Out-of Court Problem Solving and Restructuring: Guide to a Successful Outcome

OUT OF COURT PROBLEM SOLVING AND RESTRUCTURING
A Lawyer's Guide to a Successful Outcome
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Michigan Lawyers Weekly May 30, 2005

I would like to offer attorneys, who are consulting with their business clients on the various options available to resolve financial difficulties, my opinion on the step by step process of the out of court restructuring option.

While the legal profession focuses on training individuals in developing the framework for business problem solving with court supervision in a variety of areas, the area that has become known as the "Out of Court Chapter 11", which has gained great popularity over recent years as a mechanism to restructure the debt of a company that finds itself in serious financial condition, is largely unfamiliar territory to the legal community.

Any number of events may lead a company to seek the advice of counsel: lawsuits, issues with taxing authorities, problems with customers or with a lender who has "lender fatigue". There are several first steps that should be taken by the attorney who faces providing advice to a client with these types of problems, which, if not properly addressed, could be life threatening to the business. The first step in this process is the initial meeting and interview, during which the following areas should be carefully explored with the business owner seeking advice and guidance:

What is the history of the business? How long has it been operating? What are the financial results? What does the most recent balance sheet reflect? Has the business ever operated profitably? What appears to be the reason for the financial difficulties? Who are the shareholders, operators, and key personnel, and do they have experience in the industry? Does management have any idea of what has caused the problems and are they still present?

After these basic questions and others have been discussed, several more areas need to be considered before deciding if this business is a candidate for an out of court restructuring of its debt. I suspect the most important consideration is to determine if there is evidence of insider dealings, such as transfers or fraudulent conveyances and/or third party preferences. While these areas should be broadly discussed by the attorney during the initial interview, an insolvency analysis will ultimately be required before the final decision is made that a composition agreement with creditors is an option. These are areas that are usually focused on by creditors when asked for forbearance and cooperation in structuring a

compromise or composition of debt without court supervision. They need to be discussed as the first step in the process of determining if this type of proceeding should even be attempted.

Secured creditor and/or lender support and cooperation is the next area to consider. These types of creditors need to be enlisted for continued support of working capital and the possibility of restructuring the secured debt from short to long term to provide even further working capital. There is no place for the secured creditor and/or lender in the process of an out of court composition of unsecured creditors. The status of these creditors places them in a conflicting and priority position that does not easily lead to compromise or composition. Security agreements and bank documents should be carefully reviewed, which includes conducting a UCC search to establish that the lender has properly perfected its secured position. I have seen big surprises in this area over my many years in this field.

Taxing authorities and unpaid taxes are other areas that do not lend themselves to the out of court process. They have other avenues that can be pursued, such as levies and liens, and are not the types of obligations that can be comprised or composed through an out of court restructuring of unsecured creditor debt.

After the initial attorney meeting, the development of a 90-day projection is the next step. This document should portray the business continuing in at least a break even or profitable operating mode so that further losses are not eroding assets and possible future payments to creditors. The projection should assume that all current obligations, principal and interest payments, lease obligations, taxes and all other current expenses including payrolls, utilities and insurance payments, along with payments to vendors for current goods and services. It is unnecessary to provide for payments on existing unsecured debt after a given "freeze date", inasmuch as this is the debt the company hopes to settle.

If the insolvency review does not disclose any insider transactions, fraudulent conveyances or third party preferences that could possibly be recovered through a bankruptcy proceeding, and the 90-day forecast portrays the company can stabilize and meet its current obligations, then consideration can be given to the attempt to structure an out of court workout with creditors.

The next step is one that many attorneys attempt themselves on behalf of the company. That is the initial notification and/or communication with creditors. My over 40 years of experience in this field has convinced me that creditors do not relish being contacted by an attorney for any reason, let alone an invitation to participate in the business problem solving process. Business persons usually want to deal with other business persons, and while there is a place for the attorney in the process, it is certainly not during the initial stages of creditor communication and the meeting structuring period.

Either the company, or even better, an independent third party such as the company's advisor or accountant, working with management, should make the initial creditor contact, prepare for the meeting and decide when and where the meeting will be held. It is during the meeting that the company will provide information to creditors, seek creditor cooperation for a freeze on past due debt and invite creditors to form a committee to work with the company to structure a resolution for past due

obligations. There are a variety of methods that have been used for this step. I have used them all, however, the most successful approach has been a generic letter to all creditors and a special letter to the top 20 creditors with an invitation to this group to attend a meeting. Both letters will be sent simultaneously and must be carefully prepared and should not read like a letter drawn by an attorney. Remember, the goal here is to portray the image of resolving the business problem by business persons and this is the message that should be conveyed clearly in the initial contact with creditors.

Preparation for the initial creditors meeting is the next step. Creditors will want the reasons for the company's financial difficulty and will need current financial information. I usually provide a formatted five-year summary of financial information, rather than a complete financial statement, and a current balance sheet and collateral analysis that projects the funds that may be available to pay creditors from a liquidation of the company's assets. I also provide both a summary preference analysis covering the past 90 days and a transaction analysis covering the past 12 months. The thrust here is to provide enough information to creditors that will allow them to conclude for themselves the extent of any payment through the company's failure and ultimate liquidation of assets and the unlikelihood of any recovery through the pursuit of preference or insider payments by a bankruptcy trustee.

The most successful meetings are held at an impartial location that allows creditor representatives ease of attendance, certainly not at the offices of the company's attorney or accountant. The best location seems to be a conference room in a hotel, either in or adjacent to a major airport, to encourage attendance of creditors from out of town. Before the meeting commences, attendees are required to sign in, indicating their companies' names and amounts owed. A Confidentiality Agreement is distributed to each attendee. After the agreement is signed, a package of information is then provided. Participants can begin reviewing information before the formal meeting commences. The meeting is convened by either the advisor or accountant and an agenda is discussed. The reason for the meeting is explained and the business owner and principals address the gathering. The attendees are thanked and management provides a brief overview of the company's present financial and operational condition.

The materials are then discussed in great detail by the participants and questions are answered to the best of management's ability. I always insist that the advisor or accountant moderates this portion of the meeting. After all of the creditors' questions have been responded to and the materials fully discussed, it is now time for the meeting to be turned over to the company's attorney. The attorney then provides an overview of the company's options and makes a request for creditor support. The goal here is that the attorney conveys the company's intent to resolve its financial difficulties in an out of court manner. The attorney then suggests that creditors meet privately, discuss the information provided by the company and form a committee to represent all unsecured creditors. The attorney also suggests that a goal of the committee will be to work with the company to reach an agreement that the committee can recommend to all creditors as being in the best interest of unsecured creditors under the circumstances. Creditors are urged to select an attorney to represent the committee as soon as possible and also an accountant to review the company's financial information and any other information they may feel is necessary that will allow the committee to make an informed decision. The creditors are informed that the company is prepared to pay for the costs of the committee's professionals within

reason. The company's representatives leave the meeting at this time, allowing creditors to meet among themselves in confidence.

Once this point in the out of court process has been reached, counsel and their clients can weigh the probable reactions of creditors to the matters discussed during the meeting and contemplate the options and alternatives that may be available.

James V. McTevia is widely regarded as a pioneer in the highly specialized field of crisis management and business problem solving. With more than 40 years of experience, his engagements today primarily focus on business restructuring, refinancing, management reorganization and transition, and mergers and acquisitions. He is the Chairman of McTevia & Associates, Inc., management and financial consultants, in Eastpointe.