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General Counsel's Role in a Financially Distressed Company

BY STEVEN D. USDIN
AND NELLA M. BLOOM

Special to the Legal

On April 25, we published an article in *The Legal* titled "Identifying Signs a Company is in Financial Distress." That article addressed the issues that general counsel should look to for indications that a company is either in or sliding into a financially distressed situation. Among the red flags that we identified were cashflow issues, repeated litigation, labor problems, the company's inability to perform contracts and debt-heavy balance sheets. We also suggested that general counsel's next step would be to contact outside professionals to assist in analysis of the company's situation, interpretation of where to go next and, ultimately, negotiation on behalf of the financially distressed company.

However, general counsel's role in a financially distressed company does not end at contacting outside professionals. Once a company has determined that it is in a distressed situation, general counsel can play an essential role in resolving its debt



USDIN

STEVEN D. USDIN is a shareholder in Flaster Greenberg's bankruptcy, financial restructuring and risk management practice group. He focuses his practice on commercial and personal bankruptcy, general corporate and transactional matters and commercial litigation. He can be reached at steven.usdin@flastergreenberg.com or 215-279-9903.



BLOOM

NELLA M. BLOOM is an attorney in the firm's bankruptcy, financial restructuring and risk management practice group. Admitted to practice law in Pennsylvania, New Jersey and Delaware, she focuses her practice on general bankruptcy and corporate matters. She can be reached at nella.bloom@flastergreenberg.com or 215-279-9916.

structure. Here we address general counsel's duties when the company decides to (1) work out payment plans with creditors informally; (2) sign a forbearance agreement with secured lenders; or (3) file a bankruptcy proceeding.

WORKING OUT PAYMENT PLANS WITH CREDITORS

Staff of the company other than general counsel generally performs much of the work when a company determines that its best course of action is to work out alternative payment plans with creditors on an informal basis. Accounting staff may identify the company's creditors, analyze the company's cashflow and propose realistic payment schedules. Salespeople and executives may reach out to the creditors directly to propose the payment structures going forward. The role of general counsel here is generally to negotiate and review contracts relating to those payment proposals, and to coordinate between management and other parties in resolving issues that arise.

ENTERING INTO FORBEARANCE AGREEMENTS

Forbearance agreements can allow a company some measure of short-term relief from long-term secured debt by restructuring payments of interest and principal. If a company enters into forbearance agreements, its executives will often be in the best position to identify any obligations the company needs to restructure. The executives may reach

out to each secured party alone, but should include general counsel in any follow-up meetings or communications.

Many times, the secured lender will reach out to the company to schedule a meeting. This first meeting provides the secured lender with an opportunity to review the position of the company and start the process to restructure/re-establish the debt. General counsel should participate in this meeting and should inquire of the secured lender if the lender intends to have its own counsel attend the meeting. If so, it is strongly recommended that outside counsel with experience representing distressed companies also attend. This needs to be done to assure that there will be a level playing field during discussions, presentations and any negotiations of the debt.

The role of general counsel here is to work with the secured lender, outside counsel and the company's own executives and accounting staff to determine the demands of the lender and realistic expectations of the company's cashflow and profitability. Outside counsel will take the lead on drafting and/or reviewing the forbearance agreement and all other documents.

FILING A BANKRUPTCY PROCEEDING

If the company determines that a bankruptcy is in its best interests and will best assist it in reorganizing its debt or liquidating its assets, the role of general counsel is greatly enhanced. General counsel acts as a bridge between the distressed company's staff and its bankruptcy counsel, while always keeping in mind new obligations that arise due to bankruptcy court supervision.

General counsel stands in a unique position in the company when the company

files a bankruptcy. Often he or she is the only individual with both legal training and firsthand knowledge of the company, meaning that he or she can place the company's practices into a legal context and evaluate the impact. In fulfilling that role, general counsel must assist bankruptcy counsel in complying not only with the Bankruptcy Rules and orders from the bankruptcy court, but also in complying with any requests that might be forthcoming from the court or the Office of the United States Trustee.

Once the executives decide to file a bankruptcy, in the early stages general counsel will be called upon to perform certain tasks:

- General counsel must work with executives and accounting staff to coordinate the creation of a list of all secured creditors,

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including banks, mortgage holders, lessors and holders of UCCs. Included in this task is determining whether all security interests are up-to-date and the order of priority of those interests. General counsel should also review all leases, whether for equipment or real property. Reviewing leases is necessary to determine if the leases are true leases or financing agreements. General counsel can then work with management to determine whether the leased items are necessary for the continued operation of the reorganized company. General counsel will need to also determine whether the leases or financing

agreements are current, whether they have buyout provisions and whether those provisions apply.

- General counsel should identify all priority claims, such as employee wages and benefits or claims of taxing authorities. Because these claims have priority status, it is essential to understand the extent of these claims and determine how and when the company will pay. Notably, tax claims in a Chapter 11 bankruptcy — the most common type of business bankruptcy — are not dischargeable for a corporation and must be paid in full, with interest, within five years.

- With the assistance of accounting staff, general counsel will coordinate and create a list of all general unsecured creditors. These creditors are likely to want to form a "committee of unsecured creditors," also called a committee. The committee is appointed by the U.S. Trustee to represent the interests of all general unsecured creditors and stands in a fiduciary relationship to all general unsecured creditors. It is important to note that the committee's professionals are paid from a debtor company's bankruptcy estate and payments must be approved by the bankruptcy court.

- While performing the duties above, general counsel will become very familiar with the finances of the company. This familiarity is essential for general counsel's next duty: to assist with the preparation of bankruptcy schedules and statements. These documents provide the bankruptcy court and all creditors with a snapshot of the status of the company as of the filing date. Such information includes the identities of secured creditors, priority creditors and general unsecured creditors. However, the debtor company must also disclose the nature and location of

all of its property, its equity security holders, any co-parties to ongoing contracts, and other financial information. Because this information goes to the very heart of the debtor company's business, general counsel may have to explain to management the necessity of full and complete disclosure, and that failure to comply could result in the dismissal of the case or the case's conversion to a liquidation case under Chapter 7 of the Bankruptcy Code.

- General counsel can assist in identifying the debtor company's "critical vendors." A critical vendor is a vendor whose business is so essential to the company that the company would cease to operate if the critical vendor refused to continue the business relationship. Upon bankruptcy court approval, and in limited circumstances, critical vendors can be permitted to be paid for prepetition work post-petition. If a critical vendor is not identified and refuses to continue working without its payment, the company may collapse despite all best efforts to reorganize.

Later, after the bankruptcy is filed, the company may draw upon general counsel to assist with:

- Evaluating what should be done with any assets the company identifies as unnecessary to the operation of the reorganized company. This task includes evaluating which assets the company should consider selling, determining whether the company should abandon any assets that have little-to-no value to the company as reorganized, contacting potential purchasers of the assets, coordinating with an appraiser to determine fair market value of the assets, organizing an auction or sale and giving notice to lienholders or secured parties who may have an interest in the assets at issue.

- Drafting and reviewing ancillary agreements. These agreements may be lease agreements relating to real or personal property, employment agreements, sale agreements and noncompete agreements for the executives or other staff. Many, if not all, of the agreements will have to be submitted to the bankruptcy court for approval.

- Continuing to meet the debtor company's disclosure obligations to the bankruptcy court. Within two weeks after the company files a bankruptcy, the company must file an initial operating report, and every month thereafter until the confirmation of the debtor company's plan of reorganization the company must submit a monthly operating report. These reports detail the company's income and disbursements. Repeated failure to timely submit these reports, and to supply information requested by the U.S. Trustee, can result in the dismissal of the debtor company's bankruptcy case or its conversion to a liquidation case.

- Becoming involved in the bankruptcy litigation process to the extent necessary. General counsel can assist in identifying creditors who could be subject to litigation under the Bankruptcy Code, including creditors who received payments within 90 days before the bankruptcy, or parties who failed to pay the debtor company its outstanding receivables. General counsel can also participate as corporate representative for the meeting of creditors held pursuant to Section 341 of the Bankruptcy Code. At that meeting, the corporate representative must be able to testify under oath to the company's financial status and the circumstances giving rise to the bankruptcy filing. General counsel may also be called upon to attend bankruptcy court hearings as well.

When a company becomes financially distressed, the role of its general counsel changes. Whether the company seeks to recharacterize its debts through an informal process, enter into forbearance agreements or file a bankruptcy proceeding, general counsel's job is to facilitate the process. He or she can do so by calling upon previous experience, as well as organizational skills and transactional expertise. General counsel can also pull from knowledge of the workings of the debtor company and his or her general legal background.

The participation of general counsel is very important to a bankruptcy practitioner and the company generally. General counsel's assistance can smooth the bankruptcy or reorganization process. By minimizing the time spent on reorganizing, general counsel can assist in the most important part of a reorganization: allowing the company to get back to its normal business operations quickly. •