CASE WIND-DOWN

Time Matters: Maximizing Recoveries in Wind-Downs

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Time is money," Benjamin Franklin once famously said, creating one of the most enduring adages in the American business world. The cliché, of course, refers to the opportunity cost of lost time and to the ideas that costs are incurred as time passes and that revenue cannot be generated through idleness.

The processes of bankruptcy, liquidation, and distribution to creditors are certainly different from those of running an ongoing, thriving business. But as debtors and creditors proceed through the complicated and often time-consuming steps of winding down a company, they owe it to themselves to keep Franklin's truism in mind. A key take-away from the phrase in the bankruptcy context is this: the longer something takes in the process, the more it costs. Specifically in cases that involve liquidating a company's assets, an equally important corollary comes to mind: the longer it takes to liquidate an asset, the lower the recovery will be.

Performing tasks in parallel rather than in sequence is a method often used by healthy businesses to get more done sooner. This same method of operating works in bankruptcy, too.

Anatomy of a Wind-down

The surge in bankruptcies that occurred in 2008 and 2009 featured a greater number of 363 sales followed by liquidating plans than in prior bankruptcy cycles. A "363 sale" refers to the sale of any asset that is allowed by the bankruptcy court under Section 363 of the U.S. Bankruptcy Code. Typically, the term is used to describe the sale of a majority of a business's assets as an ongoing enterprise.

In a best-case scenario, a 363 sale might take a few weeks to execute, especially when a buyer is lined up prior to the filing and, because there are no realistic alternatives, no auction is held. Such was the scenario in both the General Motors and Chrysler Chapter 11 reorganizations. More likely, however, the process will take two to four months and sometimes longer.

Once the major assets are sold, the real work of the wind-down begins. The remaining assets are liquidated; the remainder of the company is wound down; secured creditors get their collateral (or more likely the cash equivalent of their collateral up to the value of their claims); unsecured creditors' claims are reviewed, valued, and then

Photo: Luca diFilippo © iStockphoto.com/LdF paid in full or in part, generally in accordance with the priority scheme established in the Bankruptcy Code.

A debtor can't just write checks to prepetition creditors. Unsecured creditors can receive distributions in one of three ways:

1. Through a liquidating plan
2. By converting the case to Chapter 7 and having a trustee distribute the assets
3. Through a structured dismissal, in some jurisdictions

A liquidating plan is generally the preferred method because the fees and expenses of new professionals in a Chapter 7 conversion are often higher than the costs associated with a liquidating plan. A structured dismissal is an alternative to converting to Chapter 7 when there are insufficient funds for a liquidating plan. This article focuses on wind-downs that use the liquidating plan method; when "plan" is used, it refers to the liquidating plan.

While plan details vary from case to case, the general requirements are that a) the creditors agree to the plan, b) there are sufficient liquid assets to pay administrative claims once the plan is confirmed, and c) there are sufficient assets to carry out the rest of the plan. All details are reviewed and approved by the bankruptcy court with the end goal being a signed confirmation order of the liquidating plan by the bankruptcy judge.

Typically, a debtor retains financial professionals who have a good understanding of near-term cash flow and unpaid professional fees. They likely also have some understanding of administrative claims. It is imperative for a debtor to maintain this discipline after the 363 sale.

Interested parties are often tempted at this stage to dismiss the organization's financial advisor, crisis manager, or chief restructuring officer (CRO) to preserve cash. The company's key employees, perhaps now retained on a contract basis and with new full-time jobs, can easily lose track of administrative claims and incurred professional fees.

In reality, the best time to begin digging into administrative claims is when the 363 sale is coming to a close. Some claims may go away because the buyer assumes a contract and cures any default. But other claims may need special review.

For example, if a debtor faces 503(b)(9) claims for goods shipped within the last 20 days prior to commencement of the case, someone must determine whether those goods were actually received and whether any payments for them were made. Are there any administrative tax claims that could be considered prepetition priority claims instead? The key is to use resources that are already available—the advisors and employees involved in the 363 sale and the computerized records used—to resolve these types of issues. Granted, it may be too early to file claims objections, but it certainly helps to have these resources working to determine where a company stands.

The assets that remain after the 363 sale must then be liquidated. These can include such items as accounts receivables, inventory, equipment, deposits, and tax refunds. These assets must be assessed, finalized, and liquidated in a way that maximizes the recovery for creditors. Also included are "litigation assets," including preference or avoidance actions. The information needs for these assets should be identified sooner rather than later as well, before ready and affordable access to the information is gone.

The fact is, after the initial flurry of activity surrounding the execution of a 363 sale, a certain sense of inertia tends to set in.

Unsecured claims are reviewed in what is called the claims reconciliation process. Claims entitled to priority treatment under the Bankruptcy Code are paid before general unsecured claims. As a result, maximizing the recovery to general unsecured creditors requires taking a hard look at these priority claims. While the bulk of these can be reviewed after the plan effective date, it helps to have a general idea of the total amount of unsecured claims going forward.

Often, secured claims are filed for actual or estimated property taxes on the assets that were just sold. Because these claims are secured by the sold assets, they are typically paid even before administrative claims. Having employees in place and computer systems up and running makes resolving these secured tax claims easier, a good reason to move on these once the 363 sale is completed.

As for other claims, obvious duplicates and other issues are teed up for objection. If little is expected for the general unsecured creditors, little expense should be expended on this aspect of the case. But if the distribution to these creditors is significant and some claims are egregious, they should be addressed. Claims related to litigation should be fixed as to amount before distributions to general unsecured creditors are made. Again, employee knowledge in this regard is helpful.

Pitfalls, Opportunities

Inevitably, battles arise between secured and unsecured creditors. After all, the latter group is left to divvy up what remains after the secured creditors have been reimbursed. There can also be disputes with the owners. Such skirmishes tend to delay plan confirmation and the entire wind-down process. Sometimes, the lengthiest fights occur when sufficient funds clearly exist to reimburse unsecured creditors, especially those not entitled to priority treatment. Ben Franklin likely would not be pleased with this scenario.

Recoveries from non-paying accounts receivable, real estate, litigation, and other remnants are sometimes delayed until a liquidating plan is confirmed. The temptation is to let the plan administrator pick the attorneys needed to collect troubled accounts receivables and pursue other litigation, including preferences, and brokers to sell real estate. In other cases, the liquidating plan is deferred until sufficient assets have been liquidated to pay higher than expected administrative claims.

The fact is, after the initial flurry of activity surrounding the execution of a 363 sale, a certain sense of inertia tends to set in. The debtor's management team and outside professionals are often ready for some serious beach time. To prevent further costs from piling up, they are tempted is to shut down the systems, let everyone go, and pass the bulk of the responsibility for carrying out the remaining details of liquidation to the plan administrator.

Still, expenses mount. Employees remain on the payroll to collect accounts receivables, sell minor assets, and handle other details of the wind-down. Expenses for yet-to-be liquidated property—taxes, insurance, and maintenance—continue to accrue. Computer systems remain online to assist with searching company records, managing collections, reconciling claims, and resolving preference actions and other possible litigation.

Until a liquidating plan becomes effective, there is an ongoing churn of professional fees for the debtor, creditors' committee, and others, and each year the company continues to exist, another set of state and federal tax returns must be prepared and filed.

Of course, by the time the plan administrator becomes involved, an important window of opportunity has likely been lost—company records are now much more difficult to locate,

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accounts receivable are more elusive, and equipment may have depreciated. Prospects for a favorable recovery from remaining assets have diminished.

Cases in Point

Clearly, time matters, which means that the key to maximizing recovery for creditors after a 363 sale is to do more—and to do it sooner. Two recent wind-downs, one involving a high-profile toy retailer and the other a scrap metal concern, are particularly good cases in point.

No stranger to the world of bankruptcy, eToys had become a holding of The Parent Company (TPC), a roll-up of Internet children's products retailers with a Delaware nexus. For most of TPC's subsidiaries, which included some of the more notorious dot-com flameouts, 2008 had been a particularly stressful year.

Retailers in general were suffering from a troubled economy that produced a freeze in consumer spending. Unfortunately for TPC, the company was in trouble with its lender long before the season started. In February 2008, the majority stockholder posted $15 million in cash collateral. In early December, the majority shareholder became the lender, replacing the bank. TPC filed bankruptcy in the last days of December 2008.

The majority of the company's assets were sold in a 363 auction in February 2009. The committee and the woefully underwater lender reached an agreement in March that left funds for the remaining wind-down and a liquidating plan. Funds to pay off unsecured creditors were to be generated by collecting deposits, preferences, and from some promising litigation.

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Efforts to collect deposits and liquidate miscellaneous assets continued at a very slow pace during the remainder of the year, while the inevitable churn of professional fees continued. In November 2009, the company's chairman and remaining officer was replaced by an outside director and CEO with bankruptcy experience.

Despite the specialists' best efforts over the next several months, deposits and assets brought in less than expected and preferences were disappointing. A liquidating plan became effective in September 2010 after professionals in the case agreed to defer payment of fees and expenses until more assets were liquidated and the litigation was resolved.

In hindsight, such a plan could have been put forward and confirmed earlier in the process; doing so would have reduced the churn costs of professionals, including the contract officers, as well as other costs that ended up hampering the debtor's ability to pay off creditors. A crisper understanding of the remnant assets earlier in the case might have led to quicker settlements and perhaps even an agreement to defer payment on professional fees until sufficient assets were available after the plan was confirmed.

Sturgis Iron & Metal (SIM), a Michigan-based scrap metal recycler with seven processing yards in three states, had been in woeful default of numerous loan covenants with its bank, mostly due to poor inventory controls.

Lacking cash and buyers for the company, SIM filed for bankruptcy in April 2008. A 363 auction was held soon after that. Except for a few hard-to-sell assets—accounts receivables, a few small buildings, and a yard in Elkhart, Indiana, that had been declared a Superfund site—a bidder eventually offered $42 million for SIM's assets. The sale closed in June, leaving the debtor with more than enough cash and assets to pay the senior lender in full and leave additional funds for the unsecured creditors.

But the creditors' committee, the owner, and the lender sparred for the next 11 months over the proceeds and theoretical avoidance actions. All the while, a liquidating plan was anticipated, so the debtor held off retaining litigation counsel to collect certain receivables and investigate preference actions. The parties finally reached an agreement in March 2009, and a plan was confirmed in May. By that time, nearly a year had lapsed since the conclusion of the 363 sale—precious time during which expenses mounted, the remaining collectibles grew older, and professional fees continued to accrue.

Although they made out well in the 363 sale, involved parties eventually learned firsthand that time matters. An important period of deferred activity after the sale led to missed opportunities, as well as unnecessary expenses for the debtor's estate. In the end, less was recovered than what might have been possible for several reasons:

- The committee could have been more realistic about its chances at the outset
- The debtor could have retained counsel sooner to collect disputed accounts receivable for a better recovery
- With key debtor staff, professionals systems, and records still available, an analysis of preference actions could have been completed sooner and at lower cost.

Staying on Track

Keeping in mind that every wind-down presents its own unique set of facts and circumstances—and that keeping the 363 sale process on track should always be the first order of business—here are some suggestions for maximizing recovery during the bankruptcy process:

- If collection attorneys are needed, they should be brought onboard before the filing and retained as ordinary course professionals.
- A review of preference actions should be undertaken as soon as the debtor's organization can support the process to take advantage of the company's systems and members of its support staff while they are still available.
- Real estate brokers and others should be retained as soon as possible to sell assets that are not likely to be included in a 363 sale. The size and timing of any recovery can be better estimated with a broker's help, which may aid in formulating a liquidating plan and other related issues, and the debtor's staff can assist in marketing efforts.
- Administrative and 503(b)(9) claims should be evaluated as soon as possible. An accurate assessment of their value is necessary to determine the feasibility of a liquidating plan. Moreover, while they are still available, debtor staff and systems can be used to evaluate the claims.
- Deferring professional fee payments and perhaps other administrative claims in the plan may mean that an otherwise insolvent case can be confirmed (provided that recoveries from other assets and litigation merit doing so). Often, cases drag on while minor assets are recovered or preference claims are litigated to generate cash to pay administrative claims on plan confirmation. Waiting, however, means more churn costs and ultimately a lower overall recovery.

One can almost hear Ben Franklin now, roundly endorsing the main thrust of these suggestions—that time is of the essence and that idleness and delay ultimately work against maximizing recoveries. For emphasis, Franklin might even add a phrase borrowed from his colleague Thomas Jefferson: Never put off until tomorrow what you can do today.

When it comes to winding down a company in bankruptcy, that advice from those two gentlemen is well worth heeding. CR

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