





VALCON '09
MID-MARKET RESTRUCTURINGS: WHAT HAPPENS
IF NO ONE COMES TO THE SALE

ISSUES RELATED TO USE OF CASH COLLATERAL TO PROVIDE
FOR INCREASED OPTIONS FOR DISPOSITION OF A
DEBTOR-IN-POSSESSION'S ASSETS



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The topic at hand, namely, the options available to restructuring professionals and other stakeholders when sufficient value cannot be derived from a routine sale of assets or from some other mechanism, but where the viability of the enterprise is questionable, presents few opportunities for optimism. “What does it matter,” the reader might ask, “how we fall?” *When the fall is all that’s left, it matters very much*¹. If a debtor’s stakeholders planned to derive value from a sale and the market decided otherwise, the stakeholders are left with three options:

1. *continue the sale process as currently configured;*
2. *terminate the bankruptcy process (essentially throwing in the towel and either filing or converting to a case under Chapter 7, dismissing an already filed Chapter 11 or filing a rapidly cobbled together Chapter 11 liquidation, or;*
3. *running the business using what cash can be generated by the company’s operations, so as to avoid further deterioration of the estate’s assets while possibly preserving viability of the business, either for a later sale or an attempt at restructuring around one or more viable core businesses.*

If Albert Einstein was correct and the definition of insanity is, indeed, doing the same thing over and over again and expecting different results, then we can dismiss the first option. While there may be cases where timing or sufficiency of the marketing effort were of such nature that the same sale process, merely repeated or extended for a longer period, will yield different (or better) results, those cases are the vast minority.

In considering termination of the bankruptcy process, it is useful to examine again the same criteria that served (or should have served) as the initial assessment of the distressed entity,

¹ “The Lion in Winter”. Copyright 1966 & 1968. James Goldman. Quoting the exchange between Prince Geoffrey and Prince Richard:

Prince Geoffrey: You chivalric fool ... what does it matter how you fall?
Prince Richard: When the fall is all that is left, it matters very much”

ideally well before bankruptcy was considered. To be considered viable, either in a turnaround or to survive through a sale process, a distressed company must have:

1. a viable core business or businesses.
2. adequate organizational resources and skills.
3. adequate “bridge” financing to provide for operations through the turnaround (or other disposition) – and this measure can be further broken down into three components:
 - a. Liquidity, proven through the analysis of cash and working capital.
 - b. Solvency (even if fleeting), which can be assessed by an analysis of the income statement and balance sheet.
 - c. Positive cash flow, which requires a granular understanding of sources and uses of cash by the business on a go-forward basis.

In general, the absence of any *one* of these requirements (except for solvency, which, in the context of a Debtor in Possession, is presumed to be lacking already) compels either a sale or other termination event for the distressed business. If, upon the failure of a sale effort, a new examination shows that the company is lacking one or more of these requirements (and it may be likely that the degree of shortfall has grown since the first assessment, as the company has continued to operate in distress), if a thorough marketing effort has failed to generate credible interested parties at a reasonable value (or any value acceptable to the stakeholders, which should be any value superior to a realistic liquidation value), and the company lacks the ability to reorganize or survive, then cessation of operations may be the only responsible option. The debtor’s counsel and its advisors must make a frank assessment of the obligations of the debtor’s directors and officers to the creditors of the distressed company and that assessment should

weigh heavily upon the decision-making process. What, however, can be done if a sale effort failed to yield acceptable value, but the company may be able to live long enough to either wait out a market cycle or implement some change that changes its perception in the market?

Cash Collateral

The debtor, in consultation with its legal and restructuring professionals, must determine how the company's assets will endure through operations in a Chapter 11. If the nature of the debtor's operations is such that continued operation will cause erosion of the value of the debtor's estate (i.e., if the company *is not* operating at or above break-even), then it may be in the best interests of the estate to cease operations and consider other alternatives, such as immediate liquidation or a sale at whatever value can be obtained (i.e. a "fire-sale" value). If, however, the company is able to generate enough cash from operations to meet operating and restructuring expenses, without having to incur additional debt to fund operations (i.e., the company *is* operating at or above break-even), then the continued use of cash collateral may be an option for preserving the estate long enough to seek some other disposition – either a restructuring or a revitalized sale effort, at a later date.

Section 363(a) of the Bankruptcy Code (11 U.S.C. §363(a)) defines cash collateral as

“cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use of occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

For all practical purposes, cash collateral is the proceeds of accounts receivable collections that are subject to the lien of a pre-petition secured lender. The Bankruptcy Code goes on to state, in §363(c)(2), that


The trustee may not use, sell or lease cash collateral under paragraph (1) of this subsection unless –

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale or lease in accordance with the provisions of this section

Convincing a secured lender to consent to the continued use of their cash collateral will generally require proving that the value of the lender's collateral will not diminish through the use of cash collateral and that the lender is adequately protected as to its lien position and the value of the collateral relative to the amount of the secured claim. This same showing is required when asking the court to grant use of cash collateral over the secured party's objections. Generally, adequate protection requires granting the secured party a replacement lien in replacement collateral – for example, to secure permission for the use of accounts receivable as they are collected, a debtor will have to grant the secured party a replacement lien on newly generated accounts receivables, which may, when collected, be used to fund operations, *ad infinitum*. The mechanism generally used to show that a company can operate using only cash collateral (and not require new debt) and to show that secured parties will be adequately protected is the 13-week cashflow budget, a key tool in managing distressed businesses.


The 13-week Cash Flow Budget



While the mechanics of formulating the 13-week cash flow budget are perhaps beyond the scope of this material, a brief review of the underlying principles may prove useful. Beyond the obvious use, which is a forecasting of anticipated sources and uses of cash by the business through a rolling 3-month period, the cash flow budget encapsulates twelve key principles of turnaround management ²:

1. Understand cash flow contributions to different product lines and/or business units and overall strategies and risks.
2. Involve those who will be accountable.
3. Identify and communicate key performance metrics.
4. Adapt the cash flow planning and update processes to the organization's capabilities.
5. Encourage open debate and fact-finding on the cash flow plan.
6. Quantify the magnitudes and likelihood of risks and opportunities to the base plan.
7. Monitor execution weekly or daily.
8. Update assumptions and renew outlook weekly.
9. Communicate thoroughly.
10. Recognize owner and stakeholder priorities.
11. Focus on significant improvements.
12. Measure and monitor for results.

² Turnaround Management Association and the Association of Certified Turnaround Professionals: CTP Body of Knowledge, Accounting & Finance section. Copyright ACTP, 2006



While these principles apply as guidance for the turnaround/restructuring practitioner in the formulation of the initial cash flow budget, they are also helpful in understanding, from a dollars-in and dollars-out basis, in what manner and for how long a business can exist on its own means on use of cash collateral alone.


The construction of the cash flow budget is straightforward – all sources of income, by operating division, unit or location should be shown, and all expenses should be shown. For purposes of a “whole-company” cash flow perspective, allocation of corporate expenses to different locations (especially in the case of a retail operation) is not necessary for the purposes of a cash collateral plan (although an understanding of allocations of overhead to locations is a necessary step in making “keep or close” decisions in a retail or multi-site operation). Timing of both inflows and outflows is of paramount importance in determining whether or not a company can survive on use of cash collateral alone. In cases where a company is borderline in terms of operations relative to break-even, management should consider whether certain expenses can be shifted from one week to another to smooth the use of cash. The ability to defray payment of some operating costs, especially those related to the restructuring itself (such as professional fees, retailers, utility deposits and other expenses that fall outside of some statutory or regulatory schedule) can be the difference between survival on cash collateral and the need for new borrowing.

Consider the cash flow budget shown in Exhibit A to this document. This budget was filed on the petition date attached to a motion to permit borrowing under a DIP credit facility which was being offered by the pre-petition secured lender. The facility was to include a roll-up of approximately \$50 Million of pre-petition debt, and an extension of \$8 Million in new borrowing. Upon cursory examination, the need for borrowing is clear in the early stage of the

case. In the week immediately pre-petition, the company forecasted a net cash loss of \$899,000 (column B, row 55) and in the first week of the case, the company forecasted losses of \$2.966 million (column C, row 55). The company proceeded with filing of the DIP motion and obtained interim approval from the bankruptcy court for limited borrowing. The Official Committee of Unsecured Creditors, when it was appointed, immediately objected to the DIP on the basis that it was unnecessary.

A critical analysis of the budget supports the Committee's position. Consider that, of the \$3.630 Million in cumulative cash losses over the first two post-petition weeks of the case, approximately \$1.4 Million was comprised of accruals (which are not cash and should not have been so forecasted), professional retainers and fees for the Debtor's professionals and other items that could be moved by a few weeks to minimize the cash impact (columns B and C, shaded areas). Consider also that collections were higher than forecasted and the debtor was able to survive on cash collateral alone – the company never borrowed on the interim DIP and, by the date of the final DIP hearing, new borrowing would be unnecessary for the duration of the case. This placed the case on a very different footing for several reasons. First, a roll-up of the pre-petition debt, which would have created a number of advantages for the secured lender, never occurred, which can be seen as a “leveling of the playing field” for the unsecured creditors and other stakeholders. Second, several hundred thousand dollars in commitment and other fees demanded by the secured lender in exchange for providing the DIP didn't need to be paid, thus preserving value in the estate. Finally, operating expense and complexity of the Debtor was minimized.

More importantly, however, is that a cash collateral budget showed an outcome which, without critical analysis, was deceptive. A reasonable observer would conclude that, facing



operating losses nearing \$4 Million in a two-week period without adequate funds available to cover the losses, the company would not meet the requirements of viability necessary to sustain operations. Had this issue occurred later in the case, the results might have been dramatically different. There are few competent turnaround managers who, knowing the company was about to hit a wall and run out of cash to fund operations and payroll, would allow it to do so. But the same cash flow budget that initially indicated failure during the first two weeks of the case actually represented a company that could survive to reach the “promised land” of the asset sale that as to occur in week 11 (column L, row 9). How can the same cash flow budget reflect the same company during the same time period? The answer is one of perception, not reality. The company’s operations did not fundamentally change between the two outcomes – rather, the methodology used to forecast the company’s cash needs changed to reflect actual events rather than a forecast which turned out to be overly conservative.

The construction of the cash flow budget is not rocket science. It requires knowledge of the debtor’s operations (which, one presumes, the company possesses) and insight into the management of a debtor in possession (which the turnaround manager possesses) – but at its most basic, formulation of this budget is the collision of timing and basic math. The results are telling – for a company that seeks to maximize the value of its assets, the ability to see that operations can continue at breakeven means that the company can sustain itself without further deteriorating the value of the estate and therefore, may live on to achieve a more suitable value at a later date.



EXHIBIT "A"



A	Post-Petition													Total 13 Weeks
	B	C	D	E	F	G	H	I	J	K	L	M	N	
	Pre-Petition Wk1 16-May	Wk2 23-May	Wk3 30-May	Wk4 6-Jun	Wk5 13-Jun	Wk6 20-Jun	Wk7 27-Jun	Wk8 4-Jul	Wk9 11-Jul	Wk10 18-Jul	Wk11 25-Jul	Wk12 1-Aug	Wk13 8-Aug	
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