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Avoiding bankruptcy through neutral facilitation

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As a U.S. bankruptcy judge and appellate panel judge for over 26 years, I was astounded by the number of disputes in adversary proceedings and contested matters that should have been settled, but rather proceeded through dispositive motions, discovery, trials and appeals.

BOSTON, MA — Although relief under Chapter 11 of the nation's bankruptcy laws can have consummate benefits for a business in financial trouble, evaluating the advantages and disadvantages of a bankruptcy filing is an essential analysis for every business in financial distress.

The expected surge of post-pandemic bankruptcy filings and the backlog of trials that need to be scheduled post-pandemic are likely to mean delayed outcomes in bankruptcy courts.

The usual disadvantages of a business seeking bankruptcy are numerous and include the expense of professional fees, including those for not only debtor's counsel, but financial advisors and creditors' committee professionals, who are paid from the estate; the uncertainty of the outcome of the case; the risk of loss of assets and control if the court appoints a trustee or if confirmation of a plan is denied; the limited scope of the discharge, in particular that it may not assist with most tax debts and the liability of guarantors; and the negative impact on obtaining future financing.

The costs of undertaking a Chapter 11 reorganization are substantial, and the substantive law and applicable procedures are complicated. In addition, the monthly financial reporting requirements and oversight by parties in interest are cumbersome.

No person or business should rush into bankruptcy; it is a remedy of last resort. In fact, the overwhelming majority of Chapter 11 cases fail. Litigation is not an effective solution to a business's financial problems, either before or during a bankruptcy reorganization.

As my colleague, retired U.S. Bankruptcy Court Judge Randall Newsome, aptly observed: "Particularly in large Chapter 11 cases, compromise is king."

As a U.S. bankruptcy judge and appellate panel judge for over 26 years, I was astounded by the number of disputes in adversary proceedings and contested matters that should have been settled, but rather proceeded through dispositive motions, discovery, trials and appeals.

Although disputes often did settle, most on the eve of trial, many still went to evidentiary hearings, briefing and an opinion, costing parties both time and money.

The solution to the dispute or the terms of a reasonable compromise frequently seemed clear to me, but because the role of a judge is to "call balls and strikes," as Supreme Court Chief Justice John Roberts noted in his Senate confirmation hearings, I was reluctant to impose my views on counsel and the parties or mandate a resolution.

Most bankruptcy judges allow counsel to decide whether to pursue litigation or settle. Some bankruptcy professionals view a settlement overture as a sign of weakness, although I doubt clients would agree that saving legal fees by reducing or avoiding litigation is problematic.

The solution

Exploration of non-bankruptcy alternatives such as workouts — a negotiated, consensual agreement to adjust debts — with the assistance of a neutral skilled in insolvency, can assist any financially distressed business in its turnaround.

Reducing debt through a restructuring outside of bankruptcy is often possible for a financially distressed business. An out-of-court workout, which is often more cost-effective than a bankruptcy filing, should always be explored.

Frequently, creditors of a financially distressed business do not want to see it seek protection under Chapter 11 because of the expenses and delays associated with this arrangement. Using alternative dispute resolution early in the process of resolving financial problems can assist in getting creditors a greater recovery and saving the troubled business.

First steps

It is prudent for a financially troubled business to propose an out-of-court workout to its creditors before considering a Chapter 11 filing.

Whether a Chapter 11 is the right solution to a business's financial problems is a question unique to its situation, the debts owed and the assets owned, as well as revenue and expense.

If a business is considering bankruptcy, the first, and most important, step to take is to retain two insolvency professionals: a financial advisor, also known as a turnaround consultant, and an insolvency lawyer.

Before providing advice about any remedy, these professionals will examine the business's finances and determine whether it can be turned around. If the business is sustainable, the professionals will then determine how debts can be restructured through a variety of options, such as refinancing, assets sales, revenue enhancement, cost containment, debt reduction, an infusion of capital, obtaining new investors, an out-of-court workout, or a bankruptcy filing.

As always, the experience, qualifications and reputation of insolvency professionals should be considered before retaining them. Engaging competent and experienced insolvency professionals who can take the business into Chapter 11 if the workout fails demonstrates to creditors that it is serious about successfully restructuring and reorganizing.

The out-of-court workout and neutral facilitation

"Workout" is a term used by insolvency professionals, lenders and businesses to describe an attempt at restructuring without formal use of the bankruptcy process.

A workout, a contractual debt adjustment agreement reached after negotiation, is a cooperative venture of all parties with the objective of restructuring liabilities without the necessity of resorting to Chapter 11. Essentially, a workout is a negotiation with creditors.

An advantage to a workout is that all parties and constituents can participate, including guarantors, and multiple levels of agreements can be reached. Types of debts that typically can be worked out include bank loans and lines of credit, secured or unsecured; leases; franchise agreements; merchant and suppliers' debts; and employee and pension liabilities.

The terms of a workout are limited only by the creativity of the parties involved and the willingness of the parties to consent to proceed to a restructuring. Workouts are considered preferable to a Chapter 11 reorganization because they are faster and less expensive than a bankruptcy proceeding.

In general, the insolvency professionals for a distressed business will develop a workout plan for treatment of debts.

One of the difficulties with workouts is that they are voluntary, meaning that the consent of all parties is a prerequisite. One dissenting creditor can often block the adoption of a workout plan.

The presence of a neutral mediator can assist in facilitating consensus among the parties. A neutral can assist in diffusing any lack of trust or poor communication that has developed as a result of the financial distress by providing a respectful and fair environment for negotiations. The neutral can assist all parties in understanding the non-monetary aspects of financial distress, including the emotional aspects of the borrower and the corporate cultural factors of the creditors.

The neutral facilitator can make sure that all parties have full disclosure of adequate financial information, provide an objective assessment of the details of a proposed workout plan, propose alternatives, and facilitate negotiations to the point of agreement.

Just as a business should hire the best insolvency professionals to represent it, the parties to a potential workout should select a neutral with proven experience mediating both out-of-court workouts and bankruptcy reorganization and liquidation cases so that all options for reaching consensus can be explored.

A neutral's tools in the workout context are quite varied. A neutral skilled in workouts can usually facilitate an agreement, or know that a workout is not possible, within one or two sessions.

During the workout negotiation process, the neutral can adopt a variety of roles and strategies, depending on the parties' needs and wants. As previously stated, the neutral can promote dialogue with creditors, making sure that the business has provided all the information that the creditors need to evaluate the financial affairs of the business and decide whether to agree to the workout plan or propose modifications.

A neutral can facilitate settlement in a workout and add value to the negotiations in the following ways:

• Making sure that all parties have adequate financial information to evaluate a workout proposal;

• Persuading a business to disclose the details of its finances and sources of repayment, exploring the feasibility of a plan and then analyzing its advantages and disadvantages;

• Proposing terms of a forbearance or "standstill" agreement so that the parties can assess the workout plan without the pressure of an impending foreclosure or lawsuit. Similar to the automatic stay that is triggered upon a bankruptcy filing, a forbearance agreement can provide a moratorium on lawsuits and collection actions so that the parties can negotiate;

• Proposing that the terms of the forbearance agreement include continuation of the business with current management. Alternatively, the neutral can assist in negotiating the terms of an interim change in management, or any other associated terms;

• Assisting in proposing changes to the business, such as cost-reduction or revenue-enhancing plans, and developing such plans;

• In a complex case, organizing constituencies of creditors and conducting multi-level negotiations;

• Proposing particular terms for each creditor or class of creditors;

• Assisting in waiving defaults and negotiating new financial covenants;

• Highlighting the strengths and weaknesses of a workout plan to all parties and providing alterative terms;

• Evaluating expert opinions;

• Proposing alternatives according to the wants and needs of the parties;

• Providing expert guidance regarding the confirmability of the workout plan as a Chapter 11 plan in the event of a Chapter 11 filing if objections to the workout by creditors cannot be resolved;

• Providing guidance on sales and liquidation options in the event consensus to the workout cannot be reached. In a mediation, the parties may be able to negotiate more robust terms than they would in a Chapter 11 plan, such as the procurement or modification of guaranties;

• Assisting in negotiating the resolution of any counterclaims a business may have against its creditors;

• In the event of an impasse, proffering a "mediator's proposal" to finally resolve the dispute;

• Facilitating communication during the period of performance of the workout plan, monitoring compliance with the plan, and providing a forum to facilitate any post-workout issues that arise.

A workout for a troubled business facilitated by a neutral evaluator can be tailored to meet the goals of all parties. Achieving consensus may be easier when using a neutral mediator.

For a business experiencing financial distress, an out-of-court workout, facilitated by a neutral, can be an effective and efficient alternative to Chapter 11 reorganization and can lead to a speedy and efficient turnaround.

Even if the workout does not culminate in a settlement, neutral facilitation and evaluation can focus the parties on the material issues and conserve valuable resources.

Retired U.S. Bankruptcy Court Judge Joan N. Feeney is a JAMS neutral in the Boston Resolution Center. She serves as an arbitrator, mediator, special master and neutral evaluator in a variety of disputes, including accounting/finance, appellate, bankruptcy, business/commercial, estate/probate/trusts, family law, federal, professional liability and real property.