ABI
Public Hearing
April 19, 2013

John G. Haggerty
Argus Management Corporation
Chapter 11 from the Middle Market Perspective

I have been asked to provide my views on the requirements for reform to the Bankruptcy Code as pertains to the middle market. Argus is a small firm of 3 principals and 25 staff. We have led or participated in "turnarounds" of numerous troubled or underperforming companies for over 30 years. I joined Argus in 1986 and became President of the firm in 1999.

Most of our engagements consist of serving as advisor or interim CEO, COO, CFO or board member for middle market companies operating outside of Chapter 11 but facing insolvency and at least considering a bankruptcy filing. In some cases we work with the company through a bankruptcy process.

In the last 10 years, we've seen an increase in the use of out of court alternatives for turnarounds, restructurings, sales, or liquidations, particularly by our smaller clients. I initially thought this was a good trend since "out of court" is often preferable from a business perspective, but the trend to avoid bankruptcy can benefit certain parties to the detriment of others, so the Chapter 11 option needs to be preserved. However, today "in court" increasingly is not a viable option because the bankruptcy process has become too time consuming and complex, and, as a result, too costly. Moreover, for smaller companies with limited access to capital, a bankruptcy filing often means ceding complete control to the secured creditor who has leverage over cash collateral, is the only realistic source of DIP financing, and/or has the ability to dominate any plan approval process. The removal of bankruptcy as an option has been leading to more state proceedings, assignments for the benefit of creditors or unsupervised wind downs.

I have been in many cases recently that would have filed for bankruptcy protection 10-15 years ago, but remained out of court due to a general distrust of the process by debtors and creditors from a cost / benefit perspective or a disbelief in the ability to use bankruptcy to maximize stakeholder value. To recapture credibility, the bankruptcy process needs to be streamlined and equitable to the business that we are trying to preserve which leads to the maximization of value.

In no particular order I offer some observations and possible solutions (although that's probably a stretch) that pertain to simpler cases with uncomplicated debt structures that we typically see in the lower middle market.

1. **Limit the secured creditor's ability to control the case.**

   Over the years the secured lenders have increased their control over the company during the pre-petition period by taking dominion of the cash via lockbox sweeps; and requiring strict budgets and forbearance agreements. These actions enable the secured creditor to

significantly increase their control over borrower cash and ultimately over a Chapter 11 filing should the borrower choose to go that route. In these situations, the company is often reluctant to file Chapter 11 pre-emptively to protect itself because it knows that the lender will use its leverage over cash collateral and DIP financing to control the company's post-petition actions. The secured creditor often uses this leverage to extract terms giving them effective veto power over the company's decisions in the bankruptcy process.

This control by the secured creditor eliminates the debtor's ability to pursue a plan of reorganization that the lender does not approve. The lender's control of the plan process is even greater if it has a deficiency claim that allows it to overwhelm unsecured creditors who do business with the debtor on a daily basis and have an interest in it staying in business.

The end result of this secured creditor leverage is a quick sale processes, either in our out of court, that achieves the lender's goal (or the goal of some subset of the lender group) of getting out of the credit as quickly as possible. This goal, however, is often achieved at the expense of reorganization options that may increase value while having the added benefit of preserving jobs and business for vendors.

Reigning in this leverage is a difficult task to achieve. For starters, the secured creditor's ability to demand veto power over the company's decisions in the bankruptcy process should be limited. Allowing the debtor to classify secured lender deficiency claims separate from general unsecured claims would, in some cases, reduce the secured lender's leverage over plan confirmation, thus giving the debtor, and the court, more potential options to consider.

2. Standardize the process.

The cost of bankruptcy is a huge issue, particularly for smaller companies. $1 million of professional fees means a lot more to a company with a $20 million enterprise value than to one with a $200 million enterprise value.

Most of the simpler cases have the same first day motions requesting use of cash collateral, the ability to maintain existing bank accounts, the ability to pay accrued payroll, etc. An effort to standardize these filings and procedures would eliminate needless debates, reduce professional costs, and make the process more predictable for the company. Standardizing 363 sale procedures including bid protections would achieve similar ends.

3. Rationalize the level of professionals at the onset.

The cost of financial advisors in bankruptcy is escalated by every constituency retaining an advisor at the company's expense. These multiple financial advisors often duplicate each other's work and duplicate each other's demands on the company's finance team

which interferes with their ability to run the business. This pain is particularly acute in smaller companies with less finance staff.

The composition and quantity of professionals and their cost estimates should evaluated at the onset of the case in relation to the size of the case and the company's cash generation.

4. **Enhance Debtor supervision of professionals.**

   Control over debtor professional fees should start with the debtor, but often there is no one formally responsible for supervising the professionals. In part, this is because bankruptcy is a foreign process, but most competent CFO's can tell when problems arise. The CFO or someone of equivalent level of the company should be required to review bills of the debtors' professionals and sign off on their reasonableness.

   Furthermore, the company needs an outlet for raising issues that it has with its professionals. The forum needs to be objective, know the case, and have standing. If the issues or disputes are material, a mediator or examiner could be brought into the case early to help resolve the dispute.

   Hopefully if a mechanism for dispute resolution existed, it would make the company's supervision of professional more meaningful and issues would be resolved before reaching the complaint level.

5. **Limit excessive secured creditor professional fees**

   Secured lender professional fees are a contributor to the escalating cost of Chapter 11. These fees seem to be far higher than they were years ago. In many cases, I can only attribute this escalation to the increasingly complex nature, size and composition of lender groups where much of the cost appears to be related to managing the group, avoiding exposure, and/or dealing with dissidents within the group. It is not clear that these incremental costs should be passed on to the company.

   FA's and attorneys for the secured lenders should be required to be more transparent as to billings amount and work performed if their fees are being passed through to the debtor.

I'm sure most of these suggestions will be too simple to fully address the complex problems. I do think the changes will need to be dramatic for Chapter 11 to become effective for the small company and to allow for the preservation of many businesses that have a core profitable operation but can't withstand the cost or complexity of the current process.