By Dan Dooley

10 Rules for Liquidating a Manufacturer or Distributor

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If you have never managed a liquidation of a manufacturing or distribution company, you might assume that it is a straightforward process to simply sell all of the company's assets. That is true if you do not focus on the "net" recovery for creditors.

However, to effectively maximize the "net" recovery, liquidations become extremely challenging projects for liquidation consultants, who must balance minimizing expenses with maximizing asset sale value. "Net" recovery is heavily dependent on the skill and creativity of the consultant managing the liquidation. This article summarizes 10 rules for liquidating a manufacturer or distributor.[1]

Rule 1: Protect AR's Value

During a liquidation, accounts receivable (AR) are usually the largest source of creditor recovery, except when the company owns significant real estate, plant equipment or intellectual property. Thus, protecting AR is critical. This simply means devising a strategy for collecting the highest percentage of AR possible during a liquidation.

Effective AR protection is a function of upfront planning and proactive communication with customers. The planning phase should analyze four key factors for each major customer:

1. Major customers' AR payment patterns (*e.g.*, pay each Friday, end of the month, etc.);
2. Contractual obligations to provide products or services to assess the risk of potential breach-of-contract claims;
3. Status of major customer orders in the existing backlog, as customers are likely depending on these orders to be delivered; and
4. Assessing the difficulty for these major customers to re-source the products and how much time it will likely take them to do so.

Analyzing these four factors in the planning phase will assist you in determining your leverage when entering negotiations with major customers regarding payments on current, and any subsequent, AR for new shipments. When companies liquidate, they give customers numerous reasons for short-paying or simply not paying invoices. Various reasons for not paying the full AR balance could be potential future returns or warranty claims, breach-of-contract claims, consequential damages due to the extra costs of re-sourcing, or simply the ability to pay less because the company is liquidating and unlikely to file a lawsuit over an AR balance unless a large dollar amount is involved.

The key to protecting AR is minimizing economic disruption or damage to your customers while winding down operations. In essence, the goal is to help the major customers re-source products in exchange for getting payment in full or close to in full for the AR balance. Re-sourcing/supplier transition typically takes at least 30 days, but often 60 days or longer. Facilitating a 60-day supplier transition aligns well with Worker Adjustment and Retraining Notification (WARN) Act requirements (which mandate a 60-day notice before mass employee terminations). These two situations often work out well to both assist the customers with a 60-day transition and to comply with the WARN Act requirements of a 60-day notice prior to employee termination.

Once the decision has been made to liquidate a company, all stakeholders (*i.e.*, employees, vendors and customers) will learn about it, whether from the company or another source. Therefore, it is wise to "proactively" announce the decision to liquidate and wind down to employees, vendors and customers on the same day. This can be accomplished by first informing employees using a company-wide town hall meeting(s). Next, senior employees can be tasked with calling primary suppliers and vendors. Finally, senior sales managers should be responsible for advising major customers.

It is standard and proper practice to provide the senior employees responsible for making calls to employees, vendors and customers with a standard written script so that everyone communicates a consistent message. All supplier and customer communications should at first be strictly verbal, as written documents or notices can easily wind up in news articles or exhibits to future lawsuits.

In certain situations, a liquidating company will have control of assets that a customer needs returned in order to resource such products as tooling, specialized equipment or intellectual property. If the liquidating company owns these assets, they can be sold to the customers. If the customer owns the assets, they should be sur-

1 The author is using his key takeaways from his decades of consulting experience in liquidating companies. In addition, he has been involved in many of the scenarios presented herein.

rendered only when the customer has fully paid off their existing AR balance and paid cash for any other assets, such as inventory or equipment, that they have previously agreed to purchase.

Rule 2: Sell Finished Goods to Existing Customers

The best avenue through which to sell finished-goods inventory is the current customer base. In cases where customers cannot easily procure a substitute product and will be at risk of running out of product during the re-sourcing process, the liquidating company will be able to sell its best-selling inventory items to those customers at or near full value. If the finished-goods inventory is a commodity that customers can buy elsewhere, discounting might be required to sell the inventory to induce customers to buy the inventory as a bargain. A final option, if a sale of a significant amount of the finished-goods inventory through current customer channels is impossible, is to explore a bulk sale to an inventory liquidation firm. This final option is simple, but typically not the maximum-net-recovery option.

There are two points of caution when liquidating finished-goods inventory. First, time is not your friend, as it costs money to store and handle inventory. Thus, the focus should be on the expected "net" recovery (which is the expected sales value less the costs of holding the inventory (*i.e.*, occupancy and warehouse labor costs)). Second, make sure that the customer pays when the inventory is sold. Customers buying closed-out inventory can easily decide to make up a reason to short-pay the invoice once they have possession of the inventory in their warehouse. For this reason, the inventory should be sold on a cash-sale basis.

Rule 3: Finishing Out WIP Inventory Is a Cost-Benefit Decision

A manufacturing company will always have work-in-process (WIP) inventory. The WIP is of value under two conditions: Customers (1) need this product finished and are willing to pay for it, and (2) are willing to pay a surcharge in addition to the current price. It only makes sense to finish out the WIP if it is profitable for the company to do so.

Therefore, it is important to calculate an aggressive surcharge to ensure that completing the WIP increases the net recovery. In cases in which the company manufactures a custom product or one where competitors have long lead times, it is typically cheaper for customers to pay the regular price plus a significant surcharge to maintain product supply than it is to run out of stock of the product.

Once the appropriate amount of surcharge has been calculated, it is vital to stick to your guns during the ensuing negotiations with the customers. For example, a 20 percent or greater surcharge would not be atypical. Also, customers may request continued product manufacturing beyond simply completing the WIP in the plant. Give customers one-week payment terms on finishing out the WIP and continuing production and closely monitor timely receipt of payments.

Rule 4: Knowledgeable Employees Are Critical to Maximizing Net Recoveries

In all liquidations, key employees should be kept on board to help because their institutional knowledge is simply impossible to replace. In addition, the cost of paying existing employees is substantially less than using more external consultants. The most important people in a liquidation are often not the C-level officers, but rather the middle managers, such as the AR collections manager, key account sales manager(s), plant manager, warehouse/distribution manager, controller and employee benefits manager.

One general rule is this: If you need to keep certain employees longer than the 60-day WARN Act period, then you need to offer these employees an employee retention bonus, typically a 50 percent retention bonus for each month that the company wants and needs the employee to stay. For example, if you want to keep someone for four months, offer a two-month bonus if the employee stays for the full four months. If the employee leaves earlier, the bonus opportunity is lost. All employees asked to stay and assist with the liquidation should be given a planned date of employment termination when their services will no longer be needed; this way, employees can plan their job search accordingly. The tasks that employees will help with include AR collections, sales of inventory, securing paper and electronic records, facilities and equipment maintenance, employee benefits, and financial reporting.

Rule 5: Timing of Starting the Liquidation Process Is Important

Assuming that there is a choice on the timing of when to start the liquidation process, it is best to start right after major customer(s) make large payments and/or shortly after payroll is funded. This way, AR is at a relatively low amount and/or the requirement to fund payroll is not imminent, but rather a week or more in the future.

Rule 6: Liquidate Without Filing for Bankruptcy

Most businesses can be liquidated without incurring the cost of bankruptcy. This allows the liquidation to be done faster and cheaper, as the administrative complexities and high administrative costs of bankruptcy are avoided. The two keys to staying out of bankruptcy are providing open communications and establishing financial transparency to all creditors, which enables creditors to observe that the owner is not benefiting from the liquidation at the expense of the creditors. Retention of an independent consultant to manage the process is advisable, because company ownership and management will be viewed as biased and will simply not have enough credibility to communicate effectively with the creditors. Management also will most likely not have experience in how to maximize liquidation net recoveries.

It is useful to prepare a simple letter to all creditors explaining the decision to liquidate and how the liquidation will be managed. In addition, it can be helpful to pro-

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vide some financial disclosures of the most recent income statement likely showing significant losses, a balance sheet showing assets to be liquidated, and the amount of secured debt that will be paid first from the liquidation. Liquidations typically result in an extremely low payout or no payout at all for unsecured creditors, so providing a conservative estimate on net recoveries likely to be available to unsecured creditors — even if it is zero — is an important part of the initial communications. It is also a sound idea to arrange a "listen only" conference call (800 number) with all creditors to explain the process and to provide a contact name, email address and phone number for subsequent questions.

If you believe that the trade creditors/unsecured creditors will likely be hostile to the company because of the size of large suppliers' credit exposure or because management has made payment promises that cannot be fulfilled, consider organizing the unsecured creditors into a committee. This would involve recommending that the five largest creditors form a creditors' committee and hire an insolvency attorney to represent them as a committee, with the company funding the attorneys' fees. This is a strong demonstration of an open-book approach to the liquidation process and intent to provide full financial disclosure. In essence, offer the unsecured creditors the same oversight that they would receive in a bankruptcy proceeding. To be successful in staying out of bankruptcy court, it is important to provide full disclosure and be responsive to creditor questions and concerns.

Rule 7: Some Liquidations Will Eventually Result in a Bankruptcy

It is always best to start a company's liquidation out of court. However, the company may eventually end up in bankruptcy due to an involuntary filing by creditors, or if a creditor gets a large court-awarded judgment and the company decides to file for bankruptcy to avoid enforcement of the judgment. If the liquidation is started out of court, most of the heavy lifting and major activities (*e.g.*, termination of employees, sale of inventory and AR collections) can be accomplished without the administrative burden of a bankruptcy.

The following is a nonexhaustive list of creditor issues that have a significant probability of eventually resulting in bankruptcy: (1) hostile junior secured creditors; (2) hostile seller noteholder(s); (3) multimillion-dollar litigation claims; (4) unpaid WARN Act claims; (5) significant owner or insider payments or distributions in the previous two years; (6) significant supplier base anger; and (7) government regulator claims or investigations. Bankruptcy might be, in fact, a good option at some point to enhance creditor recoveries, as some claims might be enhanced by filing for bankruptcy, such as the ability to pursue preference and fraudulent-conveyance claims and to file a director and officer breach-of-fiduciary duty lawsuit.

Rule 8: Secure Facilities and Records

In a company liquidation, one must be extra vigilant about who has access to the physical facilities and to the information-technology (IT) system and records. Consider changing locks and facility access codes, as well as reviewing and potentially revising IT system administrator access. Always create a backup of IT systems environment (systems, applications and data). All legal and accounting paper files need to be organized for easy access, and consider making secure copies of the most important documents.

Rule 9: You Can Still Sell the Company

It might sound unorthodox, but you can still sell a company — or part of it (division, product line or plant) — even after publicly announcing a company liquidation. A liquidation might create a significant economic threat for a customer or a supplier, such that buying some or all of the company at a value in excess of the estimated liquidation value is a better option than letting the company liquidate.

A positive consequence of announcing that a company is liquidating is that potential buyers realize that they need to act fast to preserve their ongoing operations. Otherwise, there will be no employees, suppliers or customers left, and hence, no operating company. Sales of liquidating companies occur more often than you might think.

Rule 10: Engage Insolvency Counsel

Although an out-of-court liquidation is a business and financial process, be sure to consider the legal aspects of all key decisions. The liquidating company is undoubtedly insolvent, which means that some creditors are unlikely to recover their full credit exposure. Human nature drives people to lay blame onto others for their loss, so involve insolvency counsel (*i.e.*, a bankruptcy attorney) in all major decisions; this is simply an exercise of sound business judgment. Note that the attorney should be kept in the background as much as possible to minimize the tendency for creditors to bring in their attorney if you bring in yours.

Conclusion

Liquidations appear simple on first impression. However, they require substantial upfront analysis, planning, and most importantly, the flexibility and cleverness of an independent consultant in order to maximize net recoveries for all creditors. abi

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