PRACTICAL CONSIDERATIONS BEFORE FILING BANKRUPTCY

SIMON R. MAYER
Locke Lord LLP
600 Travis St., Suite 2800
Houston, Texas 77002
simon.mayer@lockelord.com

The University of Texas School of Law
33rd Annual LLC's, LPs and Partnerships
July 11-12, 2024
The Otis Hotel Austin, Austin Texas

Practical Considerations Before Filing Bankruptcy

A discussion of practical considerations for business lawyers and their clients when the client's business is facing financial perils.

I. Introduction

When a client's business is struggling and unable to meet its financial obligations, bankruptcy may be the best option. Bankruptcy offers a shield from unsatisfied creditors and can provide a company the breathing spell needed to right the ship and reorient the business and its finances. Bankruptcy can thus provide the struggling client with a "fresh start", or it can be a more effective way to liquidate the company's assets. However, filing for bankruptcy is not a decision to be taken lightly or by the uninformed. Filing a bankruptcy case without adequate information and planning can place a company or their owners in a worse situation, and any company contemplating a bankruptcy filing should consult with knowledgeable bankruptcy counsel. However, the company's business counsel can play a major role in identifying and evaluating the issues that should be considered prior to filing bankruptcy. Taking the time to assist the client with conducting the necessary due diligence is critical to making the correct determination of whether to file bankruptcy, and if a filing is necessary, to positioning the company strategically so that it is able to obtain the best outcome possible under the circumstances.

This paper focuses on what business counsel and their clients should consider when a company is in financial peril and considering bankruptcy. The earlier this evaluation is initiated, the more likely it will be that the company is able to identify and implement a plan to avoid financial collapse or, at the very least, reduce its severity. Time is of the essence. A key to successfully navigating financial peril is having the foresight to recognize the approaching tough times and to identify and implement corrective measures with sufficient time before the company becomes insolvent. The single most important indicators as to whether a company will be able to successfully navigate and emerge from bankruptcy is whether the distressed company recognizes early enough in the process—before insolvency—that it is in or approaching financial peril and can identify corrective measures and timely implement them.

II. Primary Drivers of Financial Distress – Identifying When a Bankruptcy Consult May be Needed

As business counsel, you are likely on the "front lines" of seeing when a company begins to experience financial distress. Frequently, however, the company may not completely understand the actual source or severity of its problems. One of the first tasks business counsel must perform, then, is to assess and identify the company's actual financial situation. Performing a thorough financial analysis with the client, which may include CPA and/or tax counsel as appropriate, can help identify the reasons for the company's financial troubles. Such an analysis includes examining the company's income statements, balance sheets and cash flow statements, and future projections. Identifying the cause of the financial troubles will be key to assisting your client to evaluate its options, mitigating its risks and, when necessary, taking corrective action.

Generally speaking, the sources of a company's financial distress can be grouped into the following three categories: (i) financial issues; (iii) operational issues and/or (iii) external factors.

1. Financial Issues

Financial challenges are the most common source of a company's distress. These challenges include cash flow problems, insufficient capital, and excessive debt. Cash flow problems can arise from poor collection of accounts receivables, poor financial management, and/or high operating expenses. They can also be the result of funds having been diverted to meet the needs of an affiliate or an equity holder. In each case, the company is left with insufficient liquidity to meet its financial obligations, which often results in insolvency. A company may find itself with insufficient capital if the client has underestimated operating costs of a startup or after a period of business expansion. The costs of the startup or the expansion often come due before the company realizes the financial benefits of those expenditures. If the company lacks sufficient capital to tide it over and no additional or new financing is available, such a situation can also eventually lead to bankruptcy. Finally, in today's world with increasingly high (by recent historical standards) interest rates, excessive debt can make it difficult for a company to repay its loans or refinance its existing obligations.

2. Operational Issues

Operational issues, including poor management decisions, can also play a significant role in a company's financial distress. These issues include inadequate or poor business management, poor or no forecasting or planning, inadequate decision making, and problems with the company's leadership, whether over the entire company or in a significant sector of the company. Operational issues may also include how the company is performing in the market (*see also* External Factors, below). This is particularly true when the company is operating in a highly competitive market, where the business may be unable to gain sufficient market share or to generate enough profits to remain a going concern. A company must also invest in keeping up with changing customer demand and industry trends. Failure to do so may lead to a gradual decline of market share and, ultimately, financial hardship.

3. External Factors

The third category consists of external factors outside the company's control that are causing financial distress. Examples include an economic downturn, such as a recession or slowdown, that can negatively impact customer demand, thereby reducing the company's revenues and profitability. New regulations or changes in the laws can also significantly impact the company's operations, increasing costs or reducing profits. Other external factors would include natural disasters and other unanticipated events, such as floods, hurricanes, fires, and pandemics (*e.g.*, COVID), all of which can lead directly to financial hardship.

Identifying the root cause (or causes) of the company's problems can give the business attorney the necessary information to properly advise the client as to the best options available to right the ship or, as may be appropriate, guide the company into a successful winddown. It will

Title search: Practical Considerations Before Filing Bankruptcy

Also available as part of the eCourse
2024 LLCs, LPs and Partnerships eConference

First appeared as part of the conference materials for the
33rd Annual LLCs, LPs and Partnerships session
"Preparing for a Bankruptcy"