

BANKRUPTCY & RESTRUCTURING ROUNDTABLE

The **Bankruptcy & Restructuring Roundtable** panel is produced by the L.A. Times B2B Publishing team in conjunction with Avant Advisory Group; Greenberg Glusker LLP; and M-Theory.



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Bankruptcy – and the restructuring process – are challenging and complex endeavors, requiring a variety of tactics and resolution mechanisms. For the parties involved, financial expectations can be at odds with the reality of the situation, and knowing when to compromise and how best to proceed for your organization's specific needs is essential.

Due to some of the significantly disruptive trends of the last couple

of years, including pandemic-related challenges, international conflicts and unrest, supply chain issues and more, the number of Chapter 11 bankruptcy filings has dramatically increased.

The Los Angeles Times B2B Publishing team turned to three uniquely knowledgeable experts for their thoughts and insights about the bankruptcy and restructuring process and what executives can do to help their organizations rebound successfully.

Q: ARE THERE ANY NEW LAWS AND REGULATIONS TO BE AWARE OF THAT AFFECT THE BANKRUPTCY AND RESTRUCTURING LANDSCAPE IN 2022?

A: Banner

The talk of the bankruptcy world lately has been the “subchapter v” bankruptcy process – which is a form of “mini-chapter 11” aimed at making chapter 11 reorganization an affordable option for small and mid-sized businesses. The subchapter v process was created under the 2019 Small Business Reorganization Act (SBRA) to help streamline the costly chapter 11 process, reduce the likelihood of litigation with creditors and provide principals the opportunity to retain their equity even if creditors are not paid in full. The original SBRA only allowed the smallest of small businesses to participate

company has insufficient cash or other resources to service its debt

- Recurring operating losses substantially depleting the company's equity base
- Onerous legacy agreements, e.g., lease commitments that hamper the company's operations but that can only be removed via rejection in bankruptcy
- Litigation judgments and/or other claims that might only be discharged in bankruptcy
- Intractable lenders and other creditors unwilling to cooperate in an out-of-court restructuring

A distressed company facing one or more of these situations, or that is operating in the zone of insolvency, may find itself in an untenable, overwhelming circumstance. Bankruptcy may be the last resort to provide the necessary “breathing room” for the company to survive.

Q: AS BUSINESSES RE-EMERGE FROM THE COVID-19 SCENARIO, WHAT ARE SOME CRITICAL FACTORS FOR MANAGING A TURNAROUND OR RESTRUCTURING?

A: Vartanian

Since most of my thoughts and energy revolve around tech and the surrounding community, I naturally take some guidance that most would think is reserved for tech startups. The same lessons that guide nascent stage companies also help companies of any size ... the lesson being properly managing your capital efficiency. These days, venture capitalists are taking a page out of the private equity handbook, looking for profitable cash flow companies instead of funding high-growth businesses. Measuring capital efficiency will be instrumental for managing a turnaround, post-COVID. You can predict the length of your runway by understanding “burn factor.” If you are burning 2x net-new revenue, you have poor and disconcerting capital efficiency. To safely re-emerge from the COVID scenario, finding the problem that impacts your burn is key. All serious problems, from gross margins to founder-leadership problems, will eventually impact the burn factor. Find and solve for your burn.

Q: AT WHAT POINT SHOULD A BUSINESS CONSIDER HIRING A BANKRUPTCY OR RESTRUCTURING PROFESSIONAL?

A: Davidson

If management has lost the trust or confidence of its creditors in a distressed situation, restructuring or bankruptcy experts can oftentimes restore needed credibility. Skillsets utilized in a growth company can be completely different from

those required of a financially challenged company. Turnaround professionals or financial and restructuring advisors are skilled at assessing complex, troubled situations to determine the underlying causes that resulted in the company's dire circumstances. These experts can then determine if the business is viable and recommend corrective actions and steps to ensure the company's viability. By scrutinizing the company's financial statements (sometimes forensically), determining, and implementing turnaround plans, these experts can work with creditors and other stakeholders to achieve a successful restructuring or exit from bankruptcy. Quickly recognizing when a turnaround, restructuring, or bankruptcy expert is needed, may be crucial to the ultimate survival of a business.

A: Banner

The short answer is “at the first signs of financial distress.” A common misconception is that a bankruptcy professional is only needed at the time when a company is beyond the proverbial “point of no return” and has no choice but to file a bankruptcy; at which point it may be too late to avail itself of certain benefits of the bankruptcy code or successfully restructure. Just as bankruptcy is a last resort for a company, the filing of a bankruptcy is typically viewed as the last option for a bankruptcy professional. On the slow path to bankruptcy, a company's non-bankruptcy options become more limited until they are left with no other option. The earlier we are engaged, the more tools a bankruptcy professional has in their toolkit to help a company avoid bankruptcy.

Q: WHAT IS THE FIRST THING A COMPANY SHOULD DO IF IT PLANS TO FILE FOR BANKRUPTCY?

A: Vartanian

Avoid it! CEOs must fight, at all costs, not to succumb to bankruptcy. As CEO of M-Theory, I have faced the possibility of insolvency more than once. After wiping the tears and sweat from my face, I recalled a line from a well-known 80s movie about staring into the abyss with nothing staring back – how that provides a moment for you to find “your character” and see what you are really made of. Before moving forward into the abyss (aka bankruptcy), it is important to identify cost-cutting initiatives. Each time I was faced with insolvency, we implemented a technology solution to reduce costs substantially, which often meant that “technology” would reduce headcount, but reduced headcount is better than no headcount. The second step is negotiating with all your payables. This step is critical as it will help preserve cash. Two years ago, growth was king. Now the proverbial “cash is king” is the new mantra. Tackle each

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– those with debts not exceeding \$2,725,625. As such, a small business with a \$2-million line of credit and \$1 million in trade debt would be locked out from the “mini-chapter 11” process. Congress thankfully extended the debt limit during the COVID pandemic to \$7.5 million, an increase that has only recently been extended until 2024. With the new “mini-chapter 11” process, reorganization is a viable option for more small and mid-sized companies.

Q: WHAT ARE SOME OF THE KEY SIGNS THAT BANKRUPTCY MIGHT BE A NECESSARY PATH FOR A BUSINESS?

A: Davidson

A bankruptcy may be the only remaining option for a distressed bankruptcy, particularly given specific indicators. Just a few of the warning signs include:

- High debt leverage such that the

area and the cumulative efforts will pay off and avoid the bankruptcy abyss.

Q: WHAT ARE SOME BANKRUPTCY PITFALLS THAT BUSINESSES SHOULD AVOID?

A: Banner

The moment a company begins to experience financial distress, close attention must be paid to the flow of cash. For instance, payments to equity holders or other “insiders” of the company made within a year of filing bankruptcy could be later clawed back through the bankruptcy process. Similarly, payments to any creditors within the 90 days before a bankruptcy could be clawed back as “preferential” payments to those creditors (to dissuade companies from paying off the creditor they like prior to bankruptcy). Those are only two examples of common pitfalls a company faces after a bankruptcy filing. Consulting with a bankruptcy professional early in the process can help mitigate the risks associated with the company’s financial dealings leading up to a bankruptcy filing by advising against problematic cash flow decisions before they are made.

Q: WHAT ARE THE FIDUCIARY OR CORPORATE GOVERNANCE CONSIDERATIONS RELATED TO AN INSOLVENT COMPANY OR ONE OPERATING IN THE ZONE OF INSOLVENCY?

A: Davidson

It’s important to evaluate whether a company is operating in the zone of insolvency because the fiduciary duties of its company’s officers and directors may have been extended beyond those to the company’s shareholders alone. While insolvency is a predominantly legal issue that relates to the rights of creditors, the business judgment rule is also relevant, and insolvency is based on financial measures. When a company is determined insolvent, the following financial analyses are pertinent from a financial and board/corporate governance advisory perspective:

- Balance Sheet* (legal insolvency), whereby:
 - Fair value of the company’s liabilities exceeds its assets; and/or
 - The amount of debt is relatively high in relation to equity, i.e., capital is unreasonably small for company size.
- Cash Flow* (equitable insolvency) relating to:
 - Company’s inability to pay its debts as they become due.
 - Adequate capital and concern of equity protection for creditors.

For an insolvent company or one operating in the zone of insolvency, director and officer decisions that are inconsistent with duties to creditors (not only shareholders) may subject management and the board to liability, especially when scrutinized by a creditors’ committee, individual creditor, or a bankruptcy trustee.

Q: HOW HAS COVID-19 AFFECTED THE M&A LANDSCAPE?

A: Vartanian

This is a loaded question and far too complex to provide a simple answer. In short, after COVID-19, the world made an unprecedented decision to collectively shut down. Supply chains were impacted, and the global economy took a major hit as a result, not to mention the deliberate death and destruction of certain businesses/industries and the

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ascension of others, encouraging “winner take all or most” outcomes by a few. The U.S. economy bounced back, fueled by PPP and stimulus and loose fiscal and monetary policies. The direct result was an artificial demand for nearly everything, propelling the valuation multiples of business, particularly tech companies.

Who knew this would lead to inflation? Everyone. Then it all comes crashing down. The venture and investment community realizes 50-70% discounts, causing them to modify capital allocation strategies. The impact to M&A is the ability to capitalize on discounted values of great business, with positive cashflows and synergies. This might be that very free-for-all moment.

A: Davidson

As the pandemic hit the country during the first months of 2020, government-mandated lockdowns, quarantines, and other restrictions, combined with fear, and uncertainty, drew M&A activity to a screeching halt. However, beginning in the latter part of 2020, private equity and

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other acquirers with high levels of side-lined capital resumed aggressive pursuit of investment opportunities. This led to an acceleration of deal-making activities. The imminent presidential election and the looming prospect of tax rate increases, combined with uncertainties related to a new administration and a higher regulatory environment also contributed to robust M&A activity. The consolidation that occurred in various sectors to drive synergies, reduce costs, and gain new customers also impacted the M&A market. All of these factors resulted in a deluge of closely held business sales, corporate divestitures, and public company deals. Bain & Company’s 2021 M&A Report stated that all records were broken in 2021 as total deal value skyrocketed to \$5.9 trillion in announced transactions.

Q: WHAT’S THE BEST WAY FOR A DISTRESSED COMPANY TO FIND A QUALIFIED BUYER OR FINANCING IN TODAY’S MARKET?

A: Banner

Companies are often surprised to learn that there is an entire field of professionals dedicated to the sale of distressed assets – whether it is the sale of restaurant equipment or the sale of a going concern with millions in annual revenue. In short, if there is a buyer out there, such professionals will find them. We have had great success over the years connecting clients with appropriate professionals to maximize the value of a distressed asset sale.

Q: WHAT ARE SOME BEST PRACTICES IN M&A DUE DILIGENCE IN TODAY’S CLIMATE?

A: Vartanian

One of the benefits of being the CEO of M-Theory is the opportunity to get first-hand experience in many facets of the business world, above and beyond merely running a tech company. I typically find myself immersed in due diligence, both on the buy and sell side. In addition to getting a full grasp of the target’s financial condition and identifying synergies, and growth potential, it is a best practice for buyers to dive deep into IT, security and governance. A comprehensive, 360-degree understanding of the target’s risk profile is a must. Proper due diligence will provide comprehension of the target’s IT infrastructure and roadmap, security, governance, and regulatory compliance policies as well as potential pitfalls if they’re missing. Focusing on these areas could also result in spotting immediate cost-cutting opportunities and anticipating impactful costs going forward. By finding gaps, buyers can determine if and how technology improvements could impact the growth and profitability of the acquisition target.

Q: HOW DOES FILING FOR BANKRUPTCY IMPACT THE SALE PROCESS?

A: Banner

Often, a sale through a bankruptcy is preferable to an out-of-court sale. The reason for this is that, under the Bankruptcy Code, a buyer is able to purchase assets “free and clear” of liens and claims encumbering the assets through a bankruptcy sale. This offers a buyer a tremendous amount of comfort and security, which typically cannot be achieved outside of a bankruptcy setting. One of the challenges we face when representing a buyer outside of bankruptcy, whether by foreclosure or otherwise, is that creditors and other parties continue to go after a buyer for the liabilities of the seller. A “free and clear” bankruptcy court sale order, on the other hand, provides a near iron-clad defense to any such claims.

Q: IF THE BUSINESS IS PRIVATELY HELD, WILL A BUSINESS BANKRUPTCY HURT THE OWNER’S CREDIT SCORE?

A: Banner

The short answer is “no.” A company’s bankruptcy filing should not affect a principal’s credit. However, if the principal’s personal financial affairs become intertwined with the company’s, there is a possibility of an adverse credit event. For instance, company credit cards are a common way that company debts make their way to an individual’s credit report. If a company credit card has your name on it, you should be concerned about personal liability. Also, principals often guarantee the debts of a company, which could lead to collection and lawsuits after the underlying company files bankruptcy. Any time you take on debt for the company, you should consider what will happen if the company later files for bankruptcy.

Q: WHAT ARE SOME VIABLE ALTERNATIVES TO BANKRUPTCY?

A: Davidson

Alternatives to bankruptcy depend upon the specific facts and circumstances. Other options include:

Out-of-court restructuring

- Less expensive and faster
- Potential flexibility to treat creditors differently
- Resources can be fully applied to operations rather than depleted by costs of a formal bankruptcy proceeding
- Recovery may be higher
- Relationships among parties may be easier to manage, and relationships may be less adversarial than in litigation

Article 9 “Friendly Foreclosure”

- Consummated quickly
- More cost-effective than a Chapter 11, S363 bankruptcy sale
- Good title can be given because an Article 9 foreclosure eliminates junior liens
- Minimal disruption to operations
- Mitigates risks to buyer of claims by company’s creditors

Out-of-court liquidation – self-liquidation

- May yield the most efficient, highest recovery
- Management turns raw materials and work-in-process into finished goods for greater recovery
- Management may have better success than a lender in collecting receivables

A: Banner

In California, there are formal alternatives to bankruptcy, such as an Assignment for the Benefit of Creditors (ABC), an out-of-court process where a company is liquidated through an assignee, or a receivership, an in-court process where a company’s assets are liquidated through a court-appointed receiver. Though each may have its advantages in certain situations, my favorite “alternative” is an informal restructure through stakeholder negotiations. More often than not, the source of a company’s financial distress is derived from a single source – their main supplier; a bank loan they have fallen behind on; a landlord that’s losing its patience; or perhaps a group of creditors that have been knocking on the door. Although negotiations with such parties can sometimes be difficult, the disgruntled creditor often understands that a failure to reach a negotiated resolution could lead the company into bankruptcy – a bad result for everyone.