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Which Debtor Companies Will Emerge From Bankruptcy

Viability depends largely on whether management accepts responsibility for its problems or blames external circumstances.

Debtor attorneys are usually brought into a case prior to a bankruptcy filing, and are part of the decision making process as to whether bankruptcy is the right option. Creditor attorneys generally come in after commencement of a case, and are relied upon to assist in determining whether the debtor is viable and if the creditors should assist in reorganization or pursue liquidation.

Both debtor and creditor attorneys need to answer the question, "Can this debtor be turned around?" The answer depends largely on two factors:

- whether management understands the true origins of the problems they need to solve, and

- whether they have a realistic action plan for overcoming their operating problems -- a plan that says who is responsible for each step, how success will be measured, and when significant milestones in the corrective action will be reached.

The decline

Businesses do not generally become financially troubled overnight. Many managers blame a cataclysmic event such as bad weather, actions of a competitor, computer system problems, a depressed local economy, or a rogue employee -- but usually the problems that cause financial distress are cumulative and have been building under the surface for a long time.

Unfortunately, because most of the warning signs of impending business failure are ignored as minor operating problems, early remedial action is not taken, and management is later shocked at the “sudden” insolvency or inability to operate. Failure to understand the symptoms and their causes can make a successful turnaround, whether in or outside of bankruptcy, highly unlikely. Management that refuses to accept this reality will be unable to successfully emerge from bankruptcy.

You will often hear failed business owners proclaim that “everything was going great, we just ran out of money, and all we need is another round of financing to make us successful." When was the last time you heard someone say “I ran out of ability,” or, “I had a mismatch between my operating strategy and my financing strategy,” or, “I failed to generate enough quality sales”? It is usually left up to the outside professionals to determine the root causes of the problems and whether they are fixable. Fixability often depends on how far along the company is in its decline.

Stage 1: warning signs

The early stages of trouble usually include falling cash balances (but only sporadic shortages), isolated operating bottlenecks, eroding margins, stagnating or declining sales, rising inventory, and slower bill payment. Corrective action at this stage can fix most problems relatively easily. Unfortunately, management is not typically concerned at this stage, as it often believes that the problems are temporary or due to isolated external shocks.

Stage 2: disruptions

If ignored, these problems become more acute. Operating problems mount as shortages disrupt normal business flow. Receivables collections slow as customers become more concerned. Margins continue to erode, cash balances become dangerously low, and meeting payroll becomes a challenge. Lenders will start becoming concerned at this point, and meetings with lenders consume growing quantities of management's time. Morale falls, and good employees start leaving the company. If allowed to progress too far, the "vicious circle" starts feeding upon itself at increasing rates. At this point the company is still fixable, but the prognosis is rapidly becoming more in doubt.

Stage 3: crisis management

As the decline continues, everything is in chaos. Chronic material shortages and customer emergencies disrupt operations on a near continual basis. Receivable collections have dropped dramatically, and most material purchases are on a cash-on-delivery or cash-in-advance basis. Financial management is spending virtually all of its time trying to satisfy the creditors, and internal management reporting becomes sporadic and inaccurate. Both customers and employees are leaving the company, and management is totally focused on reacting to each moment's crisis, which makes it nearly impossible to implement any meaningful corrective actions. If outside professionals are not brought into the case until this point, the company may already be too far gone. A strong and convincing case must be made to the remaining employees, suppliers, and customers to keep them all interested in supporting a turnaround, but management may have lost its credibility with all of these groups by this point.

Bad luck or ineffective management?

While almost every manager in troubled circumstances believes that he or she got there due to an unusual run of bad luck, there are almost always more common causes. These include lack of planning or budgeting, poor reporting systems (it is hard to get somewhere else if you can't determine where you are), and over-dependence on key employees, key customers, or key suppliers. Other potential problem causers include ineffective incentives for employee retention, lack of product innovation, and failure to penetrate key markets.

The two most cited causes of failure, excessive leverage and under-capitalization, are usually the result of a mismatch between financing strategy and operating strategy. Unless management has realistic action plans for these problems, there is usually little chance for the company to redeem itself.

Some will survive, some won't

It is critical for management to acknowledge that its troubles are related to basic business management. Despite their protests that the company got into trouble due to coincidental exogenous shocks, there are very few businesses that fail for unique reasons. Good management knows that the best ways to avoid trouble are to establish good budgets and monitoring systems and then quickly respond to whatever divergences are found; listen to your employees, customers, and vendors; deal with the problems and not their symptoms; stay calm and focused; and realize that more capital is almost never the answer.

Managers that are focusing on getting more cash to throw into the holes rather than stabilizing the existing cash flows, and who have developed long-range plans to attract new investors rather than a short-term business plan that outlines the steps necessary to strengthen or support the core business, do not understand the critical issues and will not survive, even under protection of the bankruptcy code.