WHAT IT REALLY TAKES TO SURVIVE A CORPORATE BANKRUPTCY.

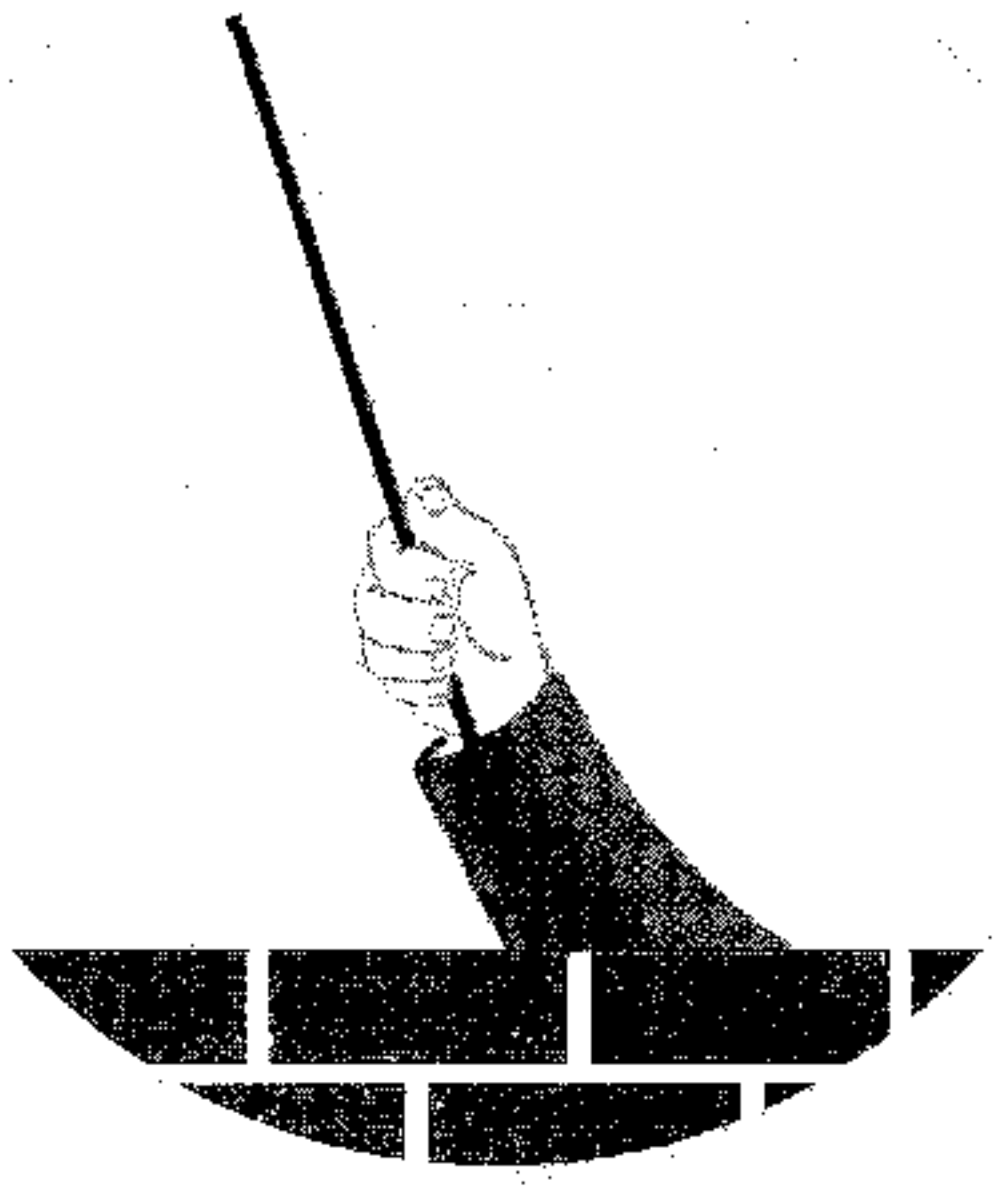
Mastering the Turnaround

BY VINCENT RYAN

What awaits companies when they enter the perilous waters of a Chapter 11 bankruptcy filing? Several possible outcomes loom, none easy to achieve nor pleasant to contemplate. ¶ That bleak reality was made worse by the Bankruptcy Reform Act of 2005, which gives companies less time to reorganize and rid themselves of costly lease agreements, trims the deadline for a company's self-formulated rescue plan, and makes it harder to retain key employees.

ILLUSTRATIONS BY ALISON SEIFFER

Nervous lenders will likely push to recover debt fast, fearing that the organization's assets are losing luster daily. Second-lien holders, meanwhile, may angle to capture equity. ¶ Who needs the headache of overhauling a balance sheet and dealing with conflicts among creditor classes? There's just too much risk (and cost), some executives say, in trying to navigate through all that. The easier route? Sell the company to one of the many asset-hungry distressed-debt investors circling U.S. corporations, making it someone else's problem. Filing for Chapter 11 can even up the price by lowering the risk for the buyer.



There is another way, however, and that way is the turnaround—a restructuring of the business financially, operationally, or both, that puts it on the road back to health. It can be a long, hard journey. Some CFOs, in fact, would rather exit quietly and find a more stable situation than run that gauntlet.

Turnarounds are achievable, but the odds are not great. Of the 450 large, public-company bankruptcies from 1998 to 2007, only about a third ultimately exited a Chapter 11 intact and resumed life as a going concern.

"The bankruptcy laws do not give companies a fresh start like they used to," says William Lenhart, national director of restructuring services for BDO Consulting. "And the cost of bankruptcy can kill a company. There are a lot of people looking over your shoulders—creditors' representatives as well as financial and legal advisers—who cost money."

There is also the unfamiliarity of the terrain to consider. As Kenneth Buckfire, managing director of investment bank Miller Buckfire & Co., says, "Everything CFOs learned in business school about finance doesn't apply in a restructuring."

A company's odds of success depend in part on whether it needs only a financial restructuring or a total operational overhaul, says Jacen Dinoff, CEO of KCP Advisory Group. "A company that has a profit from operations but negative cash flow has a good chance of getting rid of the sins of the past if it can get the debt load refinanced," Dinoff says. "But the bigger egg is the operational restructuring—that's the one that requires crisis-management skills."

How can CFOs steer companies through such trials? Interviews with crisis-management experts, restructuring advisers, and CFOs who have been through the storm reveal a handful of key steps that better the odds of pulling a company back from the brink—an achievement that almost any CFO would be proud to have on his or her résumé. Given that business-bankruptcy filings in the first quarter of 2008 rose 39 percent over one year ago, to 8,713 (and 9 percent over the final quarter of 2007), this is advice that many CFOs need now. And since many of these tips essentially rectify financial and operational misjudgments made months or years before a Chapter 11 filing, they will help many other CFOs spot trouble in time to avoid a Chapter 11 discussion at all.

Avoid bankruptcy—but not at all costs

There's no doubt that bankruptcy can be a long, hard slog. Solutia, the $3.8 billion chemical-business spin-off of Monsanto, spent four years, two months, and 11 days in Chapter 11 before exiting last February. Although the company grew revenues 34 percent while under court supervision, CFO James Sullivan had to file five amendments to the plan of reorganization as creditor committees battled for a bigger piece of the growing recovery. "It was especially frustrating for me," Sullivan says. "I thought the company was ready to come out in 2006. Then the credit markets collapsed in front of us." Solutia had to sue its exit financiers to complete its $2.1 billion emergence financing.

Knowing that, companies often do anything to avoid bankruptcy, but beware of taking extreme actions too late in the game. The time to perform business and operational adjustments is at the first sign of trouble, not when a default occurs, says Lenhart. During high-growth years, inefficiencies creep into processes that can be quickly identified to pare costs, Lenhart says. What is it really costing the company to deliver products and services, and what are customers paying for them? "You can always do something to reduce costs," echoes Charles F. Kuoni III of CRG Partners Group LLC, a turnaround management firm. "Making that an everyday job is how you stay out of trouble."

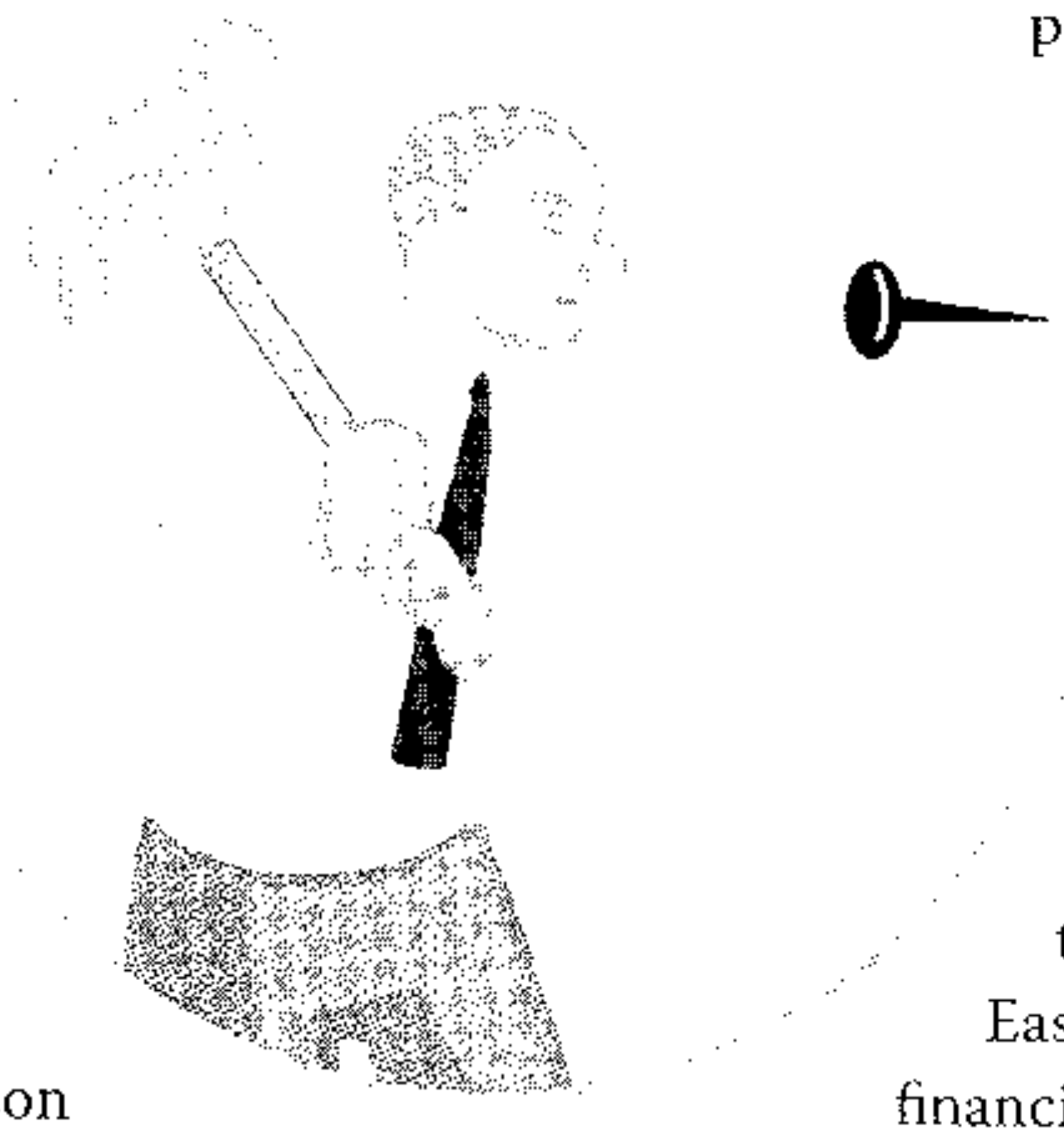
At the same time, should debt-covenant defaults and excessive delinquencies on payables be present, the CFO should make every effort to avoid creating adversarial positions for key stakeholders. The CFO has to seek support by sharing information in good faith with senior lenders and critical creditors, says Dinoff. The frequency of financial reporting has to rise exponentially. "You don't want the decision to file bankruptcy to be taken from you," Dinoff says.

Still, the CFO has to know at what point it makes sense to capitulate and live to fight another day under Chapter 11. Many executives desperate to avoid bankruptcy wind up hollowing out the business by collateralizing all the assets or selling the company's best assets to raise cash and extend the runway, says Buckfire. One common result: companies without assignable collateral wind up paying exorbitant terms on debtor-in-possession financing. "It takes tremendous discipline to not liquidate and say, 'We'll work it out,'" Buckfire says.

Explore the "prepack" option

In a "prepackaged" bankruptcy, creditors, bondholders, and other constituents agree to support a plan of reorganization before the company files with the courts. Remy International Inc. was the third major U.S. auto supplier to file in 2007. It spent only 59 days in Chapter 11 (the average is about 16 months). But the debt-laden company had spent months prior talking to bondholders, says CFO Doug Laux. The filing allowed Remy to reduce its long-term debt by $360 million and then focus on its operational repair, Laux says.

Prepacks are most appropriate for a straight balance-sheet restructuring, when a company is, for the most part, operationally sound and current on trade agreements, says Jonathan Carson, president of Kurtzman Carson Consultants, a claims and noticing agent servicing corporate restructurers. Importantly, none of Remy's creditors took a significant haircut in the recovery, Laux says, which made the process faster.



The caveat is that prepacks can cause issues with valuation. Because the operational restructuring comes after the reorganization agreement, the bankrupt entity's valuation will be partly based on actions that haven't yet been taken, Lenhart says. And that risk lowers the company's valuation, giving creditors that are swapping debt for equity, for example, a larger share in the business.

Fix the business

While in the weeks prior to filing Chapter 11 a smart CFO focuses on the analytical work of restructuring, once a company files, experts say, the priority has to be fixing the business. "The CFO has to immediately start paring costs" to preserve cash flow, says Kuoni of CRG Partners, who has stepped into CFO roles in crisis situations. "I've been in situations where we had large equipment leases and on the first day of filing rejected them and sent the equipment back to the owner," he says.

The cash-flow forecast "operates in real time" and becomes a critical tool in this period, KCP's Dinoff says. "You have to know how much time is left before the company is completely out of funds. You want to get from that crisis stage to stabilization quickly."

While steering New York–based St. Vincent's Catholic Medical Center through Chapter 11 in 2005, CFO Martin McGahan fought immediately to preserve liquidity and cool a $10 million per month cash burn at the 600-physician hospital. "We had a shrinking number of beds as well as revenue and collection problems," says McGahan, a managing director at turnaround advisory Alvarez & Marsal. McGahan evaluated the location of the large, critical receivables; determined the priority of payables; and sought to minimize spending in other areas, such as the hiring of consultants. "As you track cash, it exposes a lot of the broken processes inherent in the system that leads to a real tactical response," McGahan says.

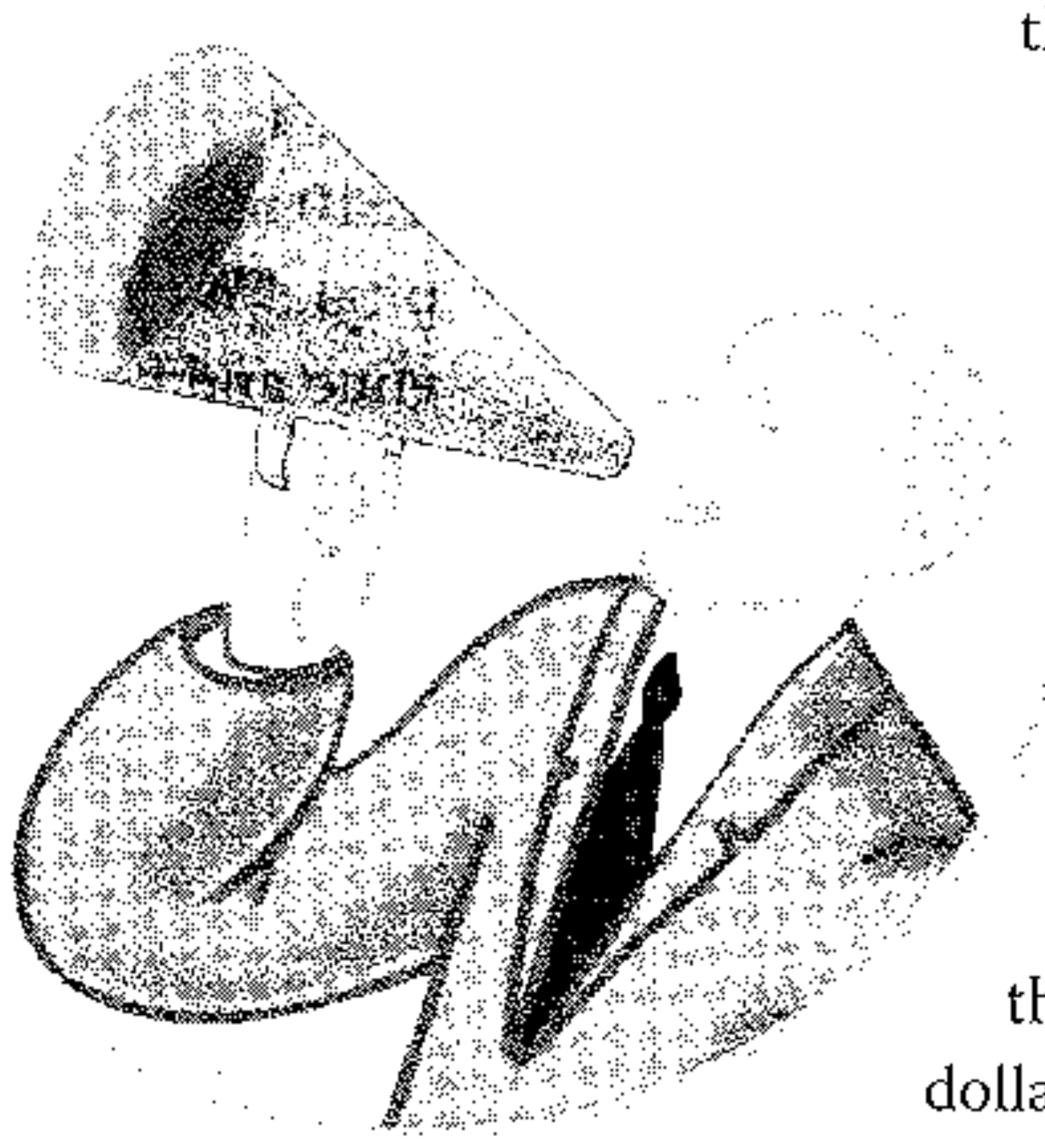
Within a little more than a month of Sullivan's coming on board at Solutia, the company had instituted price increases on some of the plastics it manufactures, closed its acrylic-fibers business, and formed a team to build market share in the Far East. "We needed to demonstrate to financial institutions that we could stop the bleeding," Sullivan says. Long term, while still in Chapter 11, the company was able to invest cash into opening a new plant in China to build Saflex, a special type of protective glass.

Similarly, Dana Corp. focused on "a massive rehabilitation of its business-cash flows and income statements and not just a balance-sheet fix," says attorney Corinne Ball, leader of the bankruptcy practice at Jones Day, which advised the auto-parts maker. The changes played no small part in Dana's attracting a $790 million preferred-equity investment led by Centerbridge Capital Partners and a $2.1 billion debt financing to exit Chapter 11.

Talk it out

When a company is in bankruptcy it is natural for employees—and the company as a whole—to lower their heads and cease communicating. But the opposite is required. Within days, if not on the first day, management has to set up cross-functional communications to break down the silos, says McGahan. "Operations has to know who to call in finance if there are no supplies on the shelf, and marketing has to know the strategy from the finance and operational perspective," he says. Employees "need to have operating guidelines. They can't sit in crisis mode for 90 days," Dinoff says.

Communication to the outside world has to be assigned to the right personnel. The CFO may be the one who has to call the credit manager of the company's largest supplier, explain the rescue plan, and negotiate the terms on which the vendor will start supplying product, he says. The aim: to demonstrate that the business will continue to exist and creditors won't get burned.



Bankruptcy is a public forum, explains Lisa Donahue, co-head of the turnaround and restructuring practice at AlixPartners and the CFO of energy supplier Calpine, which went through a contentious two-year reorganization before exiting last February. "Sharing as much information as possible with creditors makes the process easier," she explains. At Calpine, which filed with $18 billion in debt and operating losses, Donahue and her team set up weekly conference calls with all creditor committees so they could review power-plant sales proposed by management and ask questions. "Make it as orderly and consistent as possible, and have an agenda," Donahue suggests.

Seek the greatest good

It pays to play ball in bankruptcy—at least when it comes to cutting in creditor classes and maximizing their recovery. With companies now having just 180 days to file their own reorganization plan, Calpine felt the time pressure, Donahue says. But because the company coordinated very closely with constituents, it was able to overcome that hurdle—the technical expiration of the "period of exclusivity" deadline passed with little notice. And, before all was said and done, Calpine was also able to get the best deal for creditors—general unsecureds recovered 85 percent or more and equity holders received warrants to purchase new common stock. "I don't believe adversarial is the best approach to restructuring," Donahue says.

At Solutia, as one of his first steps, Sullivan froze the company's defined-benefit plan, which was underfunded by $500 million. But instead of ditching pensioners altogether and leaving them to the Pension Benefit Guaranty Corp., the company tapped its debtor-in-possession financing to inject $300 million into the plan. "We needed the support of the people in the pension plan," Sullivan explains. "And there would have been another claim against the estate that would have diluted recoveries, so bondholders backed it."

The prevalence of distressed asset investors holding corporate debt, a common occurrence of late, actually presents an advantage in this context. Some of these investors tend to look at their stake as an equity investment, so they may be happy with 80 cents on the dollar if they bought the debt at a lower price. That can potentially leave some value or cash for creditors further down the priority waterfall, says BDO Consulting's Lenhart. "They don't have to hit a home run on all their deals," he points out. Likewise, senior lenders are often amenable to "give-ups." "Pigs get fat, hogs get slaughtered," CRG's Kuoni says. First-lien lenders recognize that if

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they wipe out equity 100 percent, they will lose the cooperation of equity in a reorganization process, possibly leading to a pure liquidation, he explains.

Fight for flexible capital

For many companies, overweight capital structures can cause a cycle of bankruptcies, so it makes sense that the last piece of advice is this: build a serviceable balance sheet during and after a reorganization.

"The capital structure has to line up with your strategy," says McGahan. Within two months of joining St. Vincent's, McGahan had negotiated with a new lender to take out the entire debt structure. The company paid off eight different bonds and revolving credit facilities with a single-term facility so that it could hawk valuable real estate or use it as new collateral. "Otherwise, we would have needed consent from the different bondholder groups for the asset sales," McGahan says.

In Remy International's case, debtor-in-possession and exit financing were negotiated simultaneously. Remy didn't have to take on onerous covenants, as many Chapter 11 filers do, to get $330 million in financing from lead lender Barclays Capital and others, even though it exited during the credit crunch. That was because new capital came in behind the facility, CFO Laux says, in the form of $85 million of preferred shares. And the new capital had a payment-in-kind feature in case cash got sparse again.

Similarly, Calpine's exit facility included an accordion feature that allowed leverage to increase at the company's discretion. Corporate-level debt could expand to refinance more-expensive project-level debt used by some of Calpine's individual power plants, CFO Donahue says.

"The CFO has to be the arbiter of what's best for the company—from both a feasibility and a longevity perspective," Donahue says about raising capital in bankruptcy. "The capital structure has to have a platform for growth."

Growth, in fact, might be thought of as the light at the end of the tunnel. Entering a bankruptcy, CFOs could be forgiven for thinking they are heading toward that other kind of light, but that need not be the case. You can, in fact, turn things around. CFO

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Trying to Avoid Signals of Distress

IN THE CURRENT CAPITAL markets, CFOs hoping to avoid the "distressed" label and having their hand forced have to defend against investors in distressed assets. Distress investors may be looking to "loan to own," whether by negotiation or by forcing a business into Chapter 11, says attorney Corinne Ball, leader of the bankruptcy practice at Jones Day.

The distressed investing industry is incredibly well organized, well capitalized, and well represented, says Ball, who advised Dana Corp. on its Chapter 11 filing in 2006. **"They invest in your securities because they think the company is undervalued, but the bad news is they want to realize that value on their investment, not the equity,"** Ball says. "They're waiting for an event [like a proposed asset sale or a technical covenant default] that brings them into voice." One of the issues that pushed energy supplier Calpine into bankruptcy two years ago was a lawsuit by bondholders that prohibited the company from using $313 million of proceeds from domestic-gas asset sales.

Well-prepared CFOs have a detailed knowledge of their company's existing and expected compliance with the covenant and default provisions of all debts in the capital structure, Ball says. They also know the timing and extent of cross-default issues upon an "asserted" default. **Of course, knowing the identity of the company's debtholders is critical, so much so that gaining some control over who can own the company's debt and trade it,** by obtaining "consent rights" in lending agreements, may be worth an increased cost in exchange for the certainty. Don't assume a refinancing is readily available, that a "misguided or incorrect" assertion of a default or even acceleration is harmless, or that a lender will waive a violation, Ball says. And if a committee of debtholders knocks at the door or fires off a furtive letter to the board, engage them, don't slam the door. "Don't pick a fight you can't afford to lose," she adds. —V.R.