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SAVING SMALLER MIDDLE MARKET BUSINESSES: A PERSPECTIVE

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Introduction

The concept of a fresh start through the bankruptcy process has been around for decades and was specifically codified through the enactment of the Bankruptcy Code in 1978. The goal of the Bankruptcy Code is to provide the mechanism for a financially distressed company to get a second chance and to rehabilitate itself for the overall good of the US economy. Once upon a time, in a not-too-distant past (relatively speaking and between approximately 1978 and 1989) the Bankruptcy Code was interpreted such that closely held middle market businesses in financial distress could utilize Chapter 11 of the Bankruptcy Code as a vehicle to restructure a business and get a "fresh start" such that the business owner was able to retain ownership and control of the business. While there was not a limit on the amount of debt that could be restructured through a reorganization plan under Chapter 11, typically a standalone restructuring plan for a closely held company was most workable for smaller companies with a simple debt structure of under approximately $20 million of secured debt.

Competent, honest, and industrious owners of over-leveraged companies that were unable to meet debt obligations but were running a financially viable business, had options and business tools to preserve ownership of their businesses. This was an important option particularly for mid-market service-based companies where the viability of the company's ability to restructure, stay in business, and preserve jobs were closely tied to current ownership and management. These owners could utilize Chapter 11 of the Bankruptcy Code to negotiate with creditors, reject burdensome contracts, and submit a Plan of Reorganization (a "Plan") to restructure and repay some or all their debts over time. The owners' contribution and work to rebuild value in their business would be treated as "sweat equity" which allowed them to, in effect, buy back the business within the structure of the Bankruptcy Code, assuming they were able to garner enough support from the creditor body and otherwise meet the legal and financial criteria required for approval of the restructuring Plan.

As part of meeting the Bankruptcy Code criteria, and indeed in any restructuring, the Plan needed to be based upon realistic and attainable financial projections that established how much and how fast creditors would be paid back over a future period of time (typically five years). This would include specific milestones along with a description of the mechanics on how that would be accomplished. The Plan provided a realistic probability of:

1. The secured creditor being paid back the full value of the secured debt over time.

2. The unsecured creditors being paid back a sizable portion of their trade debt.

3. Trade creditors maintaining the customer relationship and the ongoing value of the associated sales and profits.

4. The owner being able to retain ownership and control of the business with a reasonable opportunity to regain equity value over time.

A Simplified Sample Restructuring

The key to any method of financial restructuring is to have an objective third-party Financial Advisor (FA) put together a realistic business plan and multi-year financial projection for the distressed business. It is critical that business owners seek outside help, not only to take advantage of an experienced and skilled FA professional, but also to add credibility for the creditor base that only an objective finance professional can add to the debt restructuring process.

A sample plan (albeit each case is different) would be to use, for example, 85% of free cash flow produced by the company over five years to provide pro rata distributions to unsecured creditors in semi-annual payments. Unsecured creditor debt would be frozen as a non-interest-bearing note and set aside into an Unsecured Creditors Pool. Free cash flow would be defined as Net Income plus non-cash Depreciation and Amortization less normal Capital Expenditures and less "scheduled" Bank Debt interest and principal payments over time. After the term of the Plan (again, typically five years), any unpaid Unsecured Creditors Pool balance will be forgiven.

What Changed?

Three primary changes over the last 40 years dramatically affected the practical ability to rehabilitate closely held smaller to mid-market financially distressed companies using Chapter 11 Bankruptcy as a tool.

In or about 1988, certain Bankruptcy Court cases interpreting the "absolute priority rule," which specifies the order of payment priority to creditors of a business in bankruptcy, created significant barriers for owners to retain their ownership interests. Court decisions determined that “sweat equity” in the form of future services of the owner was not as valuable to creditors as new cash. This meant that to exit bankruptcy via a Plan or an asset sale in bankruptcy (typically under section 363 of the Bankruptcy Code), a company must be fully marketed for sale to determine the value of the business and that the current owner could only use new cash to sponsor a Chapter 11 Plan and to participate in a 363 sale. As a practical matter, this means that owners who lack cash to invest no longer have the chance of rehabilitating the business and maintaining ownership. Instead, many owners of smaller or moderate sized companies, knowing that it is unlikely they can retain any ownership interest or knowing that the company cannot survive a bankruptcy process, try to sell their businesses outside of the bankruptcy process, often by themselves without professional investment bankers. The attempt to sell the business outside of a bankruptcy process typically resulted in failure, which culminated in owners not even trying to sell the company as a going concern, instead just liquidating the company out-of-court rather than going through the personal and emotional stress of a bankruptcy process.

The second major impact was that US banking regulations dramatically changed. Commercial banks are now more heavily penalized economically by banking regulators and the stock market for holding non-performing loans for financially distressed companies for longer time periods. Long-term holds cause the lenders’ quality rating on the distressed loan to be downgraded. Therefore, long-term, loan-based workouts have become a “thing of the past” for many commercial banks. Post the 2008-2009 Great Recession bank regulators have been much more difficult for commercial lenders/banks to deal with and banks are under great pressure from the regulators and internally to move out non-performing loans than they were pre-Great Recession. These two forces disincentivized banks from participating in otherwise viable loan restructuring plans, even when the bank’s ultimate recovery on a loan would exceed a loan exit through a business sale or an asset liquidation.

Finally, the cost of bankruptcy has increased dramatically, primarily due to changes in the Bankruptcy Code requiring utility deposits, favored treatment for creditors supplying products within 20 days of filing (503(b)(9) claims), the standard practice of Critical Vendor payments, increased use of attorneys, financial advisors, and even investment bankers for multiple creditor factions, and escalating professional hourly fees. Often, this has rendered Chapter 11 Bankruptcy as generally unworkable for smaller, closely held, middle market companies under the current rules of play, resulting in the loss of ownership of these businesses and occasionally the associated jobs that would have had a chance of being retained.

What Has Happened Since?

In 2019, subchapter V of Chapter 11 was added to the Bankruptcy Code which provides a simplified process for small businesses to reorganize, and which also provides the basis for small business owners to retain ownership of the business if the criteria under that section is met. Only very small businesses with less than approximately $3 million in debts qualify under subchapter V. In view of the COVID-19 pandemic, through the CARES Act, the debt level was temporarily increased to $7.5 million, but only until June 21, 2024. So, subchapter V is now back to the original small debt level.

What is a Better Solution?

Now, a few years after the impact of the COVID-19 pandemic, the “powers that be,” including Congress, the insolvency community (bankruptcy attorneys, financial advisors, and investment bankers), commercial banks, and governmental agencies/bank regulators, should step back and consider “Going Back to the Future” (i.e., how we did it years ago) as a means to guide viable companies back to healthy, productive businesses. Today, unfortunately, most smaller companies that file under Chapter 11 see their business assets sold through Section 363 sales.

Currently, many small businesses have insufficient access to cash as they continue to attempt to recover from the economic impact of COVID-19. Government support offered by PPP loans and their forgiveness, and the ERC funds have now been exhausted. Many small businesses need an extended period to repay suppliers, landlords, service providers, and other unsecured creditors because they do not have adequate access to cash to meet customer demands causing negative trickle down and trickle up economic impact.

Complicating matters post-COVID is that many credit risk profiles have declined, and trade credit has become tighter. Despite tighter credit, bad debt losses are likely to increase as some businesses fail. Of course, the significant increase in interest rates (now abating) has really hurt those industries that are especially interest rate sensitive, like construction and housing. Finally, liquidation and going concern sale values have gone down.

Many of these companies are going to need to accomplish debt restructurings fast and with more affordability or they will be liquidated. The US bankruptcy system has many good attributes, but no one describes the current bankruptcy system as either fast or cheap.

The best option is to give these small to middle-sized companies experiencing financial distress the opportunity to use a hybrid approach of Chapter 11 and subchapter V or a similar alternative for purposes of restructuring debt and preserving the business as a going concern. Practically, giving a second chance to both the owner and the secured lender is dependent on both working cooperatively together for the long-term benefit of all parties.

Again, let us consider going back "Back to the Future" to strengthen the future.

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