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Four steps to an effective restructuring

For the past few years, companies across a range of industries have managed to kick the can down the road. But in an environment characterized by rising interest rates and tough business conditions, highly leveraged companies must confront their balance sheet issues and take a hard look at their long-term viability.

Some enterprises will face painful decisions—such as undergoing a financial and operational restructuring. If they're short on time and money and can't complete a restructuring out of court, then filing for bankruptcy might be their only option for preserving jobs and remaining going concerns.

The best route to a favorable outcome for all constituents is early contingency planning for multiple possible scenarios. That way, no matter what scenario ends up materializing, a company will be prepared. In this article, we lay out a four-step process for creating and executing such plans.

BUILD A PLAN NOW

"By failing to prepare, you're preparing to fail," Benjamin Franklin said. Today all too many companies are reeling from unexpected blows. For example, retail, energy, and commodity-based industries have seen prices for their offerings plummet. And in most industries, companies have been blindsided by changes in the ways customers choose and buy products and services.

For highly leveraged companies, those conditions can lead to financial crises that trigger the need for restructuring. Such companies' boards and management teams must prepare themselves for multiple possible outcomes from a crisis. In fact, as interest rates rise but global growth merely muddles along, many companies—not only highly leveraged ones—may have to finally fix their balance sheets in a meaningful way. Distressed exchanges and other kick-the-can-down-the-road scenarios aimed at extending liquidity and providing only short-term relief from running out of cash might not be enough.

Companies should take a more sustainable approach. To do that, they need to align their long-term liabilities with their current cash flows and other economic realities, all of which requires thoughtful planning in anticipation of several different possible scenarios. For instance, by planning for a bankruptcy filing, a company often can get an out-of-court restructuring done. If that proves impossible, the company would have to go to bankruptcy court to restructure, which comes with its own challenges. Yet we see companies head down that road all too often. Following a four-step process can help companies get back on their feet and resume the fight from the strongest possible position.

STEP 1: ASSEMBLE YOUR TEAM

Something has triggered a crisis. Maybe it's plummeting commodity prices, a new competitor, changing consumer tastes, or a crushing debt load. Whatever the catalyst, your company's no longer profitable, and you need to act—fast. But if your company's like most, your management team and board are devoting their time and energy to keeping the business running, including managing relations with employees, customers, vendors, and lenders. That's why you need to assemble a team of experts who are familiar with restructurings and who can guide you through your options. Put together a team that includes financial advisors experienced in restructurings, legal experts, and bankers, along with public relations specialists to handle internal and external communications.

A good restructuring team is one that could develop several different scenarios that could play out for your company. Team members would also define the financial options for enabling your business to continue as a going concern. In addition, they would devise potential operational solutions for fixing what's wrong with your business and returning it to health. Examples include selling off noncore or unprofitable businesses, getting out of unprofitable leases, or rightsizing the company's operating expenses. The team might also start conversations and manage negotiations with lenders, customers, vendors, unions, and other interested parties. Many companies in fact hire a chief restructuring officer to head the team and oversee all aspects of the restructuring.

Cash-flow forecasting tips

- Remember that filing for bankruptcy can affect your collections. Customers might look for alternative suppliers, drag their feet in paying, or take more credits than usual.
- Conduct a sensitivity analysis that generates a base scenario along with best- and worst-case scenarios in your forecast. That way, you can know how much breathing room you have.
- Identify onetime collections, and assess the likelihood of their being paid. In your worst-case scenario, exclude such one-off collections. Or assume that if they come in, it would be far in the future.
- On the disbursement side, forecast employee turnover, lease rejection costs, exiting losing businesses, and vendors' requests for cash on delivery.
- Include anything that might limit your credit lines and reduce your credit terms.
- Be mindful of requests from local, state, and federal agencies that would drain cash. For instance, you might have to post cash bonds for various indemnities, tax assessments, and increases in unemployment premiums.
- When assessing your company's liquidity on a short time horizon, understand and model all timing anomalies, such as seasonality of sales.
- In your forecast, account for capital plans, legal and advisor fees, bank fees, and default interest payments.
- Determine whether your company pays its bills and obligations by way of a revolving line of credit based on a borrowing base rather than on actual cash in the bank. If it's by way of a revolving line of credit, make sure you understand your credit agreement and lender relationship so you don't commit a misstep that jeopardizes that cash availability. Some proactive companies draw down their remaining availability as a safety protocol. This can raise lenders' eyebrows and lead to litigation if lenders believe it was done in bad faith or the company defaulted on a covenant. So, if you're considering this, discuss it first with your legal counsel.

STEP 2: GET A CLEAR PICTURE OF YOUR CASH FLOW

Cash is king when a company's in crisis. Do you know how much cash you have? As one of its first tasks, your restructuring team should develop a detailed cash-flow forecast so you can get a clear line of sight into your company's liquidity. The forecast should be built based on a direct-method model that shows receipts and disbursements and that sheds light on your company's liquidity runway. This exercise generates many key performance indicators and tracking tools that the company's management team can use to monitor, measure, and even reward performance. The cash flow forecast also reveals potential funding shortfalls that need addressing in a bankruptcy or other scenario. A detailed and accurate forecast helps everyone on your management team stay focused on cash instead of on the accrual-based income statement.

STEP 3: MAP OUT YOUR OPTIONS

Your restructuring team's in place. You have a solid understanding of your cash flow and liquidity. Now take a close look at how to get out of the crisis. Start by viewing the business through a legal entity lens instead of a function or business matrix lens. Most large enterprises don't operate day to day on a legal entity basis. In bankruptcy court, however, you'll have to account for and provide reports on each legal entity your business comprises.

When it comes to options, distressed companies typically pursue an out-of-court restructuring first. For instance, they could raise new equity or debt, sell or merge the company, or restructure it with existing stakeholders. Those are all viable options. Indeed, out-of-court restructurings have advantages over in-court restructurings: They're less disruptive to the business. Constituents can often reach agreement faster than in an in-court process. And costs are lower. But out-of-court restructurings require full consent from all constituents—such as lenders, bondholders, and shareholders—with regard to how to adjust the company's liabilities. Out-of-court restructurings also take considerable time, and so, if time is running out or constituents can't agree on next steps, an in-court restructuring may offer your company its only hope for survival.

The word *bankruptcy* sounds scary, but the process offers a number of advantages. For one thing, your company wouldn't need 100% consent from constituents to adjust its liabilities. In addition, you can reject executory contracts like pension obligations and leases that you see as above market. Your company would be granted an automatic stay[1], and it could recoup preferences[2] and fraudulent transfers[3]. What's more, certain tax law provisions such as cancellation of debt could make it more advantageous to file for bankruptcy than to attempt an out-of-court restructuring.

For each option you consider, craft a plan for putting it into action should that option materialize. Make sure your plans stipulate such issues as the methods whereby you'd communicate important decisions and changes in your organization to both internal and external parties. As you build a plan for a bankruptcy scenario, include a work plan for first-day motions. For example, determine how you'd meet payroll, use whatever cash you have on hand, maintain bank accounts, and manage other resources to keep your company operating.

STEP 4: EXECUTE YOUR PLANS

Once you've determined which crisis resolution scenarios might materialize and in what sequence, start implementing the plans you've developed for those scenarios. As mentioned earlier, most companies attempt an out-of-court restructuring first. If that describes your situation, you'd have to execute your communications plan to give interested parties the information most relevant to them.

Also start negotiating with your lenders and other creditors the amounts your company owes. For instance, try to renegotiate operating leases and negotiate with unions or employees. If you can't get consensus on desired changes from those constituents, you may have to file for bankruptcy. But at least you'd be prepared, thanks to the planning you've already done. You'd go into the filing better informed to navigate the negotiations to come.

[1] An automatic stay is an injunction that halts actions by creditors, with certain exceptions, to collect debts from a debtor that has declared bankruptcy.
[2] In a recouping of preferences, a company transfers assets or pays a debt to a creditor shortly before going into bankruptcy.
[3] A fraudulent transfer is an attempt to avoid debt by transferring money to another person or company.

Managing the first-day motions you've defined in your bankruptcy plan is crucial for executing the plan. Bankruptcy is a judicial process characterized by extensive reports and complicated, strict schedules. It involves huge volumes of data that you and your team would have to gather, analyze, format, and submit to various interested parties. And all of that will run much more smoothly if you get help from your advisors.

If you end up filing for bankruptcy, once you've filed the petition the automatic stay kicks in to stop creditors' actions. But immediately after the filing, you'd need court authority to pay certain various liabilities essential for continuing business as usual. They include taxes as well as payments to employees, vendors, partners, and insurance providers so that you can continue business as usual. You'd also try to get approval from the court for your first-day motions.

Another big milestone involves your plan of reorganization and your disclosure statement that is prepared for your creditors. Those legal documents disclose how creditors would be treated. They also contain financial data that creditors can use to decide how to vote on your plan of reorganization. If the plan receives the necessary votes from the creditors, the court conducts a confirmation hearing. And once the plan has been confirmed, the company would work toward an emergence date.[4]

Emerging from bankruptcy is not the endgame for your company. Certainly, the company would come out of the process in financially healthier shape. For instance, it may then have a cleaner balance sheet, less debt, and less-burdensome pensions, employee contracts, and other obligations. However, your company and its financial advisors and attorneys would still have work to do. For example, you'd have to resolve claims reconciliations, potential preferences, and distributions.

As the saying goes, good planning is good planning, but bad planning lasts forever. If your company is facing a financial or operational restructuring, you'll want to craft a robust plan. And assembling that team of experts who can advise you on your options and guide you through out-of-court versus in-court scenarios is an excellent first step. By taking it, you'll give your company its best shot at emerging from the crisis with renewed resilience. And as a result, your company will stand a good chance of surviving to fight another day. **A**

[4] Any litigation that could arise is beyond the scope of this article. This article provides only a high-level overview of a typical bankruptcy timeline.

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