieve a higher settlement. In most instances, this is faulty logic for several reasons. First, if the company files for bankruptcy, the creditor will forgo the opportunity to be paid out of court. Assuming all circumstances are equal, the return will be reduced by the amount of professional fees that must be paid to exit bankruptcy. Second, if the creditor is paid a higher percentage than other creditors are paid, the additional amount ordinarily is not enough to cover the legal fees the creditor must pay for the collection work. Third, if the company ends up filing for bankruptcy within 90 days, then the payment is subject to being recovered as preference. In the final analysis, in most instances it makes more sense a creditor to work with a company in financial trouble than to file suit against it.

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[2] Texas Penal Code, Section 32.33. Hindering Secured Creditors.