Representing a Business in a Workout or Bankruptcy

By Jason W. Bank

Attorneys play an important role in business formation, growth, and innovation. Attorneys also play a critical role when businesses experience financial distress. According to the U.S. Bureau of Labor Statistics, for every startup business that succeeds, one will fail within five years.[1] This article examines key aspects of representing a financially troubled business in a loan workout, restructuring, or business bankruptcy.

Smooth waters ahead: The lender-borrower relationship begins

Credit is the lifeblood of small- to middle-market businesses, which require capital to begin and sustain operations. Banks and lenders are in the business of loaning money, primarily through term loans and lines of credit. When a business in need of capital meets a lender with plenty of it, a business relationship is formed that benefits both parties: the business obtains funding for its operations and the lender earns interest and fees on its loan.

Generally, a bank is willing to loan significant funds to a business only if it can obtain liens and security interests against all business assets. A lender may also require that a business owner have "skin in the game" by personally guaranteeing repayment of a business loan and potentially pledging personal assets to secure repayment. Liens and personal guarantees are often those fine-print details that are ignored or glossed over by a business owner eager for a loan. At closing, a default is the last thing on the mind of an optimistic business owner, who envisions blue skies and smooth sailing ahead.

"Best Practices" is a regular column of the *Michigan Bar Journal*, edited by Gerard Mantese and Theresamarie Mantese for the Publications and Website Advisory Committee. To contribute an article, contact Mr. Mantese at gmantese@manteselaw.com.

Storms develop: The loan workout

The lender-borrower dynamic works well when a business is running smoothly and is profitable. The relationship becomes more strained when a business encounters stormy waters or plunges into insolvency. Businesses experience financial stress for many reasons, including changes in market conditions, liquidity issues, a poor business model, or mismanagement. Often, a distressed business will default under its loan documents by missing a required payment to the lender or breaching a financial covenant.

A default by a borrower that is not resolved is a potential game changer that places the business's survival in peril. The loan may be reassigned from the friendly, originating loan officer to a lender's workout loan officer who specializes in resolving troubled loans. The workout department is charged with taking the necessary steps to recover repayment of a loan as quickly and efficiently as possible.

During a workout, a borrower discovers that what it thought was a 'til-death-do-us-part relationship with a lender is instead a 'til-*default*-do-us-part relationship. A default typically permits a lender to accelerate and require immediate repayment of its entire debt. In the loan documents, the borrower typically grants a lender the right to exercise various remedies if a borrower defaults, including sweeping money from a borrower's bank account, collecting receivables owed to a borrower, or having a receiver appointed to liquidate assets. These remedies are potential death blows that may grind business operations to a halt. As a result, a borrower's next steps are critical to the business's survival.

Remain calm and communicate

Management of a distressed business that receives a default letter typically has several critical items on its plate, such as meeting payroll or paying essential suppliers. It is tempting for management to ignore the lender and focus on the business's immediate needs. Hoping the lender will not take aggressive action, however, is not a good strategy.

During a workout, a borrower discovers that what it thought was a 'til-death-do-us-part relationship with a lender is instead a 'til-*default*-do-us-part relationship.

> It is tempting for management to ignore the lender and focus on the business's immediate needs. Hoping the lender will not take aggressive action, however, is not a good strategy.

It's probably too late to work toward a solution if you wait to engage in discussions with a lender until after receiving the lender's complaint or motion to appoint a receiver. By the time a complaint is filed, a lender will have drawn its own conclusions regarding the viability of the business and the lender's best course of action.

Accordingly, a borrower should be proactive, contact its loan officer, and schedule a meeting as soon as possible. At the meeting, the borrower should exhibit a conciliatory attitude as opposed to a confrontational or litigious attitude. The borrower should keep in mind that it borrowed the money, agreed to the terms in the loan documents, and is now in default.

At the meeting, the borrower should provide the lender with a detailed explanation of the root causes of a company's financial problems. Not every cause is viewed the same by a lender. A workout lender may react differently to a business facing a liquidity crisis due to an unforeseen spike in commodity prices, as opposed to a business owner who has committed gross mismanagement or fraud. A lender may decide to work with a borrower in the former example and take aggressive action in the latter.

Presenting a plan: What comes next?

Once the details of the situation are communicated, the borrower must present to the lender a comprehensive plan to right the ship. The plan should identify how the lender will recover the money it loaned. A borrower should provide an updated, comprehensive financial statement; a budget detailing the company's projected revenues and expenses; and a cashflow forecast to confirm the company will not run out of funds. The lender will also want to see an appraisal or valuation of business assets. This information should help both borrower and lender better understand the company's financial picture.

A business owner and management may not have the requisite skills or time to compile the necessary financial information that a lender will want to see. Further, some lenders may not trust financial information provided by an owner who is having difficulty steering the ship and fighting for survival of the business. Accordingly, a distressed borrower should consider engaging an accountant or financial advisor who specializes in turnarounds. A financial advisor could help management as needed or take the wheel and operate the business as a chief restructuring officer.

A financial advisor can help reestablish credibility with a bank. An advisor with turnaround experience will speak the same language as a workout officer, and the lender may rely on the advisor's recommendations. The advisor will also be invaluable to presenting realistic endgame scenarios for both lender and borrower.

Avoiding shipwreck: The forbearance agreement

Lenders who send default notices are on the verge of exercising remedies that could close a business's doors. The default notice generally means the business has a small window of opportunity to reach an agreement with a lender to avoid the doomsday scenario.

Lenders may be willing to agree to postpone exercising default remedies under a forbearance agreement, which is a contract used regularly in workouts. Before considering a forbearance, lenders will require a detailed game plan and the financial information described above.

A forbearance agreement typically contains the following terms:

- The lender will provide a borrower with a limited timeframe (three to six months is common, subject to extensions) to obtain financing to satisfy the lender's claims.
- A business may be required to pursue a certain course of action (such as sale of the business or liquidation of certain assets) as a condition of forbearance.
- The lender will require a borrower (and any guarantor) to waive any claims they may have against a lender or any defenses they may have to the lender's claims.
- The lender may require that a borrower execute a pocket consent judgment or order appointing receiver that the lender may file if the borrower does not satisfy its obligations by the end of the forbearance term.

Not all forbearance agreements are the same. Some provide borrowers with a reasonable period to implement a turnaround plan and pay off the lender. Others are heavily drafted in favor of a lender with the potential to create a scenario in which the borrower has in effect ceded control of a business and set up the company for liquidation. As a result, negotiation of a forbearance agreement with reasonable terms is critical.

Speak softly and carry a big stick: Chapter 11

Theodore Roosevelt's famous phrase described a policy of careful negotiation ("speaking softly") supported by the unspoken threat of a powerful military ("big stick"). A struggling business facing lender pressure may be well-served to adopt a similar strategy. If a lender is pursuing aggressive remedies like forced liquidation

or appointment of a receiver, the *threat* of a Chapter 11 bankruptcy petition may be a borrower's last line of defense and best leverage in negotiations. If negotiations do not lead to a settlement, a Chapter 11 filing may be necessary to preserve business operations.

Chapter 11 provides significant benefits for the distressed business (known in bankruptcy as a "debtor"):[2]

- The automatic stay immediately goes into effect upon filing of the bankruptcy petition. The stay prohibits *any* act to collect a debt from a debtor or obtain possession of a debtor's assets. The stay acts as a shield against creditors while providing a breathing spell for a business to develop and implement a restructuring plan free from creditor pressure.[3]
- The debtor remains in possession of its assets and is free to continue to operate its business in the ordinary course of business. Management remains in control of the business in most Chapter 11 cases unless cause is shown for the appointment of a trustee.[4]
- A debtor may file a plan of reorganization—a contract between the debtor and its creditors governing the treatment of claims owed by a debtor upon the debtor's exit from Chapter 11. A plan may eliminate pre-bankruptcy defaults, discharge or eliminate debt, and restructure a debtor's obligations with longer payment terms to creditors.[5] A debtor has the exclusive right to file a plan of reorganization in the first 120 days of a case, subject to extensions.[6] Most creditors may vote to accept or reject the plan, and they may file objections to the plan. Ultimately, the bankruptcy court conducts a confirmation hearing and determines whether to approve or confirm the plan, which permits the company to emerge from bankruptcy.[7]

Generally, a lender wants to avoid Chapter 11 because:

- A judge has the final say over disputed matters. For example, a court can authorize a company to use cash that is the lender's collateral to pay certain expenses of the business over the lender's objection.[8]
- A business debtor may obtain court approval of a plan of reorganization against the bank's wishes under the so-called "cramdown" confirmation provisions.[9]
- A two-party dispute outside of bankruptcy court becomes a multiparty proceeding. Any creditor owed money by the business debtor may participate in the case and be heard.[10]
- A committee of the largest unsecured creditors may be formed, and the committee may scrutinize the bank's loan documents and dealings with a company and potentially bring claims against the bank.[11]
- The amount of a lender's secured claim may be reduced in certain circumstances if the value of the underlying collateral is less than the debt.[12]

A Chapter 11 bankruptcy petition, however, is not a wonder drug that will automatically cure a company's ills. A company will incur significant professional fees in a Chapter 11 case. Management is required to spend a substantial amount of time on the case, taking its focus away from the business. Vendors who provided a company with credit terms on shipments may demand cash payment upon delivery with a company in bankruptcy. Chapter 11 will not solve a company's liquidity or funding issues.

There is often significant uncertainty over how a judge will rule or whether a debtor can obtain confirmation of its plan. Confirmation is a potentially grueling process. Filing a plan with the support of a lender and creditors can result in a smooth and relatively fast exit from bankruptcy. While a borrower may obtain court approval of its plan over the lender's objection, the process will be lengthy and expensive. Further, a company that is unable to confirm a plan may end up in liquidation under Chapter 7 of the Bankruptcy Code.[13]

Accordingly, even after a bankruptcy filing, there are numerous reasons why a borrower should continue to engage in settlement discussions with a lender to try to resolve their differences. Agreeing on a consensual plan that will pave the way for a company to emerge from bankruptcy is in the best interest of all parties.

Conclusion

A troubled business requires keen navigation and a nimble hand at the wheel to survive. A workout also presents a tremendous opportunity for a company to restructure and strengthen its business. An attorney's guidance may mean the difference between a company's rebirth and dissolution. ■

Jason W. Bank is a member of Kerr Russell, Detroit's oldest law firm, and leads the firm's bankruptcy and restructuring practice. He is a certified mediator and serves on the mediation panel for the U.S. Bankruptcy Court for the Eastern District of Michigan. He is also a former adjunct professor at Michigan State University College of Law and former president of the Turnaround Management Association's Detroit chapter.

ENDNOTES

1. *Do economic or industry factors affect business survival?*, Small Business Facts, SBA Office of Advocacy (2012) <https://www.sba.gov/sites/default/files/Business-Survival.pdf> [https://perma.cc/64F4-ERZC] and *Table 7: Survival of private sector establishments by opening year (1994–2018)*, Business Employment Dynamics, Bureau of Labor Statistics, US Dep't of Labor <https://www.bls.gov/bdm/us_age_naics_00_table7.txt> [https://perma.cc/P7KV-87HX] (both sites accessed September 7, 2019).
2. See generally 11 USC 1101 *et seq.*, which covers reorganization under the United States Bankruptcy Code.
3. 11 USC 362(a).
4. 11 USC 1101(1), 11 USC 1104, 11 USC 1107, and 11 USC 1108.
5. 11 USC 1123.
6. 11 USC 1121.
7. 11 USC 1129.
8. 11 USC 363(a) and 11 USC 363(c)(2).
9. 11 USC 1129(b)(1) and 11 USC 1129(b)(2)(A).
10. 11 USC 1109(b).
11. 11 USC 1102 and 11 USC 1103.
12. 11 USC 506(a) and 11 USC 1111(b).
13. 11 USC 1112.