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Hallmark Capital, a New York-based investment bank, speaks on the subject of corporate bankruptcy alternatives.

BANKRUPTCY ALTERNATIVES

Other Options For Troubled Companies

MORE THAN 330,000 companies filed for bankruptcy over the past few years, according to the U.S. Bankruptcy Court. Many were heirs to the "merger mania" of recent years, which resulted in companies overleveraging themselves in huge debts they had no ability to repay.

Even more startling, however, is the fact that many of these bankruptcies were avoidable. Alternatives to bankruptcy exist that make sense for many companies, but their success depends on management, their attorneys and accountants detecting the first signs of trouble early enough and getting the proper experts involved to rectify the situation. It does not hurt the company or cost much to have contingency plans in place which include developing alternative sources of cash.

Bankruptcy should be a last resort, used only if all other options have failed – it is costly, time-intensive, messy, and plays havoc with a company's reputation, credibility and control over its destiny. The process of bankruptcy and a company's re-emergence can take years to complete and cost millions of dollars, money that could be used to invest in company growth. It by no means guarantees a company's survival, and makes it prey for unwanted suitors. Bankruptcy judges have a great deal of discretion in deciding a company's future, and their ideas may clash with that of company management. A judge may order creditors to foreclose and seize control of specific assets, or that certain divisions be sold.

Bankruptcy Alternatives

Two alternatives to bankruptcy which should be carefully considered are **recapitalizations** and **rights offerings**. In a recapitalization, a company in trouble seeks a new layer of both equity and debt to help it through a tough period. Part of the new money is usually used to repay a certain portion of existing debt, to restructure the balance sheet. Certain lenders and investors specialize in seeking out these investment situations because they can earn higher-than-average returns. Attracting the attention of these "vulture" lenders or investors can be a challenge, due to the competition involved. Generally, the larger the company, or the earlier the company starts seeking help, the better its chances.

In a rights offering, a company usually offers the right to buy additional shares in the company on favorable terms to all or certain security holders – bond-holders and/or debt holders – and often common shareholders. The prospect of buying shares at $6 each when they are usually traded at $8 per share often is enough of an incentive to spur an infusion of cash which will put the company back on its feet.

The preferred way to accomplish either a recapitalization or a rights offering is through a private placement of debt and/or equity. This means a limited number of financial institutions is approached for capital after being selected with care and prescreened. Whether the number is five or 50, the confidentiality outweighs the slightly higher costs involved compared to a public placement. A company can keep its privacy, and need not expose its financial condition in the company, making competitors ravenous, and customers and suppliers nervous and jittery.

Among the advantages of alternatives to bankruptcy are:

■ **Company management most likely will retain more control over the company's destiny**. It is a mistake to assume that bankruptcy means total protection. Forces beyond the control of, and often deaf to the priorities of, management tend to take over. Bankruptcy judges increasingly have more discretion in choosing the path the company will take. In addition, any current bondholders now have an open forum, thanks to the court system, to present their case for protecting their own interests first.

■ **The company can have more flexibility.** Financial institutions with experience and interest in investing in troubled companies allow the company to offer terms and conditions that provide more room to maneuver.

■ **Potential sources of additional capital are in place**. Financial institutions that make an active decision to invest in troubled companies understand that additional funding may be necessary one or two years down the road, and they should be more amendable to providing additional capital the company needs.

■ **Access to sophisticated advisors is provided.** The company can benefit immeasurably from the extended network of resources available through association with investors in troubled companies.

Companies for whom it is appropriate to take advantage of refinancing avoid it for a number of reasons. For instance, management may hope and pray for a good quarter or two to pull them out of a financial hole, even if this is unwarranted. Inertia is another reason. The company, stuck in a pattern of behavior, procrastinates until a crisis stares them in the face – the worst possible time to make a financial decision.

Sometimes, management adopts a plan, which falls through, and has no "Plan B" as a back-up strategy. For example, a privately-held company counting on an initial public offering to raise capital to bail its way out of financial trouble may be left out in the cold if the IPO market closes down, as it does periodically. However, if the company had retained an investment bank to obtain a private placement as a back-up plan, the necessary funds would have been available regardless of IPO market forces.

Privately-held companies often do not have a realistic view of their company in the marketplace, since they lack the specific guidelines for accountability to shareholders that public companies have.

A publicly-held company facing a serious cash drain need not necessarily file for bankruptcy. If management heeds warning signs early on, it can seek to secure proper financing through a rights offering before a potential problem looms into a disaster.

Stay in Control – Be Prepared.

The success of any strategy depends on the willingness of management and its attorneys to face signs of trouble early on, and to put into place contingency plans for raising alternative sources of cash.