

## Frankly Speaking... Bankruptcy Attorneys Can Help Persuade Clients to Make Tough Decisions

BY DAVID BAGLEY

**Distressed companies and their general counsel** often don't realize what kind of help they really need. The more corporate leaders and their counsel understand the benefits of enlisting bankruptcy attorneys early in the process, the better chance that they will take essential and timely actions to get the company back on track. In the end, forcing a frank conversation about a company's trouble, coupled with bringing in bankruptcy counsel, is the right thing to do.



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**B**ankruptcy is often a scary idea for company leaders, and they associate meeting with bankruptcy counsel as a precursor to something they want to avoid at all costs. In reality, clients are often in trouble because they did not act with the urgency necessary to react to changes in their marketplace. Frequently, the inactivity continues because the owner's inner circle of advisors does not push hard enough to force the difficult decision to consult with bankruptcy counsel. This article explores some possible options to overcome the understandable reluctance to bring in bankruptcy counsel.

### **Bankruptcy as a Strategic Tool**

Clients generally assume that a bankruptcy attorney will automatically advise a company to file bankruptcy. Actually, the best bankruptcy attorneys are in the bankruptcy avoidance business.

When given a reasonable timeframe, many companies can work through financial difficulties and be restructured without filing bankruptcy. An out-of-court restructuring can often be faster, and is regularly much less expensive. One reason many companies fall into bankruptcy is because

decision makers simply wait too long to engage the right resources to help address the situation. Precious time and money, and often the ir retrievable opportunity to avoid a formal bankruptcy filing, are many times lost as decision makers approach serious financial distress with noble but ill-advised cautiousness.

Working with a bankruptcy attorney does not mean bad news for the company or its corporate counsel. Instead, the right bankruptcy attorney will be a partner with peculiar expertise to better serve the distressed client, providing highly skilled, competent guidance and communicating specialized strategies where necessary.

Often the looming possibility of a bankruptcy filing can assist in restructuring discussions. Using the threat of a bankruptcy, a company can gain leverage to renegotiate leases or unprofitable contracts and force restructuring of overleveraged debt. Certain clients can even raise their pricing to customers or obtain financing from vendors to support the operations of the company. Frequently, even the simple act of inserting bankruptcy counsel into a negotiation increases the urgency and improves the outcome.

There is much to gain by pushing clients and corporate counsel to confront the difficult issue of partnering with a bankruptcy attorney. Initially, advisors may be reluctant to advocate bringing in bankruptcy counsel because it will force them to have complicated and perhaps daunting discussions with the client. However, in the long term, a timely call to action will reinforce their standing as a trusted

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advisor, leading to a stronger relationship. A more hard-line approach often protects and enhances the relationship.

### **Denial Delays Action**

A principal contributor to the lack of action is denial. Psychology textbooks suggest denial is a deeply emotional behavior that operates heavily on a subconscious basis. The person in denial will attempt to minimize the serious nature of the issues or refuse to accept responsibility, even if they recognize the depth of the problem. Advisors often facilitate denial by allowing the individual to continue to discount obvious and growing signals of financial distress.

Most owners of financially distressed companies truly believe their turmoil is a well-kept secret from third parties and even within their own workforce. This misperception may be perpetuated by an owner's past experience when they felt they survived similar crises unnoticed.

However, such troubles are rarely a secret. Numerous people are typically "in-the-know" about a company's financial distress, including:

- The outside accountant who normally compares the company's performance to historic figures
- The banker that reviews the financials and sees the loan balance and cash balances daily
- The vendors that were paid with a fast-pay discount and now are stretched out to 90 days
- The accounts payable associate who receives daily vendor phone calls
- The controller who has to hold checks so the bank is not overdrawn
- The purchasing department that bartered needed shipments for overdue payment commitments

Moving quickly to solve the financial problem is more important than trying to conceal it. By moving expeditiously, the company may actually avoid a worst-case bankruptcy scenario and begin the first stages of a successful corporate turnaround.

### **Time Creates Options**

One significant element of a successful turnaround is making internal operational changes to avoid impending disaster. A financially distressed company needs to rapidly react to either retain existing avenues of opportunity or to create new options. Any time that slips by without action is an opportunity that cannot be reclaimed.

Recently, we saw first-hand what happens when a company waits too long to work with a bankruptcy attorney to explore its options. Our firm was strategically engaged to advise a regional hospitality company. For more than a year, in an attempt to avoid bankruptcy, the owners had utilized all of the cash from its profitable organization to prop up a failing company. They provided cross guarantees from the profitable organization as well as substantial personal guarantees to support leases and loans of the distressed company. But results continued to decline and, in the end, all of the value of the profitable organization was wiped out by the obligations of the failing company.

By not exploring the opportunities afforded them by bankruptcy, the failing entity eventually eliminated all equity in the profitable one and the owners were placed at significant personal financial risk.

### **Reasons to Face the Music**

Even knowing the benefits, there is typically reluctance to bring in bankruptcy counsel. Nevertheless, there are some less than obvious benefits that should be considered by corporate counsel and decision makers.

### **Maintain Influence**

A common tactic utilized by lenders is to "request" that troubled borrowers hire a financial advisor. This is often more of a requirement than a request. It is generally made clear that the lender's willingness to continue to negotiate forbearance agreements, or provide continued financial support, or not act on existing defaults, is predicated on the borrower doing so. Frequently, there may be a brief mention that if the borrower does not hire an advisor, the bank will hire one itself, and the borrower will simply be required to reimburse the bank for the cost under the loan agreements.

The lender's request predictably contains a short list of advisors that the bank considers acceptable. Frequently, the financial advisors will have their own short list of bankruptcy attorneys they would recommend, which may not include the corporate counsel's firm.

This cascade of preferred vendors could result in the general counsel working with a bankruptcy attorney from a different firm. Forging a working relationship between the company, its corporate counsel and the newly retained financial advisor and bankruptcy counsel is more easily accomplished prior to the onslaught of any actual bankruptcy filing. The challenges to the new restructuring group are already substantial without immediately adding new ones created by an actual filing.

### **Get Paid**

Often distressed clients are behind in paying their legal bills. The issue is exacerbated as law firms typically bill monthly and generally try to maintain a positive relationship with their clients at the expense of aggressively collecting overdue receivables.

Frequently, if the company heads down the path to a formal bankruptcy filing, it can cause the long-standing firm for the client to be conflicted out of representing the client in the bankruptcy case. A professional with a pre-bankruptcy claim against the estate cannot be considered disinterested under the definition of "disinterestedness" in 11 U.S.C. §101. A professional hired by the estate must be disinterested per 11 U.S.C. §327 and §328. In addition, a professional that has been paid irregularly before the bankruptcy can be disqualified due to preference liability. See *In re Pillowtex, Inc.*, 304 F.3d 246, 255 (3rd Cir. 2002).

### **Fulfill Fiduciary Duties**

A board of directors faced with an insolvent company needs to show a pattern of taking reasonable business actions to protect the value of the business. This is important for both the distressed company and its corporate attorneys. As counsel to the company and the board, corporate counsel should be prepared to demonstrate that they have provided appropriate legal advice to the company, which in cases of impending insolvency will often include recommending that the company obtain bankruptcy advice.

One of the issues that a good bankruptcy lawyer can typically help with is explaining to a recalcitrant board their obligations when the company is in the zone of insolvency. If a corporation is insolvent, the duty of its directors starts to shift.

Previously, the board of an insolvent company was thought to share duties to its shareholders and its creditors. However, according to the Delaware Supreme Court's decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007), directors now are seen to retain their direct duty to shareholders, but creditors can assert derivative claims for actions taken when the company is insolvent.

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The shift in thinking highlights that the duties within the zone of insolvency are complex and require advice from a practiced and knowledgeable bankruptcy attorney.

### **Provide Client Some Free Advice**

One of the most common excuses for not being more aggressive in introducing bankruptcy counsel beyond the fear of being too forward, or the potential that the client would be offended by the implication of financial distress, is the perception of another layer of additional legal expenses.

However, most good bankruptcy attorneys know the value of donating some time doing initial groundwork and brainstorming basic strategies. From the perspective of the bankruptcy counsel, it is a simple economic decision to spend a few hours with a potential client. The client gains the benefit of advice and strategy without cost, the bankruptcy group appreciates the lead and counsel fulfills its duties to the client.

### **Get Them Back on Track**

Clients are great when they are growing, conducting acquisitions or mergers, needing assistance with refinancing or exploring equity rises. Everyone wants successful clients. All parties benefit from moving out of distress and back in to a business-as-usual scenario.

To advise a distressed client properly, it is critical to have knowledge of the options that bankruptcy offers in exploring alternatives to an out-of-court negotiated resolution. Developing an appropriate strategy to turn the company around or restructure the company using the leverage of bankruptcy requires extensive knowledge of the tools that bank-

ruptcy offers debtors. Often, corporate counsel has incorrect views of what can and cannot be accomplished in a bankruptcy case. This can lead to an under-utilization of applicable leverage by the client in negotiations with lenders. Bankruptcy attorneys can provide more insight on this topic than regular corporate counsel.

Providing the client with the right assistance will help get it back on track faster than attempting to wait for financial conditions to improve marginally over time.

### **Become the Trusted Advisor**

A highly valued bond between advisor and client is forged working through financially distressed situations. Working on the front lines for the very life of the company creates a similar level of connection to those formed when the company was first being launched. Surviving through a turnaround and working hand-in-hand with a client will forever enhance efforts toward being a trusted advisor.

Distress is often the catalyst to becoming a trusted legal advisor to the company. The corporate counsel that successfully works through the turnaround from distressed company to healthy company is seen as a trusted advisor. And, the possibility of that turnaround is enhanced by the help of counsel knowledgeable about the bankruptcy process.

Distressed companies and their general counsel often don't realize what kind of help they really need. The more corporate leaders and their counsel understand the benefits of enlisting bankruptcy attorneys early in the process, the better chance that they will take essential and timely actions to get the company back on track.

It just takes a little faith that the financial advisor's relationship with the client is strong enough to withstand the frank and direct conversation about the trouble the client is in and what needs to be done to address those problems. Forcing that discussion and bringing in bankruptcy counsel is often the right thing to do, for all involved. **abfj**

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