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WORKING IT OUT

Turnaround lawyers help distressed companies—
and the companies to which they owe money.



By Jack Gordon

On its face, the term “bankruptcy lawyers” is a straightforward description of a specific legal practice. Some specialize either in corporate or personal bankruptcy, and some represent mostly debtors while others work mainly for creditors, but they’re all bankruptcy lawyers. Aren’t they?

On the corporate side, at least, the answer is, yes and no. “‘Bankruptcy lawyer’ is a term that confuses people,” says attorney Steven DeRuyter, a shareholder with Leonard Street and Deinar of Minneapolis. If you visit a doctor for an ailment, he says, the doctor might recommend a spectrum of treatments short of major surgery. For a company in trouble with its creditors, bankruptcy is an option amounting to surgery. “What I do,” DeRuyter says, “is work with distressed businesses to try to find solutions.”

He is not just using euphemisms. Neither are most attorneys who refer to themselves by such names as “turnaround lawyers.” By a margin of five or six to one, DeRuyter says, the majority of work he does for distressed corporate clients takes place outside of the court system in private “workouts” with creditors. That is to say, while he is, indeed, an expert in bankruptcy law, more than 80 percent of the distressed businesses he represents have not filed for bankruptcy protection. They hope to avoid the need.

Katherine Constantine, a partner at Dorsey & Whitney of Minneapolis, mostly works the other side of the table, representing banks, suppliers, and other creditors who are owed money by troubled businesses. She refers to herself as a corporate-restructuring lawyer; her clients’ interests often are best served if the debtor company does not file for Chapter 11 protection or get pushed into Chapter 7 liquidation.

John McDonald, a shareholder at Briggs and Morgan of Minneapolis, has represented debtor companies including Sun Country Airlines when it entered Chapter 11 shortly after the 9-11 terrorist attacks. His current clients are creditors, mostly major banks that lent money to commercial borrowers.

Whichever side of the fence an attorney works, McDonald says, “when the job is done properly, you really accomplish something. Either you right the ship, save jobs, and [emerge with] a productive company, or you get the assets into the hands of someone who can do something with them.”

BOOMING BUSINESS

It’s a thriving legal niche, thanks to the country’s economic woes. Last fall, Constantine served on the organizing committee for an

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annual two-day training event sponsored by the Minnesota State Bar Association. At the suggestion of the bankruptcy court, the 2009 program was split into two tracks, one for experienced bankruptcy lawyers and one for lawyers who have recently adopted the specialty. “The courts told us that there are so many new practitioners in the area that they wanted them trained,” Constantine explains.

Chapter 11 filings in the state have taken a significant jump in the past two years. The first 10 months of 2009 saw 83 filings, according to Lori Vosejпка, clerk of court for the U.S. Bankruptcy Court for the District of Minnesota. In 2008, the January-through-October figure stood at 57, not dramatically higher than same-period figures for 2007 (37) and 2006 (30). By year-end 2008, however, the number of filings jumped to 118, with more than 50 coming in December alone.

The numbers for late 2008 and early 2009 are skewed somewhat by cases involving multiple corporate entities run by investment swindler Tom Petters and Minnesota auto dealer Denny Hecker. But Vosejпка expected to see more than 100 filings by the end of 2009.

Assuming there are many more private workouts than formal bankruptcy cases, those numbers represent only a fraction of the work available for lawyers specializing in turnarounds, workouts, and restructuring.

When a client does wind up in bankruptcy court, the lawyer obviously runs the case. But otherwise, what is it, exactly, that these attorneys do?

MAKE IT WORK

“Businesses don’t call lawyers until they perceive a problem,” DeRuyter says. “I usually get called in when a bank or some significant creditor is saying, ‘If you don’t pay what you owe by such and such a time, we’ll sue, we’ll shut you down, we’ll take back our collateral.’”

Thomas Flynn, a shareholder at Larkin Hoffman in Bloomington, also works for companies that have run into trouble with debt. He says that clients sometimes call him only after they have gone through a predictable progression. First they try to get swing loans or other types of capital infusions “to see [them] through this rough patch.” Then they explore the idea of selling shares in the company. Then they wonder about selling the company outright. Investment bankers might enter the picture.

“Selling the company can be a good solution; sometimes I recommend it,” Flynn says. “But there are a million reasons why you can’t sell a company. I prefer to be called in earlier, before they’ve tried to sell it, but sometimes that’s the point when they see me.”

An attorney also might be recommended by (or might recommend) a local turnaround or workout consulting company, such as the Platinum Group of Eden Prairie or Alliance Management of Minnetonka, that attempts to make the troubled firm more viable and that may negotiate with its creditors.

Part of negotiating with creditors boils down to the exercise of common sense on both sides of the table, Flynn says. “You can’t get blood out of a stone. If I owe you money that I can’t repay, and you put me out of business, you’ll often get next to nothing. Some [creditors] seem amazingly ignorant of that, but most aren’t.”

Common sense is only a starting point, however. While turnaround consultants are far more expert than lawyers at finding ways to cut costs, increase sales, and otherwise strengthen a distressed business, neither consultants nor accountants “necessarily understand Chapter 11 all that well,” Flynn says. And Chapter 11—as in, “Here’s what will happen if we file”—is often what he calls the “baseline” in negotiations with creditors.

“People look at me funny when I say this, but it’s true,” he says: “At some point, when the numbers get big, it doesn’t mat-

ter what I owe you. I owe you \$10 million? You’re not going to get it. The only question is, how much can I pay?”

How does Chapter 11 become a key to answering that question? Though filing has drawbacks for a debtor, it is called bankruptcy protection for a reason. Suppose, Flynn says, that you have a prosperous business in Minnesota. You expand to Illinois. The expansion fails miserably. You’re stuck with a 20-year lease on a building in Chicago at \$1 million a year.

Subject to a thousand caveats (these are legal issues, remember), even though your Minnesota business is solvent you could file for Chapter 11 protection and reject the lease, limiting the landlord’s claim to one year of rent—that is, \$1 million, which the court might agree to let you pay over a period of five years at a low interest rate. This would save you about \$19 million.

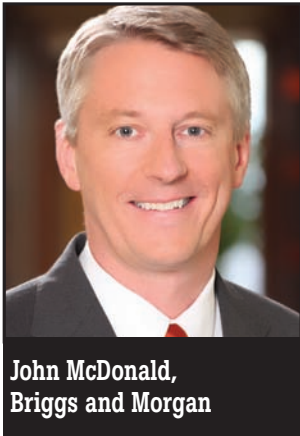
That’s what you will do if the Illinois landlord keeps demanding \$20 million. But you’re willing to pay more than \$1 million in order to avoid Chapter 11. “Now we have a baseline to talk about,” Flynn says. “Not \$20 million, but \$1.5 million or \$2 million, or whatever.”

So Chapter 11 can work as a debtor’s threat. But the negotiation often is not particularly adversarial, Flynn says: “Most workouts are more cooperative than you might think.” He estimates that more than 90 percent of Chapter 11 agreements are formed by “virtually unanimous” decisions between creditor and debtor. “It’s not about how to get out of paying debts,” he says. “It’s about maximizing value for everyone in a difficult situation.”

FINDING VALUE

McDonald says that a lot of businesspeople overestimate Chapter 11’s potency as a threat. In the first place, he says, the threat “only carries weight if you can show a bank that there’s a viable restructured company underneath here somewhere—and if you could convince a judge of the same thing.”

The type of business and the collateral involved has a lot to do with a creditor’s willingness to work things out with a borrower. Constantine observes that a manufacturing plant, for example, “typically has



John McDonald,
Briggs and Morgan

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more value as an ongoing concern than if you shut it down and sell it off piece by piece." A creditor might even put more money in to keep the company going "if it sees a bigger eventual payback."

On the other hand, she says, if a bank lent money to a real estate developer, taking as collateral a piece of property whose assessed value has since plummeted, "the land is still only worth X, whether the developer is in or out of bankruptcy."

The flavor of a workout also is "personality dependent," Constantine says. "When I represent a creditor who believes the borrower is forthcoming and honest, [negotiations] will have an entirely different tone and outcome than if the creditor believes the borrower is hiding the ball or trying to take advantage."

DeRuyter says that some borrowers who appear to be hiding the ball are merely ignorant of the way the process works. This is an area where a specialized lawyer can come in especially handy. "The company may try to paint too rosy a picture of its situation for the bank," he says. Or the debtor and creditor "might be talking two different languages: The bank needs a certain set of facts, the company tries to give it something else, the bankers say, 'They must be lying.' . . . We know how to get information from a client and present it in the way the lender needs to see it."

None of these attorneys expect their heavy workload to ease until the economy picks up considerable steam. "I think things will continue at this pace through 2010, at least," McDonald says.

In any recession, "you get a classic trailing effect," he says. The first wave of undercapitalized companies, or those in hard-hit sectors such as real estate, are swamped by debt shortly after a severe downturn. Stronger companies can hang on longer by downsizing, reducing inventories, and otherwise cutting costs. But as the recessionary ripples continue to spread, McDonald says, more businesses will find that they can no longer weather the economic storm. Until the storm abates, a lot of them will be looking for a turnaround lawyer. **TCB**

Jack Gordon is a senior writer for TCB.