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Bankruptcy Issues For Healthy Companies: What Creditors Face

The Editor interviews ***John L. Heller****, Director in the Advisory Services Division of Marcum LLP and resident in the firm's Fort Lauderdale, Florida office.*

Editor: Tell us about your practice, including your work in situations involving distressed companies.

Heller: I have 23 years of experience in accounting, tax and management related to insolvency, turnaround and related litigation issues. I am a CPA, a CFF (Certified in Financial Forensics) and a CIRA (Certified Insolvency and Reorganization Advisor) promulgated by the AIRA (Assoc. of Insolvency Advisors). I get involved in bankruptcy and restructuring matters from cradle to grave. If you were to equate troubled companies to sick patients, I would equate my roles to the emergency room doctor, the triage surgeon, the recovery room nurse and if things go bad, the undertaker.

Editor: Who are your clients in the bankruptcy context?

Heller: My client base consists of creditors, official committees of unsecured creditors ("Committees"), law firms, and bankruptcy panel trustees, with emphasis in debtor and fiduciary engagements. As a fiduciary, I've acted as the chief restructuring officer (CRO) in a bankruptcy, as a receiver outside of bankruptcy and as an assignee under the State of Florida bankruptcy statute. Within the Chapter 7 or Chapter 11 contexts, we may be hired as the financial adviser for the bankruptcy trustee.

Of recent note on the creditors' side, I managed Marcum's engagement as the financial advisor for the Committee on the recent Rothstein Rosenfeldt and Adler (RRA) bankruptcy, a $1.2 billion Ponzi scheme in the Southern District of Florida in which the creditors recovered 100 percent of their allowed claims.

Editor: What issues do corporate clients face as potential creditors in a bankruptcy matter? Do you encourage Committee participation?

John L. Heller

Heller: Creditors doing business with a prospective debtor face a number of issues. At some point the debtor, a liquidating agent, the Committee or a trustee may sue them for recovery of monies paid to them by the debtor, either during the 90-day period prior to bankruptcy (known as the "preference" period), or perhaps during a longer period depending on the debtor/creditor relationship. If I am consulted early enough I can help a creditor mitigate potential damages as a result of alleged preference payments.

The decision about Committee participation depends on the facts and circumstances of the debtor/creditor relationship and the specific financial impact of the bankruptcy to my client. We do a cost-benefit analysis regarding the allocation of a manager's time, either to unpaid participation on the Committee or to uninterrupted focus on the company's current issues and revenue-generating activities. If a small receivable is involved, especially in proportion to overall sales and A/R, Committee participation may not be optimal. This is especially true if other similarly situated creditors have higher exposure and, therefore, a greater interest in the outcome. Alternatively, if my client is owed 20 percent of its A/R or last year's sales, I may advise Committee participation, either to maximize a financial recovery or, more often, to ensure that the debtor-customer survives as a going concern for the benefit of the creditor.

Editor: What creditor issues do you handle on the litigation side?

Heller: Creditors may face a demand or a lawsuit about a preference payment. The typical response is to assert simply that goods were sold and paid for, but it's not that easy. The preference law involves an arbitrary timeline per a legal theory dating back to Queen Victoria. It states that 90 days prior to a bankruptcy, the debtor is presumed insolvent; thus, provisions are made to ensure that all creditors are treated equally. Creditors that were paid within the preference period are asked to return the money.

Now there are defenses to a preference action. For instance, the "ordinary course" defense asserts that a preference payment must occur outside of the ordinary course of business. If the creditor/debtor relationship can show continuing operations in accordance with established payment terms, even if they exceed the standard 30 days, and if the creditor continues this practice during the preference period, then the ordinary-course defense is available. We provide the required analysis on historical payment methods from the creditor side to mitigate and defend the preference action. Additionally, the timing of the delivery of goods during the preference period for which the debtor does not remit payment also leads to certain "new value" defenses.

Editor: Do you serve as an expert witness in the bankruptcy courts?

Heller: Yes. Preferences tend to be settled more often through mediation or direct negotiation, sometimes out in the hall on the day of trial. Very rarely does the expert actually testify, but I've written many reports and have taken the stand a number of times, both in pursuing and defending preference actions.

More commonly, this work pertains to "fraudulent transfer" actions, which are subject to a two-year statute under the Bankruptcy Code and up to a five-year statue under state regimes. Fraudulent transfers come into play when it is determined that

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(1) a debtor was insolvent going back the requisite number of years on a fair-valuation or balance-sheet test and (2) the creditor and debtor have an "insider' relationship, which means the creditor was exercising significant influence over the debtor during those years. This alleged insider may be a bank or a major supplier, and the determination of insider status will consider whether, for the purpose of setting a credit limit, the creditor was given financial information by the debtor or was engaged in direct conversations with management on a weekly or monthly basis beyond that of a typical debtor/creditor relationship.

If so, the Committee or liquidating trustee may deem a creditor an insider and seek to recover payments by the debtor to the creditor/defendant going back two to five years, depending on the applicable statute. Here, I will opine about the insolvency of companies and when they went insolvent. We often can demonstrate that the debtor was not insolvent for the entire period, but rather for a much shorter period, which decreases the "insider" creditor's exposure significantly. Additionally, I assist the creditor/defendant with the recovery of documents that assist counsel with neutralizing the insider allegation. We get involved in those situations and help creditors defend the actions.

Editor: What valuation methods are used to make insolvency determinations?

Heller: The common method for determining insolvency is the balance-sheet test, but sometimes, and under certain state laws, there's a second valuation based on the servicing of debts. It's not so much a valuation of the business itself, but rather a net-asset-value in the first instance and essentially an income-statement valuation relating to whether a debtor is paying its debts as they come due in the second instance.

The purpose of this exercise is to determine how far back a company is deemed to be insolvent and stop the clock on a creditor's exposure or liability. Remember, during the 90-day period, the debtor is presumed by law to be insolvent, but beyond that the debtor and creditors will use experts to present their cases for justifying the date of insolvency. It all goes to determining when a fraudulent transfer claim can be made against a creditor.

Editor: What is the role of forecasting and budgeting?

Heller: In a Chapter 11 proceeding, the debtor's assets that represent the security interest of a secured lender must be preserved. If the debtor wants to continue to operate post-filing, it must get a "cash collateral order," which involves submitting a budget that convinces the court that continued operations will not diminish the secured creditor's collateral. In short, the debtor can continue to operate only if it remains profitable.

We often help the debtor's management team with preparing the cash collateral budget, which we present and justify before the court. The courts usually allow about 60 days before requiring a progress report from the debtor. Thus our job requires constant updates about current and projected performance to prove that the interests of secured creditors are not being eroded beyond where they stood when the bankruptcy filing occurred.

We also help Committees that want an objective accountant, both to review and test the cash collateral budget and to advise about its objectivity and reasonableness. Certainly, this has a big impact on the potential recovery.

Editor: I understand that Marcum offers premier forensic services.

Heller: We do. It's important to note that only a small percentage of bankruptcies occur as a result of political or economic developments beyond the debtor's control. The vast majority of insolvencies happen because of misguided decision making, for instance, a debtor failing to downsize in response to current and foreseeable external and internal developments in order to maintain profitability. Moreover, some cases involve frauds and planned mismanagement, such as within a Ponzi scheme, which includes hiding money and destroying records. Here, we dive deep into the forensic analysis and reconstruction of books and records. Marcum has a dedicated computer forensics division that preserves and images the core debtor computers, electronic mediums and even phones, and further investigates the documents, emails and electronic files contained therein to identify and locate hidden funds. Then we go after the banks to recover that money. Financial advisors are critical in this context, so it's not surprising that we do significant work in this area.

Editor: You mentioned the Ponzi scheme in the RRA case. How did you deliver an extraordinary 100 percent recovery for unsecured creditors?

Heller: First, I will say that the trustee did an outstanding job. Beyond that, we essentially determined that some deep-pocket banks had made fatal errors, and we were able to recover enough to make all of the investors whole. Commonly, our work in bankruptcy matters involving Ponzi schemes also includes securing clawbacks from investors that either made money outright or recovered a suspiciously high proportion of their original investments before the bankruptcy. In this context, we also identify who are the "net winners" or even the "net losers," meaning investors who figured it out before the filing and took back some or all of their money. There were a few significant clawbacks in the RRA case, but much of that recovery came from the banks.

Editor: How do your services translate to the negotiating table?

Heller: In the CRO context or as a financial advisor in a turnaround situation, we actively engage in negotiations. Generally speaking, creditors are in a better position because they are healthy companies with an experienced credit manager or CFO who understand the business and industry and can make informed decisions about (1) whether they are willing to accept a small recovery because they want the debtor to emerge as a going concern, thereby preserving a future revenue stream, or (2) whether they want to stand on principle and push for a full financial recovery. We are here to provide guidance in those situations.

The interesting thing about bankruptcy matters is that once they are initiated, the books are very open to the creditors. But prior to a bankruptcy, if a creditor suspects that there has not been a full and honest disclosure of the debtor's financial condition, trust issues arise. We often step in to ferret out the issues and ensure that creditors are working with accurate information as they make important decisions about the debtor and impairment of their receivables, both pre- and post-bankruptcy.

Editor: Let's close with some comments on responsive service, a hallmark of Marcum LLP.

Heller: Marcum has a deep and robust advisory department. We know that bankruptcy matters happen suddenly and are extremely time sensitive, and with boots on the ground in eight states nationwide as well as throughout China, we can assemble the right team, from partners to staff members, in all situations. I'm only partially kidding when I say that our best strategy for getting involved in billion-dollar cases is to plan a family vacation over a long weekend because, inevitably, on that Friday at about 4:45 p.m., the call will come in – and we will respond.