Outlook

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The Bankruptcy Alternative: What You May Not Know

While the politicians, pundits, and talking heads argue about whether we are in a recession, it is clear that the current economic climate is requiring consumers to re-evaluate their priorities and businesses to re-think their plans and strategies. In an environment where default and foreclosure rates are dramatically increasing, cash flow is rapidly decreasing, and borrowing money has become exceedingly difficult, many developers and management companies have been forced to examine their business plan alternatives. For some, this may mean considering the possibility of seeking protection and relief from creditors under federal bankruptcy laws.

For most, a bankruptcy filing is viewed as a last resort, and that should be the case. For others, the advantages that can be gained by filing bankruptcy make this alternative worth another look. Whether a bankruptcy case should be filed is entirely dependent on the particular circumstances a company faces, and no two companies are alike. This is an extremely important decision because the survival of the company usually depends on it. When making such an important decision, it is advisable for the company and its senior management to seek advice from both qualified legal counsel and financial advisors.

Non-Bankruptcy Options

Given that many creditors, including secured lenders, have been dealing with financial issues of their own in this depressed economy, a growing number are showing a greater willingness to work with their debtors. Since the largest debts are often those owed to secured lenders, it is this type of creditor on whom troubled companies must usually focus their primary attention. For an out-of-court workout with a secured lender to be a viable option, however, it is imperative that borrowers communicate frankly with their lenders. A lender who is fully informed and aware of the borrower's situation is much more likely to work with the borrower. Secretive or untruthful borrowers de-incentivize the lender to engage in an out-of-court workout.

Out-of-court workouts can be beneficial for both the lender and the borrower and typically result in the parties entering into a forbearance agreement. In a forbearance agreement, the lender agrees to forbear or refrain from exercising its legal rights against the borrower. This gives the borrower the comfort of knowing the lender will not sue during the forbearance period and allows the borrower to focus its energies and attention on its business. In exchange, lenders often increase the interest rate, require borrowers to pledge additional collateral, pay additional fees, give a complete release, and follow a strict repayment schedule. Since both sides stand to gain at the expense of the other, it is important for both sides to carefully analyze the transaction and the ramifications of entering into such an agreement. What a party agrees to in negotiating a forbearance agreement may come back to haunt him if he later winds up in a restructuring or bankruptcy situation. Knowing what these potential pitfalls are may save a lot of trouble—and more importantly, the company—down the road.

In some cases, a forbearance agreement provides a borrower with the time needed to solve the problems and resume business as usual. In others, it merely delays the inevitable: a bankruptcy filing or corporate dissolution. This decision should only be made after careful consideration of all relevant business, legal, and financial issues. In many cases, it is advisable to consider and plan for more than one of these alternatives. While it is human nature for management/ownership to do everything to stay out of bankruptcy, if it becomes necessary, however, a company must be prepared. This requires time and careful planning.

Changing Fiduciary Duties

It is extremely important for companies to realize that once debts begin to mount and it is teetering on insolvency, fiduciary duties and responsibilities begin to change. Where initially, management had had duties to the shareholders and responsibility to act in the best interests of the company alone, the scope of these duties begins to expand to cover others. This concept is often overlooked and, in many cases, even ignored at the peril of the company and its member/employees.

As debts rise and the ability to repay them diminishes, management must focus not only on the best interests of the company but also on decisions that must be made with the best interests of the creditors in mind. An emerging theory of liability, known as "deepening insolvency," seeks to hold officers and directors liable for corporate actions and decisions that creditors argue played a role in the company's inability to pay its debts, including unsecured debts. Creditors argue that these decisions only increased the amount of debt, making it less likely that the creditor would ever be repaid and more likely that the company should have taken steps to cut its losses instead of making them worse. Although the case law on this legal theory of liability is still developing, it is clear that these types of claims are becoming more popular. Being aware of them up front may help a company avoid and defend against these claims on the back end.

Taking the Leap

Filing a bankruptcy case is a critical decision. It is very helpful to utilize the advice and counsel of qualified professionals, who have successfully been through the process. These professionals can answer questions, such as (1) what type of bankruptcy is best for the situation, (2) where should it be filed, and (3) how the process can best be used to benefit the company. They can help a debtor understand what really happens in a bankruptcy case. They can also clear up any confusion a debtor may have about advantages of filing bankruptcy and then help navigate a way through the rough waters.

At the onset, a company must decide under what chapter of the bankruptcy code to file. If the goal is to liquidate the company's assets and to pay creditors as much as possible while shutting down the business as quickly as possible, the company would consider filing a Chapter 7 case, or alternatively, utilizing state insolvency laws. In Chapter 7, a trustee is appointed to take control of and liquidate the debtor's assets, then distributing the proceeds to creditors. If the company wants to try to reorganize, a Chapter 11 case is the best option. Chapter 11s may also be used for liquidation purposes, as it allows a debtor to stay in business and thus maximize value prior to the sale of the company and its assets. Either way, in a Chapter 11 case, debtors are provided with a vehicle to propose a plan under which they will pay their creditors and, if all goes well, reorganize the company.

Chapter 11: Common Misconception

There are many misconceptions about a Chapter 11 bankruptcy and what it means for a debtor. Perhaps the most common is that bankruptcy is the equivalent of going out of business, and that even if the doors stay open, current management loses control of the company.

Filing a Chapter 11 bankruptcy does not mean that a company is going out of business and does not mean that current management automatically loses control of the company. In Chapter 11, the company stays in business and continues to operate under the watchful eye of the bankruptcy court, the United States Trustee, and creditors. A Chapter 11 debtor is not required to go through a liquidation but rather operates as normally as possible under the confines of the bankruptcy laws. Upon filing, the company becomes known as a debtor-in-possession, which means that it stays in possession of its assets and control of its business. Current management runs the company throughout a Chapter 11 case, unless cause exists for the court to appoint a trustee. Cause typically includes egregious conduct on the part of management, such as fraud, dishonesty, or gross mismanagement. A debtor-in-possession is a fiduciary and owes fiduciary duties not only to the company but also to its creditors. A debtor-in-possession that is mindful of these responsibilities and abides by these duties will remain in control and will help direct the business out of bankruptcy.

Protection for Guarantors of Corporate Debt

In certain cases where non-debtors (i.e., owners, officers, or directors) have personally guaranteed the company's debts, the debtor may be able to obtain an injunction from the bankruptcy court preventing creditors from trying to collect from these guarantors during the bankruptcy case. This legal strategy is based on one of the primary purposes of the Bankruptcy Code: to promote successful reorganizations.

To this end, courts may consider whether individual guarantors are so important to operations of the business that their complete focus and attention must be available to the company to help lead the company's reorganization efforts. The distractions that would inevitably be present in having to defend against guarantor lawsuits would divert their attention from the bankruptcy process making a reorganization less likely. If the debtor can prove this to the bankruptcy court, an injunction may be granted, thus protecting the company and the guarantor. In deciding whether to grant an injunction, courts also look favorably upon a guarantor who contributes personal assets to the debtor's case or who funds the Chapter 11 plan. In some cases, it is even possible to obtain an injunction after the company emerges from bankruptcy through the Chapter 11 plan of reorganization, under which the debtor repays its debts so that creditors do not have to turn to the guarantors for repayment.

Three Advantages/Opportunities

While the process is very challenging and subjects debtors to very strict scrutiny, it also offers debtors opportunities that would not be available to them outside bankruptcy. A fundamental concept of bankruptcy law is known as the automatic stay, which comes into play immediately upon filing a bankruptcy case (under any chapter). Upon filing, creditors are immediately and automatically, without any court action, prevented from (among other things) pursuing claims against the debtor that arose prior to the bankruptcy filing or from trying to take possession of property of the debtor's estate. To pursue a debtor for these claims, a creditor must first get permission from the bankruptcy court by proving it is entitled to this relief.

Another advantage only available in bankruptcy is the ability to decide which executory contracts and unexpired leases to keep and which ones to reject. A debtor may use its business judgment to decide that a particular contract or lease is burdensome to the estate and may relieve itself of future performance obligations under that agreement. On the other hand, a debtor can choose which contracts and leases it wants to keep. A third fundamental bankruptcy concept is known as the discharge. Bankruptcy laws enable a debtor to discharge—or do away with—certain debts. A successful bankruptcy case that results in a discharge prevents creditors from ever pursuing the debtor for collection of discharged debts.

With thoughtful planning and knowledge of the bankruptcy system, a troubled company can negotiate with its creditors in an effort to resolve their payment issues and other problems out of court. If this cannot be done or if a company decides bankruptcy is a better option, it can utilize the advantages that only bankruptcy laws provide to turn the situation around and successfully emerge as a new, stronger business. D

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