

Successful Use of a Receiver

The Company:

A manufacturer of fungible plastic compounding pellets sold its product for the construction of boots, carpet backing, soles and various other plastic/rubber goods. The company was one division of a small holding company, and the parent company found itself funding the plastic compounding business unit from other, more profitable entities. The plastic compounding division was facing several economic and operational challenges. First, the company had lost a major share of its customer base to overseas production, and then did not develop new compounds or new markets to offset the lost revenues and margins. In addition, the company had difficulty attempting to integrate the acquisition of a major Canadian customer into its US operations. With the decreasing demand for U.S. products and rising oil-based material costs, the company saw its near end. Faced with insolvency and imposing lawsuits, the company needed a new strategy, new direction and a restructured Balance Sheet. A bankruptcy filing contained too many obstacles and costs, and thus an opportunity arose for a more creative solution.

The Challenges:

A majority of the company's customers had moved their manufacturing facilities off shore, and sourced materials from local manufacturers as opposed to their former U.S. suppliers. This universally shrinking customer base was creating pricing issues in an overcrowded and compressing U.S. market. Plastic compound manufacturers were facing bankruptcy around the country, and to make matters worse, a local competitor was selling at below cost as part of an attempt to cover up a major fraud. With declining revenues, the company faced a second industry challenge when its major raw materials, all oil based, started to soar with escalating oil prices in mid 2004.

The company had two product lines, one of which was commodity in nature. Many of the company's customers used this commodity material to make plastic compounds for products such as soles, boots and floor mat backing, and the pellets used for these plastic compounds could be sourced from a variety of vendors. Margins were squeezed razor-thin in this marketplace.

The company's second product line had proprietary formulas in the composition, commanded substantially higher margins, and faced less competition. Customers used this compound to make gel shoe insoles and high-end rubber products, and paid a higher price based on the compound's differentiated properties. Production for this line was not operationally efficient, however, and created capacity issues. The manufacturing facility for all practical purposes operated on a fixed and a semi-fixed basis, and labor was a small component of the total cost. Nevertheless, the company operated out of a large facility that was well under capacity, and this created unabsorbed costs and ongoing losses.

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In an attempt to save its business, the company acquired an insole manufacturer and then promptly suffered the results of its poorly planned and executed integration into the facility. The insole business had robust margins and a solid customer base, but also a strong backlog. The unanticipated integration costs and ongoing losses in the compounding business created severe working capital and raw material shortages, all of which jeopardized this business as well.

The company was sued in court by several vendors, two of which initiated the appointment of a receiver mainly because the company failed to appear at the assigned court dates. To make matters more complicated, the courts actually appointed not one but two receivers. The receivers used their appointments as bullying leverage to collect their clients' debts instead of functioning as true receivers, which are meant to collect receivables and possibly liquidate assets for the creditors. The company continued to operate as usual, while occasionally running up against the receivers when failing to meet the terms of prior payment agreements.

Confronted by its own operational issues and significant industry challenges as well, the company faced bankruptcy. A bankruptcy filing would cause substantial damage to the holding company as other related entities within the corporation had guaranteed the debt. The value of the company's inventory in liquidation was well below cost, and thus a filing could result in the secured party's looking to the guarantors for payment.

The Strategy:

Early in our engagement we counseled the company to consider a reorganization of one type or another. We felt the low margin compounding business was no longer viable, and we urged the company to look at ways to eliminate the business while not endangering the other related entities. The client refused our early recommendations and fought hard to maintain its original business. As time progressed, the undercapitalized entity was suffering from increasing losses based on deficient cash. The lack of adequate working capital created raw material shortages, which then caused excessive overtime based on the irregular schedule of raw material procurement. Added to these costs were escalating professional and bank fees, all of which forced the company to reconsider our recommendations.

At this point our client agreed to abandon the low margin compounding, and move forward with the higher margin specialty compounding business and the insole manufacturing operation. The company required not only operations restructuring, but also a restructured Balance Sheet, as the unsecured debt load was overwhelming. Options reviewed included the following: (1) Secured party sale to a NewCo (2) Assignment for the benefit of creditors and a sale to a NewCo (3) Chapter 7 or 11 filings with potential sales evolving out of the filings, and/or other means to provide a future for the company and some payment to the unsecured creditors. It was felt that a bankruptcy proceeding was cost prohibitive. Furthermore, the company had slim odds of existing a chapter 11, the filing of which was complicated by a number of factors including inter-company relationships, high costs, and potential third party intervention.

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The company agreed to move forward with an assignment for the benefit of creditors and a sale to NewCo in efforts to minimize complications and avoid potential third party involvement. Under this plan, the unsecureds received a distribution over time that amounted to substantially more than they would have received in a liquidation or court proceeding. As the company progressed with the assignment, the issue emerged of the receiver being a principal of the court, and it was agreed that any action should go through the receiver instead of an assignee.

The company and its professionals reviewed the situation with the receiver. The receiver assessed the company's financial issues and agreed the best result for the unsecured creditors would come from an out-of-court reorganization. The receiver determined that the payout offered to the unsecureds was well above the distribution they could or would receive in any other proceeding. The receiver approached the court, and was granted court approval to sell all assets to NewCo.

The Results:

NewCo came into existence with old and new shareholders, and fresh equity as well. The company enjoyed freedom from the burden of unsecured debt, solid margin products, and a plan to maintain over 80% of its employees. The secured lender funded NewCo, and was paid out 100% from the customers eliminated in the reorganization. The old, slow moving/obsolete inventory was also liquidated to provide full payment to the secured lender. With the appropriate product mix, reduced overhead, and adequate working capital to procure merchandise, NewCo began to turn a profit.

In this case, the receiver provided an efficient vehicle for the execution of a reorganization. While not appropriate under all circumstances, the use of a receiver or assignee can produce outstanding results in the right situations.