

Crossing the River Styx: Guiding a Lender through a Bankruptcy

Lenders facing the threat of a borrower's bankruptcy should engage qualified guides. Bankruptcy advisors can help you evaluate your risks and manage them, and guide you into, through, and out of a bankruptcy proceeding.

By Howard Brod Brownstein, Contributing Editor

"They then came to the black river where they found the ferryman, Charon, old and squalid, but strong and vigorous, who was receiving passengers of all kinds into his boat, magnanimous heroes, boys and unmarried girls, as numerous as the leaves that fall at autumn, or the flocks that fly southward at the approach of winter. They stood pressing for a passage and longing to touch the opposite shore, but the stern ferryman took in only such as he chose, driving the rest back."

— Virgil's *Aeneid*, Book VI

So begins the poet's description of the treacherous route through the Underworld. In every distressed loan situation, the specter of bankruptcy looms offstage, like the chorus in a Greek tragedy. Particularly for a secured lender, the threat of a borrower's bankruptcy can seem like a perennial Hobson's choice: "am I better off in bankruptcy or not?" For the well-prepared lender armed with good legal counsel and a financial advisor, bankruptcy can be a viable and even preferable alternative, and in some cases a welcome sanctuary from the bad acts of an unscrupulous borrower. But for the ill-prepared lender, bankruptcy can be an unfamiliar and Harry Potter-esque world, in which even the law of gravity is seemingly suspended, and vicious hellhounds devour your collateral.

As with the intrepid Greek heroes crossing the River Styx, the key is to engage qualified guides. Like the wagon train leaders of the westward migration who knew where to cross the rivers and how to negotiate with the Indians, bankruptcy advisors can help you evaluate your risks and manage them, and guide you into, through, and out of a bankruptcy proceeding.

Generally, secured lenders should engage two advisors in every case involving a distressed loan, where the loan amount is of any consequence to the lender: special legal counsel expert in debtor-creditor law, and a financial advisor experienced in bankruptcy proceedings.

In engaging legal counsel, some lenders prefer to seek out the same attorneys who did the "front end" documentation when the loan was originated, the rationale being that they may retain some familiarity with the borrower and the history of the relationship. Lenders who follow this practice may feel that the attorneys should have to "live with their documents", and be forced to help the lender through any problems caused by imperfections in the loan documentation.

A different view held by some lenders is that the skill sets necessary for effective legal representation in "back end" or "workout" situations are different from those in "front end" legal work (the difference has been analogized to carnivores and herbivores). Lenders who follow this view may feel that they do not want the "front end" attorneys to be tempted to cover up any documentation mistakes made at that stage.

Whichever practice a lender follows, the key is to engage legal counsel early. The sooner counsel is engaged, the sooner the lender can learn of any defects in its documentation and remedy them. For example, collat-

eral may have been moved — albeit innocently — to a different jurisdiction, requiring an additional lien filing. There may be property of the borrower that is not covered by the lien language, e.g., after-acquired fixed assets, or intellectual property. If for no other reason than winning at "Beat the Clock" on preferences, at the earliest sign of trouble, engage counsel.

Similarly, a financial advisor should also be engaged on behalf of the lender at an early stage. Preferably, the financial advisor should not be simply reactive, waiting to see what the borrower does. The financial advisor should proactively help the lender determine what information should be required of the lender, how it should be prepared, and how regularly it should be submitted.

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In cases where the lender expects the borrower to be recalcitrant or uncooperative, it may be advisable to select a financial advisor with a "harder edge", perhaps one that typically is engaged by borrowers and therefore knows every trick that borrowers try to pull, rather than one that typically advises lenders. The financial advisor should gain onsite access to the borrower, interview its management, and review its internal reports.

The efforts of the financial advisor should be focused on the key risk points of the borrower: How does this borrower make money? What are the "pinch points" in its operations? What are the risks in this business, and how does the borrower manage them? Most important, what is the current cash flow trajectory, and how can it be improved?

As bankruptcy becomes a likelihood, the financial advisor is essential in helping the lender determine whether to permit use of its cash collateral and on what basis, what should be the terms of any DIP financing provided to the borrower, and how to monitor the progress of the borrower (the debtor-in-possession) through the bankruptcy proceeding. Can the debtor realistically reorganize? Should the lender insist upon the engagement by the debtor of an investment banker to prepare the sale of the business as an alternative?

A financial advisor that is engaged by the lender must take care not to expose itself and the lender to liability or equitable subordination. This means being firm but reasonable in the demands that are placed upon the borrower to provide information, and never telling the borrower what it should

do or how to run its business. In particular, even though cash flow is usually tight and not all obligations of the borrower can be met, the financial advisor should never get sucked into the trap of telling the borrower which creditors to pay or not to pay.

Notwithstanding these dangers, the financial advisor can be a valuable force for improvement by the borrower by using the Socratic method used in law schools — ask questions. For example, the financial advisor's analysis may suggest that certain activities of the borrower are unprofitable, although the borrower may be in denial about this. In such a case the financial advisor might share its analysis with the borrower (or the borrower's financial advisor, if it has one), asking, "Our analysis suggests XYZ. Could this be right? Please help us by checking it over and telling us what you think."

In many cases the lender is Administrative Agent for a lender group to which it has contractual obligations. Needless to say, the participant lenders may be disappointed that their outstanding loan is in jeopardy, and may focus this disappointment on the Agent. Their decision making process may have become sclerotic. The lender group may include fundamentally different viewpoints, due to being comprised by: regulated and nonregulated lenders, lenders that have taken a reserve versus those that have not, lenders that have transferred the loan to their workout group versus those that have not, distressed debt purchasers who own their portion of the loan at a discount, etc. The Agent may feel that it is fighting a two-front battle, one with the borrower and one with its own lender group. The financial advisor can be the key to getting all of the lenders on the same page, expediting their decision making processes, and preventing claims against the Agent.

As mentioned earlier, one good reason to engage advisors early is to prevent exposure to preference avoidance by the debtor. Simply stated, the preference rule in bankruptcy permits the debtor to avoid transactions within the ninety-day period preceding the bankruptcy filing through which a creditor improved its position. The exceptions to this rule are several and can be complex, and the application of the preference rule to a lender may depend on whether the lender is over or undersecured. Since this often cannot be reliably determined in advance, the safest approach is to prevent application of preference avoidance by taking necessary actions early and hoping that the ninety-day preference period elapses prior to a bankruptcy filing. And taking such actions requires having one's advisors engaged and in gear.

Another standard action is to obtain a release from the borrower for any alleged prior bad acts by the lender. It is typical for borrowers in distress to blame the lender for having previously made credit obtainable, and for now shutting off the faucet. The earlier a release is obtained, the likelier it will stand up legally if later attacked.

The lender's legal and financial advisors should act collaboratively. Typically they will know one another, since the world of corporate renewal is really a community. Regular communication among the lender, legal counsel, and the financial advisor will keep everyone updated and ready to take action.

As bankruptcy filing draws nearer, it will become apparent whether it is prepackaged, preplanned or "free fall". In a prepackaged bankruptcy, the necessary support for a successful reorganization has been lined up in advance, a Plan of Reorganization can be filed on or soon after the petition date, and the entire process can be reduced to a matter of months. Since such instances typically require unsecured creditor support to proceed, they are rare except where the decision making of unsecured creditors is concentrated, such as where much of the unsecured debts are owed to bondholders. More typical is the preplanned bankruptcy, where debtor and the secured lender enter the proceeding in agreement concerning the use of cash collateral or DIP financing. Preplanning requires vigilance and early action on the part of the lender, starting with the engaging of advisors. The statistics for middle market companies emerging from bankruptcy and avoiding a recurrence are not promising, especially for a defensive, "free fall" bankruptcy filing, but the probabilities go up dramatically where there is preplanning.

Craig Rasile¹, a veteran bankruptcy lawyer in the Miami office of prominent national law firm Hunton & Williams, says that when he is engaged by a lender in a distressed loan situation in which bankruptcy is a likelihood, he first seeks to identify the nature of the borrower's business and basis of its problems. How does the lender's financing work, and what are the types of defaults (e.g., monetary or non-monetary) that have or are likely to occur?

Craig reviews the loan documentation on a fast track, often having subordinates in his department help him digest the typically voluminous files by summarizing each document. He and his team analyze whether or not bankruptcy benefits the lender, and how timing issues impact the case. Working with the lender's financial advisor, Craig helps frame alternatives for the lender based upon whether the borrower can likely reorganize, whether a sale of the business is possible and preferable, whether the borrower's management team is up to the task of getting through a bankruptcy, and many other variables.

Once Craig has delivered his analysis to the lender, he helps the lender come to grips with its goals and its bottom line, using three scenarios: Plan A, a best-case outcome for the lender; Plan B, what the lender would be willing to live with; and Plan C, the worst case scenario, how far the lender would be willing to go before forcing liquidation.

Armed with this analysis, the lender's actions in a loan situation that is heading for bankruptcy can include a release as noted above, stipulation by the borrower to amounts owed and the validity of the lender's liens, provisions for lift of the automatic stay, requirement that the borrower engage a turnaround professional who is required to provide information regularly to both the borrower and the lender, and adherence to a budget that is the centerpiece of a forbearance agreement. This can provide a segue to determining whether and how to support a borrower through bankruptcy.

Another prominent legal advisor to lenders, Brian Trust² of Mayer Brown Rowe & Maw's New York office, emphasizes the importance of using the cash collateral stipulation or DIP financing order as an expansive device to create control for the lender. Even where it is expected that use of cash collateral will be sufficient for the debtor's needs, Brian prefers to utilize a DIP financing structure where a DIP loan facility is utilized only in the (unlikely) event that cash collateral is insufficient. This provides the lender with better leverage to control the timeline of the reorganization as well as other aspects like exclusivity, default triggers, and possibly bridging to a §363 sale. The cash collateral stipulation or DIP loan order should typically require the debtor to engage a turnaround advisor or Chief Restructuring Officer who is required to provide information to both the debtor and the lender.

Increasingly, lenders in distressed loan situations are unwilling to finance a long turnaround. While they might prefer repayment through the borrower's recovery, lenders today typically provide for a second and third way out: sale of the loan³ and sale of the borrower's business. Regarding the latter, many lenders require the borrower to engage an investment banker that specializes in distressed M&A, before bankruptcy if possible, but even more so as part of bankruptcy preplanning. The distressed M&A specialist is often called upon to keep all stakeholders informed of its progress, including the likelihood of a sale and amount of possible sale proceeds.

Where the borrower wishes to pursue a sale of the business as its main strategy for corporate renewal, a bankruptcy proceeding can be a valuable way to "cauterize" the assets, freeing a buyer from successor liabilities and ensuring good title to the assets purchased. In such cases, it is not unusual to see a §363 motion to sell the business attached to or follow closely upon a bankruptcy petition.

One prominent distressed M&A expert, Mark Chesen⁴ of SSG Capital Advisors, focuses on enterprise value, especially to a strategic buyer, since underperforming companies often do not enjoy EBITDA multiples or other methods of valuation that will attract financial buyers. Mark says, "The ins and outs of §363 sales in various jurisdictions are quite complex, and the path for prospective buyers has to be blazed by an experienced distressed M&A firm." The process is intricate: canvassing prospective buyers, dissem-

inating information about the debtor pursuant to a nondisclosure agreement, obtaining preliminary bids, selecting a stalking horse bidder, assisting in negotiations of sale terms, establishing bidding procedures and break-up fees, obtaining court approval, supporting the provision of due diligence to bidders, and managing the sale through to closing. Mark cautions that, in order to be effective, the investment banking firm should be engaged at least three to six months in advance of when a sale is desired, otherwise the process can be constricted and lower sale prices result.

Finally, the matter of professional fees: For quality oats, you must pay a reasonable price; for oats that have already been processed through the horse, you can pay less. Therefore, choose quality advisors that are proven experts in their fields, even if they are not the least expensive. The legal advisor should have several years experience in creditors' rights, and be comfortable appearing in bankruptcy court in the jurisdiction where a proceeding will be filed. If that is a different jurisdiction from the legal advisor's location, then local counsel should also be engaged in order to have familiarity with the judge's expectations. Choosing a financial advisor that is a Certified Turnaround Professional (see www.actp.org) can provide some assurance that he or she has earned an important credential in the field, and has made corporate renewal a career and not a stopover. It is important to pay one's advisors; those who failed to pay Charon, the mythical ferryman of Hades, were "not permitted to pass the flood but wander a hundred years, and flit to and fro about the shore." [abfj](#)

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ENDNOTES:

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- 3 See my colleague Keith Stein's article, "Exit Strategies for ABLs: Asset-Based Loans and the Secondary Market" in *ABF Journal*, October 2003, available at <http://www.nhbteam.com/pdf/Stein.pdf>
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