

Checking Your Blind Spots...

Preparing for a Borrower's Bankruptcy

Planning for your borrower's bankruptcy proceeding must be systematic and comprehensive. While it's easier when you have ample time to prepare — perhaps even to see if a "prepack" is possible — such preparation usually must be made with a tempo of controlled urgency.

By Howard Brod Brownstein

The day was beginning routinely enough for a Monday morning. The weekly Borrowing Base Certificates had been reviewed on Friday by your account officers, and there had been no blips, no over advances. Ineligibles were not increasing, assets were turning nicely, and the collateral was all tucked in, sleeping peacefully. You lean back in your chair, sipping your second cup of coffee and scan the morning news headlines: election campaign news, Argentina advances in World Cup competition, oil discovered in the Islets of Langerhans, France imposes antidumping tariffs on American cheese...

You turn to the business news, and your eye spots the short item at the bottom of the page: "Feds Recall Venetian Blinds":

"Washington (AP Wire Services): The Consumer Product Safety Commission announced a recall of a leading brand of Venetian blinds, citing potential safety hazards to children caused by peeling paint. The blinds, sold under the popular brand names 'Morning Glory' and 'Lovely Louver,' as well as through private label at Wal-Mart, Kmart and Home Depot, were manufactured in China for Boulevard Blinds, the leading U.S. distributor of blinds. The chain stores as well as independent retailers have been ordered to remove the product from their shelves immediately. CPSC has set up a toll-free number for consumers to obtain further information: 1-800-No-Blind (662-5463)."

Boulevard Blinds is one of your borrowers! One of your largest borrowers! The company had experienced an increase in sales returns and allowances lately, but had assured you that everything was under control. It was just a problem with the supplier, the company would be able to pass along any returns or discounts. The company CEO had recently returned from China and had announced that the problem had been solved.

There's no way Boulevard Blinds will be able to avoid bankruptcy. Even with a cooperative supplier, there will be an avalanche of inventory returns, collections will dry up as customers posted debits. Cash flow will shut off like a spigot.

You call your borrower, who has read the news and somberly concurs that it has already begun planning a bankruptcy proceeding. He confesses that he knew the CPSC had been investigating but had believed the problem was limited to a few stores and one or two bad product batches. You ring off and think about your next steps. You take out a pad and begin to make a list.

While the facts vary from case to case, the disciplines and skill sets that are required remain the same. Planning for your borrower's bankruptcy proceeding must be systematic and comprehensive. While it's easier when you have ample time to prepare — perhaps even to see if a "prepack" is possible — such preparation usually must be made with a tempo of controlled urgency.

Get Counsel in Gear

Like many areas of the law, representing lenders in a borrower's bankruptcy is a specialty. While lenders may utilize the same legal counsel that performed the "front end" loan documentation work, many lenders seek out a "back end" specialist, perhaps within the same law firm, who specializes in consensual workouts and bankruptcy proceedings.

One such specialist is Brian Trust of Mayer Brown Rowe & Maw in New York. Trust is frequently called in by the administrative agent in large loans, as well as smaller lender groups in middle market loans, and is an expert in debtor-creditor law. While Trust is no slouch in a fight of the nastiest kind, he feels that too many bankruptcy proceedings are needlessly adversarial. He prefers to look upon his lender clients as providers of capital — in the form of debt — to borrowers, with an alignment of interests with management on the critical issue of maximizing value.

The key, Trust says, is to get management to understand this, and in particular the fiduciary duties of the board of directors and officers that they owe to creditors in an insolvency. It is common for the directors of even a substantial enterprise not to be independent outside directors, but to have been installed by an equity sponsor or large investor. Trust therefore writes to the directors to inform and remind them of their duties to creditors.

Trust reaches out early to debtor's counsel in order to establish one or more game plans for the bankruptcy proceeding, to "begin with the end in mind." What are the possible exit strategies? Is this a "sale" case or a "plan" case? A "free fall" bankruptcy always hurts enterprise value, and nearly all debtors will be able to win use of cash collateral at least temporarily. Therefore, a consensual cash collateral stipulation or DIP agreement is a great opportunity for the lender to control the course of the proceeding. Reporting requirements can be agreed upon, benchmarks and milestones for cash flow performance can serve as useful parameters to keep the proceeding on track, and other guidelines can control whether to shift to a sale strategy if a turnaround and reorganization appears unlikely.

The best lender's legal counsel should follow Trust's approach of pragmatism: focus on cash flow, understand the cash management system of the debtor and how it will operate in bankruptcy. Also, it goes without saying that a document review and lien search should be performed immediately, although if the company has been in distress then this should have been already accomplished, together with the remediation of any document or lien imperfections as part of forbearance agreements or covenant waivers. Regardless of when the document and lien review is performed, Trust has seldom found a case without document or lien imperfections that should be addressed.

Engage a Financial Advisor

Turnaround management is a specialty just like debtor-creditor law, with its own distinctive skill sets and disciplines. While there are several well-known firms that concentrate on lender-side engagements, the key is who within an advisory firm that you will get. And in some cases, engaging a firm that is more commonly known for debtor-side engagements can be an advantage.

For example, in one recent case, the debtor had stubbornly refused to engage an advisor except to seek refinancing, and so there was a lack of reliable and useful information available about the debtor's business and its plans for reorganization. The lender engaged a firm known for debtor assignments, which was quickly able to develop the information needed for the lender to make sound decisions. The financial advisor's analysis showed clearly that two of the debtor's business lines were hopelessly unprofitable, but this was obscured by the debtor's cost-averaging and other accounting policies. The lender's financial advisor dared not dictate to the debtor how to run its business, which could have created exposure for lender liability and equitable subordination for its client. So the advisor, which had established a good rapport with the debtor's management, shared its analysis with the debtor stating that "the analysis must be wrong" and asked debtor's management to help find the mistakes so that the lender could be advised correctly. Of course, there had been no mistakes, and once the debtor had performed the same analysis and reached the same conclusions, it took action to shut down the underperforming operations. The advisor was careful to document that the debtor had decided this on its own.

Where the lender is administrative agent for a lender group, it may find itself facing issues not only with the borrower, but also with members of its own lender group who may be more than disappointed at the turn of events. The lender group may include a diversity of viewpoints from regulated and unregulated lenders, not all of which lenders may have recognized a write-off. There may be debt-buyers among the lender group whose outlook and timetable may be very different, and who are accustomed to taking an equity stake for a longer-term return. The financial advisor can help to harmonize the lender group by objectively establishing a common understanding of the facts and taking heat off of the agent.

A financial advisor who is a certified turnaround professional can help establish credibility with all sides in the case, including issues among the lender group itself. Unlike an attorney, a financial advisor is not an advocate, so in order to be effective, a financial advisor should have a reputation for objectivity, and be able to establish collegial relationships with other professionals in the case. The advisory firm should act in close cooperation with lender's counsel, serving as an important gatherer and analyst of information, as well as a potentially valuable back channel to the borrower's advisors to help reach a common understanding of the facts, achieve consensus and minimize unnecessary squabbling.

Lenders should avoid being penny wise and dollar foolish, eschewing the engagement of a financial advisor to save money. In any sizable loan, the stakes are just too high. Better to engage a reputable firm and candidly discuss budget constraints. The advisory firm should work with you to identify the key drivers of their fees, so that you will have more control over the cost and ensure that you're getting what is most important to you.

Gather the Files & Assemble the Troops

Some hard-copy files may be in other offices or in storage, with only electronic images readily available. Originals may be needed for evidentiary purposes and to confirm that everyone is working from the latest revision or amendment. Auditors should be dispatched to check the collateral, even if it had already been done relatively recently. The loan register should be kept up to date, and an eye should be kept on debt trading, including of unsecured claims. News sources should be monitored, and where the borrower's problems are legal or regulatory, an independent assessment should be made of its situation.

Assign staff to this credit — exclusively if necessary. Bankruptcy proceedings are typically front-loaded with tasks for the all parties including the lender, so be sure you have the staffing to handle it.

Start Restructuring the Deal

Redo the credit analysis and identify areas of risk and how these should be managed. For example, for a retailer, inventory turns, discounts and sell-through rates, four-wall store analysis, and comp store reporting could all be helpful in managing the credit. Watch a retailer's supplier support closely. For vendors, watch bookings and shipments to key customers, as well as inventory turns, sell-through and discounts. A smart customer will not want to depend on a vendor that may or may not reorganize, so be alert for degradation in the customer base.

Revisit credit enhancements and obtain releases. While these may or may not later be considered avoidable preferences, it's better to have them. And while on the subject of preferences, have your financial advisor examine historical records of payments to vendors, since preference recovery may become important to your recovery.

Require the debtor to engage a qualified turnaround manager in either an advisory or management role, as appropriate to the situation. For example, if there has been any suspicion of improprieties, it may be necessary to insist upon an interim CEO or CRO. The turnaround professional's scope of work should be mutually approved, and the lender group should receive copies of his reports and have access to him.

Restructure the loan from scratch, if possible, as part of the cash collateral stipulation or DIP loan agreement. Minimally, require that the debtor stay on a conservatively formulated cash flow projection, with room only for reasonable variation. Identify and establish key milestones and timetables, e.g., for important initiatives such as inventory or cost reduction, to be accomplished, as well as for progress towards a Plan of Reorganization. Install alarms and covenants to provide early warning of further difficulties, such as loss of key customer or vendor relationships. The cash collateral stipulation or DIP loan agreement may be your best opportunity to get as much of your "wish list" as possible.

Have a Back-Up Plan

If a sale of all or part of the debtor's business may be necessary to maximize value, consider requiring the debtor to engage an investment banking firm at the outset, and establish a decision date and criteria for executing the sale efforts.

In one engagement, it was unclear at the beginning of the case whether the company would be able successfully to implement a turnaround. It was therefore agreed that the debtor would engage a financial advisor as well as an investment banker, and the financial advisor would include in its scope of work, the assembly of information for the investment banker's initial due diligence and formulation of a confidential sale memorandum. The investment banker was also authorized to begin assembling names of potential strategic and financial buyers. Then, when in fact a turnaround was not possible, the investment banker was able to proceed without delay to pursue a sale exit for the creditors.

It also pays to maintain an up to date liquidation analysis. Enterprise value can easily deteriorate during a bankruptcy, including the value of intellectual property such as store brands and trademarks, as well as technology that can obsolesce.

Lenders that think about bankruptcy as a part of loan management, and are prepared to go to "battle stations" when necessary, can maximize value not only for themselves, but for all stakeholders. **abfj**

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