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Q&A

Unable to Pay for Chapter 11 Expenses, Small and Medium-Sized Businesses Liquidate Via 7s

An increasing number of small and medium-sized U.S. businesses cannot readily get credit from banks and are being forced to file for bankruptcy protection, says **Wayne Kitchens**, co-managing partner at **HughesWattersAskanase LLP** in Houston. Many of these businesses are unable to foot the high costs associated with a Chapter 11 so they end up liquidating via a Chapter 7, he said in an interview with Aleksandrs Rozens.

Q: Where is most of your activity? Chapter 7s or 11s?

A: People are using Chapter 11s to do a 363 sale, to get those assets moved from oldco to newco, free and clear of anybody's liens or other interests. That's kind of brought about a whole valuation industry to help facilitate those sales. I've used that process and I'm getting ready to use that on a case that hasn't filed yet; we are going to attempt to sell a company's valuable assets to an investor group and they will put some money into a liquidating plan so unsecured creditors can receive at least something. You've seen that structure a lot in the last 10 or 12 years.

Q: Should we expect more Chapter 7s from businesses?

A: In the small and mid-range (companies), the answer is yes. A couple of clients now who have long-time, established, once-very-successful small to mid-sized businesses with annual revenues of a couple of million to $70 million have just reached the end of the line. They don't even have the funds to pay for the administrative costs of an 11. They are just going out of business. We have an extensive trustee representation. Three of my colleagues are Chapter 7 trustees; so we do a whole bunch of Chapter 7 trustee and liquidation work. Ninety-five percent of Chapter 7 trustee cases are individuals and consumers, but you have that five to 10 percent that are businesses. Some of them can be quite large businesses.

Q: Do you think we will see an uptick in 15s given the lockup in credit markets in Europe?

A: I think we probably will. But one thing to keep in mind is that a 15 is not like an 11 where you have a flurry of activity here. The reorganization the 15 is designed to recognize is actually going on somewhere else. You are attempting to have the U.S. bankruptcy court recognize that foreign proceeding and extend the U.S. court's protection around U.S. assets of the foreign company. The last one I was involved in was a valve manufacturer in Seoul, South Korea.

Q: When we look at reasons behind the filings – what exactly is the cash flow problem? Is it the slowdown in the economy that brings about a drop in demand for a debtor's services or are lenders pulling back?

A: It is both. In a lot of cases the problem is in commercial lending; lines of credit have dried up and people don't have the working capital without those lines of credit to be able to continue. One of the larger banks here in town wanted a credit moved. A multi-million dollar operating capital loan and they wanted it out of the bank. Not because it was in default. They just don't want that type of credit anymore.

Q: Is it that they don't like the industry the business is involved in or is it the geographic location of the business?

A: It is not the region because they bought into the region. It's a Texas-based large regional bank that came into the Houston market and bought one of our larger local banks. It is a recurring theme: either the line of credit is completely used up and the bank will not extend further credit or they want the credit out of the bank. I've seen that on multiple occasions. We represent a lot of banks and we're seeing it on the workout side as well.

Q: When a bank wants a credit off of its books how much of it is tied to the industry the borrower is involved with?

A: It seems to be on a case-by-case basis. This particular business is in the automotive field and they don't want to lend to that type of business anymore.

Q: What are other common denominators behind bankruptcies that you are involved with?

A: In my region of the country we've had a number of oil field service bankruptcies such as pipe manufacturers, rig manufacturers which you would be surprised at because we seem to be in an energy boom. But you also have to remember natural gas right now is about $2 per thousand cubic feet.

Q: Has the bankruptcy case load at your firm picked up? When did the uptick become evident?

A: 2009, 2010 and 2011 – the first half of 2011 – we were very busy. In the second half of 2011 we definitely had a downturn in our business on the commercial bankruptcy side of it. Starting in February my partners and I have been steadily busy on the creditor and debtor side of the ledger. Smaller business people will make the serious mistake of funding their cash flow by not paying their employment or sales taxes. I've seen that many times with small business bankruptcies. You have the IRS knocking on your door and you have penalties. Whoever is responsible for collecting those employment taxes - that liability sticks to them personally. If you withheld from your employees' paychecks but you didn't remit to the government, you can be held personally liable for that.

Q: As an adviser to creditors what's on their minds?

A: We do a lot of real estate work and so we have been involved with quite a few out-of-court restructurings and out-of-court workouts. We have been involved in a very large transportation company that we were able to successfully resolve outside of bankruptcy court. Unless things have gone completely to hell in a handbasket many of our lender clients are interested in doing out-of-court restructurings and out-of-court workouts because bankruptcy is just so expensive. That involves extending a loan, taking back part of the property, finding additional capital to put into the business.

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