Business Opportunities from Corporate Bankruptcies

Rees W. Morrison

A volume in the Wiley Professional Banking and Finance Series,
Edward I. Altman, Series Editor

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Series Preface

The worlds of banking and finance have changed dramatically during the past few years, and no doubt this turbulence will continue through the 1980s. We have established the Wiley Professional Banking and Finance Series to aid in characterizing this dynamic environment and to further the understanding of the emerging structures, issues, and content for the professional financial community.

We envision three types of book in this series. First, we are commissioning distinguished experts in a broad range of fields to assemble a number of authorities to write specific primers on related topics. For example, some of the early handbook-type volumes in the series concentrate on the Stock Market, Investment Banking, and Financial Depository Institutions. A second type of book attempts to combine text material with appropriate empirical and case studies written by practitioners in relevant fields. An early example is a forthcoming volume on The Management of Cash and Other Short-Term Assets. Finally, we are encouraging definitive, authoritative works on specialized subjects for practitioners and theorists.

It is a distinct pleasure and honor for me to assist John Wiley & Sons, Inc. in this important endeavor. In addition to banking and financial practitioners, we think business students and faculty will benefit from this series. Most of all, though, we hope this series will become a primary source in the 1980s for the members of the professional financial community to refer to theories and data and to integrate important aspects of the central changes in our financial world.

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1 Business Opportunities and Bankruptcy Debtors

The purpose of this book is to identify and explain the many business opportunities presented by corporate bankruptcies. It will explain various ways to participate in and profit from the bankruptcies of corporations, describe the advantages and potential disadvantages of doing so, and familiarize the reader with associated legal and business considerations.

The book describes scores of businesses that have seized these opportunities. Individual bankruptcy buccaneers include the present owner of the Indiana Pacers, Carl Landegger; Irwin Jacobs, who realized a great deal of W. T. Grant money; the Ohio liquidators, Sam Nassi and Jerome Schottenstein; and investor John Templeton. Another businessman to profit from bankruptcies is Cyrus Tang, who "has established a pattern of buying bankruptcy companies, operating them successfully and then selling them."[1] As a preview of profits that can be made, we should mention Sol Shenk, who operates a liquidation company called Consolidated International, Inc. In 1976, Consolidated bought the assets of Diamond Reo Motors out of Chapter XI bankruptcy, the chapter of the old Bankruptcy Act that governed reorganizations of bankrupt companies. Shenk and his partner cleared $3 million within three months by reselling the company's finished and unfinished inventory of trucks, spare parts, equipment, and drawings.[2]

Richard W. Gerrity, head of Simmons Machine Tool Corp. in Albany, New York, took over that company from his father, who had bought the Chapter XI debtor in 1974. Gerrity proceeded to turn the company into a profit center. In an interview Gerrity observed that huge assets with very low productivity were available in the Midwest and Northeast and noted that he might take advantage of the option to buy the assets of a large bankrupt business and turn it around. "Everybody is looking to buy something cheap, but we are doing it systematically. "Bankruptcy," he concluded, "is the game in the Northeast and the Midwest."[3]

The theme of this book is the game described by Gerrity: many business opportunities exist through which one can profit from another company's bankruptcy: "like a forest fire that creates more productive land by burning off dead trees and scrub, the failure of one company often yields markets, capital and skilled labor that fuel the growth of another."[4]

BUSINESS OPPORTUNITIES WITH CORPORATE BANKRUPTCIES

Venturing into bankruptcy entrepreneurship opens up many favorable business opportunities. For example, we will see how a company can procure a bargain–rent lease from a bankrupt tenant and thereby save thousands of dollars by paying preinflation rental rates. We will see how assets can be bought for far less than their book or replacement value and how securities of debtors can make astonishing gains. This book introduces many other methods to turn the demise of one company into fruitful opportunities for another.

The opportunities are everywhere. In 1976 the National Conference of Bankruptcy Judges found that the major bankruptcy courts were administering $27 billion in assets. A later study of the ten largest cases in New York City, Dallas, and San Francisco estimated that the courts of those three cities were administering $8 billion in assets.[5] Companies or individuals who are not in bankruptcy can buy these bankruptcy assets, take over favorable contracts, merge with debtors and shelter taxable income, speculate in claims against debtors, garner fees, and rack up capital gains. Bankruptcy offers a large, and for the most part untapped, reservoir of income for those who understand the opportunities.

Each chapter of this book introduces and develops a business opportunity or a situation that can lead to profit from a bankruptcy case. Here we will delve into the range of variations on each basic opportunity; creative and informed executives may further develop these techniques. Understanding the bankruptcy process allows an entrepreneur the means to extend, vary, or combine the basic techniques in ways most appropriate to particular business needs and resources.

The ventures discussed in this book often resemble business practices used in non-bankruptcy situations. For instance, a letter of intent between the parties may precede any merger or acquisition, and letters of intent will show up in chapters 4, 5, and 6 of this book, which are concerned with acquisitions of bankruptcy debtors, their assets, and operating units. Wherever useful, the chapters will refer to analogous legal and business practices and will note basic differences between the bankruptcy procedures and the non-bankruptcy procedures. Readers of this book will then be better able to apply their own experiences in understanding what should happen in a bankruptcy transaction. From this, they may learn to take advantage of the complexities of bankruptcy business.

Emphasis on Corporate Bankruptcy

This book emphasizes opportunities in bankruptcies of corporations. Corporate debtors (bankrupt companies are called "debtors") are statistically infrequent among all bankruptcy cases because of the huge number of bankruptcies by individuals. Almost 87% of all bankruptcy cases filed in the first fiscal year of the Bankruptcy Code, October 1979 to October 1980, were filed by individuals—a total of nearly 420,000 cases.[6] Most of these bankruptcy cases involved individuals owning nonexempt assets worth less than one thousand dollars. In such cases, the opportunities for using the techniques discussed in this book are minimal. Even so, situations involving bankruptcy debtors that are not corporations sometimes arise; in such cases, the methods discussed here can readily be applied to noncorporate cases. For example, Richard and Linda Tipton filed individual petitions to reorganize under Chapter 11 of the current Bankruptcy Code. As it turned out, they owned an asset ripe with possibilities for profit, the Tipton Terrace Mall and its approximately 2.5 acres and 22 business establishments.[7]

In fiscal 1983, approximately 68,000 companies failed.[8] Of that number, not all filed for bankruptcy relief (as will be discussed later); 60%, however, did file. In the year ending June 30, 1982, 56,423 businesses filed for bankruptcy, up from 47,414 in the previous year.[9] Approximately 5333 companies filed for reorganization in the Bankruptcy Code's first year.[10] By comparison, roughly 2.6 million corporate income tax returns are filed each year, 1.4 million of which are filed by corporations having less than $100,000 in assets. Thus most bankruptcies of corporations offer little in the way of business opportunities,[11] because few assets remain, even though corporate debtors account for nearly all the opportunities demonstrated in this book.

The largest bankruptcies generate the most opportunities for achieving profit. Billionaire bankruptcies include Wickes Cos., Itel Corp., NuCorp

Energy, Baldwin–United, and GHR Energy Cos. In terms of annual revenue, Wickes, the gigantic retailer, was the largest company ever to file for reorganization. Wickes had about $4.1 billion at the time of filing.[12] By March 1983, 14 companies with liabilities greater than $100 million had started reorganization proceedings.[13] GHR Energy was ranked in 1981 as the nation's third largest private industrial company. A closely held company can pile up impressive debts, as did GHR and Veco International Inc., an oil and gas services company.[14] When Veco filed in October 1979, it owed nearly $39.3 million.[15] On the other end of the scale, in the tiny corporate bankruptcy of Weiner King Corp., all the assets of this fast food franchise system were available at the opening offer of $30,000.[16]

Entities other than individuals and corporations also seek bankruptcy relief, and the opportunities described in this book can be sometimes applied to their bankruptcy cases. Unions file for bankruptcy relief, as in the case of Professional Air Traffic Controllers union,[17] and the American Federation of Television and Radio Artists. AFTRA filed because of a $10 million judgment entered against it.[18] A partnership in bankruptcy offers nearly all the chances for profit of a corporate bankruptcy, and this book could include partnerships in its treatment. For simplicity, however, we refer to debtors as corporations.

This book deals more extensively with reorganization bankruptcies than with liquidations. In a reorganization case under Chapter 11 of the Bankruptcy Code, as we will see in chapter 2 of this book, the debtor rearranges its business and tries to propose a contract with its creditors that they will accept; by contrast, in a liquidation a trustee is appointed by the bankruptcy court whose task it is to sell the assets of the debtor as quickly as is economical and then distribute the cash. Fewer opportunities for employing the techniques of this book are possible in a liquidation than in a reorganization bankruptcy, but those that exist are explained in this book. Many Chapter 11 reorganization cases convert to Chapter 7. Some mammoth companies that were buried after trying unsuccessfully to reorganize in bankruptcy are W. T. Grant, Korvettes, Railway Express Agency, and Diamond Reo Motors.

Organization of the Book

This book explains each opportunity and its important aspects in a separate chapter. Case studies and actual examples make clear the procedures and timing that come into play. Names of companies and people, dates and dollars, will clarify and fix the lessons. This book refers to more than 225 different bankruptcy debtors and more than 200 nondebtors who realized that bankruptcy offers opportunities for profit. Bankruptcy transactions involving well over $600 million are described in this book.

The opportunities revealed by this book will be adapted most efficaciously by those who have some familiarity with the laws and procedures of bankruptcy. But this book will discuss the legal technicalities of bankruptcy only insofar as they are necessary for explaining the business contexts of bankruptcy transactions. Otherwise, the legal technicalities will be left to lawyers. Anyone seeking to employ the techniques of this book should consult competent advisors. This book discusses no case law, nor does it delve into any points of law. It focuses on actual examples of how companies have turned corporate bankruptcies into bottom line results; the discussions of legal matters are only incidental to this purpose. The person who employs the techniques described here will feel more comfortable with some understanding of the jargon of bankruptcy, so the vocabulary will be carefully explained.

Since this book is intended for nonlawyers, the chapters explain what happens in a bankruptcy case in terms of what an outsider, rather than a debtor or some company owed money by the debtor (a creditor), should watch for and understand. As a result, it is hoped that this book will help to demystify bankruptcy for those persons and companies to whom the law refers as "third parties." Nearly all writing and speaking on the subject of bankruptcy addresses debtors and creditors; this book looks at other parties in the business community who might find a stake in the bankruptcy process.

This chapter contains a case study of one large bankruptcy case that exhibits most of the opportunities described later in the book. Chapter 2 will familiarize the reader with the legal and practical underpinnings of bankruptcy law that pertain to available opportunities, explain how bankruptcy cases proceed in light of what is important to an outsider, and introduce much of the terminology that appears throughout the remaining chapters.

Each of the ten following chapters introduces and elaborates on a business opportunity. Chapter by chapter we introduce general opportunities, illustrate them with numerous real examples, and examine how techniques for taking advantage of bankruptcy vary from case to case. Some time will be spent in each chapter on the specifics of how, when, and where transactions employing such techniques can be carried out. Each chapter will also note possible drawbacks or risks, which will also be illustrated by examples. Step-by-step analyses of how the paperwork, court appearances, and judicial process interact with the practical business calculations will enable the reader to apply the ideas presented here to particular circumstances.

Broadly speaking, the opportunities introduced in chapters 3 through 12 have been arranged to develop from the least complex through the more complex—from carrying on business or buying a single asset to buying a company. Several chapters then consider the provision of such services as debtor financing, investing in or trading securities and claims, and working for debtors or other bankruptcy participants. Chapter 13 elaborates the earlier issues raised in the book and explores how the ideas of various chapters can fit together for the opportunistic entrepreneur. The final chapter also suggests bankruptcy business opportunities on an international scale.

The progression of ideas in the book requires a complete reading for best results. Because the book builds cumulatively in a number of ways, the reader will reap the greatest benefit by reading the chapters in order: many of the techniques build on or are related to others previously discussed. The explication of the legal context of the methods also grows chapter by chapter and should become familiar as the book progresses. Such themes as procedural steps, the amounts of time necessary for completing transactions, and the rights of competitors take on increased meaning as they recur chapter after chapter. On the other hand, if only one kind of opportunity interests a reader, careful study of the chapter exploring that opportunity and the introductory chapters, combined with frequent reference to the index, should suffice.

The following section dissects a bankruptcy case, the reorganization of Saxon Industries, with particular attention to events that bear on the techniques expounded in this book. The reader will be able to see from this large Chapter 11 bankruptcy reorganization that many chances are available for those who apply the techniques referred to in the discussion of the Saxon case and explained throughout the rest of the book.

THE SAXON INDUSTRIES REORGANIZATION: A CASE STUDY

Background of the Saxon Industries Chapter 11 Case

From its headquarters in New York City, Saxon Industries, Inc., a maker and marketer of paper and paper products, oversaw plants in several states, employed more than 18,000 people, and earned income in the first nine months of 1981 of $2.78 million. In 1980 Saxon Industries ranked 381st among the nation's largest publicly traded industrial concerns.[19] But troubles were mounting.

On April 15, 1982, Saxon Industries filed for bankruptcy relief under Chapter 11 of the Bankruptcy Code in the Southern District of New York. The bankruptcy clerk's stamp on the petition opened a treasure trove of opportunities for others. The bankruptcy of Saxon Industries was, as we will see, unusual in some ways, but it also presents an array of examples illustrating the kinds of opportunities for profit corporate bankruptcies offer to those who are able to take advantage of them. In the following section, examples of the business opportunities provided by the Saxon Industries bankruptcy are presented in the order of the chapters of this book. This selective appraisal of the Saxon Industries case provides an integrated account of how available opportunities can fit into a reorganization case. This section will review the Saxon Industries case in plain language, specifically addressing issues that business executives should know. The chapter will then proceed to an assessment of the Saxon Industries case as representative of corporate bankruptcies in general and conclude by providing a broad perspective on bankruptcy opportunities.

Saxon's management continued to operate the business of the debtor in possession (the term used to describe a reorganizing company where the court has not appointed a trustee). A week after the filing, the firm named William Scharffenberg, who had previously gained extensive experience in management under Chapter 11, to be its new president. Scharffenberg had been president of Penn–Dixie Corp. from 1979 until after it emerged from bankruptcy proceedings as Continental Steel in February 1982. The new president had also held executive positions at Duplan, Inc., another reorganized company.[20] No trustee was ever appointed, which is fairly typical for large debtors.

The affidavits and lists of creditors filed by the debtor disclosed secured debts of $16 million owed to at least six banks and five insurance companies, an unknown number of priority claims, and total assets of $503 million.

The debtor's unsecured debts of $461 million were owed to approximately 2000 creditors. To enable those creditors to present a coordinated front and be represented, the U.S. Trustee appointed a committee of unsecured creditors, with 17 members, on April 22, 1982.[21] Later, Kewanee

Industries, Inc. was also appointed a member to replace one that resigned.[22]

Through September 1983, the members of the committee, consisting of nine banks and eight trade creditors, sought reimbursement from the estate for their expenses of $111,915.74.

The accounting firm of Ernst & Whinney became the accountants for the committee by an order signed May 25, 1982.[23] As of February 1984, that accounting firm had not made interim allowance of compensation because it was paid periodically upon submission of invoices to the debtor, in accordance with the original order authorizing its retention. One month later, the committee was authorized to employ PMS to act as secretary. In October 1983, PMS applied for compensation of $5146 and reimbursement of the expenses of its personnel in the amount of $474.51. The committee also turned to the expertise of Oppenheimer & Co., Inc., which was retained pursuant to an order dated April 20, 1983.[24] The New York City law firm of Shea & Gould was chosen by the members to represent the committee, and the court authorized the retention of the firm by its order on May 5, 1982.[25] By August 31, 1983, this firm billed the estate $328,882.69 (holding back 25%) for services and $59,119.41 for expenses.

The banks that had lent to Saxon formed an Unofficial Committee of Bank Creditors and retained the New York City law firm of Zalkin, Rodin & Goodman. Saxon retained Salomon Brothers as special consultants to assist with the reorganization.[26]

Doing Business with Saxon Industries

Some businesses stopped trading with Saxon Industries when it entered bankruptcy, but many others continued or became new customers after the filing. This phenomenon will be considered in chapter 3. The bankrupt company continued to buy and sell goods much as it had before the case began. During its reorganization, goods worth hundreds of millions of dollars were sold to Saxon by various companies. Goods worth that much were purchased from the bankrupt company. In short, Saxon carried on business almost as usual, with more than 4000 customers.[27] During the bankruptcy Saxon Industries did business with a range of vendors and service companies. Approximately one year after the case began, the debtor reported that it had had "favorable cash flow" from operations and "adequate working capital" to conduct its business.[28]

Saxon Industries was a mammoth corporation, making this bankruptcy case highly atypical: the average size of corporate debtors is probably closer to $200,000 in assets than to the $500 million in assets of Saxon. Companies with assets equal to or exceeding that size, ranging up to Wickes Cos. with assets exceeding $2 billion, have offered the most bankruptcy opportunities.

But the size of a debtor does not necessarily determine whether or not a particular case will offer opportunities. Opportunities may well be available in a case involving a debtor with few assets, if the transaction, assets, or services suit a particular need. Also, a company may be able to repeat a productive technique with several smaller bankruptcies.

Buyers of Assets of Saxon Industries

Saxon Industries reorganized partly because third parties bought various of its assets. (Chapter 4 will detail this opportunity further.) Many companies bought bits and pieces of Saxon by court sales and by other sales in the ordinary course of the company's business. One such "piece" comprised two condominium apartments owned by the debtor in Islamorada, Florida. They were purchased by individuals.[29] Other sales included office furniture from some stores, excess inventory, and discontinued lines.

Unlike the situation that prevails in many liquidations and some reorganizations, liquidators did not have a heyday in the Saxon bankruptcy. As of July 1984, no company had bought goods and resold them as often happens in large bankruptcies.

Saxon sold nearly all the assets of its National Metallizing Division to a newly formed company, NMD Inc., for a cash price in excess of $3 million. The sale of the National Metallizing Division was announced as part of the company's plan to reorganize around its paper distribution and converting business. The notice of the sale indicated that the purchase price would be in the area of $5.48 million, subject to adjustments. The buyers included a former executive vice president,[30] a fact that raises an important point. As we will see, insiders, former officers, and directors often enter into transactions with debtors. Unfortunately, NMD Inc. also went bankrupt sometime after the acquisition.

After numerous meetings with several potential purchasers, Saxon signed a letter agreement with Alco Enterprises, Inc., on July 13, 1982. This agreement with Alco, an investment group based in Tenafly, New Jersey, concerned Alco's proposal to acquire the assets and business of the Business Products Division in Miami Lakes, Florida, and to assume certain of its obligations. That division, which manufactured the bulk of Saxon Industries' copiers, was to be disposed of in the late summer of 1982. Alco Enterprises agreed to pay an undisclosed amount of cash and subsequent payments based on the extent of business initiated by the investment group. Alan Cohen, the president of Alco, specializes in liquidations and turnaround situations.[31] Following this agreement, Copystatics Inc. made a better offer, $15 million, subject to some adjustments according to the actual inventory of copiers, other assets, and the receivables outstanding of the division. Copystatics paid this amount by a wire transfer of $6 million on the closing date, $.5 million 12 months and one day after the closing, and the balance 18 months after the closing. The Copystatics obligations were in the form of promissory notes secured by two irrevocable letters of credit issued by Fidelity Bank in Philadelphia.[32]

U.S. Playing Card Co., a closely held Cincinnati concern, made a cash offer to acquire almost all the assets of Saxon's Hoyle Products division, which makes playing cards. The *Wall Street Journal* reported that more than 20 companies had shown an interest in purchasing the Hoyle group of companies.[33]

Interestingly, West Coast Paper Co., based in Seattle, Washington, wrote a letter to the court in early July 1982 informing it that if the debtor ever intended to liquidate or sell its Blake, Moffitt & Towne division that West Coast would be interested in pursuing the opportunity.[34] That procedure offers a useful suggestion to anyone considering the purchase of bankruptcy assets.

Many debtors have no assets that are not collateral for some secured creditor. But opportunities still exist in cases involving encumbered assets. A debtor, for instance, can sell a piece of mortgaged land as long as the debtor provides the protections to the mortgagee required by the bankruptcy laws.

Purchasers of Operating Units of Saxon Industries

Even before its case began, Saxon was selling operating units. Bunzi Corp., a unit of Bunzi Pulp & Paper Ltd., bought E. Greene & Co. and Millen Industries, Inc., bought Royal Lace, for a total of $5 million. The debtor reported that the sales were part of its planned asset-redeployment program.[35]

Once in bankruptcy, Saxon Industries created opportunities for outsiders to buy operating units, as part of its return to profitability. Seeking