Alternatives To Bankruptcy Liquidation — Crisis And Turnaround Management

by **RAY LACKNER**

The search for value in distressed companies is the first step on the road to recovery. A rep firm's survival will depend upon how well the company capitalizes on opportunities and protects itself against vulnerabilities that occur inside and outside the organization. The survival will also depend on how the company deals with its customers' changing needs. For a growing number of small- and medium-sized companies, selling expenses have severely cut into profits and additional sales come at even higher incremental selling expense. The governing strategy for these companies cannot be "more of the same," it must be "a better way"! It must be an innovative way of satisfying the existing market and/or a new market.

An innovation may include an invention, but it is something different — it is a better way of doing something physically, economically or socially. Two of the most famous innovators were "King" Gillette and Cyrus H. McCormick, as described in Peter Drucker's 1974 publication, *Management*.

"King" Gillette did not invent the disposable razor blade, in fact, he had lots of competition in that. In his time, most blades sold for one cent each, and the handle sold for about $8. But $8 could buy 80 shaves at the local barbershop. Gillette repositioned his company by practically giving away the handle and selling the blades for five cents — half the price of a store-bought shave.

Cyrus H. McCormick is credited with inventing the mechanical harvester. However, his machine was one of several similar and expensive machines on the market, and the farmers could not afford them. McCormick's real innovation was the installment sale of farm machinery to groups of farmers. The farmers staggered planting times so that they could share the use of the machines, the cost of which they shared.

The key to any successful turnaround are decisions as to what the reconstituted innovative business "should be" (the new business model), and then the concentration of all the organization's resources to realize the new business model.

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Repositioning and restructuring a distressed company may require the filing for protection from creditors under Chapter 11 of the U.S. Bankruptcy Code. Ideally, such filing is made after:

- The new business model has been postulated.
- A plan for its implementation created.
- Some steps have been taken to implement.

In any event, under the U.S. Bankruptcy Code, for 120 days after filing, the debtor company has exclusivity for proposing its reorganization plan. Such a legal step (a petition for reorganization) provides the distressed company with a breathing space, namely time to think, plan and act — free of harassing calls, levies and garnishments by creditors. A well-prepared and well-executed Chapter 11 reorganization may maximize chances for a company's survival. Costs, benefits and risks of employing the Chapter 11 mechanism must be carefully weighed against those benefits, of course.

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Bankruptcy Offers Protection

Bankruptcy laws are vital to our free enterprise system. Without such protections, few if any entrepreneurs would be willing to start a new business. In the absence of bankruptcy protection, insupportable debts accumulated as a result of past errors or misfortunes would hound the unfortunate debtor forever. The bankruptcy system is a normal and necessary part of our capitalist system. Still, bankruptcy should always be a last resort. Company managers, directors and stockholders should always first consider other ways to restructure, reengineer and/or reposition their companies.

If properly handled, banks, government bodies, unions and trade creditors are generally open to alternatives to the debtor company's bankruptcy liquidation (Chapter 7). The reason for that is simple: Only a fully secured creditor can be indifferent to liquidation, which is usually at a fraction of book values of the debtor's assets. In addition, certain administrative expenses take precedence even before a bank's security. The situation gets more complicated when the owner issues personal guarantees and has unencumbered assets that the beneficiary of the guarantee can seize. However, prior to insolvency, even such situations can be generally handled well.

When a business is in a crisis situation it is advisable to have an expert turnaround manager evaluate the company's future prospects. The expert is able to make a competent and dispassionate review of the company's situation and available alternatives.

While the alternatives may initially be obscure, the core of the diagnosis is simple and follows the same broad lines. The enterprise's efforts are not producing the desired results. A systematic and penetrating analysis of costs and revenues, including entire product lines, must be undertaken. Costs that don't contribute to profits must be eliminated. Innovative ways of producing, marketing and distributing products and services must be considered. In addition, the accumulated obligations may or may not be supportable for the company. They may have to be restructured, postponed, reduced or converted into something that is supportable.

Keeping Focus on the Future

It is well known that many executives, just like workers and middle managers, resist change. The press of the day-to-day business is their concern and the fear of the unknown is a problem for many at all levels. Yet, a real crisis manager looks undaunted at where the company needs to be, admits past misfortunes and errors, and focuses on how to get the company to the promised land.

Some of my own experiences, presented here, are not as revolutionary as the Gillette or McCormick examples, but some of them required courage — a serious leap of faith to bring about the needed changes that were required to make the companies viable again.

- A regional manufacturer of industrial equipment had a full line of equipment and was successfully competing locally and nationally. The only problem was the more product they produced, the more money they lost (not an uncommon problem, actually). My analysis of the company's products revealed that only one of the product lines could be produced profitably. This single line was patented and could be sold nationally with an above-average markup. At my initiative, the company raised prices and even quoted longer lead times on the unprofitable lines in order to encourage orders only from customers who were prepared to pay fair price for these products. I also replaced the in-house sales force with commissioned independent sales agents across the country. We also shifted the advertising away from distributors and focused on national advertising in national magazines in order to support the new agents. Our inventory decreased, both in dollar terms and in number of items carried. The workforce was reduced, too. The sales of the best product really took off, and distributors who wanted installation and service work now solicited the company.

• My first experience with debt restructuring (reduction) was in 1974, during one of the few strong steel markets and its aftermath. I worked then for a steel distributor. Our largest competitor consistently outbid our company and was able to secure large quantities of the product we competed for. Later, when the bottom fell out of the market, he was stuck with several million dollars of over-priced inventory. We waited for the bankruptcy notice, but it never came! The competitor talked his bank into writing off a large part of his loan and offered his suppliers and other creditors 25 cents on the dollar. They all went for it! I talked to managers of the steel mills and they all said the same thing: "We were pushing operations to get every pound of steel out the door that was possible. We knew the market wouldn't last forever and that we would eventually take some losses when the music stopped, whether on inventory or on receivables. We decided it would be on receivables!" It turned out that our competitor was a perceptive man who had his ear to the ground before he made his move with his steel mills' creditors.

• A 75-year-old scrap processor operating in a rural area without competition nearly went out of business when the local steel mill closed. After losing its largest source of scrap, that processor reached out to a wider area to attract enough scrap to operate profitably. The combination of reduced volume and higher product acquisition costs caused the company monthly losses in six figures. My solution was to place roll-off containers at the vendors' facilities and have the vendors prepare the scrap to a size that could then be shipped out directly to a mill or foundry without any additional processing. Even though the company paid a slight premium for the prepared product, the reduction in the transportation and handling costs allowed the company to become profitable again. The innovator was blamed for some lost jobs, but that is another story!

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• A large industrial distributor with 12 warehouses nationally filed for bankruptcy, liquidated inventory, sold equipment and finally auctioned off its warehouses. One of the facilities bordering on the Ohio River went for $26 million to investors seeking a riverfront property for a gambling casino. This $26 million, pre-bankruptcy, would have saved the company. You have to ask, was the company so consumed by its problems that it was unable to give any consideration to the sale of this property before it was sold in the bankruptcy court? In this case, I represented one of the creditors.

• A large stainless steel fabricator operating at a loss had difficulty reconciling scrap losses on individual orders with the company's overall scrap losses. The company had strengthened its internal controls and security, but still the shortages persisted. All the scrap was shipped in cleaned railroad cars using contractual railroad weights. Herein was the problem! Railroads make weight agreements with shippers and receivers, and as a matter of law the railroad will not weigh any cars where a weight agreement is in place. If both the shipper and receiver have weight agreements, the receiving weight is used. In this case the fabricator was relying on the railroad for accurate weights and the railroad relied on the scrap processor, which had an inbound weight agreement. I was executive vice-president of the company, and in order to test the weights of the scrap we were shipping, I instructed the company to send out a loaded scrap car without a destination. After the car was weighed and the weight reported, the company reconsigned the car to the scrap processor. The scrap processor's weight was 18% lighter than the railroad weight. I estimated that prior to my intervention, the company had been losing more than $100,000 annually.

• A privately owned industrial concern waited until its secured credit line was in default before calling for advice. The bank was fully secured and had the sole owner's stock as security. My analysis of the company showed the equity had been already wiped out in the process of the company trying to sell into a market that no longer existed. I also saw that the company had three valuable assets not recorded on its books: (i) a very large tax loss carry forward; (ii) a long-term lease at an attractive facility on favorable terms, and (iii) a highly skilled workforce. Those assets, plus some negotiation which I conducted, were enough to save the company. The bank, after some "arm twisting," released the company stock, I located a financially sound company in an allied field and in another part of the country who wanted to expand into our area, and I directed the merger.

The fact is, management concerned about keeping the doors of the enterprise open are rarely able, on their own, to simultaneously turn their company around. They are too busy, too stressed, and the decisions required generally run contrary to their instincts honed in operating profitable companies. Accounting firms and other purely financially oriented advisors can help companies reduce expenses, improve cash flow and sometimes restructure finances. This is fine as far as it goes, but what is really needed by distressed industrial companies is a consultant that can do the foregoing. They must also be able to restructure, reengineer and reposition the operations of the company with innovative strategies and methods concerning product focus and development, manufacturing, distribution and promotion.