Advising a Financially Distressed Business

By Michael M. Beal

According to National Geographic, an approaching tsunami is often preceded by a noticeable fall in water levels.[1] In 2020, there were fewer business bankruptcy filings and out-of-court workouts in South Carolina than normal despite a global pandemic, government mandated shutdowns, and recession, so, perhaps the economic experts are correct – a wave of business failures and restructurings is about to come crashing down upon us. This article highlights some of the issues and considerations practitioners should consider when advising business clients facing financial distress.

ENGAGEMENT ISSUES

1. Conflicts

As with all clients, at or before the initial client meeting you must determine whether you have a conflict of interest. Although you might be able to represent a client in an out-of-court workout with a single creditor, you might have a conflict which would preclude you from representing the same client in a Chapter 11 bankruptcy case if the out-of-court effort fails. Conflicts in a bankruptcy context can be much more nuanced and numerous than conflicts in civil litigation. In a Chapter 11 you will be representing the client in a proceeding against all of its creditors. If you have a conflict with any one of your client's creditors, you can be disqualified from representing the client in a Chapter 11 case.

Proposed counsel for a debtor-in-possession must file a verified statement which discloses "all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee."[2] Full disclosure is paramount and the Bankruptcy Code (11 U.S.C. § 101 *et seq*.) requires an applicant to "disclose all connections regardless of whether they are sufficient to rise to the level of a disqualifying interest…."[3]. The verified statement is closely scrutinized by the United States trustee and the Court to determine whether counsel is "disinterested".[4] If the verified statement discloses a potential conflict and an objection is filed, the Court must determine whether an actual conflict exists.[5] Furthermore, the obligation to make conflict disclosures continues throughout the bankruptcy case.[6] Failure to make adequate disclosures can result in counsel disqualification[7] and forfeiture or disgorgement of legal fees.[8]

2. Client Identification

You should immediately review the entity's organizational documents (by-laws, operating agreement, shareholder agreements, etc.) to make certain that the persons who engaged you are authorized to do so and that the client will be able to obtain the corporate authorization necessary to dissolve or file

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[1] "Tsunami Facts: How They Form, Warning Signs, and Safety Tips." National Geographic Magazine (April 2, 2007)
[2] FED. R. BANKR. P. 2014.
[3] *In re Am. Int'l Refinery, Inc.*, 676 F.3d 455, 465 (5th Cir. 2012).
[4] See 11 U.S.C. § 327(a).
[5] See 11 U.S.C. § 327(c).
[6] *In re Harris Agency, LLC*, 451 B.R. 378, 391 (Bankr. E.D. Pa. 2011).
[7] *In re Crivello*, 134 F.3d 831, 839 (7th Cir. 1998).
[8] *In re Matco Electronics Group, Inc*., 2008 WL 141908 (N.D.N.Y. Jan. 11, 2008).

bankruptcy. You should also determine whether the entity has observed all corporate formalities or acted in a manner which could lead to veil piercing litigation.

Your client might have numerous affiliates. In your engagement letter you should clearly identify who you represent, and will be well served to specify who you do not represent. Counsel representing multiple parties (*e.g.*, a company and its owners) must disclose those relationships and could be disqualified from representing one or more of the parties if the Court finds an actual conflict of interest.[9]

3. Fees and Adequate Retainer

Get an adequate retainer, make certain that your client pays your fees on a timely basis, and ensure that your retainer always exceeds the amount your client owes you. If you are owed money on the date the bankruptcy case is filed (*i.e.*, the petition date), expect to have to waive any claim for unpaid legal services to avoid being disqualified because you, as a creditor, hold an interest adverse to the debtor's estate.

If your client gets behind on pre-petition invoices, payments you receive within 90 days of the petition date could be considered preferential transfers,[10] which can disqualify you from representing your client in bankruptcy. Furthermore, receipt of these payments increases the likelihood that you might be sued for recovery of the payments.

Ideally, the retainer should come from the client. The source of all payments, payment terms, identity of any guarantor, etc. should be disclosed under Rule 2014. Payments from a third-party can also create conflict issues practitioners should consider.

INITIAL ADVICE

1. Fiduciary Duties

After you are retained, you should advise your client's management[11] about their fiduciary duties as directors and officers of an insolvent business. Upon insolvency, fiduciary duties owed by directors and officers shift from shareholders to creditors,[12] and decisions must be made in the best interests of creditors, not equity. Directors and officers can be liable for violating fiduciary duties. Chapter 7 trustees focus on events that occur in the period between insolvency and the petition date and often sue officers and directors for breaches of fiduciary duties.

2. Attorney/Client Privilege

We all know communications between attorneys and clients are privileged. However, if the client is a corporate entity and ends up in a chapter 7 bankruptcy case, the privilege will belong to the chapter 7

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[9] *See In re Coal River Resources, Inc.*, 321 B.R. 184 (W.D. Va. 2005); *In re Big Mac Marine, Inc.*, 326 B.R. 150 (8th Cir. B.A.P. 2005); *In re Adelphia Communications Corp.*, 336 B.R. 610 (S.D.N.Y. 2006)

[10] *See* 11 U.S.C. § 547.

[11] For purposes of this article, the term "directors and officers" refers to all directors and officers of a corporation as well as managers of a limited liability company.

[12] *See PCS Nitrogen, Inc. v. Ross Dev. Corp.*, 126 F. Supp. 3d 611 (D.S.C. 2015); s*ee also FDIC v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982).

trustee, who can waive the privilege.[13] Courts have also allowed Chapter 11 trustees,[14] creditors' committees,[15] and examiners[16] in Chapter 11 cases to obtain privileged information based on the same theory. Be very careful about advice you give distressed business clients. If the company lands in bankruptcy court, your formerly privileged advice could become Exhibit A in a lawsuit against you and the directors and officers.

3. Assess Immediate Threats

If a foreclosure, claim and delivery or other creditor action is pending, or if a critical contract or lease is in danger of being terminated, assess that risk immediately as it will likely dictate the time constraints and options available.

Property sold at a final foreclosure sale cannot be recovered absent fraud – consequently, a bankruptcy filing after a foreclosure sale has occurred will not be helpful in recovering the property.

Collection attorneys routinely include a request for the appointment of a receiver. Although section 543 of the Bankruptcy Code requires a receiver to immediately turn over all property of the debtor, after notice and hearing, the court can excuse turnover if the interests of the creditors would be better served by permitting the receiver to remain in possession. If Chapter 11 is inevitable, ideally, the petition would be filed before the receivership hearing and certainly before the court enters any appointment order. If the receiver is well-qualified and is doing a good job, the bankruptcy court might be more inclined to maintain the status quo (*i.e.*, maintain the receivership), which would defeat the purpose of the Chapter 11 filing.

A bankruptcy filing cannot revive an executory contract or lease that has been terminated by court order or in accordance with the terms of the agreement. Be sure to discuss all of your client's most important leases and other executory contracts at your initial meeting and determine which, if any, are about to be terminated by counterparties.

If any of the foregoing are about to occur, your client should consider immediately filing Chapter 11 to stay the action.

4. Prioritize Cash Flow

When advising a financially distressed business, it is important that you advise the business to conserve resources. One of the most important resources is cash, and most distressed businesses have limited liquidity. Prior to determining which creditors to pay, confirm that the available cash is not vulnerable to attachment or setoff; if it is, move the cash to a secure account if possible.

Distressed businesses trying to reorganize must prioritize which creditors to pay with their limited cash. Where possible, a business should pay its taxes and employees because these creditors have the potential to shut down the business and their claims likely have priority over other creditors in bankruptcy. Further, the business should try to maintain payments to utility providers, as failure to pay utilities can result in

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[13] *Commodity Future Trading Com. v. Weintraub, et al.*, 471 U.S. 343 (1985).

[14] *See Official Committee of Unsecured Creditors of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del., Inc.)*, 285 B.R. 601 (D. Del. 2002).

[15] *In re HH Liquidation, LLC*, 571 B.R. 97 (Bankr. D. Del. 2017).

[16] *See In re Boileau*, 736 F.2d 503 (9th Cir. 1984).

power, internet, water, etc. being shut off and could result in a closure of the business. In addition, payments to critical vendors should be maintained if possible. A distressed business should also try to maintain all leases and executory contracts that are vital to its ongoing operations so that these agreements are not terminated. Finally, if funds remain after prioritizing these creditors, the business can make payments on its long term secured and unsecured debts (*e.g.*, lines of credit, credit cards, vehicle and equipment leases, mortgages, etc.). Bankruptcy retainers for counsel and other advisors should be funded as well.

BANKRUPTCY OPTIONS AND ALTERNATIVES TO BANKRUPTCY

Ask your client to prepare a 90-day cash flow which pays current expenses on a prospective basis but excludes legacy liabilities and long term debt (which will be stayed and addressed in a Chapter 11 plan if that becomes necessary). If the analysis shows substantial negative cash flow, then the business is probably not viable and an unlikely candidate for an in court or out of court restructuring other than a quick sale. If the cash flow is positive and the business appears viable, ask the CFO to revise the cash flow to include the additional expenses associated with a bankruptcy filing (Debtor's counsel and other advisors' fees, unsecured creditors' counsel and advisor's fees, U. S. Trustee quarterly fees, etc.). In addition, anticipate a loss of top line revenue because customers might not want to do business with a bankrupt company or slow down payment. This task will also help you determine whether current management (particularly the CFO) is competent and up to the task of shepherding the business through the restructuring process.

1. Other Professionals

If your client has substantial assets and liabilities (or inadequate financial oversight) consider advising your client to engage a "turnaround consultant", a professional who regularly deals with distressed company restructurings and liquidations. The turnaround consultant should be vested with the power to make the difficult decisions to help the company improve its income statement so that it can be restructured or sold.

Also consider engaging an investment banker. An investment banker will help the client right-size its balance sheet by bringing in new financing or equity or finding a buyer for the assets. These additional professionals are not necessary in most cases filed in South Carolina, but should be seriously considered for larger, more complex businesses.

2. Restructuring Options

Your initial consideration should be to determine whether it is possible to renegotiate payment terms with the client's most problematic creditors. Often, to get creditors to the table, you have to explain that a bankruptcy filing is imminent unless they will agree to your non-bankruptcy restructuring proposal (which could include enforcement forbearance, a reduced interest rate, principal deferral, etc.). It is helpful in these types of negotiations to show the creditors the prepared (but redacted—see below) bankruptcy schedules, so they understand that you are seriously considering bankruptcy and not just making a hollow threat. Preparing bankruptcy schedules is also a useful exercise as it summarizes all of your client's assets, liabilities and other important financial information in one place which will help you assess the viability of the business.

Avoid group meetings with creditors. If your out of court restructuring effort fails, your introduction of the creditors to one another (at the meeting or through unredacted schedules) will make it easier for them to file an involuntary bankruptcy petition against your client.

If an out of court restructuring is not possible but the business needs its balance sheet restructured or needs to effectuate an asset sale under 11 U.S.C. § 363 (free and clear of liens, similar to a foreclosure), then it is certainly appropriate to file Chapter 11. Properly preparing and filing a Chapter 11 case requires an in depth analysis of all aspects of the business and its cash flow so that you can develop a short term strategy to allow the business to survive in bankruptcy and a long term strategy to exit bankruptcy, all of which exceed the scope of this article.

Chapter 11 can be expensive and time consuming, and some viable businesses simply cannot afford a Chapter 11 case. One alternative to a traditional Chapter 11 is the newly added Subchapter V to Chapter 11,[17] which provides an alternative for small business debtors[18] to reorganize through a more efficient, cooperative and affordable bankruptcy process. If your client's aggregate debts are less than $7,500,000 (the amount reverts back to $2,725,625 after March 27, 2021) a Subchapter V Chapter 11 case may be a viable option.[19] One advantage to Subchapter V is that the Debtor does not have to comply with the absolute priority rule.[20] By not having to comply with the absolute priority rule, equity can retain ownership without paying unsecured creditors in full.

3. Liquidation Options

Failing businesses are not required to file bankruptcy. If the business clearly has no viable path forward, then liquidation will be necessary. One way to liquidate is through Chapter 7; however, that is not always the best option.

When considering whether to file Chapter 7, one critical issue which must be analyzed is whether preferential transfers or fraudulent conveyances exist which could easily be avoided and recovered in a bankruptcy case. Although fraudulent conveyance claims can be pursued by creditors outside of bankruptcy using the Statute of Elizabeth[21] and preferential transfers can be pursued under state law using S.C. Code Ann. §27-25-20, a bankruptcy trustee is vested with the rights of a lien creditor (and other status) under 11 U.S.C. § 544 which allows the trustee to bring recovery actions under both the Bankruptcy Code and state law on behalf of all creditors.

More importantly, the trustee can avoid fraudulent conveyances which occurred well before the two-year reach back period in 11 U.S.C. § 548. One recent South Carolina case[22] allowed the trustee to step into the shoes of the Internal Revenue Service using the Federal Debt Collection Procedures Act ("FDCPA").[23]

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[17] See 11 U.S.C. §§ 1181 – 1195.
[18] As defined in 11 U.S.C. § 101(51D).
[19] The statutory definition of "small business debtor" caps the aggregate debt limit at $2,725,625. However, the debt limit was temporarily increased by the CARES Act to $7,500,000 and expires on March 27, 2021, unless further extended by Congress.
[20] 11 U.S.C. § 1191(c).
[21] S.C. Code Ann. § 27-23-10.
[22] *Vieira v. Gaither (In re Gaither)*, C/A No. 18-01317-dd, Adv. Pro. No. 18-80040-dd (Bankr. D.S.C. November 30, 2018).
[23] 28 U.S.C. §§ 3001 – 3308.

The FDCPA contains a 6 year look back period (with certain exceptions), so the Trustee could presumably use the FDCPA to avoid fraudulent transfers that date back six years prior to the bankruptcy filing.

There are alternatives to chapter 7 for liquidating a business which should be considered. For example, a business unable to pay its creditors can close it business, wind up its affairs, monetize its assets, distribute the proceeds to creditors and then dissolve under state law.[24] In many cases, dissolution under state law will result in higher dividends to creditors because the legal and administrative expenses are substantially lower than in a chapter 7 case.

Another alternative to liquidation in bankruptcy is an assignment for the benefit of creditors ("ABC"). Although South Carolina law allows ABCs[25], the statute is rarely used. Nevertheless, the South Carolina code provides this scheme, and it should be considered.

GUARANTOR ISSUES

A bankruptcy filing will not stay an action against a non-debtor guarantor. Bankruptcy Courts have granted temporary injunctions against such actions but obtaining that relief is rare. Although you might not represent the guarantors you should inform them that a bankruptcy filing could cause an action to be filed against them and that they should consult independent counsel. If the loan is a CMBS Loan or other "non-recourse loan" the filing of a bankruptcy petition, opposition to appointment of a receiver or other enumerated actions by the debtor could convert a non-recourse guaranty into a full recourse guaranty of all the debt.

CONCLUSION

There are many nuances to representing businesses in financial distress. As counsel, it is our job to assess each client's needs and to explore all available options to determine the best path forward. The facts of each case will dictate whether to restructure or liquidate, and whether a client's goals can be accomplished out of Court or whether a bankruptcy filing is necessary.

[24] S.C. Code §§ 33-14-101 – 33-14-107 provides the statutory rubric for voluntary dissolution of a corporation. S.C. Code Ann. §§ 33-44-801 – 33-44-812 provides the statutory rubric for dissolution of a limited liability company.
[25] S.C. Code Ann. §§ 27-25-10 – 27-25-160.