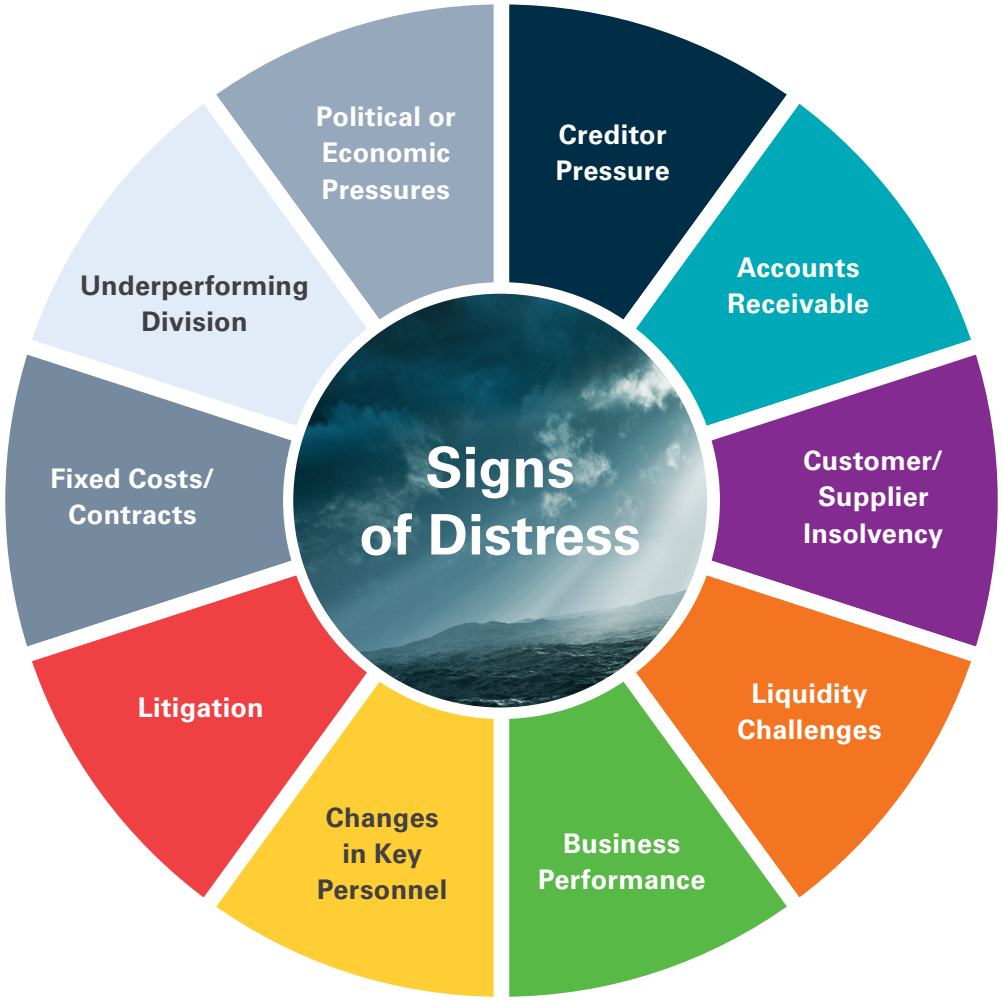
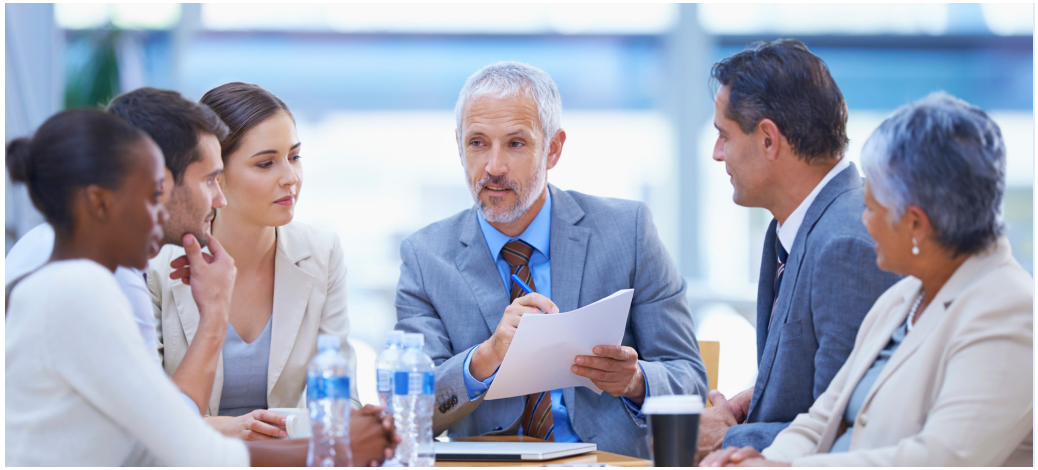
SQUIRE PATTON BOGGS

How to Identify Distress in Your US Business and Companies You Do Business With

April 2022





Identifying Distress

Identifying distress in your own business or those with whom you do business is vital to ensuring its financial health.

Some distress indicators are due to external circumstances beyond the control of management, but nevertheless can pose a threat to the ongoing success of the business, others are internal, indicating that management may need to make operational or financial changes.

A company, through no fault of its own, may find that it is facing distress and management should consider whether it is appropriate to take action to address that distress, considering both the informal and formal options outlined in this quick guide, alongside the duties of the company's officers and directors.

Where there are signs of distress, seek advice early because there are various options that management may explore that can support the financial health of the business and avoid greater distress and potential insolvency.

This note is intended as guidance only and should not be relied on as legal advice. Should you require advice in relation to your own specific circumstances then please contact one of our team whose contact information is at the end of this guide.

Signs of Potential Distress

There are a number of signs that a business or those it does business with may be in distress. The following are some common factors and indicators to consider when analyzing the strength of a business.

Creditor Pressure

Increasing pressure from creditors is one of the more obvious signs of distress.

If a business is taking longer to pay its creditors, this could be an early sign of potential cash flow problems. Some of the biggest creditors of any business are the taxing authority, so failing to pay tax on time and falling behind with payments to key creditors are early indicators of distress.

Creditor pressure is more obvious if a business is receiving or subject to demand letters, collection letters, litigation, judgments related to unpaid amounts, or involuntary bankruptcy petitions.

Accounts Receivable

A good cash flow can soon turn into a poor cash flow if a business' own customers fall behind with payment. If accounts receivable are slipping, how will this impact the business and what can be done to reduce that slip?

Insolvency or Loss of Major Customer or Supplier

Is the business dependent on a major customer or supplier?

A perfectly healthy business can face acute problems if, without warning, it loses a key customer or supplier and it does not have a contingency plan in place to address those challenges.

Liquidity Challenges

A business may be asset rich but cash poor, making it difficult to meet cash requirements. Revenue may be based on seasonal trends that have perhaps underperformed. The business may be waiting on a large payment that is overdue before it can satisfy its own liabilities. Does the business have sufficient room in its credit facilities to cover substantial unexpected expenses?

Business Performance

If demand for goods and/or services is slowing, it is important to identify this and understand why.

Are orders slowing down or inventory levels increasing? What is happening in the market? Are you keeping up with emerging trends or what your clients or customers need? What changes can you can make to the business that can address any slow-down? Is this just temporary, and can the business survive any down period?

Are key suppliers falling behind with deliveries? Are delivery dates being missed or deliveries late? What impact is this having on the business? If supplies are arriving late, is the business able to manage its own contractual commitments?

Changes in Key Personnel or Management

The loss of a critical employee or disputes at board level can have a serious impact on any business.

Litigation

Litigation or another dispute with a landlord, supplier or customer can cause distress in a number of ways, i.e., it could delay payments coming into the business, prevent timely delivery of supplies, or increase costs. If the litigation or other dispute escalates or persists, this is likely to lead to higher costs, as well as more immediate pressure on cash flow.

Fixed Costs/Contracts

Is the business tied into a long-term supply contract where margins are becoming increasingly tight? Are fixed costs, such as rent, no longer at market rate?

Underperforming Division or Business

Is part of the business underperforming or starting to show signs of deteriorating performance? What impact will this have on other more profitable parts of the business? Can losses from an underperforming business unit be sustained, or should steps be taken to insulate the "good" parts of the business?

Political and Economic

Most businesses have felt some pressure during the COVID-19 pandemic and are now seeing pressure from other areas, such as supply chain issues, employee shortages and rising energy costs. These pressures may have a direct impact – being aware of the pressure they are placing on the businesses and people you do business with can be key to avoiding some of the other distress indicators described in this guide.

If a Business Is Facing Distress, What Options Are There?

There are a number of options and avenues that a business can explore when faced with distress. Depending on the circumstances, a combination of these could be appropriate to help mitigate or avoid a distressed scenario.

This guide does not contain a definitive list of all potential options, and for officers and directors that are concerned that their business is in distress, they should consult with their legal and financial advisors.

Informal Options

Even when informal options are being considered, officers and directors should engage with their advisors and stakeholders to ensure that their decisions take into account their fiduciary duties.

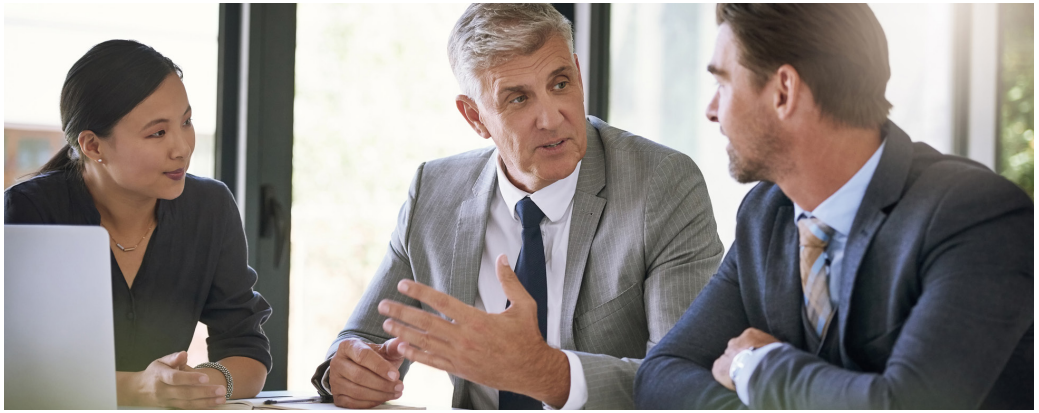
It is critical for officers and directors to be aware of their various fiduciary duties as they are managing a distressed business.

Managing Cash Flow/Balance Sheet

- Negotiate with landlords and key suppliers
- Negotiate with taxing authorities
- Review key contracts and supply agreements
- Restructure the workforce
- Agree to informal or formal compromises with creditors
- Close unviable operations or sell underperforming divisions
- Tighten collection processes

Finance

- Increasing existing facilities
- Easing reserves
- Invoice factoring
- Private equity funding
- Refinancing
- Asset-based lending
- Debt for equity swaps



Managing Cash Flow/Balance Sheet

Landlords, Key Suppliers and Other Creditors

Depending on the longer-term cash position of the company, negotiating a payment plan or asking for forbearance from landlords, suppliers and/or other creditors can provide a solution to temporary cash flow problems.

If a business is temporarily cash strapped, a short "breathing space" may enable the business to manage the position. However, management will need to consider whether extending payment terms or agreeing a period of non-payment is the right thing to do. Informal arrangements can ease pressure, and may not need to be formally documented; however, if they only delay the problem, then they might not be the optimum solution.

There are several ways to restructure payment obligations, for example:

- **Landlords** – Agreeing to monthly instead of quarterly rent payments; renegotiating rent; can the company negotiate a surrender of any leases if the company's real estate footprint has reduced?; or could it exit over rented premises and agree something at market rate?
- **Suppliers** – Renegotiating contract terms, agreeing to a repayment plan or having a longer time to pay.
- **Creditors** – Agreeing a repayment plan, compromising outstanding debts, or offering.

Taxing Authorities

If a business has accrued tax liabilities that it cannot pay on time, various taxing authorities may agree to payments over time. However, it is important for a business to engage early with taxing authorities. It is also critical that a business be aware of its obligations with respect to trust fund taxes such as sales tax receipts, which must always be remitted.

Employees

- Can the business restructure its workforce and thereby reduce overheads? The employee needs of many businesses have changed as a consequence of the pandemic and continue to do so.
- If the business is overstaffed, then restructuring the workforce could provide a straightforward cash flow solution.
- You should consult with employment counsel prior to restructuring or reducing your workforce to ensure compliance with all local, state and federal requirements.

Accounts Receivable

- Ensuring that the business has robust credit control procedures in place will ensure that it keeps on top of delinquent debtors, recovers receivables on time and can take swift action, if necessary.
- Keeping an eye on a customer's performance (are they slipping?), and checking credit ratings and how the company's customers are performing, will help inform whether a company should take formal action to recover unpaid accounts receivables before the debt becomes a "bad" nonrecoverable debt.
- Consider whether credit insurance is an option, or whether there are guarantors from whom the businesses can recover payment? Or can the business request a guarantee to protect against a bad debt? Does it have or can it obtain security that it could enforce if the debt is unpaid?

Close Unviable Operations or Sell Underperforming Divisions

Is there one part of the business that is underperforming and having an adverse impact on otherwise profitable parts? A solution might be to close or sell that part of the business to ring fence and protect the rest.

Supply Chain Mapping

- Mapping supply chain (looking at the business' suppliers, their suppliers and so on) enables a business to identify risk areas that might impact the viability of its own business, and then enable it to devise a plan to manage/reduce risk.
- A plan could help manage supply shortages, surges in demand or something more unexpected (a global pandemic, for example).
- Consider such things as dual or local sourcing and auditing your own suppliers' financial health alongside reviewing supply contracts to ensure they contain adequate termination rights, allow the business to move suppliers or even provide for greater monitoring and reporting requirements.

Retention of Title (ROT)

Review contracts with key customers to ensure they contain a retention of title clause (and that it is incorporated into the contract). A good ROT provision can put the business in a strong position if customers do not pay to recover unpaid goods and re-sell them or, if the customer enters an insolvency proceeding, an enforceable ROT usually puts the business into a better position to negotiate a payment.

Finance

There are various options depending on the circumstances and needs of the company, although if the business is in distress, directors should consider these options in light of directors' duties and in conjunction with advisors.

Existing Lenders

There are a number of options that a business can explore with its existing lenders. Those might include increasing its existing facilities, extending overdrafts or extending payment terms, or agreeing a period of forbearance.

New Lenders

Refinancing could enable existing debt to be refinanced with more favorable terms, such as lower interest rates or extensions on payment periods.

Additional Finance

The business may be able to raise additional funds against its assets by raising finance secured against stock, equipment, machinery, property, etc.

Similarly, the business could look to raise additional cash through private equity funding, loans from directors or third parties injecting funds into the business.

Part of the company's business or assets could also be sold to raise capital.

Some businesses could also benefit from invoice discounting.

In simple terms, factoring involves a business "selling" their invoices to a third party at a discounted rate. The factor will advance an initial cash payment to the business, and then collect the debt before accounting to the business for the balance of the invoice, less an agreed percentage for its collection fees. Invoice discounting is similar but often cheaper to arrange than factoring. The business will receive a cash payment against outstanding invoices, but the business will remain in control of debt collection. Although the business will receive less than the full invoiced amount, both types of finance enable a quick injection of cash into the business.

Formal Options

An insolvency proceeding is a last resort, but if efforts to stabilize the business and ensure its viability are not successful, or it is simply too late in the day to rescue the business, then officers and directors generally have a duty to consider whether the business should enter an insolvency proceeding. The decision about which one should be made in conjunction with the company's legal and financial advisors.

- Voluntary dissolution
- Chapter 11 bankruptcy reorganization
- Chapter 7 bankruptcy liquidation
- Assignment for the benefit of creditors

Voluntary Dissolution

As business operations come to an end, financially distressed companies seek to maximize the value of their assets for distribution to creditors. While a Chapter 7 or Chapter 11 bankruptcy might be an appropriate means of liquidating a company, a voluntary dissolution can, depending on the circumstances, be better suited to achieve this goal.

Advantages over bankruptcy:

- Often more efficient and less costly than a Chapter 11 or Chapter 7 liquidation.
- Afford the business more control over the liquidation, claims resolution and asset distribution as compared to Chapter 7 bankruptcy, which involves trustee oversight.
- Require shareholder approval rather than creditor approval, which can make it a better fit for private companies.
- Offer more privacy, as bankruptcies require extensive disclosures.

Corporations often elect to dissolve when they:

- Anticipate being able to pay creditors in full and return some funds to shareholders.
- Are insolvent and their creditors are willing to work with the corporation to liquidate the assets without a foreclosure.

For the latest updates on managing business risk, please subscribe to ***Restructuring GlobalView***.

Chapter 11 Bankruptcy Reorganization

Chapter 11 of the Bankruptcy Code provides a procedure that allows a company to continue operating its business while it either formulates a plan of reorganization with its creditors or liquidates its affairs. It is available to most corporations, partnerships and limited liability companies, as well as to foreign companies recognized under Chapter 15 with assets in the US.

Advantages

- Automatic stay will pause all creditor actions against the company.
- The company will be afforded the time necessary to attempt to restructure or liquidate.
- Allows for the sale of assets "free and clear" which can expedite the sales process and result in a higher sale price.
- Enables the debtor to reject onerous executory contracts and unexpired leases.
- Can recover payments and avoid certain liens.
- Special provisions to allow for the reorganization of small businesses.

Disadvantages

- It can be an expensive process.
- While the debtor's management remains in control many actions are subject to court approval.
- There is a loss of confidentiality and increased reporting and disclosure requirements.
- There is a greater risk of complete loss to equity.

Chapter 7 Bankruptcy Liquidation

A chapter 7 bankruptcy liquidation is generally disfavored by business as management will immediately lose all control over the business. Upon commencement of the case, all business will immediately halt and all employees will generally be dismissed. The court will automatically appoint a chapter 7 trustee to assess the condition of the company's assets to determine whether it should be sold as a going concern or liquidated in parts. Either way, the trustee will proceed to administer the liquidation, run a claims process (if applicable) and wind down the operation.

Assignment for the Benefit of Creditors

An assignment for the benefit of creditors (ABC) is a common law or statutory alternative to a chapter 7 bankruptcy liquidation. Through an ABC, the debtor's assets are liquidated in an orderly fashion for the benefit of creditors of the debtor's estate.

An ABC is governed by statute in most states and can either be court-supervised or conducted outside the court process. Many states have codified the ABC process by statute and the rules governing ABCs can vary widely from state to state.

Despite the similarities between an ABC and a Chapter 7 bankruptcy case, there are significant differences, including that:

- An ABC does not provide the debtor with a discharge.
- An ABC does not afford a debtor an automatic stay from creditor collection and enforcement activities.
- A sale in an ABC does not provide the purchaser with the right to purchase the assets free and clear of liens, claims and encumbrances.

Contacts

Stephen Lerner
Partner, Cincinnati and New York
T +1 513 361 1220
E stephen.lerner@squirepb.com

Nava Hazan
Partner, New York
T +1 212 872 9822
E nava.hazan@squirepb.com

Norman Kinel
Partner, New York
T +1 212 407 0130
E norman.kinel@squirepb.com

Karol Denniston
Partner, San Francisco
T +1 415 393 9803
E karol.denniston@squirepb.com

Travis McRoberts
Partner, Dallas
T +1 214 758 1589
E travis.mcroberts@squirepb.com

Kelly Singer
Partner, Phoenix
T +1 602 528 4099
E kelly.singer@squirepb.com

Mark Salzberg
Partner, Washington DC
T +1 202 457 5242
E mark.salzberg@squirepb.com

Jeffrey Rothleder
Partner, Washington DC
T +1 202 457 6462
E jeffrey.rothleder@squirepb.com

Peter Morrison
Partner, Cleveland
T +1 216 479 8712
E peter.morrison@squirepb.com

Christopher Giaimo
Partner, Washington DC
T +1 202 457 6461
E christopher.giaimo@squirepb.com