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Legal Finance Insights

Evaluating Options for Insolvent Companies:

Business leaders need to understand the tools available to them—as creditors *and* debtors.

FEW companies can survive without debt: establishing credit with vendors and lenders is usually essential to start or grow a business. Yet when economic bumps arise, these obligations can destroy a company if not handled with knowledge and care. All business professionals should understand the tools available to address insolvency, because even if your company doesn't face an economic hardship, at some point your key customers and vendors almost certainly will.

WORKOUTS. When a company is loaded down with debt, experienced professionals may be able to help guide it through this problem to bring it back to life. Accountants, turnaround experts, and attorneys can help the company understand its options, including ways to resolve its obligations without resorting to the courts. Creditors are often willing to accept a restructuring of their debt to avoid a bankruptcy or default. Conversely, debtors are often willing to accept some long-term additional costs in exchange for short-term relief.

Unfortunately, companies sometimes have too many creditors to restructure their debt out of court. As a result, insolvent companies (or their creditors) often turn to bankruptcy courts for relief.

BANKRUPTCY. Successful Chapter 11 bankruptcy reorganizations allow the company's management team members to stay in place and provides breathing room so they can turn the company around. But bankruptcies must be well planned in order to lead to success. If a company resorts to bankruptcy haphazardly, the result is more likely to be a liquidation after an expensive and drawn-out fight. The rate of successful Chapter 11 reorganizations is strikingly low, sometimes estimated at 20% or less. And about a fifth of Chapter 11 debtors that do reorganize eventually file another bankruptcy, often because their "successful" bankruptcy plan was anything but. Bankruptcy can be a good (and sometimes the only) option for a struggling company, but careful planning is required for a successful result.

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Bankruptcy can be a potent tool for creditors as well. One of the heaviest hammers available to creditors is accessible only in a bankruptcy: the preference action, which allows creditors to recover many types of payments made in the 90 days before a bankruptcy filing, or a full year for payments to company insiders. If an investor, lender, or vendor is concerned that its funds have already flowed out the door, its best option may be to force the insolvent company into bankruptcy.

RECEIVERSHIP. Washington has a well-developed receivership act that can provide many of the benefits of bankruptcy with lower costs and greater flexibility. As in bankruptcy, Washington's act provides a (limited) "automatic stay" from enforcement actions, allows the sale of property without successor liability for purchasers, and permits the termination of unprofitable contracts. The receiver may be selected by the creditor, or by the company itself, depending on the circumstances. This flexibility to select a receiver requires careful planning because receivers run the gamut from turnaround firms that can profitably operate or liquidate companies to individuals who have little clue how to run or sell a business. Receivership proceedings are also overseen by state court judges or commissioners who may lack expertise in insolvency or even business law.

A state court receivership is often the best option for an inexpensive liquidation or a short-term business operation. One of the main limitations of a receivership is that there is no discharge of debt after the proceeding is over. So unless a company can pay off *all* of its creditors, a receivership proceeding is unlikely to save a struggling company.

Whether companies pursue workouts, bankruptcies, receiverships, or all of the above, careful planning is critical for success.

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