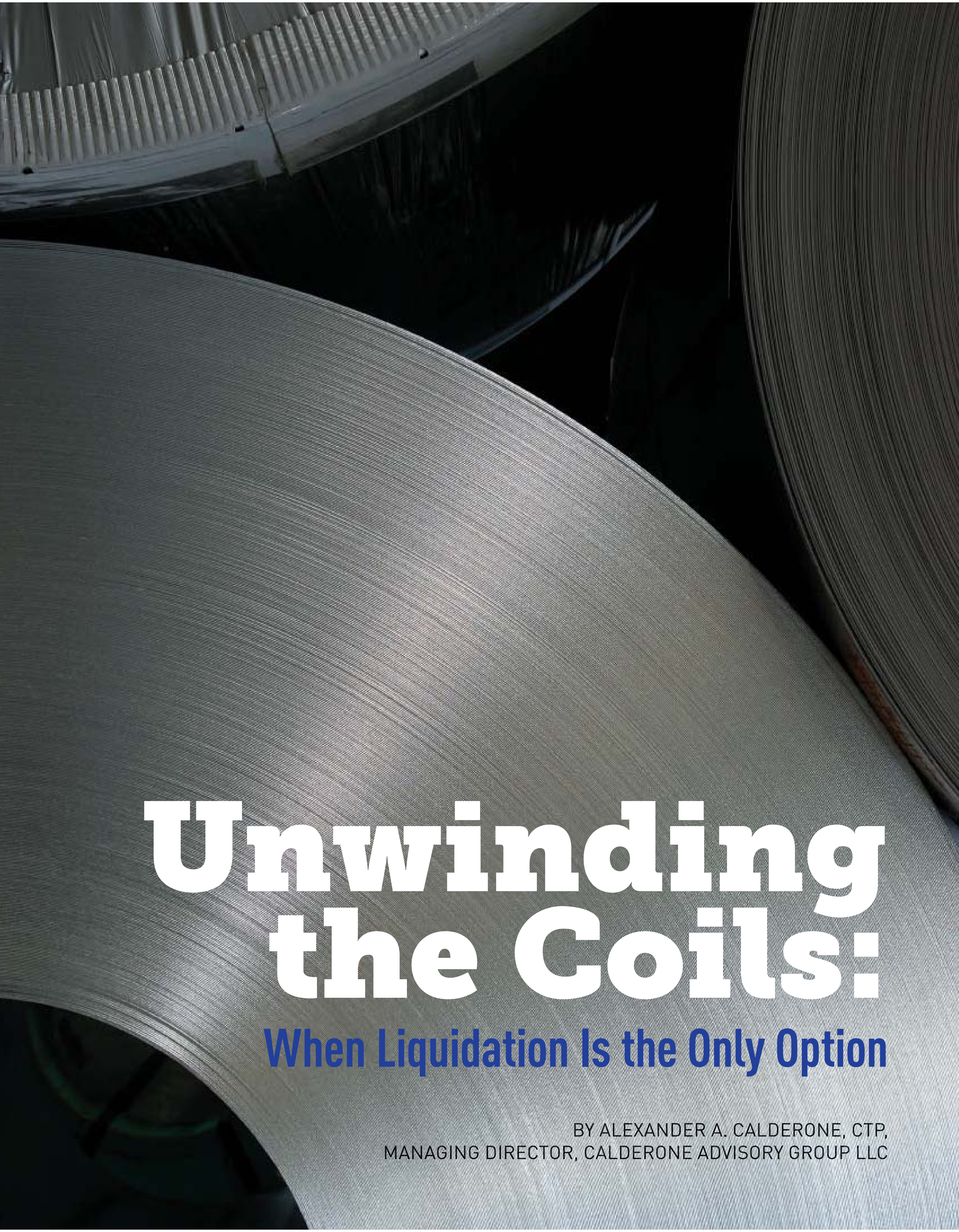

Unwinding the Coils:

When Liquidation Is the Only Option

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With domestic steel prices hovering around their lowest levels since May 2009, many U.S. steel distributors and service centers (hereafter collectively referred to as service centers) find themselves facing unprecedented challenges. The combination of a strong U.S. dollar; weak demand stemming from the precipitous slowdown in investment related to the energy sector, which was a primary consumer of steel pipes; and a glut of imported Chinese steel that continues to enter the United States at artificially low price points has resulted in what many industry observers consider the proverbial perfect storm. Having ransacked its way from Michigan through Texas, this perfect storm already counts among its casualties equity holders, senior lenders, unsecured (trade) creditors, and, most unfortunately, laid-off employees.

In many instances, service centers that had survived even the harshest of yesteryear's downturns, including the recent Great Recession, found that the damage done to their balance sheets from December 2014 through May 2015, when domestic steel pricing declined in excess of 40 percent, would be fatal. Some of these companies worked collaboratively with their senior lenders to effect quick going concern sale transactions and/or orderly liquidations, while others decided to pull the Chapter 11 ripcord with hopes of reorganizing after cutting deals with their junior and senior creditors. In many of these situations, the end result was inevitable and the same—some or all of these companies' assets ended up being liquidated, either out-of-court or in the context of more formal bankruptcy proceedings.

To this end, this article offers helpful tips that every turnaround practitioner should know when tasked with providing consultation and advice relative to the liquidation of a steel service center.

Survival in the service center business requires not only sound business acumen, but also thick skin and in some instances, controlled aggression. The industry, or at least the lower to mid middle market portion, is laden with business owners who started with nothing and, through perseverance, hard work, and a little good luck, developed historically successful companies. These entrepreneurial, Type A business owners are currently in survival mode. Some have gone all in and guaranteed bank debt with 100 percent of their personal assets. Others, having known no other way of life for their entire careers, simply see no alternative employment opportunities for themselves or their family members outside of their current organizations.

What does all of this mean to turnaround practitioners who step onto the scene of a distressed steel service center facing liquidation? The answer is simple: they should expect that some level of controlled, timely, and professionally directed aggression and vigilance will be necessary to maximize the estate's recoveries for all constituents.

Accounts Receivable

One of the largest asset categories on any service center's books and records are accounts receivable. It is this category of assets, in particular, on which a turnaround practitioner must keenly focus from the onset of the assignment.

Setoff risk is significant in the service center business. While there are numerous legitimate reasons for account receivable setoffs, such as improper or irregular metallurgy, rust, and/or other defects; sizing and weight differences; etc., once a coil has been shipped to a customer, it can be particularly challenging to verify whether setoff explanations are actually valid.

During normal times, when customer relationships are important to both sides of a transaction, one can expect that most purported setoffs are valid. Even in a worst-case scenario, when the two parties cannot come to a satisfactory resolution of a setoff claim, a service center can ask that its coil be shipped back to its warehouse for inspection and resale, resulting in an unwinding of the transaction altogether and a chance for the service center to resell its material for an appropriate market value.

However, in a liquidation scenario in which staffing is thin and historical books, records, and email correspondence can be hard to access, resolving a setoff dispute can be particularly challenging, if not outright impossible. That is particularly true if the customer knows that the service center is being liquidated and that it therefore need not be concerned with damaging a future business relationship.

As a result, in this type of a scenario, when the funding clock is ticking and a former customer is no longer concerned about a future business relationship, a returned coil will likely end up at a scrap yard, as opposed to at someone else's manufacturing facility. This author has seen on more than one occasion a coil that originally sold for 30 cents per pound being returned and then sold to a scrapper for less than 4 cents per pound.

In a worst-case scenario, a service center customer may allege sizable setoffs and refuse to pay some or all of an outstanding invoice, while also failing to return the defective material in question because they no longer have it in their possession. Such situations, in the absence of a turnaround professional's attention, can significantly erode recovery prospects for all parties in interest.

So what should a turnaround professional do to protect the value of account receivable collateral? Here are four simple, yet effective, suggestions to keep in mind:

1 Pursue Timely Collection Efforts. While commencing legal action against customers is typically an option of last resort for operating companies that want to preserve future business relationships, this should not be the case in liquidation scenarios. A turnaround professional should strongly consider pursuing this type of legal action immediately, while proper funding and employee access are still available.

To prevail in such collection proceedings, a service center's attorney requires access to employees and email servers to collect evidence necessary to dispute frivolous setoff claims. Far too often, accounts receivable end up being turned over too late to collection attorneys who are forced

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to settle for pennies on the dollar because they no longer have access to employees and other evidence necessary to prevail in their lawsuits.

2 Sell As-Is and for Cash on (or before) Delivery, if Possible. The easiest way to eliminate setoff risk is simply to modify customer agreements to indicate that all items sold during a liquidation process are final, without a right to future setoffs. While one can reasonably expect that such a sale would come with its own valuation discount, such a markdown typically pales in comparison to the cost of lengthy litigation in the future. Furthermore, receiving cash upfront eliminates future collection risk, which is currently at an all-time high across the service center industry.

3 Analyze Accounts Receivable Insurance Options. Service centers, more so than other businesses, tend to be enrolled in accounts receivable insurance programs. While such policies can be confusing to navigate and rarely cover 100 percent of losses, they can significantly protect against collection risk if they are used properly.

In many instances, claims must be reported before receivables become excessively delinquent (typical cutoffs for claim reporting range between 90 and 180 days past due). In addition, most policies require that a detailed set of claims reporting procedures be followed. It is imperative that a turnaround professional inquire about such policies at the onset of an engagement to ensure that submission deadlines are met and proper reporting procedures are followed.

4 Pay Careful Attention to Credit Risk. As stated previously, most service centers currently face unprecedented levels of distress. In a worst-case scenario, a liquidation can result in valuable inventory assets being transformed into uncollectible accounts receivable. A company offering to pay the highest prices for a service center's inventory may not be the most reliable of customers from which to collect receivables. In fact, once word of a liquidation gets out, some companies on the brink of financial failure may be more inclined to purchase from a liquidating company, because they perceive the risk of being held accountable for a delinquent invoice to be much lower. In a service center liquidation, significant attention should be paid to credit risk.

Inventory

In most instances, an inventory listing for a service center can include thousands of line items. In addition, such listings may contain descriptions of coils and other materials that read more like a foreign language than an accounting ledger. A turnaround professional in charge of liquidating a service center must ensure that inventory is being sold for its highest and best value under the circumstances.

In a perfect world, one would expect book value to approximate market value. However, in the current environment, that is rarely the case. As such, it is advisable to bring in an inventory specialist at the onset of the engagement to revalue a service center's inventory so that policies and procedures can be put in place to ensure that selling prices approximate current market values.

One example of this type of a policy would be that sales of inventory that fall below a certain threshold—for example, 80 to 90 percent of the specialist-valued amount—must first receive approval from the turnaround practitioner. Spending the time and money to have a specialist value the inventory at the onset of the liquidation can be particularly effective in ensuring that selling prices are appropriate. At a minimum, introducing these types of checks and balances ensures that salespeople and other employees adhere to their fiduciary responsibilities of maximizing recoveries for the estate, given the conflicting interests that can arise when the service center's employees are seeking new employment, often with a competitor's or customer's business.

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Land, Buildings, Equipment

It doesn't take a genius to understand that selling any asset in a gun-to-the-head situation inevitably results in lower recoveries. In the author's recent experience, many troubled service centers with initial hopes of effecting a going concern sale or bankruptcy reorganization pursued such a singular path, only to run out of cash and realize after the fact that a quick, forced liquidation sale was their only viable option. In these situations, every stakeholder is damaged.

As such, it is imperative that parallel marketing paths be pursued from the onset of the turnaround practitioner's involvement. An extra 60 days to market-test and appropriately auction off these types of assets can go a long way in creating incremental value for the estate. Additionally, pursuing such a parallel path can make bankruptcy situations much more palatable to all constituents involved and eliminate the need for costly litigation associated with sale motion objections from unsecured creditors, who often have the most to lose in liquidation scenarios when there are questions regarding the extent of collateral coverage on a secured lender's claim. ◼