

# What Does Business Debt Elimination Really Mean?

Eliminating business debt. At first, it might seem to imply “a business not paying what it owes.”

It does not.

What debt elimination refers to is what must be done ethically and rationally when a business no longer has the resources to pay what was originally contracted.

In the context of insolvency and default, business debt elimination can be understood as a resulting benefit from an alternative form of business asset liquidation that preserves underlying business value, operations and jobs.

Business owners are generally ethical and honorable people who are compelled to meet their obligations. When they can, they most often do. However, the reality is that every year approximately 180,000 businesses file for bankruptcy, and many thousands more fail to meet their obligations and face insolvency.

*“I’ve come across three companies so far this year where there was so much leverage there was nothing left for the owner to walk away with...and no way to sell the company. I think (debt elimination) represents a huge opportunity. I really do.”*

- Mike Kendall, Kendall Capital Group  
*Bankruptcy Destroys Business Value*

The vast majority of those businesses that fail under the burden of unsupportable debt and are liquidated in the bankruptcy system still have underlying core operational value that otherwise could have and should have been preserved—along with the associated jobs and economic activity.

Even more irrationally, approximately 75% of Chapter 11 filings fail to reach a successful discharge. The inefficiencies and costs of multiple objections and subsequent legal proceedings make it almost impossible for the owner or CEO to complete the bankruptcy plan successfully. The double bind created for insolvent owners positions them between the trap of stacking new debt on the one hand, or on the other, facing a bankruptcy system which fails to preserve owners or businesses the vast majority of the time.

“We see distressed companies a lot... that are underwater with more debt than they have value. Often, they get liquidated. I just have to walk away.

Often times the underlying company is good...It’s just due to some bad decisions in the past; they’ve accumulated too much debt and can’t support it.

*If we eliminate that debt, it would be a tremendous benefit to those companies and everyone involved.”*

- Greg Carpenter, M&A Business Advisor  
*Preserving Value is Possible*

Regardless of the circumstances that brought about distress or the nature of the distress itself, core business value remains. With so many thousands of businesses being liquidated, all of that underlying business value is being needlessly destroyed on a massive scale, along with all of the jobs and economic activity associated with it.

This destruction is the legacy of a failed bankruptcy system and of the irrational means of liquidating business assets that stems from it. It represents a deep and hidden tragedy in our economy. But it doesn't have to.

Business debt elimination is both the process and result of a far more rational means of liquidating business assets that preserves the core operational value of a business in distress or default while preserving the jobs and continuity of operations.

It does not mean "not paying what the business owes when it can afford to pay," it means "preserving the underlying value of a business when it cannot afford to pay."

### **Reorganization Creates a Win-Win for all Parties**

So, what is business debt elimination? In short, it's an alternate means of liquidating business assets at the point of failure. Instead of liquidating assets at auction (and thereby destroying the core value of the business), assets can be liquidated into a purchasing entity, thus preserving passing through concern value.

Simply put, it's a far more rational and ethical means of liquidating those assets at the point of insolvency.

*"These companies still have some fundamentally sound business ideas, but they've had a series of mistakes or bad circumstances...And they have employees, so if you care about the employees, this is a way to reposition those companies to perpetuate those jobs."*

*- John Howe, Business Transition Strategies, NHBS*

To understand this process requires an understanding of Article 9 of the Uniform Commercial Code. This provision is designed for the protection of first position secured creditors—in short, the bank. At the point of insolvency or default, it allows the senior creditor to transact (liquidate) their collateral in a private, out of court sale in order to recover what they can. Importantly, it also eliminates all subordinate liens and obligations. This is to the creditor's benefit because, in order to transact on their collateral, a potential buyer requires assurance that they are receiving those assets free and clear. In short, Article 9 of the UCC creates the means for the first position creditor to sell their collateral efficiently. But unlike in bankruptcy, this collateral does not need to be sold off at auction.

So why is the Article 9 reorganizational transaction not understood more broadly? The simple answer is because lawyers are trained in bankruptcy and lenders are trained in scheduling new debt.

However, when billions of dollars' worth of economic activity and business value are being destroyed needlessly every year, along with many thousands of jobs, it's incumbent on every

owner or even advisory professional to understand the value-preservation afforded by an Article 9 reorganization. It's simply more rational for all parties involved.

*"I was really surprised to learn that this process has something in it for everybody—including the second level of lien holders that actually don't get paid on their liens—but because they're going to preserve the ongoing business and it will be a new entity probably with better management, they can keep the customer."*

- Greg Carpenter, M&A Business Advisor

Preserving ongoing concern value through an Article 9 liquidation into a purchasing entity benefits the business owner by circumventing bankruptcy. Additionally, performance-based incentives can be allocated from the purchaser back to the distressed seller to create a path to exit successfully. Beyond the benefit to distressed owners, a liquidation that preserves ongoing concern value benefits all parties, including secured creditors and vendors—which may seem counter-intuitive.

The first position secured creditor receives their valuation of the collateralized assets without the time, cost and expense of having to go through the auction process. Subordinate creditors are dealing with toxic assets on their books at the point of insolvency. When the first position creditor removes subordinate liens from underlying assets through an Article 9 short sale, subordinate creditors can write those toxic assets down efficiently while taking advantage of the tax write-offs associated with their failed investment. Vendors, who would have taken a loss on outstanding obligations regardless, may benefit by establishing a relationship with the purchasing entity, rather than losing a business relationship as well.

## **Rethinking Business Debt and Insolvency**

Simply put, business debt elimination results from the ethical and rational process of preserving value and creating the best possible outcome for all parties in the context of default.

The Article 9 short sale transaction will necessarily mean an ownership change. However, for the distressed owner, this offers a far better alternative to seeing the core operation destroyed altogether, along with incurring the costs and negative results of a bankruptcy filing and personal liquidation.

Because the core operation is preserved, owners can negotiate an opportunity to earn from the new purchasing entity via a form of employment or consultancy agreement, as part of an incentive structure affording them a path to resolve all personal guarantees (an additional benefit to subordinate creditors). At the same time, this path can uniquely allow insolvent owners to meet their ethical obligations to the employees they hired. And when the core operation is preserved, so is the possibility of earning re-entry into an ownership position in the future.

*"I recognized the value immediately. Bringing Second Wind in allows us to bring a business owner out of a really bad situation, and when everybody wins, that's the best model."*

- Troy Tucker, Blue Sky Business Resources/Committee Chair, M&A Source

Business debt elimination can't be understood solely from the perspective of the benefits to the insolvent owner, although there are many; or even from the perspective of the benefit to creditors.

Destruction of business value is unnecessary. Therefore, it's unethical as well. Too many jobs and too much economic activity are at stake in the preservation of hard-earned value. Owners, lenders, employees and our nation as a whole must reconceive how business assets are liquidated at the point of insolvency. The potential economic stimulus offered to the economy as a whole can't be overstated. The wellbeing of owners, lenders, employees, and our role in a global economy depend upon it. There is a better way.

Second Wind has conducted thousands of reorganizations in the distressed space, preserving business value, distressed owners and jobs. To find out more about how Second Wind can eliminate unsupportable debt for your business or your distressed client, contact us today.