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The Deception In Balance Sheet And Liquidation Analysis

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One of the many things that a credit executive reviews in analyzing the risk of nonpayment by a customer is the customer's balance sheet. As a bankruptcy attorney, I have learned that balance sheets and liquidation analyses can be very deceptive and that value is much more of an art than a science.

There are certain liabilities that do not show up on a balance sheet. Therefore, when preparing a liquidation analysis ("How much will I recover in a liquidation of the customer?"), one must be conscious of claims that arise in or as a consequence of bankruptcy, liquidation or on account of discontinuation of the customer's business. These "springing" claims can be either senior to the claims of general unsecured creditors or they can severely dilute (by sharing in the distributable funds) the percentage recovery that unsecured creditors would otherwise receive. Whether the numerator is reduced or the denominator is increased, the percentage recovery to general unsecured creditors declines.

One category of claims are those arising under the Workers and Retraining Notification Act, commonly referred to as the WARN Act. Generally, WARN Act liabilities are claims of employees for compensation to the extent that the employees were terminated with less than 60 days' notice. WARN is a federal law. Many states have their own version of the WARN Act and include longer notice periods. And, certain exceptions to the federal WARN Act may not be applicable under state law. An example is that, under federal law, there is an exception for employee terminations due to events that could not reasonably be anticipated. The exception does not apply in several states' versions of the WARN Act.

Additionally, if the WARN notice was given to employees after the date on which a bankruptcy petition is filed, then the claims of the terminated employees may have administrative status ("paid off the top") in the bankruptcy case — which means that the claim has a higher priority of payment than claims of pre-bankruptcy general unsecured creditors. Trade creditors typically are general unsecured creditors without priority status. Whether the WARN claim is equal in status to general unsecured claims or senior to general unsecured claims, it is dilutive of the dividend paid to general unsecured creditors and would not show up on a balance sheet of a distressed customer. Some debtors will avoid giving timely WARN notification because of the potentially damaging effect that it has on the business. Failing to provide the requisite notice risks reducing the recovery for unsecured creditors in the event of bankruptcy because larger WARN claims arise.

Another item that may not be on a balance sheet is the true extent of environmental liabilities. When a debtor ceases operations, cleanup obligations that would not have been triggered if the debtor continued operating may arise. And, the cleanup cost associated with a sale or foreclosure of the debtor's property can be much greater if the intended future use is different from the debtor's prior use. Normally a debtor will only carry on its balance sheet liabilities associated with environmental obligations that are required to be recorded by contract, law or regulation. Many environmental obligations (contingent liabilities) that arise upon cessation of business are not required to be booked. These claims may not only be significant but can have a priority for payment that is senior to general unsecured claims. Therefore they dilute the recovery.

Another form of liability not on a balance sheet, but which is dilutive in the event of bankruptcy, are contract rejection claims — claims for damages arising out of the termination of a lease or contract during the bankruptcy case. For retailers that "reject" (terminate/disavow) real property leases in bankruptcy, the landlord's damages can be as much as one year's rent. For a retailer with many stores to close, lease rejection claims can overwhelm the claims of trade creditors. In order to properly assess the balance sheet of a retailer, it would be necessary to determine the number of leases that are above market, the number of leases that are below market, and the estimated sale value of the below-market leases. Leases of photocopiers, fax machines, trucks, automobiles, machinery and equipment are treated similarly — termination triggers damage claims that inflate the pool of general unsecured claims.

Of course, the "flip side" of lease rejections and of lessor damage claims is valuable, below-market real estate leases. In bankruptcy cases, leases are assignable despite lease provisions that expressly prohibit tenants from assigning the lease. There is a market for the sale of below-market real estate leases. In fact leases for locations in shopping areas that are in great demand may sell at a premium above the present value of the differential between fair market rental stream and the contract rental stream. Leases may be valuable assets that do not show up on a balance sheet and, therefore, should be considered in a liquidation analysis.

For some industries such as supermarkets, the value of a retail lease is not simply a function of comparing contract rates to current market rates. For operating supermarkets, the profitability of the store on a four-wall basis (despite the lease being at or above market) also is a key factor.

Of course, even if a retailer has a portfolio of leases at or above market, the lease portfolio nevertheless may have value to another retailer that sees the opportunity to build instant critical mass with lesser legal, negotiating and search costs.

In the world of bankruptcy and low interest rates, underfunded pension obligations have become common. The Pension Benefit Guarantee Corp., which guarantees many pension obligations, frequently is the largest unsecured creditor in a bankruptcy case. This potential liability usually either is absent or is understated on a balance sheet.

Intellectual property is another asset category where the value identified on a balance sheet is generally not reflective of actual value. Overvaluation is more likely where intellectual property was developed in-house or is the product of generations of business use.

Does the debtor have an unrealistic view of the value of its intellectual property? Does the debtor fail to recognize that its brand's glow has faded? The liquidation value asserted by a distressed debtor is subject to "debtor syndrome" — aka "Our patents, copyrights and trademarks must be worth a lot of money because we have been in business for so long and everyone knows us." Graveyards are full of formerly iconic brands.

Polaroid, Sharper Image, Loehmann’s, Memorex, Twinkies, Hostess and Prince Tennis are iconic brands that come to mind where "IP" was a significant element of value. In bankruptcy cases, there has developed an industry in which investors purchase intellectual property and utilize it to sell products that were not previously associated with the brand. Any brand with consumer recognition may have value regardless of whether the debtor has ceased operating. A recent example is Polaroid-branded televisions, which are available for sale at Target stores.

It is very difficult to determine the value of intellectual property and what it is likely to sell for in Chapter 11. One example is the iconic name “Loehmann’s,” which operated retail clothing stores in the metro New York area for generations. Yet it sold in bankruptcy only for $850,000. Was the name simply not worth more because consumer tastes shifted or did it sell for a relatively low price because of market conditions, such as being sold in a bankruptcy proceeding? On the other hand, the Hostess case (Twinkies, Wonderbread, Ringdings, Devildogs, Yodels) is an example of intellectual property having underrecognized value. Either way, intellectual property values are subjective and highly speculative.

Companies that have been in business for long periods of time may have patents and other intellectual property that they no longer use in connection with current business operations or which can be utilized for purposes that do not compete with the debtor. In a bankruptcy proceeding (and also in an out-of-court restructuring), the question is whether the debtor is fully exploiting its intangible assets. Underutilized or underexploited intellectual property is value that does not appear on a balance sheet. A debtor may use its intellectual property every day in the routine operation of its business. But, can it license the use of a patent to a user that makes a product that does not compete with the debtor and thereby generate additional revenue? Or, does the debtor have in its portfolio intellectual property assets that it no longer uses and which are no longer necessary for its strategic plan? Such assets may be sold and yield significant recoveries.

In evaluating credit risk and performing a liquidation analysis, the prudent credit executive takes into account much more than outside-of-bankruptcy going-concern asset values. Bankruptcy negatively impacts asset values except in relatively few industries where the customer purchases goods or services without much lead time and where the unexpected unavailability of a product from a failed debtor will not harm the business of the debtor's customer. For most companies that enter Chapter 11, bankruptcy is costly — not just in terms of professional fees. It also is costly in terms of the value of time that management must devote to the bankruptcy case (dealing with counsel, responding to creditors committee demands and objections, assuring vendors, assuring customers and dealing with secured lenders). There also is an economic impact on the business resulting from management diverting a portion of its time (time better spent on managing the company) to the Chapter 11 process.

Plus, there is the often-unquantifiable cost that is measured in terms of decline in asset value when assets are sold in the context of bankruptcy. Often, assets of a business in bankruptcy are sold based upon cost or liquidation value rather than a multiple of earnings. While a turnaround consultant, chief restructuring officer or company executive may be able to present a cogent plan to restore revenue and earnings, the incremental value from a turnaround normally fails to reach creditors of the debtor. One reason is that Chapter 11 cases have now become abbreviated partially because secured creditors prefer a quick sale or peaceful surrender of their collateral rather than giving a Chapter 11 debtor time within which to restore value for its other creditors. Consequently, assumptions as to likely values received in a sale in the Chapter 11 context must take these factors into consideration.

In analyzing downside risk, a prudent creditor must take into account much more than stated asset values and stated liabilities. Bankruptcy, liquidation and closure may trigger large claims that would not exist or are not required to be stated on financial statements outside of bankruptcy. And, bankruptcy triggers a scheme of priority that does not exist out of court. Balance sheets are good places from which to begin analyzing sources of value and potential recoveries, but they are only a place of embarkation. Intended use, market conditions, regulatory requirements, applicable law, and contingent assets and liabilities all must be accounted for in assessing potential recoveries of a distressed debtor.

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