

# NEGOTIATING THE BANKRUPTCY MAZE



**T**here will always be bankruptcies, runs an old saying, as long as there are fools and scoundrels. And, it must be added, as long as there is a business cycle, and as long as bad judgments or bad luck force some companies over the edge, even in relatively good economic times.

A recent decrease in bankruptcy filings in New Jersey is no sure guide to what might lie ahead. Last year featured some especially favorable factors for the New Jersey business community. Factors that might not be repeated any time soon.

Interest rates were at historical lows; there was easy access to financing; no serious foreign or domestic disasters worked to make potential spenders overly cautious; and rising home valuations and refinancings put a lot of money in people's pockets. Factors such as these not only helped companies prosper, they also allowed a fair number of troubled companies to reorganize without a visit to bankruptcy court.

Even with these favorable conditions, some sectors of the New Jersey economy were clearly hurting and could significantly add to future bankruptcy totals. They include nursing homes, hospitals, hotels and certain specialty retailers. The restaurant and construction sectors of the economy are perennial sources of business failures, usually of the close-the-doors, turn-out-the-lights-permanently variety, which might not even involve a Chapter 7 bankruptcy filing.

Technology changes and cheap production offshore also guarantee that a considerable number of U.S. manufacturers in all parts of the country will continue to seek protection in court. Barring new federal legislation, the same is true for companies with asbestos-related problems.

It should be noted that just as some economic realities seem to ensure a sizable and perhaps a growing stream of bankruptcy filings in coming months, other developments that at first glance seem certain to increase filings may be deceptive. Yes, for example, there could well be some high-profile airline bankruptcies. But this need not necessarily generate more filings by other businesses located in airports. The

public is still traveling and airlines provide less food and other services than they used to, which is actually working to boost sales at some airport restaurants and shops.

## Interest Rate Worries

Rising interest rates are the most frequently cited reason that bankruptcies could jump in the near future. This is especially true for companies that piled on a lot of debt during the recent recovery and over-expanded. Joseph Lubertazzi, Jr., a partner at McCarter & English in Newark and head of the law firm's creditors' rights practice group, notes that higher rates "could make businesses that are [now] stressed to become too stressed."

Another thing that guarantees a continuous flow of bankruptcy filings - at least the Chapter 11 filings favored by companies seeking to stay in business after being reorganized - is the way such proceedings have come to be viewed in recent decades. Whatever stigma might or might not still attach to an individual's Chapter 7 or Chapter 13, since the late 1980s, when some very large and well-respected corporations opted to seek bankruptcy protection for reasons other than fending off their creditors, Chapter 11s have generally come to be viewed as just another business tool - albeit one that's not without the potential to create difficulties down the road.

Chapter 11s, states Peter A. Forgosh, a partner in the financial services business group of Pitney Hardin in Morristown, may sometimes "be seen as a problem by customers who get worried about deliveries. Some suppliers might step back as well and wonder . . . whether a Chapter 11 will end up a reorganization or a liquidation."

"I don't know any debtors I respect who don't feel a reluctance to file," says **Karen A. Giannelli**, bankruptcy group leader for the financial restructuring and creditors' rights group at **Gibbons, Del Deo, Dolan, Griffinger & Vecchione** in Newark. "But with a good faith debtor, my job is to make this debtor see that this is a tool. A Chapter 11 can be a fact of life. Some things are unavoidable."

The hoped-for purpose of a Chapter 11 may differ based on a company's

unique circumstances and future aspirations. This purpose might be to win debtor protection from creditors that allow continuance of present operations and arrangements that leave a company a stronger and better enterprise in the longer term; or the purpose might be to permit an orderly sale of company assets.

Not all Chapter 11s evolve into shootouts between debtors and creditors. Sometimes they are "pre-packaged." In these cases, an understanding is reached by a debtor with its creditors before actual filing, and the court finalizes the agreement.

Whatever the hoped-for end purposes of Chapter 11s, by some estimates three-quarters or more of small- and medium-sized company filings don't end up as confirmed reorganizations - quite often because these filings were ill-advised from the start. Large companies, because they frequently enter the Chapter 11 maze for reasons other than pressure from creditors (environmental problems or conflicts with employees, for example), have a better chance of emerging with a confirmed reorganization. In almost every Chapter 11, however, big or small, there's competition for what are known in the trade as "bankruptcy dollars," a commodity that invariably tends to be scarce.

The Chapter 11 process is complex, time consuming and costly. Large business bankruptcies can involve scores of parties, all with their own professional representatives, some of whom are on a Creditors' Committee working on the clock at a filing company's expense - a situation that can translate into paying the way of adversaries.

"Chapter 11 is not for every company," says Giannelli. "It's not your first resort." People thinking of filing a Chapter 11, she continues, should appreciate that there are significant costs. Small companies might be better served going the Chapter 7 route.

In addition to costs, smaller company Chapter 11s involving privately-held family businesses can have their own special problems. These filings may force company owners to face unpleasant business-related realities they would prefer to ignore - and perhaps even bring forth generational management issues that are personally painful. Some

children, for example, can run a family-owned business, and some can not. Counseling, in such situations, may have to mix in a bit of Dr. Phil with Boston Legal.

The reason that so many Chapter 11s filed by privately-owned companies do not succeed, according to Douglas S. Stanger, a shareholder in the bankruptcy law practice group at Flaster/Greenberg in Cherry Hill and chair of the firm's bankruptcy law section, is because "owners have unrealistic expectations. The challenge with these companies is to identify, often with the help of accounting and other financial professionals, the real causes of their problems and determine how they can be rectified.

"The most common problem," he continues, "is the debt load." Put simply, "you have \$100,000 in . . . debt and only \$30,000 to pay it, and you have to reduce the \$100,000 to \$30,000. If you can't do that, if you don't have a plan to become profitable, you're just forestalling the inevitable and it is better to simply close down."

The other professionals cited by Stanger might include accountants and financial advisors. And the role of such people, comments Simon Kimmelman, chair of the creditors' rights and insolvency group, Sterns & Wienroth in Trenton, is to help decide what steps to take to avoid a crisis; and whether these actions can be taken without a filing. Then, if it turns out that a filing is needed, what can be done to have access to credit afterwards. "You don't want to file a Chapter 11," he said, "until you know where you want to be when you get out."

At what point in its operations should a company consider seeking counsel about a possible bankruptcy? Though "the sooner the better" is almost always the answer offered by attorneys in this regard, the definition of "sooner" is not hard and fixed.

Dennis O'Grady, chairman of the bankruptcy group at Riker, Danzig, Scherer, Hyland & Perretti in Morristown, suggests that a company start thinking about seeking bankruptcy counsel when it is beginning to see profit



Giannelli

margins slip and when it starts to run short of funds. "It's much better to seek counsel while there's still cash in the till. You have a much better chance for a successful reorganization than if you wait. You have more time to explore options before your back is up against the wall."

As soon as you realize you have a problem or the makings of a problem, that's the time to consider seeing an attorney, is the view of Lubertazzi at McCarter & English. "If you fall way behind with your vendors, they may feel you're taking advantage of them. Banks also appreciate a good faith effort if you come to them early."

Getting things squared away with a company's bank, in fact, is simple prudence in many situations. Robert K. Malone, a partner at Drinker Biddle & Reath in Florham Park and co-head of the firm's business finance and restructuring practice, notes that it's usually counterproductive to try to hide facts from these lending institutions. "Your bank probably has a good idea of your condition," says Malone. "They have likely been monitoring your company, even if it is privately held. It's best to try to work out a deal with the bank before filing - to get a deal in advance and work together and do your best to be open and honest."

These examples of good advice, alas, can not always be followed. Often, with small firms especially, observes Forgosh at Pitney Hardin, "it comes on them suddenly. They can't always pick and choose the best solutions."

When it comes to sudden, unexpected changes in the economy, the example of 9/11 immediately comes to mind. Not only local retailers and restaurants in lower Manhattan felt the near-term sting. So, too, did whole industries such as travel and financial services.

## Where To File

One of the major decisions that used to confront medium-sized New Jersey companies that were planning a Chapter 11 was where to file. While mega bankruptcies are still usually filed out-of-state rather than in New Jersey for a variety of reasons (casino filings notwithstanding), and smaller New Jersey companies have always continued to file in-state (in part to save the cost of their lawyers travel expenses); for a

number of years Delaware's court became the favored place to file for many New Jersey firms that were neither very large nor very small.

One reason for this was a change in the law that allowed companies to file where they incorporated. And Delaware, of course, has always been a popular place to incorporate. The Delaware court's reputation for being debtor friendly, and some expedited procedures it introduced, also attracted New Jersey filers there for a period of years.

These time-saving procedural advantages, however, have largely disappeared, in part because their appeal generated too many filers. "Delaware has gotten very, very busy," says Lubertazzi. And now, he adds, "bankruptcy attorneys can see the same benefits in New York and New Jersey as in Delaware, as courts in other parts of the country have adopted similar procedures."

The very popularity of the Delaware court slowed its operations, according to O'Grady. "Delaware was popular because things moved quickly there. There was no backlog." As more companies filed there, however, a backlog developed.

Extra work and the backlog it generated led to another factor that has now made Delaware a less favored site to file bankruptcy for mid-sized New Jersey companies. There was predictability in the Delaware bankruptcy court for years because it had so few judges, O'Grady continues. "Then they increased the number of judges, imported some to handle the bigger workload, and this introduced unpredictability."

In recent years, New Jersey's own bankruptcy court has become a more attractive place to file after it adopted its own expedited procedures. "Filing locales can change and change again," notes Giannelli. For a while, you could get expedited release in Delaware. Then it got overdone.

"New Jersey is now a wonderful place to file," she goes on. "The bankruptcy court here is as good as anywhere in the country. There's no reason to file anywhere else."

This sentiment was expanded upon by Forgosh. "In recent years, local rules here have been promulgated to make the bankruptcy process [in New Jersey] better generally for litigants. And frankly, our judges in New Jersey

are as good as I've appeared before. They are a smart and efficient group."

Sometimes new laws that have no ostensible links to bankruptcy do, over time, affect the success of debtors seeking bankruptcy relief. Such might be the case with the federal Sarbanes-Oxley Act of 2002. Sarbanes-Oxley was passed in response to the shenanigans at some large corporations, such as Enron, that were getting headlines that year. The law is primarily designed to address corporate governance and business monitoring issues at such large publicly-traded corporations.

What might be the effect of this law's provisions on smaller company bankruptcies? Giannelli thinks "it could have a trickle down effect" on these firms, and might be applied to improper practices by a debtor company seeking bankruptcy protection. Malone offers the view that the law might add to the list of debts that won't be discharged because of certain behavior by company officials.

### The Attorney's Role

Perhaps the most significant fact that a business contemplating a bankruptcy filing should keep in mind is the critical need to get good advice. This is especially true when the company is considering going the Chapter 11 reorganization route.

Though some firms with debt of under \$2 million might get on a Chapter 11 fast track that avoids some costlier elements of the process, legal costs of \$150,000 and often much higher are commonplace for more heavily indebted medium-sized and larger companies in cases where a court-based reorganization runs its full course. A frank, upfront discussion about

possible legal and non-legal Chapter 11 costs is thus almost always a prudent step for would-be filers.

If business problems have been building up gradually rather than coming on suddenly, good legal counsel, at a relatively early stage of serious trouble, perhaps in conjunction with other professionals such as accountants and crisis managers, can bring into better focus a company's difficulties. This may then lead to a financial reorganization without the need to file for bankruptcy.

There are advantages and disadvantages inside and outside of bankruptcy. Much depends on a business' own special circumstances, and on whether problems can best be resolved within a bankruptcy framework. Debtors considering filing should appreciate that while this process often allows them to employ "a sword and a shield" to advance their interests, elements of bankruptcy law also now give greater protection to parties with whom a debtor may have certain agreements. Some attorneys likewise opine that some courts have become a bit more pro-creditor in recent years.

It's a big mistake to begin a Chapter 11 aimed at emerging as a reorganized entity without having a very clear idea of the company's directions and prospects after being reorganized - and of its chances to get new credit in the future. This usually means having a well thought-out, post-reorganization business plan in place from the start - a clear vision of the business that will emerge from a confirmed Chapter 11 - so that the newly reorganized enterprise doesn't go belly up a few years later.

Though it's true that Chapter 11s have largely lost their stigma and are usually

viewed as necessary business tools, especially for companies within certain industries, going through one is never a pleasant experience. Companies contemplating a Chapter 11 will thus want to do everything possible to see that there ends up being lot of light at the end of this difficult tunnel. ♣

## Types Of Bankruptcy

There are five different types of bankruptcies described in chapters of the United States Bankruptcy Code:

- **Chapter 7**, sometimes referred to as "straight bankruptcy" or "the liquidation chapter," is used by the majority of individuals who file bankruptcy to free themselves from debt, and by companies to terminate their operations.
- **Chapter 13** is for individuals who want to repay their debts but need more time to do so. These restructurings are often called "wage earner plans" because filers have a regular income (though not necessarily from wages) that can service their debt.
- **Chapter 11** is generally used by companies seeking to restructure their finances so they can continue to operate, and do so in ways that preserve jobs and pay creditors. Chapter 11 also allows for a liquidation plan that is more economically favorable to a business than Chapter 7, and that gives creditors a more active role in the liquidation. Special provisions of Chapter 11 may apply to small businesses with only a modest amount of debt.
- **Chapter 12** covers reorganization of debt owed by small farmers.
- **Chapter 9** covers reorganization of the debt of public entities.



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