By Sarah Morgenthau & Allison Everhardt

Using Investigators in Workouts, Restructurings, and Bankruptcies

Given the devastating economic impact of the coronavirus, experts expect a tidal wave of bankruptcies. We are already seeing the growing crest of that wave with Chapter 11 filings by household names such as Neiman Marcus, JCPenney, J.Crew, Hertz, and the ubiquitous fast-casual restaurant chain Le Pain Quotidien. The impact is global—in the UK, department store Debenhams and Byron Burger have also gone into administration.

In light of the competing agendas of the parties involved, restructurings, workouts, and bankruptcies are complex undertakings. They often require expertise from a wide range of legal practices including bankruptcy, commercial litigation, intellectual property, and securities. A plethora of outside experts and consultants is often needed to wade through and untangle debtor obligations and relationships. Used effectively, experienced investigators can assist counsel in protecting the interests of creditors and speeding the resolution of the process.

Legal and finance teams need a detailed understanding of a debtor's circumstances, particularly those relevant to a creditor's interest; this can require comprehensive investigation, including research in open sources and speaking to witnesses. The inquiry should be designed to assist counsel in preparing a strategy that ensures repayment and mitigates risks to the financing relationship and capital. Before any legal team goes to court to secure assets or enforce an agreement against a debtor, it should make sure it knows where those assets are and confirm that they are worth securing. Investigators can provide important assistance in answering those questions.

Successful investigators will, in the first instance, focus on the debtors, tracing debtor activity and identifying debtor relationships to develop information that is not contained in financial records. This research can identify parties with competing interests in security, indicia of fraud, or actions inconsistent with debtor obligations and covenants—all critical findings when working towards a restructuring agreement. Careful research, supplemented by disciplined source inquiries, can pinpoint the financial stress on a borrower and quantify the risks presented by their corporate, commercial credit, and lending relationships. Open source research can also identify undisclosed assets or hidden commitments such as previously unknown liens or judgments that can affect a debtor's ability to meet obligations to its creditors. Taken together, these avenues of investigation can furnish a complete picture of a debtor's actual fiscal health, help prioritize obligations, protect collateral, and mitigate the risk of default.

However, the debtor company should not be the sole focus of fact-finding efforts. Background investigations of senior officers are also important and can identify undisclosed assets, investments, and relationships that are relevant to underwriting and risk assessment. Interviews of recently departed employees, customers, or business partners can yield important first-hand observations of a company's activities and missteps—information not contained in materials customarily available to creditors. They may also point to evidence of fraud or provide invaluable intelligence on inflated performance, vulnerable business lines, and shifts in management priorities.

In bankruptcy proceedings where concerns exist about debtor behavior, asset security, and the status of secured collateral, creditors also need to prepare for the worst. Research on debtors can prove invaluable in verifying information in petitions and schedules or in preparing for creditor meetings or Rule 2004 examinations. It might uncover undisclosed interests, hidden or transferred assets, or other fraudulent activity. A background investigation of any expert or government witness involved in the matter can also provide critical insight into that witness's credibility and suitability, or lack thereof.

As the economic fallout from the pandemic continues to batter the finances of businesses large and small, many more companies—including those with household names—will likely file for bankruptcy. With so much at stake in such proceedings, an investment in investigative research made at the start can pay valuable dividends later.

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