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Turnaround Topics

By James E. Fleet

Case Study: Can This Company Be Saved from Bankruptcy?

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For many middle-market companies, there are a multitude of pressures that may drive them to the tipping point of insolvency. It is not uncommon to see companies that are performing reasonably well, but unforeseen management missteps or an industry downturn, combined with poor acquisition strategies, results in excessive debt layered onto the balance sheet, leading to impending turmoil. This overleverage creates a higher-than-acceptable debt service and results in even well-run companies finding themselves in a difficult position.

In the current capital market these companies are far from rare, but their situations are frequently masked by historically low interest rates. Add to this delusional valuations and leverage ratios, and it is no wonder that trouble can be found. In today's increasingly complex and overvalued deals, it is especially difficult to sort out the trouble that stems from multiple capital partners and agendas. This conflict creates very unique dynamics that impact the way the various stakeholders choose to work together — or not. The way the conflict is handled determines the future of the organization. This article examines the real-world challenges of a fictitious organization and its various stakeholders.

Company Profile and Stakeholders

The company in question is an old-line, well-established business in a long-standing (*i.e.*, tired) economy marketplace that suffers from declining industry opportunities and is experiencing continued consolidation. Led by a well-established management team with extensive industry experiences and relationships, the company is performing at its industry-standard Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) margin of between 5-6 percent. While satisfactory for many enterprises, this level of performance is not sufficient to service the company's debt because although revenue has declined, the debt from its acquisition remains the same. The stakeholders — private-equity investors, a senior asset-based lender, a junior or mezzanine lender and the management team — were betting on the EBITDA growth. However, in the current landscape, average growth simply does not cut the mustard when there is excessive debt on a company's balance sheet. The company's enterprise value is underwater, and each group of stakeholders has unique positions and concerns.

Private-Equity Ownership

In the eyes of the private-equity investors, their investment is largely lost due to the company's nonperformance, industry downturn and an overleveraged balance sheet. They have serious concerns surrounding potential fiduciary liabilities that surround the failure of the business and are not inclined to put any more capital at risk. These include tax obligations, federal and state Worker Adjustment and Retraining Notification (WARN) Act requirements and employee-benefit liabilities, including unpaid vacation and unfunded employee health insurance claims. For these stakeholders, the only thing worse than losing their investment is having to put up more money out of pocket to settle fiduciary obligations.

Senior Asset-Based Lender

The concerns of the senior asset-based lender are perhaps the most extensive. The lender may be concerned about whether the loan is collaterally sound or protected for the loan facility. Is the collateral being used to fund losses, thus eroding the lender's position? Does the lender have proper legal protections from both a loan document and intercreditor standpoint? Worry over potentially improper Uniform Credit Code filings may complicate matters. If bankruptcy is a consideration, is the case administratively solvent? Would the possibility of debtor-in-possession financing further erode the lender's position, preserve it or facilitate a sale? In a bankruptcy filing, regardless of a reorganization plan, execution of a § 363 sale or chapter 11 wind-down, is the lender's collateral position degraded, and what is its recovery? In theory, the collateral should have recovery values to meet the balances owed; however, a wide variety of priority and super-priority claims create potential uncertainty.

Junior or Mezzanine Lender

Given the overleveraged state of the balance sheet, this lender's position is fraught with significant loss risk. In the event of liquidation, the junior lender is very unlikely to recover its investment. Should the company undergo an enterprise sale, either within the confines of a bankruptcy § 363 sale process or in an out-of-court sale, it is still unlikely that the original investment will be recovered. If it is recovered, it will certainly not achieve the desired return on investment. The junior lender's position as the fulcrum capital provides opportunity if it views the company as worthy of taking ownership through a form of debt-to-equity swap and/or additional investment.

The junior or mezzanine lender must have an operating company with sound management that is aligned with its objectives. As such, it might be a target for a savvy management team that seeks to negotiate a better deal and threaten bankruptcy as a possible tactic to restructure the balance sheet. However, the junior lender possesses its own leverage to potentially replace management, cut a deal with private-equity investors that own the stock and gain control of the board of directors.

Management Team

In the eyes of the team that is responsible for the day-to-day operations, the executives are essentially without hope of receiving money in terms of equity upside potential, given the overleveraged balance sheet and lack of enterprise value. The leaders may believe that the situation is beyond their control because of the mature industry and macroeconomic forces stacked against the company's future. It is unlikely that they could achieve the extraordinary results that would be required to satisfy the debt and still offer economic return to them.

Their agenda is the upside of equity incentives, not the mere salaries and even bonuses. If the company is sold or liquidated, there will not be adequate resources remaining to satisfy any agreements. An aggressive executive team may attempt to gain some equity incentive compensation beyond the base compensation and attempt to exert its leverage against other stakeholders, especially the junior lender. The management team may threaten a bankruptcy filing in an effort to shed the debt on the balance sheet, an especially unattractive option to the junior lender.

With a fiduciary responsibility to all creditors in the case of insolvency, the executive team must put the interest of creditors — not themselves — first, but this creates the conundrum of opportunity. If management files for bankruptcy, it assumes significant risk that the business could be lost and, along with it, their personal opportunity. If they do not file for bankruptcy, they preserve an opportunity for themselves, but only with a restructured balance sheet and potential vendor concessions. Further, if executives are operating under noncompete agreements, it will be more difficult for them to leave and negatively impact the company. However, without noncompete agreements, executives possess greater leverage to attempt to leave the business and restart a competing enterprise or join a competitor.

Clearly, this case example outlines how vastly different positions and priorities create conflict among parties. Some stakeholders have leverage, while others simply seek the best possible outcome from a losing position. So with competing priorities and concerns, can stakeholders come together to achieve maximum return in the long run?

Stakeholder Options and Opportunities

The company in question is underperforming relative to its debt load and is struggling to succeed. There is anxiety among all of its constituents, ranging from management, private equity, lenders, unsecured creditors and employees, with everyone forced to examine problematic outcomes and make difficult decisions. Ultimately, the company's survival will depend on its stakeholders' ability to craft a collaborative solution with a level of shared pain among the enterprise value participants. Stakeholder options and opportunities vary by priority and position. Some of the possibilities are detailed below.

Private-Equity Ownership

Unfortunately, the equity is likely out of the money or is severely diluted absent the ability or willingness to put additional capital into the business, a very unlikely scenario. Its best option is likely a plan whereby it removes any potential fiduciary liabilities and receives a form of "hope" equity for some future date.

Senior Asset-Based Lender

This stakeholder has the luxury of most options. Since the senior lender holds the first position on all collateral, it may recoup its investment if the collateral has retained its value. If the collateral is clearly valued less than the loan amount, the lender may choose to adopt an approach of "first loss is the best loss" and accept a recovery shortfall but seek a rapid closure. The senior lender needs to consider all options for achieving the best value for any collateral, or maximize the recovery value through possible enterprise or ongoing sale of the business as an example. If a sale of the company is under consideration but its projected that cash burn would degrade its position beyond recovery, the lender may choose to fight the sale process, accelerate liquidation plans and rapidly wind down the company. On the other hand, if the cash burn is reasonable and the collateral value is sound, the lender may find it difficult to fend off the § 363 sale process or reorganization plan.

Junior or Mezzanine Lender

With declining or underperforming earnings and an overleveraged balance sheet, this stakeholder is unlikely to recover its investment in a bankruptcy or liquidation scenario. As such, the choices are clear: Strike a deal with private equity to gain control of the stock, which may require a variety of scenarios such as backstopping any liabilities of current equity, and/or invest additional capital in conjunction with a debt-for-equity swap. Having control of the stock and board of directors is essential in negotiating with management to establish aligned goals for increasing the company's enterprise value. The junior lender may consider further alternatives, including purchasing the bank debt on par with it or at a discount as a further measure to maintain control of the business. Essentially, loan terms determine whether the junior lender chooses to foreclose and force a bankruptcy or negotiate a settlement with management and convince leaders to stay. Either way, moving forward requires more money.

Management Team

Some might argue that the management team that led the company to this turning point should be eliminated. However, the leaders did not commit any cardinal business sins; they simply failed to react to a changing industry in a timely manner, suffered through macro-economic downturns and/or were unable to react quickly enough to other mitigating factors. The disruption created by eliminating an entire executive team is enormous, and a great amount of value exists in the relationships and knowledge that the team possesses.

When the management leaders have worthless common-stock ownership or warrants for same, the result is unmotivated executives working for a paycheck. This is a situation ripe for management to exert its leverage to attempt a reorganization plan and deleverage the company's balance sheet, or explore other destructive options for the company relative to the best interests of the other constituents. For example, they may leave the company for competitors.

Management can exert any number of strategies designed to disrupt the situation, with the potential of significantly impairing the lenders, both senior and especially junior. For example, it is also possible that the management team can execute a reorganization plan and emerge intact. However, if the plan fails, the company would not recover from bankruptcy and everyone would be out of a job. Another option is a sale to a competitor, which would likely leave the management team with resumes in hand either immediately or in the near future. Possibly, the best alternative is to negotiate an out-of-court restructuring, in tandem with the equity ownership, that satisfies both types of lenders and includes a management carve-out of an equity upside opportunity.

What Does This All Mean?

Competing priorities make working together challenging for stakeholders. However, nearly all would agree that bankruptcy is, in all likelihood, not the best solution to achieve the saving of the business and ultimately maximize the enterprise value, which would benefit all stakeholders.

Moving Forward

You might be asking, what became of the company? While a difficult process, the stakeholders worked together to structure an out-of-court reorganization. The management team negotiated with the junior lender to create an equity incentive plan based on enterprise-value creation and a substantial debt-for-equity swap, thereby reducing its debt service and creating additional cash flow. In addition, the senior lender agreed to extend its credit facility, providing further support for stable working capital.

With the new deal in hand, management negotiated with its unsecured creditors and vendors who agreed to various concessions. Some chose to accept payment plans, and others chose to cut their losses and accept a payout, still far beyond what they would have received in bankruptcy court. Fortunately, in today's environment of corporate insolvency, many vendors possess a greater appetite for concession when faced with a threat of bankruptcy. With a motivated management team intact and a restructured balance sheet completed, there is every reason to believe the company will move forward successfully.

What about the original private-equity ownership that was faced with losing everything? It received a secondary form of preferred shares with values received in the event that the company is sold at substantially higher enterprise values. Perhaps just as importantly, the junior lender will assume any fiduciary liabilities to the business should it fail. In the end, all parties did not get everything they wanted, but they recognized the upside potential of the out-of-court restructuring of the balance sheet and the continued retention of the management team. abi

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