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How to Achieve a Successful Start on a Chapter 11 Bankruptcy: The Critical Role of The CRO in First-day Orders

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A staggering 85% of Chapter 11 Bankruptcy Cases never make it to a confirmed plan of reorganization. In fact, lack of cash causes many companies to liquidate within a few weeks after filing.

Bankruptcy, and the ability to reorganize debt and business affairs, is so important to the economic freedom and health of the U.S. that it is written into our Constitution. This in itself does not guarantee that a company will reorganize, but it gives it a chance.

When our Congress legislated our bankruptcy process, the bankruptcy courts were established primarily as courts of equity. Among other things, courts of equity have some latitude to achieve equitable results—typically through a balancing of various interests. However, equity does not mean that the rules of procedure, rules of evidence and bankruptcy statutes will be ignored just to achieve equitable results, and equity does not mean that the court will allow ‘whatever it takes’ to reorganize a company, such as allowing for payments to “critical vendors” while ignoring the rights of unsecured and secured creditors. Remember, in equity, the rights of all the stakeholders must be considered, including company management, employees, suppliers, secured creditors and bondholders.

Look before you leap

Many business leaders go into bankruptcy with unrealistic expectations. Through conversations with peers and selective listening with lawyers, they mistakenly believe that a bankruptcy filing will, in effect, give them an infusion of cash. They further believe that in the course of the Chapter 11 case, the normal priority—secured lenders, unsecured trade creditors and equity ownership—will be turned on its head. That is, they expect to conclude the bankruptcy case in a controlling ownership position with the trade creditors paid in full and the secured banks taking a haircut. What they don’t realize is that such unrealistic expectations, when unsupported by adequate preparation, can backfire in the first days of the case, setting the stage for an unsuccessful reorganization and an eventual liquidation.

Assuming the company has a core business that can be reorganized, what can the Chief Restructuring Officer (“CRO”), Crisis Manager or Turnaround Consultant do to maximize probability of a successful Chapter 11? Although firms have been involved in numerous bankruptcy reorganizations in a variety of roles, for purposes of discussion, this article will focus on the role of the CRO, and the many duties of the Chapter 11 filing that the CRO can undertake to gain and maintain the support of all stakeholders.

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The CRO should be intimately involved with the negotiation of debtor-in-possession financing (“DIP Financing”) or cash collateral order with the company’s secured lenders. Too many times, the company files bankruptcy with no DIP financing or agreed-upon cash collateral order that results in bounced checks, missed payroll and other crippling financial repercussions. Why? Negotiations break down as the parties and their attorneys jockey for position and resort to threats and grabs for cash, power and advantage, then conclude with anger and distrust. Some companies are so damaged by these initial slug-fests that they never recover—even though they may limp along in bankruptcy for months.

Watching cash, analyzing value
How can the CRO best assist the company to ensure adequate financing for its Chapter 11 case? Most importantly, he or she needs to make sure the company is operating as close to break-even as possible. Many company managers convince themselves they would have adequate cash flow were it not for “too much debt.” Hoping to eliminate the burdensome debt by a Chapter 11 filing, they are surprised to learn their operating losses exceed debt service, because they spend more to make and distribute their product than they get paid for it.

What can the CRO do about this situation? It is critically important that the CRO has a realistic, achievable cash budget. Many companies have a pattern of developing and presenting “best efforts” budgets. “Best efforts” budgets are regarded as goals by the company for which they expect praise for partial achievement. Unfortunately, failure to totally meet financial projections destroys a company’s creditability with the

secured lenders. So to the extent that the CRO replaces the company’s lost credibility, it is important that the projections be accurate and achievable. The CRO would hurt—not help—the company with overly optimistic projections, because missed projections in a Chapter 11 filing will not result in praise for the effort, but possibly in a liquidation.

In addition to a cash budget, the CRO may find a liquidation analysis useful. The liquidation analysis typically analyzes the company’s balance sheet for expected values in going concern, orderly wind-down and forced liquidation scenarios. The liquidation analysis is most important in previewing for ownership what will happen to equity in various scenarios. This gives management a much more accurate picture of where they stand than the typical balance sheet, because some values on the balance sheet may disappear if the company has to be sold. Such disappearing values might include intangibles, good will, product development costs and computer installation costs, to name a few. If necessary, the CRO can use the liquidation plan to show other stakeholders that their interests lie in a solution other than liquidation because liquidation leaves them out of the money. The cash budget and liquidation value of the company allow the CRO to flesh out a business plan that would be the basis for reorganization or going concern sale.

Consequently, to increase the company’s chances for survival, the CRO must find a core business, help approach breakeven as soon as possible, articulate a business plan, develop a realistic cash budget, understand and be able to articulate various liquidation scenarios, and help find appropriate DIP financing or cash collateral arrangements.

The critical first day
Once these fundamental tools are developed, the company should be better able to determine what first-day and early case orders it needs, and to articulate and gain support for these orders from the other creditors. If the company can justify and explain critical vendor support, by all means, they should seek court permission to pay critical vendors, provided they will receive favorable credit terms.

First-day Orders frequently set the tone for a Chapter 11 bankruptcy filing. These orders let the court and the interested parties know whether the purpose of the case is restructuring the business, a going concern sale or liquidation.

The support or lack thereof for the first-day orders also gives some indication of whether the bankruptcy process will result in success or failure—success defined as maximizing the value of the estate for all stakeholders and minimizing the cost to administer the bankruptcy. While disagreements between the parties are bound to occur, a high level of distrust and conflict typically results in failure.

The restructuring advisor can help the debtor articulate its direction for the case with understandable business plans and other analysis in support. However, to a large extent, First Day Orders determine at the outset the difficulty the debtor will encounter in executing its plans. For example, a typical first-day order will determine whether the debtor’s employees will be able to provide the support needed to implement the company’s plan. The order determines not just whether they will receive pre-petition compensation in the usual manner, but also whether key employees can be promised retention bonuses for staying on with such a distressed business. If the transition from pre-bankruptcy to post-filing payroll appears to be seamless, employee

anxiety often melts away, even when other employee benefits are eliminated. However, when payroll gets caught up with other pre-petition payables, employee sentiment frequently shifts from collaborative to confrontational.

Likewise, first-day treatment of critical vendors as essential not only determines whether operations and sales will continue uninterrupted, but can also influence the trade creditors' outlook early on about whether the case is a reorganization versus a liquidation. Typically, the percentage of vendors deemed "critical" has not been as high, as in the K-Mart case. However, contrary to popular belief, K-Mart did not end critical vendor payments.

Within the bankruptcy guidelines, and particularly where vendors are willing to commit contractually to attractive credit terms, critical vendor plans can be fashioned that pass legal muster. The CRO can play a leading role in putting together plans to ensure supplies and services critical to the debtor's business are maintained.

The approval of professionals—and specifically the structure of professional carve outs in the first days of the case—is also a trendsetter. While conflicts between the parties may, on the surface, appear to be a financial issue, the repercussions go beyond the question of cash available for carve-out payments.

Indeed, a cookie-cutter approach to carve outs can turn out to be a mistake. For example, a case that is likely to result in a sale of the company would typically have a more truncated operating and proceeds-distribution phase than a reorganization. Because roles of professionals can vary from scenario to scenario, structure of the carve-outs should take into consideration the likely sequence of events and their timing.

Further, an ill-considered carve-out structure can diminish the benefits of a much-needed financial advisor. For example, management

shortcomings, as well as inexperience with bankruptcy and distressed businesses, can doom a Chapter 11 reorganization and/or sale. In such a situation, a restructuring advisor or crisis manager is essential. Yet, if other professionals feel their carve-outs are threatened by the restructuring advisor's fees, the accompanying conflict can result in curtailment of the advisor's role.

communication
Success in bankruptcy is tied to a number of factors, not least of which is the financial condition and prospects of the debtor. However, planning and communication of the debtor's plans are keys to gaining and maintaining the support of the various parties in interest, and moving the bankruptcy along quickly and efficiently. First Day Orders need to be consistent with the debtor's bankruptcy goals. Further, to achieve the First Day Orders needed, the debtor's goals need to be clearly and persuasively communicated.

The restructuring advisor plays an integral role in establishing the company's goals for bankruptcy and eventual exit from Chapter 11 as well as in adjusting expectations of various stakeholders. To fulfill this role, the advisor must help fashion a bankruptcy process that includes First Day Orders and must garner much-needed support from among the debtor's myriad stakeholders. ■

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