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The Secret Sauce for Successful Bankruptcies Requires the Right Ingredients

BY HUGH LARRATT-SMITH, MANAGING PRINCIPAL,
TRIMINGHAM INC. &
RICK HYMAN, PARTNER, CROWELL & MORING

Distressed companies often seem like a tale of two cities. On the one hand, there are those with good profit and loss (P&L) statements but bad balance sheets. On the other, there are companies with good balance sheets but bad P&Ls.

The Penn Central bankruptcy was one of the largest and most drawn-out bankruptcies in American history. It was an archetypal good balance sheet, bad P&L company.

In 1957, the business world was surprised by the announcement of plans to merge the Pennsylvania Railroad and the New York Central Railroad, two traditional rivals. The merger between these two giants raised plenty of opposition and took more than a decade for the Interstate Commerce Commission to approve. On February 1, 1968, the Pennsylvania New York Central Transportation Company, commonly called Penn Central, was created. Its history was short and ugly.

The New York Central Railroad and the Pennsylvania Railroad, with their extensive networks of merged and leased lines, subsidiaries, and related businesses, ranked among the most important railroads in the world. Together, they controlled over $6.5 billion in assets, yet combining forces did not yield an efficient or resilient entity. Freight cars were lost, switchyards were jammed, and poor service and delays plagued both passenger and freight lines. Undergirding these problems, by 1971, railroad intercity freight market share had steadily declined to 41% from 67% in 1947, due in part to the completion of the interstate highway system in the 1950s. Airline travel was also becoming more accessible and widespread.

Penn Central had a highly complex corporate structure and experienced a number of management failures. As losses mounted, the dividend was cut and the stock price plunged. Penn Central was a classic good balance sheet, bad P&L company. To fund growing losses, Penn Central had to rely on issuing commercial paper at ever-increasing interest rates.

The corporate behemoth survived only 867 days. After an unsuccessful government attempt to rescue the firm, Penn Central filed for bankruptcy on June 21, 1970. The crash of the rail giant set a new record for the largest bankruptcy the United States had ever experienced.

Penn Central had $87 million in commercial paper in default, much of which was held by Goldman Sachs. The default posed one of the biggest threats to the firm—the potential losses threatened to wipe out its capital. The Penn Central calamity sent shock waves through the commercial paper market. Goldman Sachs' commercial paper business had been an integral part of its growth. As the market leader, the firm served nearly 300 other commercial paper-issuing clients

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who suddenly faced widespread redemptions from panicked investors. Market liquidity vanished overnight.

In May 1974, the U.S. Bankruptcy Court concluded that no viable plan of reorganization for Penn Central had been presented. Using the Regional Rail Reorganization Act of 1973, the federal government nationalized Penn Central. For two years, experts sorted through the company's assets to decide what could be reshaped into a viable railroad. Then, on April 1, 1976, Penn Central transferred those rail operations to the government-owned Consolidated Rail Corporation (Conrail).

Penn Central unsuccessfully attempted to sell the air rights to Grand Central Station to allow developers to build skyscrapers above the terminal, which was denied because Grand Central was a New York City landmark. Among the properties owned by Penn Central when Conrail was created were a 24% stake in Madison Square Garden and its prime tenants, the New York Knicks and the New York Rangers.

A little over a decade after Penn Central's bankruptcy, the U.S. Department of Transportation selected Goldman Sachs to lead the $1.6 billion sale of 85% of Conrail in one of the largest public offerings at the time.

'Broken Wing' vs. 'Dying From 1,000 Cuts'

Another way to look at distressed companies is to determine whether the business is a "broken wing" company, one with a clearly defined problem that can be fixed, or is "dying from 1,000 cuts." Cannondale Bicycle Corporation was an archetypal broken wing company.

By the early 1990s, Cannondale's success earned it a place in the pantheon of Harvard Business School cases studied by the college's MBA students. In 1995, Cannondale did an IPO on the Nasdaq, raising $22 million. The high-water market capitalization for the company, in the late 1990s, was approximately $250 million, based on annual sales of approximately $175 million with a gross margin close to 60%. The company had approximately $25 million in cash and little debt.

Cannondale's magic created a juggernaut of an international brand, as cycling enthusiasts loved the special "snap" of the company's patented technology. By the 2000s, the entry level price for a Cannondale mountain bike was $3,500. Its products were sold exclusively through high-end sport bike shops—Cannondale eschewed all mass channel and big-box retailers.

And every Cannondale product was made in America—right down to the racing shirts and shorts produced in a Pennsylvania factory.

The Volvo-Cannondale Mountain Bike Racing Team was one of the most successful elite professional racing teams in the history of mountain biking. In the late 1990s, Cannondale's sponsorship of Division 1 bicycle road racing teams was highlighted by winning the punishing Giro d'Italia in 1997 and Mario Cipollini's four consecutive stage wins in the 1999 Tour de France. With their reputation for top quality, Cannondale's bicycles were marketed to road and mountain bike enthusiasts at nosebleed prices. Cannondale's subsidiaries in Europe, Japan, and Australia accounted for about 40% of the company's total sales.

But in 1998, on the advice of its investment bankers, Cannondale embarked on a product and market channel diversification strategy. The company decided to build off-road motorcycles and all-terrain vehicles (ATVs) from scratch, including the engines—and the company wanted its new products to be loaded with innovations.

Cannondale began a media blitz touting its plans to build an American-made motocross bike, competing against entrenched market leaders such as Husqvarna, Honda, and Yamaha. Cannondale's engineers threw away the original Swedish-built, single-cylinder, 450cc Folan engine that they had started with and had a four-stroke engine designed solely for them in North Carolina. Cannondale had been bitten by the innovation bug—and once it got the fever, it couldn't seem to stop. Its engineers came up with untested design ideas that almost any seasoned motorcycle designer would have shot down in 30 seconds.

The motorcycle and ATV frames and engines were to be built at a new production facility in Pennsylvania. Cannondale budgeted $20 million for this new product initiative in 1998. By 2002, the company had spent more than $80 million. The cash was gone. The Nasdaq listing was gone. Cannondale reported a loss of $46.6 million for fiscal year 2002 after reporting 11 straight quarterly losses. Pegasus Partners II replaced Cerberus as the second lien lender behind CIT Business Credit. Cannondale's valuable high-end bicycle dealers had been starving for product and were threatening mutiny.

By January 2003, Cannondale's secured lenders wanted the company to file Chapter 11 with a Section 363 sale in first-day orders. Cannondale

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Easy Gardener was a consummate good P&L, bad balance sheet company. The company had multiple successful trademarked garden brands, but it was heavily leveraged and burdened by an expensive bond issue.

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filed a voluntary petition for Chapter 11 protection in the U.S. Bankruptcy Court for the District of Connecticut on January 29, 2003, with $114 million in assets and $105 million in debts. Pegasus agreed in late January to act as the stalking horse bidder in the auction and put up an initial $25 million bid for Cannondale's assets. The expedited confirmation process was possible, in part, because it was clear that Cannondale was a broken wing company as opposed to one dying from 1,000 cuts. The founders, once praised by Harvard, were wiped out in the process.

In February 2008, Dorel Industries, a Canada-based diversified consumer products company, announced the purchase of Cannondale from Pegasus Capital for approximately $200 million.

Good P&L, Bad Balance Sheet Companies

Easy Gardener, based in Waco, Texas, was a consummate good P&L, bad balance sheet company. The company had multiple successful trademarked garden brands, including Jobe's fertilizer spikes, Ross root feeders, WeedBlock & Landmaster landscape fabrics, and a collection of garden edging products listed at major retail chains. But the company was heavily leveraged and, in particular, burdened by an expensive bond issue of more than $100 million that was held by individual investors. This retail investor bondholder structure made it almost impossible to do a consensual out-of-court restructuring. A Chapter 11 proceeding seemed to be the only option.

A key concern about a Chapter 11 filing was Easy Gardener's reliance on its largest customer, Home Depot, which accounted for more than 50% of its revenues at the time. A critical risk element was the power imbalance that had become common for American manufacturers and importers since the explosive growth of national "category killer" big-box retail chains like Home Depot beginning in the 1980s.

Companies like Easy Gardener that sold to big-box chains often had customer concentration problems. Offsetting this, however, was the fact that a Home Depot store carried 100 times the inventory of a traditional neighborhood hardware store, so big boxes often struggled to find vendors capable of providing reliable nationwide supply, especially for seasonal and specialty products like Easy Gardener's.

So, despite the size imbalance, a symbiotic relationship evolved. Giant big-box chains fed the growth of vendors like Easy Gardener, while the retailer's low-cost labor models depended on these smaller companies for field staff and third-party service providers working on the ground to restock product from inventory, educate sales staff, and groom product displays. Easy Gardener had 14 different products that were stocked in multiple departments at every Home Depot store across the country.

Home Depot could have delisted Easy Gardener's products during a bankruptcy by the supplier, but the deep relationship between the two served as protection against that. Sourcing new vendors and disentangling local merchandising resources for multiple items in different departments across each of the chain's regional management groups represented a disincentive to make rash delisting decisions. As long as Easy Gardener could consistently fulfill orders with quality merchandise and provide in-store service, the risk of delisting was low.

Notwithstanding this, Easy Gardener became extremely worried that a bankruptcy filing would upset the Home Depot relationship in the crucial selling season in the spring of 2006. But by early 2006, the company had no choice and filed a voluntary petition for Chapter 11 protection with a Section 363 sale motion. Finding a stalking horse bidder was challenging. The company's investment bankers canvassed a wide range of potential buyers, and the common refrain was that the customer concentration was too high a hurdle to overcome.

Ultimately, HIG Capital was chosen as the stalking horse because it had experience with other big retailers and was comfortable that the risk was manageable as long as Easy Gardener had the financial resources to continue to provide customers with reliable product supply and service. HIG Capital's investment mitigated the balance sheet risk that threatened an otherwise sound business. HIG Capital achieved its return with the sale of the company in 2015.

Bankruptcy Blast Off

Today, "rocket" Chapter 11 cases are becoming quite commonplace. These expedited cases can result in cost savings due to lower administrative costs and U.S. Trustee and professional fees, which may produce greater recoveries for stakeholders and preserve jobs. However, such cases are still costly and time-consuming because they require negotiating restructuring support agreements, preparing plans and disclosure statements, and achieving an out-of-court solicitation during the months prior to the filing.

By way of example, with the confirmation of Carlson Travel's plan of reorganization within 24 hours of the company's filing, expedited confirmations took another step toward normalization. Carlson Travel (better known as Carlson Wagonlit Travel), together with 37 affiliated entities, filed bankruptcy in the Houston Division of the Southern District of Texas on November 11, 2021. The debtors managed to schedule a joint hearing on the approval of their disclosure statement and confirmation of their prepackaged plan for the following morning.

As with all prepacks, the debtors had solicited votes on their plan prior to filing their cases, including a prepetition notice period for objections. The company reported that it had received acceptances from all its bank lenders and holders of more than 90% of its other secured debt. Earlier in 2021, Belk Inc. and its affiliates accomplished a similar feat in the same court. Others to confirm their prepackaged plans on an expedited timetable include Sunguard Availability Services Capital Inc. and FullBeauty Brands Inc., both in 2019.

Confirmation of Carlson Travel's plan, however, was not without dissent. The Office of the United States Trustee (UST) filed an objection to the rapid nature of the case, as it has in other similarly expedited cases. The UST argued that "[t]he speed of this case effectively shifts the burden to the creditor body without the protections contemplated by the Bankruptcy Code."

The objection focused on alleged due process violations (in the form of lack of reasonable notice) and the failure to comply with certain Bankruptcy Code requirements and norms (for example, the filing of statements and schedules and the appointment of an unsecured creditors' committee). The UST pointed out that the plan included third-party releases and broad exculpation provisions that the debtor asked the court to approve with little opportunity for objection.

Such a rapid confirmation required compromises. The court raised concerns regarding due process consistent with the UST's objection and indicated that it would approve the plan alongside a supplemental due process preservation order. The order was similar to that which the court had entered in Belk's case that extended deadlines for parties to opt out of the plan releases, limited exculpation, and expressly retained jurisdiction of the court to hear claim objections and disputes regarding executory contracts, among other things. Additionally, the order provided for supplemental solicitation and voting rights for a tranche of creditors that had been omitted from the original prepetition solicitation and received less notice.

Although Carlson Travel's path through bankruptcy provides further precedent for expedited cases, it also serves as a note of caution that serious consideration must be given to the due process rights of parties in interest. Provisions preserving for some limited time those parties' rights, including those set forth in the court's due process protection orders, may be required. Additionally, the court made clear that such extraordinary relief is not appropriate in all instances. Rather, a debtor's justification for such relief must be compelling, which, in this instance, included preserving value due to the nature of the debtor's business and protecting its employees.

Certain Bankruptcy Courts have recognized the need to administer complex Chapter 11 cases on an expedited basis. For example, the Bankruptcy Court for the Eastern District of Virginia has enacted local court rules that provide for first-day motions to be heard within two days of the petition date unless otherwise requested by the debtor. Another rule provides that the court will routinely hold an interim hearing on cash collateral every three business days in the early stages of a case. Additionally, for mega cases, the rules provide that any bankruptcy judge in the district may conduct and preside over first-day hearings, if necessary.

Takeaways

The cases of Cannondale, Easy Gardener, and Carlson reveal some of the secret sauces in successful bankruptcies. Other companies struggle through bankruptcy, only to join the parade of "Chapter 22" cases, filing for Chapter 11 for a second, or even becoming a "Chapter 33" case if filing for a third time.

Penn Central clearly lacked the secret ingredients for a successful bankruptcy. The company's bad P&L statement prevented it from making it through a successful reorganization as a single entity. Instead, the company bounced around like a pinball through spinoffs and controlled liquidation.

Hugh Larratt-Smith, MBA, is the managing director of Trimingham Inc. He is a turnaround and crisis management specialist with more than 30 years of experience. Larratt-Smith is on the board of directors of the TMA-Upstate New York Chapter and served on the TMA Global Board of Directors for five years. He also was a founder of TMA chapters in Toronto, Upstate New York, Serbia, and Croatia.

Frederick "Rick" Hyman is a partner with Crowell & Moring's Financial Services Practice and in the firm's New York City office. Whether representing financial institutions, purchasers of distressed assets, or companies facing challenges, he applies his 30 years of experience to help clients chart a path and maximize their outcome. Hyman focuses on the representation of domestic and foreign lenders in connection with in-court and out-of-court workouts and restructurings.