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The un-bankruptcy: An alternative for smaller companies navigating financial distress

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The implementation of shelter-in-place orders, social distancing, and the closing of non-essential businesses has sent the economy teetering across the United States and, indeed, around the world. Heavily consumer-facing businesses – such as restaurants, hotels, and non-essential retailers – have had to furlough or lay off large numbers of employees and, in many cases, 'go dark' with their brick-and-mortar locations. Many smaller companies now find themselves with limited financial resources and have indicated that they may need to seek bankruptcy protection.

Although President Trump has signed the CARES Act, it remains unclear how quickly companies will be able to apply for loans, when they will receive the cash, and whether the program will be large enough to meet unprecedented demand. Companies need a strategy to bridge the gap until help arrives.

In addition to considering a bankruptcy filing, many smaller companies could be better served by taking an alternative approach. We call this the 'un-bankruptcy', which entails putting the company into survival mode outside the structure of court protection.

Why not Chapter 11?

The Chapter 11 process has proven over time to be successful at helping manage through some of the most significant business and economic challenges the United States has encountered. The process of reorganizing companies in bankruptcy often works well for larger businesses – especially those with complex debt structures – because it offers many tools that form the basis of a fair and equitable treatment of like parties to support successful reorganizations.

Given this, it is understandable that Chapter 11 would be seen by many as a clear route to take for distressed companies during this period. However, there are reasons the process may not be the right step forward for smaller businesses at the current time, including:

- The process can consume significant amounts of liquidity needed to keep the business operable.
- With its many requirements (including monthly reports to the court and hearings) a bankruptcy filing can distract the management team when business operations require 100% focus.
- Receipts may have dropped well below the fixed costs a company is required to pay post-filing date.

For these reasons, during a time of crisis, a Chapter 11 that is filed without adequate planning or liquidity may quickly convert to a Chapter 7 – a liquidation of the business. Our experience is that smaller Chapter 11 reorganizations are significantly more difficult to complete successfully because of time and cost.

The un-bankruptcy framework

What type of framework would be needed for businesses to survive without resorting to Chapter 11? Such a process would need to use many of the concepts of a Chapter 11, without the legal protections or requirements and without the same expense – an un-bankruptcy.

Here is how it would work:

- **Advise creditors that the company is temporarily unable to pay:** Similar to a traditional Chapter 11 process, companies would separate their creditors into classes. For most smaller companies, there are likely only two: secured and unsecured.

  Unsecured creditors would be advised in writing that the company is temporarily unable to make scheduled payments, and it would be opening communication with stakeholders. Secured creditors would need to be dealt with individually.
- **Manage for survival liquidity:** The cessation of all payments to unsecured creditors could allow a company to prioritize critical payments that are essential to support temporary suspension of the business. However, in most cases, the company will still need to aggressively manage itself in order to maintain liquidity, updating cash forecasts weekly, pulling as much cash into the business as possible, and limiting all disbursements to absolute essentials.
- **Maintain open communications with stakeholders and seek to work collaboratively on solutions.** The company should immediately begin communication with creditors, including their anticipation of when payments of deferred amounts can begin, as well as the status of its application for loans under the CARES Act. It is important to provide regular updates on company performance.

For an un-bankruptcy to work effectively, communication, transparency, and flexibility will be critical, as will be a collective effort to keep businesses up and down the supply chain involved. In part, this is to avoid the domino effect caused by withholding payments.

Advantages of an un-bankruptcy include:

1. avoiding confusion and, potentially, legal proceedings;
2. increasing survivability;
3. providing time for relief dollars to reach the business and for thinking about the recovery phase; and
4. creating goodwill with creditors.

This process isn't guaranteed to work, and it doesn't eliminate the risk of creditors potentially disrupting operations. But, especially for smaller companies, it offers an alternative to a bankruptcy filing, for which they may lack the financial resources and necessary time to survive. For these companies, the un-bankruptcy may offer the best option to surviving the current crisis.

AlixPartners

Contact the authors

Al Koch

Managing Director

akoch@alixpartners.com

+1 248 262 8430

Gabe Koch

Director

gkoch@alixpartners.com

+1 214 647 7599

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