

Need to restructure? Try a ‘workout’ instead of Chapter 11

Silicon Valley / San Jose Business Journal - by [William-Arthur Haynes](#)

Northern California bankruptcy filings increased by about 20 percent in the third quarter, and many Silicon Valley executives might believe they’re headed in the same direction.

But lawyers and consultants say companies that need to restructure could have a better route than filing Chapter 11 — it’s known as an out-of-court workout. It costs less than filing Chapter 11, lets a firm avoid the stigma of bankruptcy and often takes less time than bankruptcy proceedings.

“The biggest advantage is secrecy, but not in the negative (connotation) of the term,” said insolvency attorney Lincoln Brooks. “Most companies survive because they’ve just needed a little time to reorganize their house of cards. Every party to a workout gets a better deal than they would have otherwise.”

Brooks, founder of Palo Alto-based insolvency boutique **Brooks & Raub PC**, handles out-of-court workouts exclusively now, calling the alternative a far more appealing process for all involved.

Workouts can take on any number of permutations, but typically creditors agree to give the distressed company time to retool the business model, offload assets if necessary and fashion a plan for sustainability so the company survives and creditors are eventually made whole.

For the quarter ending Sept. 30, Chapter 11 restructuring and Chapter 7 liquidation bankruptcy filings in the **U.S. Bankruptcy Court’s** Northern District of California increased 21 percent, according to data released this month by the **Administrative Office of the Courts**.

A little more than 300 businesses in the district filed for bankruptcy in the quarter, an increase from 251 in the previous three-month period, with two-thirds being Chapter 7 filings. The Northern District of California stretches from Monterey to the Oregon border, and from the coastline to Sacramento.

While Chapter 7 represents liquidation, the ultimate demise of a distressed company, Chapter 11 in essence provides a forbearance on creditor activity and an opportunity to restructure the business — the goal being to save the company and pay off creditors. But the costs are high in the associated professional services and court fees, as well as to the credibility of the firm’s viability.

During a long run of easy credit, when banks were offering so-called “covenant light loans” to compete for borrowers, lenders weren’t able to declare defaults as early on, said Michael Murphy, San Francisco managing director of **AlixPartners LLC**, an international corporate performance consultancy.

“That’s why you see so many free-falls,” Murphy said. “In most cases, the restructuring options were missed.”

AlixPartners served as restructuring adviser to Sunnyvale-based **Silicon Graphics Inc.** and San Jose-based **Calpine Corp.** Murphy is now working with San Diego-based broadband and wireless technology outfit **NextWave Wireless Inc.** to restructure that company and reduce debt.

What court statistics don’t show is the number of troubled firms engaged in these types of workouts, a scenario that is becoming prevalent as the recession drags on. Experts say it’s a lower-key, cost-effective process that is usually faster than court-structured workouts.

“It’s like breathing room so the company can say, ‘I have a plan for salvaging this business and paying off my debts,’” said Sblend Sblendorio, chair of the bankruptcy, restructuring and creditors’ rights practice at San Jose-based **Hoge, Fenton, Jones & Appel Inc.**

Remaining out of court eliminates the uncertainty of what can occur in a bankruptcy when all creditors are asserting their claims before a judge, and failure to reach an agreement can force the company into liquidation.

More than two decades ago, Brooks of Brooks & Raub was handling Chapter 11 cases for some of Silicon Valley's early computer companies. But the intended result — a restructured, solvent debtor company and satisfied creditors — was difficult to achieve. Customers immediately lost confidence in the companies' viability, leading to lost sales.

“They simply weren't buying when the companies went into Chapter 11, so they ended up failing,” Brooks said.

Chapter 11 is an expensive enterprise, say lawyers and workout consultants. Nearly all turnaround specialists prefer the out-of-court alternative for that reason, according to John Giovannis, principal of **Giovannis & Associates** in Newark. Giovannis has aided about 20 companies in as many different industries, including construction products, agri-chemical, and drilling and exploration. He called 18 of them successful.

“You begin to lose flexibility in what you have to accomplish” once the court gets involved, Giovannis said. “When you're in court, you have an enormous amount of repeat paperwork that you have to prepare. That doubles or triples the cost of doing an informal workout.”

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