Special Report:
Turnaround Management

SPONSORED BY TMA Turnaround Management Association® Dedicated to Corporate Renewal Philadelphia

‘Option of last resort’

Think twice about entering Chapter 11 without a plan

JEFF BLUMENTHAL | STAFF WRITER

The days of protracted battles in Chapter 11 bankruptcy reorganizations have largely become a thing of the past.

“Bankruptcy has become an option of last resort,” said Michael Menkowitz, Fox Rothschild’s bankruptcy chairman. “I’m doing a lot of stuff outside of court now, whereas in the past they would almost force you to file.”


Menkowitz

With regulators keeping a close eye on lending standards and costs for bankruptcy rising, banks cannot make riskier loans to help preserve a debtor in a Chapter 11 filing and borrowers cannot handle the financial burden of a brawl with lenders. So debtors are trying to avoid reorganization in favor of pre-arranged deals and out-of-court deals.


Colton

The number of troubled credits has diminished in the past few years as tighter standards have led to less lending to new borrowers. Older borrowers have either stabilized or are no longer borrowers. But filings remain elevated from prerecession levels despite declining from the depths of the recession in 2009 and 2010. And the lengthy economic downturn has caused more borrowers and lenders to second-guess the expense of going to war over a troubled company’s assets.

“There are not as many Chapter 11 cases that proceed,” said Cozen O’Connor bankruptcy lawyer Neal Colton. “Even if they file Chapter 11, they often move to liquidation. I think what came from the recession is how expensive bankruptcy is to litigate.”

Colton said debtors who don’t have a pre-arranged agreement before entering bankruptcy are more often failing.

“We are doing more of those that turn into Chapter 7 than litigating Chapter 11s,” Colton said.

Stephens & Lee bankruptcy practice co-chairman Robert Lapowsky said the new environment is especially tough on small and midsize businesses.

“What you see now is a function of how expensive it has become to prosecute Chapter 11 for small and midsized businesses,” Lapowsky said. “It’s just tougher to reorganize because of expenses. So I think businesses are leery of filing without pre-existing agreements.”

Since 2007, Lapowsky said borrowers are now given less time by lenders to reach a workout or sale agreement. That puts more pressure on borrowers and their lawyers to resolve things faster and have a specific plan from the day they file Chapter 11. There are pre-planned filings, which means there are some deals in place, and pre-packaged, which means all the deals are in place and the case could be resolved within 30 to 60 days.

“If someone calls and tells me they want to file without any deals in place, the first question I ask them is how they are going to survive the first 30 days, especially if there is a lien on their assets,” Lapowsky said.

Schnader Harrison Segal & Lewis Managing Partner Nicholas LePore, who doubles as co-chairman of the firm’s bankruptcy practice, said in addition to the expense of contested reorganization, there also appears to be less financing for debtors-in-possession, and fewer investors willing to fund debtors with a view to acquisition or takeover of ownership.

For those debtors who file Chapter 11 without a pre-arranged plan, they often wind up engaging in what is called a “363 sale,” which is named after the section of U.S. bankruptcy law that allows a quick sale of assets to a new company, with a court hearing. The idea is that the new company emerges and the old one continues in bankruptcy court to liquidate, sell assets and adjust claims. But many of these cases now lead to failure or are converted to Chapter 7 for liquidation.

George Miller, name partner of accounting firm Miller Coffey Tate, which specializes in bankruptcy, is one the region’s best-known Chapter 7 trustees. He agrees that the number of Chapter 11 reorganizations has declined in recent years and instead companies sell assets and then convert into Chapter 7.

“Everything is sold before it gets to me,” Miller said. “In Chapter 11, there are very few resources in terms of borrowing money. Hostess found someone, but that was the exception. Banks can’t make risky loans as there are tighter credit standards for insolvent companies due to Dodd Frank.”


Lapowsky

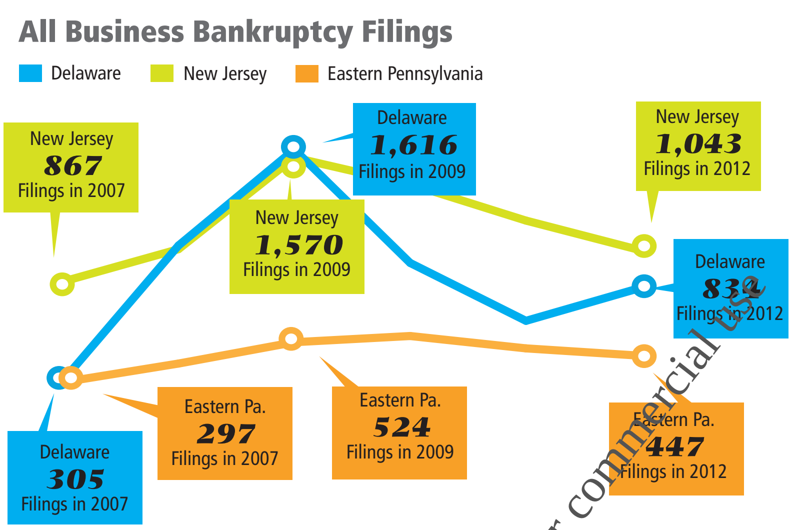
A recent example was when Michigan-based American Laser Centers, a laser hair-removal chain, received approval from a Delaware bankruptcy judge to convert its Chapter 11 bankruptcy to a Chapter 7 after the company said in late October that it didn’t have the money to fund a reorganization.

After filing a motion to convert to Chapter 7, American Laser was bought out in January 2012 by Philadelphia private-equity lender Versa Capital Management, liquidated most of its assets and started to wind down its operations. It said those moves did not leave enough funds for Chapter 11 bankruptcy.

Miller said there were no assets left for creditors by the time the Chapter 7 trustee got a hold of it. Miller said there is often not much to do these days when he receives a case with a similar profile to the American Laser one.

“I look at the carcass and see if I can find some assets to distribute to creditors,” Miller said. “If not, I close it down. And in recent years, there has not been much meat left on the carcass.”

BY THE NUMBERS



Source: U.S. Courts

TIPS

If you’re a nonprofit, and you want to avoid bankruptcy, read this

By Ted Gavin

- All budgets and forecasts should be cash basis, with bank balance projections on a monthly basis, at least. You’d be amazed how many nonprofits using accrual accounting find themselves surprised to be running out of cash when they could have foreseen it and reacted months earlier.
- Understand, particularly when doing grant work, how all administrative, overhead and staff functions are allocated to program work. Whether the organization is operating under the terms of a grant or not, if you can’t tie overhead activities to the mission of the organization, it’s time to reconsider the overhead.
- All nonprofit organizations, particularly those facing financial crisis, must interface with the community with a single voice — and that voice must be positive. There are tendencies when in trouble to sound the alarm in a plea for help, but nothing scares away donors more and this often begins a death-spiral of panic and donor flight. There must be one person in charge, speaking with one voice, and that message must be about the organization’s future.
- Keep the board out of the staff’s way. There is a tendency for board members to discount the abilities of staff — after all, if the staff was so smart, how did the organization end up in trouble? This nearly always leads to more problems. Keep the board in the boardroom. Conversely, the staff will often blame the board for not fundraising enough. There needs to be a single leader of the organization, ensuring coordination between staff and board — but the board can’t interfere in staff work and the staff is ultimately responsible for fundraising. Each side must be kept focused and accountable.

TED GAVIN is a certified turnaround professional and is the managing director and a founding partner in Gavin/Solmonese. He serves as practice leader in the firm’s restructuring, bankruptcy and fiduciary services group. He can be reached at ted.gavin@gavinsolmonese.com.