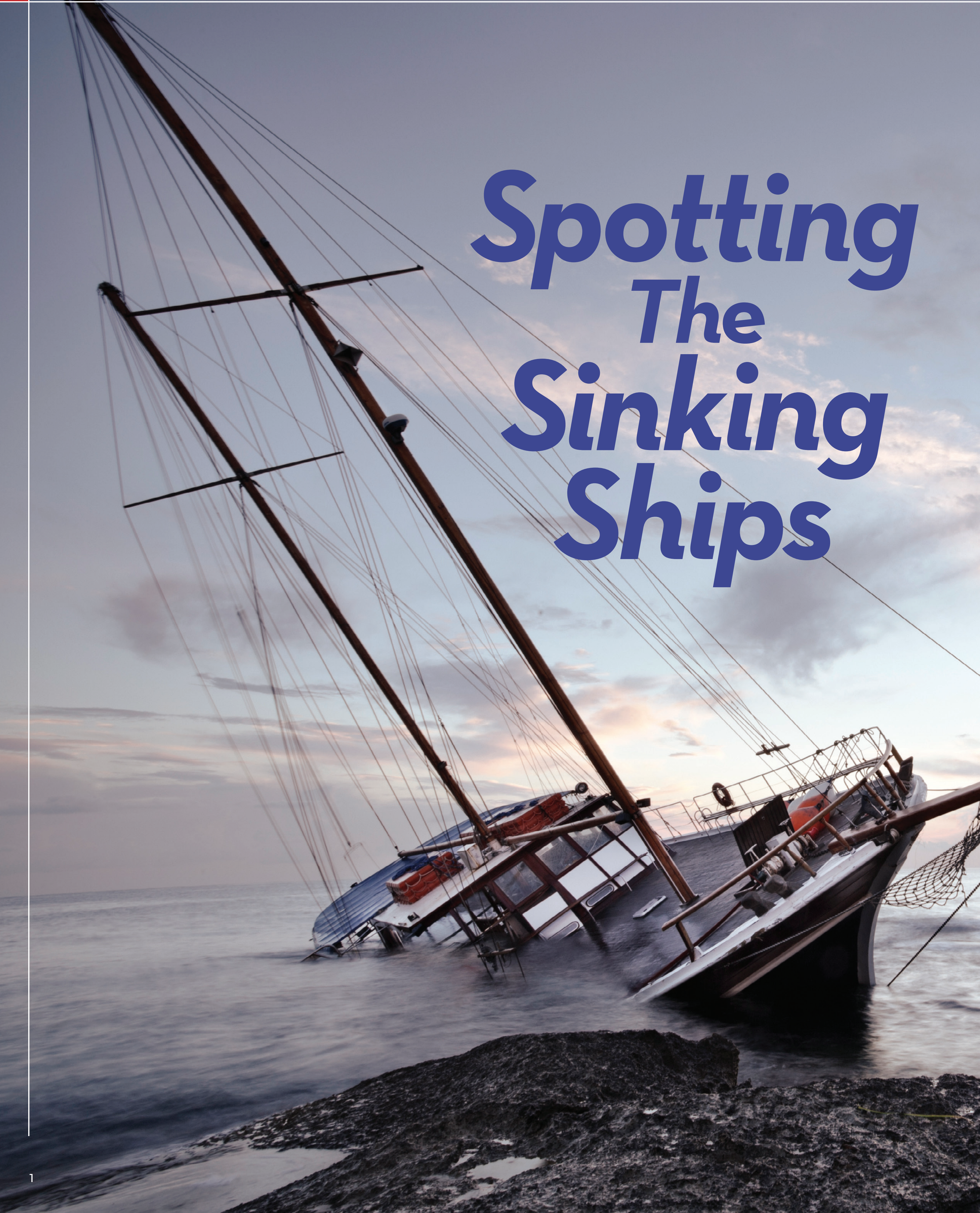
Spotting The Sinking Ships



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IT'S EASY TO SPOT a bankruptcy in the making. The warning signs that a customer is getting sucked ever closer to a Chapter 11 filing are usually quite plentiful. By quickly identifying and reacting to the impending crisis, creditors can reduce their risk of a huge write-off when bankruptcies occur.

The earliest warning signs usually involve reduced sales, declining margins, losses that grow increasingly substantial and declining cash. Distressed customers are also often overleveraged as they are forced to increase their reliance on debt to satisfy their cash flow needs.

Additional alarm bells should go off if you see that a client has a large interest, principal or loan payment due – or some combination of the three – in the near future. There may be declining availability under a customer's revolving credit facility, or a customer may choose to issue new debt rather than paying interest obligations with cash.

A customer's breach of a loan covenant; entry into a forbearance agreement with its lender, and/or payment of default interest and fees are additional red flags.

Pay attention when a customer's business starts to go south. Creditors who act wisely can avoid rough seas of their own.

When the first inkling of a financial crisis is detected, credit professionals should find out if the customer's debt is secured or unsecured. It is not uncommon for a financially distressed customer to have multiple tranches of secured debt.

If a customer's bonds are secured and sell for less than face (or "par") value, general unsecured trade creditor claims will likely not receive any recovery in the customer's bankruptcy case. That's because secured bondholders have higher priority status than unsecured trade creditor claims.

Unsecured trade creditors will also likely receive little or no recovery on their claims when unsecured bonds are trading at a substantial discount from their face value. Watch for a sudden fall in a customer's bond or stock prices.

Certain personnel changes will also tip a creditor's hand. The unanticipated resignation or firing of a CEO or CFO is not a good sign. The appointment of executives and board members with insolvency experience is another blatant hint. Trade creditors' prospects worsen when a customer has hired a law firm or financial advisor known for its bankruptcy expertise.

RESOURCES FOR DETECTION

To the untrained eye, the task of discovering all these possible clues may seem overwhelming. But there is a proliferation of online databases, electronically accessible corporate regulatory filings and proprietary news services that track and provide analysis about financially distressed companies.

Some of these sources are available at little or no cost to the creditor. For instance, there are a number of Internet search engine companies that allow users to set up alerts to receive automatic notifications about specified search terms.

Google Alerts (www.google.com/alerts) is a free service that sends users an e-mail notification concerning new web pages, news articles or blog postings that match the user's search criteria. Credit professionals can create numerous searches with the names of customers they want to monitor. The notifications can be set up for delivery on a daily, weekly or "as it happens" basis.

These alerts can be very useful in locating news stories about a customer's operating results, stock-price performance, potential mergers and divestments, industry trends, labor issues and changes in corporate management.

However, these types of alerts have their limitations. They usually do not include the more detailed information contained in proprietary databases or more sophisticated analyses that piece together disparate sets of information about a particular company or industry and consider broader trends and patterns over an extended timeframe.

Companies with publicly traded securities must also periodically file reports with the U.S. Securities and Exchange Commission (SEC), which are available on the website sec.gov. These reports contain information about the company's financial performance, including audited financial statements as well as the management's assessment of future opportunities and challenges for the business.

Any report that contains a qualification about a customer's status as a going concern or questions the sufficiency of a customer's liquidity should be noted. Indeed, a customer's mere failure to file a timely report is an additional red flag of financial distress.

An often-overlooked source of timely information about larger customers is the "investor" section of their company website. Many sites allow users to enter an e-mail address to receive timely alerts about events and information that may be useful to corporate investors.

Notifications may include company newsletters, press releases, announcements of SEC filings, investor earnings teleconferences and transcripts, as well as stock-price information and financial statements. If your company has extended significant credit to a customer, you will want to closely review the information about the customer's operations and performance provided to its investors.

If you don't have access to SEC filings or other financial information about your customers, consider requiring your customers to periodically provide financial statements and supporting information. This request should be made right from the inception of the relationship. A financially distressed customer is likely to resist such requests.

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You can also gain insights about creditors from the Uniform Commercial Code (UCC) filings as well as federal and state law tax lien filings against a customer. Suits commenced against a customer also provide insight into its dire financial condition.

Recent UCC filings may disclose that another creditor is concerned about its ability to collect claims or reveal a new lending relationship that further encumbers the customer's assets. Look for an increase in filings against the company related to delinquent taxes and/or collection lawsuits commenced by other creditors. Those are additional red flags that the customer is facing financial decline.

There are also numerous subscription services that provide analysis about larger customers. For instance, credit rating agencies, such as Moody's, Fitch Ratings and Standard & Poor's, analyze a customer's probability of defaulting on its obligations.

A decision by one or more credit agencies to downgrade a customer, and the reasons for the downgrade, can be a warning sign of financial distress. A downgrade to junk status suggests that bankruptcy is closing in.

Similarly, a growing number of propriety subscription-based businesses exist that specifically track financially distressed companies and industries. Such services include Bloomberg, Debtwire, S&P Capital IQ, Reorg Research, The Deal, Daily Bankruptcy Review, Thomson Reuter and Markit. They report publicly available financial information, press releases, gossip and "soft" information that may assist in accessing a customer's credit risk.

They may unearth some telltale signs, such as the retention of bankruptcy professionals by the customer or its bondholders; a reduction or loss of availability of credit insurance; the loss of puts protecting against the risk of the customer's insolvency, and management changes.

These services might also report on defaults and forbearance arrangements concerning the customer's loan and/or secured debt and the views of various participants involved in the customer's restructuring.

PROACTIVE STEPS

When signs point toward bankruptcy, there are a number of steps that can be taken. Creditors that are not required by contract to continue doing business with a customer can switch to cash in advance or more restricted credit terms.

Creditors subject to a long-term contract that requires the extension of credit can also protect themselves from the risk of

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A QUIZNOS CASE STUDY

Look no further than to the fast food chain Quiznos for a textbook example of how many warning signs can accumulate when a company is headed toward bankruptcy.

The Denver-based sandwich chain filed for Chapter 11 in Delaware on March 14, 2014. Certain warning signs about its financial problems were publicly known for over a year in advance of the filing, giving creditors significant time to take action and reduce or eliminate their credit exposure.

As early as February 2013, proprietary news services reported that Quiznos had experienced a 10% year-over-year drop in EBITDA (earnings before interest, taxes, depreciation and amortization) and that the price of its first lien bank debt had declined substantially since the beginning of 2013. In March 2013, *The Denver Post* reported that 10 lawsuits had been filed by Quiznos franchisees alleging that the company was improperly forcing franchisees to purchase food from a Quiznos affiliated supplier at marked-up prices.

During a company investor call in May 2013, Quiznos' management lowered its guidance for comparable year-over-year sales.

In August 2013, reports surfaced that Quiznos' majority shareholder retained a large law firm known for its insolvency expertise. In October 2013, there were news reports that the same majority shareholder hired a financial advisor known for its restructuring practice group.

Throughout the fall of 2013 there were also frequent news reports concerning significant declines in the company's sales, EBITDA and available cash.

In early December 2013, news services reported that Quiznos had entered into a forbearance agreement with its lenders that allowed the company to forego making interest and principal loan payments due on Dec. 31, 2013.

By January 2014, there were reports that the first and second lien lender groups each retained financial advisors in advance of beginning workout negotiations with the company and that the lenders extended the company's loan forbearance agreement.

Exactly one month prior to the Chapter 11 filing, *The Wall Street Journal* reported that creditors were continuing to negotiate a prepackaged bankruptcy plan and that a Chapter 11 filing could happen within weeks.

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nonpayment. For example, a creditor that agreed to extend 60-day credit terms under a long-term advertising contract might have real concerns about a customer's ability to pay the creditor's claim. However, that creditor may be hesitant to restrict or terminate credit terms for fear of being sued by the customer for breach of contract or for violating the automatic stay in the event of a customer bankruptcy.

Service providers have recourse to various state law creditor remedies to permissibly modify credit terms contained in their existing contracts, or obtain other assurances of payment when a creditor has a reasonable belief, based in part upon existing warning signs, that the customer will be unable to perform under its contract.

Some states have adopted the Restatement (Second) of Contracts, a legal treatise that summarizes and explains the current state of contract law in the United States. Sections 251 and 252 allow a creditor to demand "adequate assurance" that a customer is able to continue to perform under a contract when its financial health is in doubt.

Courts have afforded the same protections to service providers in states (such as New York) that have not adopted the Restatement's rules with respect to adequate assurance.

These protections are very similar to the rights given to sellers of goods under the UCC, which has been adopted by all states and governs transactions involving the sale of goods (as opposed to the provision of services). Section 2-609 of the UCC allows parties under a contract for the sale of goods to demand adequate assurance from a distressed counterparty.

Examples of "adequate assurance" include providing the creditor with a deposit, or other security interest in its assets, or causing the issuance of a letter of credit or guaranty from a creditworthy source in favor of the creditor. If the customer fails to provide the creditor with adequate assurance of continued performance within a reasonable time frame, the creditor has the right to treat the contract as repudiated by the customer and can sue the customer for breach.

A creditor should act with great care and under the advice of counsel when considering exercising this remedy in order to minimize the risk of being sued for breach of contract or for violation of the automatic stay where its customer has filed bankruptcy.

The creditor will have an easier time justifying its demand for adequate assurance based on its concern about the customer's ability to pay its indebtedness when the creditor can document a customer's warning signs that give rise to the creditor's insecurity.

Creditors who monitor the financial health of their customers will help keep their own company in good health as well. Successfully identifying warning signs of a customer in financial distress and quickly reacting could be the difference between collecting a receivable or suffering a significant loss in the event the customer files for bankruptcy or other insolvency relief.

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