

# Surviving the Credit Crunch - New England Roundtable Series 2008

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The credit crisis has affected companies in every industry and sector. What can companies expect in the short term? We've asked four experts for a crash course in survival. They are Daniel Carragher of Day Pitney in Boston; Sanford Davis of Withers Bergman in New York; Frederick Gold of Shipman & Goodwin in Stamford; and Paul O'Donnell of Hinckley, Allen & Snyder in Boston. This panel, moderated by freelance legal affairs writer Susan Kostal, was held at the offices of Day Pitney in Boston and recorded by Pauline L. Bailey for Catuogno Court Report and Sten-Tel Transcription.

**MODERATOR:** Let's start with the TARP. Is it having any positive effect yet?

**DAVIS:** It's not entirely clear. The TARP-meaning Troubled Asset Relief Program-has not yet had any noticeable impact on the credit markets, certainly not what was intended. The TARP was set up through the Emergency Economic Stabilization Act in October 2008. It gives the Treasury two specific weapons to address the credit crisis at the capital markets level.

One, it has the authority to buy troubled assets, such as residential and commercial mortgages, as well as their derivatives, such as CMOs, or collateralized mortgage obligations; CDOs, or collateralized debt obligations; and credit default swaps, from financial institutions.

Two, Treasury can invest in either debt or equity instruments issued by financial institutions in an effort to correct and stabilize the market. In lobbying to pass this, Treasury Secretary Paulson focused on asset purchases. Within weeks, Paulson shifted the focus to putting funds directly into large financial institutions. Specifically, the Treasury invested an initial \$125 billion in nine top financial institutions. Additionally, the Treasury is sprinkling another \$125 billion among other financial institutions that are all rushing to get their applications in to Treasury. This includes foreign-controlled banks with significant U.S.-based banking activity. The Treasury has a large amount of discretion as to who gets TARP money, most of which has not yet been deployed. The first \$125 billion has not had an impact on the large capital markets, as those institutions are hoarding the cash.

So far, we've seen none of the intended multiplier effect.

**MODERATOR:** Are financial institutions the only companies affected by TARP?

**GOLD:** Everyone is affected by the market conditions that impelled it. Manufacturers are worried that critical suppliers won't be able to deliver shipments. Suppliers are concerned that their buyers won't be able to pay. And lots of companies have concern about whether their credit line will be sufficient. The magic question is what is it that's going to turn things around. We'll know we're on the right track when people start competing to buy up low priced properties, and when Wall Street starts competing to get a good price for some of these stalled CDO, CMO, and other derivative products that are clogging the system.

**MODERATOR:** Paul, what are you seeing from your perspective as a bankruptcy and workout specialist?

**O'DONNELL:** Our bank clients have had to decide whether to take the TARP money. What's tricky is the government has made it clear that the rules may change with regard to what the requirements are for the institutions that accept these funds. So it's no real mystery that institutions aren't lending, if the government can come to them next week and say this is what we want you to do with the funds. The rules are changing on a daily basis.

**CARRAGHER:** We've entered a new era of regulation where a lot of the non-bank lenders are now accepting federal money and the increased oversight that comes with it, which includes what they pay their executives and how they conduct their business. That is likely to continue with the change of the administration. But the liquidity problem is deeper than something that will be resolved with the first \$700 billion. Clearly, companies that have relationships with banks are having liquidity problems. But so are banks. It is the banks that need to exit their credit relationships to increase their liquidity and survive. It places new pressures on both sides of the table.

**MODERATOR:** Are there situations or circumstances in which an institution would not want to take TARP money?

**CARRAGHER:** Initially, there was some fear that accepting government money would be viewed as some kind of stigma on the institution. That changed very quickly. It almost became a Good Housekeeping Seal of Approval; if the government was willing to invest in your institution, it meant that you were sound. So while many banks have signed up, those with the ability to maintain their independence are choosing to decline the

funds.

**DAVIS:** In addition to the independence factor, the Treasury can also require warrants as part of the TARP transactions, so you have a potential dilution concern as to shareholders.

**GOLD:** Keep in mind that TARP doesn't do anything directly to address home values, a key cause of the downturn. It doesn't address foreclosure issues. It's a very interesting question as to whether the credit end of the equation or the real estate end of the equation is a better place to start trying to address the problem. One way or another, both the credit and real estate markets are going to have to sort themselves out. On the credit side, these stalled derivative products need to start working their way through the system. What role the TARP funds will have in all of that is an open question.

**MODERATOR:** And addressing who owns what portions of that debt is part of solving the problem, is it not?

**GOLD:** It's a big issue that predates TARP. For some homeowners trying to restructure mortgages, finding out who owns their debt, rather than who is merely acting as its servicer, is a big problem. Some creditors are claiming that while they have a right to foreclose, they don't have a right to restructure, because they don't own the debt. There is no systemic answer to this challenge. It is being addressed in different ways by different creditors in different jurisdictions.

**MODERATOR:** What are the first steps for an in-house counsel dealing with the credit crisis? It seems like a self-audit is a good place to start—assessing where you are with your credit with a full review of existing credit agreements.

**O'DONNELL:** In a stable economy, companies negotiate a credit agreement, they close, they get access to their line of credit, and the agreement goes in a drawer in the lawyer's office and no one looks at it. Unfortunately, we're in a time where people need to pull out those documents and see exactly what they say. When does it expire? What's the likelihood of an extension? What are some alternative sources of financing? Are there any existing defaults, technical or otherwise? Cure the defaults that can be cured, and work with the lender to resolve the others as soon as possible. Know that the lenders are going to try to exit some of these credits if given the opportunity.

**CARRAGHER:** In the last boom cycle, most liquidity problems could be solved pretty easily by finding a new lender. There was intense competition among lenders, and money was given out on fairly easy terms. It was the era of covenant-lite loans, and it was almost impossible to default on the credit line until it came due. We also had new entrants into the capital markets—special-situation lenders and hedge funds, for example—that were willing to lend not only on the traditional bricks-and-mortar assets, but were willing to lend against enterprise value, and look at multiples of earnings. That led to an environment where it was easy to solve problems; someone else would always come along to refinance a lender out of a troubled situation.

Today, replacement financing is very difficult to come by, and it's not going to be on the same terms. If a company had unsecured credit and fairly open terms, they're now probably looking at an increase in pricing, tighter covenants, more restrictions, and requirements for more equity to be infused into the company. Others will find only secured financing. Companies that are asset-light, because they've sold off plants and distribution centers and leased them back, will find they don't have assets to pledge. Their receivables are their inventory. These are the companies facing the toughest times.

**GOLD:** With the absence of take-out financing, lenders are going the extra mile to work with borrowers to try to restructure, including lenders who, in the past, would simply have exercised their rights. In this environment, if it's a real estate loan, the last thing the lender wants to do is own the property. If it's an asset-based loan, the last thing the lender wants to do is take over the business. Lenders are generally forbearing as long as they can.

**DAVIS:** There is greater focus on attempting to work out the debt relationship outside of bankruptcy. The interesting thing is that notwithstanding how distressed the markets are, the number of bankruptcy filings of corporate entities is not really all that high yet. The American Bankruptcy Institute has a figure for 2007 of about 28,000, lower than any year since 1980. But data for 2008 indicates filings are now climbing fast.

Foreclosure is a lose-lose proposition. And yet, there is really little or no debtor-in-possession financing that could fund a Chapter 11 reorganization. So the options from both the debtor and creditor sides are limited.

**O'DONNELL:** In this climate, who wants to be holding real estate and trying to unload it in the market? Who wants to be chasing your borrowers' receivables and trying to liquidate their inventory? There is a desire to try to avoid the ultimate collection against the collateral. There isn't credit available in Chapter 11, and reorganization turns very quickly into liquidation. You need an exit strategy and a lender in place to help you come out of Chapter 11.

**DAVIS:** My firm serves as counsel in private equity, venture capital, and M&A transactions. With respect to new capital sources for distressed companies, as was the case in the down cycle of 2000 to 2002, the trend we're seeing is a shift to mezzanine-type investments, in which investors seek very high returns through either warrant kickers or turbo-charged multiples of preferred capital as liquidation preference.

**CARRAGHER:** Retailers selling to Target or Wal-Mart are seeing their orders cut in half for next year. In that environment, a company typically would want to consider Chapter 11 as an alternative. But Chapter 11 presents a much less workable alternative in the current market. A company that needs financing to operate during a Chapter 11 is going to find it very difficult to locate that financing. If you can't finance your company's operations during a Chapter 11, it doesn't make sense to go in. And even if you can get debtor-in-possession financing, finding replacement lenders to exit the Chapter 11 is even more difficult. So today's Chapter 11s lead very quickly to liquidations of the business, and those liquidations benefit the secured creditors and rarely anyone else. In that environment, it makes more sense to try to work out the financial problems without going into Chapter 11.

**MODERATOR:** What are a company's options, then?

**CARRAGHER:** You have to be prepared to tackle the difficult problems up front. You need to be prepared for greater transparency, being more open with lenders, allowing them to evaluate your business along with you, because changes do need to be made. Business models that made

sense in a time of greater consumer confidence and higher retail sales may no longer make sense.

**MODERATOR:** Does litigation make sense in this scenario, or is it an added expense?

**GOLD:** It almost always makes sense to avoid litigation, if possible. Litigation does not solve these systemic problems. What this economic climate does is put decision makers in a position in which they may feel they have no choice but to litigate a dispute, because the market will not come to their rescue and help solve it for them.

**MODERATOR:** In modifying loan terms in a workout scenario, are there tax considerations?

**DAVIS:** Anytime debt is restructured, there are some very significant and sometimes very subtle tax issues. One would think that when a company is in distress and having trouble meeting its obligations, tax may be the last thing to drive a transaction. The truth is, there can be, from modifications to debt obligations, such as cancellation and reduction of the overall payment obligation, cancellation of indebtedness (or COD) income. General counsel need to be aware that if the company doesn't restructure in an optimum fashion, there can end up being a tax bill, even when you are running a business at a loss.

The general counsel should look at the origin of the debt obligation. Was this an obligation that financed the purchase of an asset, or a subsidiary, or was it just a credit line to finance general operations? There is a purchase price adjustment exception to COD income recognition. If I received seller-financing, and then the value of the purchased asset declines and we restructure, rather than being forced to recognize COD, in certain cases under the tax code, the basis of that asset would be written down to the adjusted value. And the cancelled portion of the debt could be excluded from income on the basis that the parties have revalued the original purchase.

You also need to consider who is the debt holder. Where the holder happens to be a shareholder, there is a contribution to capital exception to COD. And finally, the general counsel has to take a look at the value of the enterprise as it stands. Valuation is critical to determining whether the enterprise has entered the zone of insolvency, and to what extent, because there is an exception under the Code to recognition of COD income to the extent of the insolvency.

Lastly, a general counsel should look at its tax attributes that are very valuable assets going forward, such as the net operating loss position. The general counsel should assess whether during the prior three-year period there have been changes of ownership that might limit the utilization of the NOL on a go-forward basis.

**CARRAGHER:** The zone of insolvency is a very important concept for general counsel. In this environment, a company that has historically been profitable may now be looking at losses. And while they still may have a solid balance sheet, they have liquidity problems, and they're not able to pay their debts as they become due. If they've entered the zone of insolvency, it triggers new duties, and the corporate governance issues take on a new dimension. Fiduciary duties may shift from protecting shareholders to considering the interest of creditors. The corporate board needs to be protected and needs to be advised on their duties so they don't become the target of litigation. The watchwords are good faith and diligence. Alternatives need to be considered and evaluated from the standpoint of creditors and not just shareholders.

**MODERATOR:** Are there any special concerns regarding bringing in experts to reassure the board?

**GOLD:** Watch out for conflict issues. Protecting the board and senior management from breach of fiduciary duty claims, on one hand, may be in conflict with maximizing the company's economic advantage, on the other, especially if the company is in or arguably close to the zone of insolvency. Sit down with corporate counsel and process the threshold question of whether there is an actual or potential conflict. If so, it may be prudent to bring in another team of lawyers for the benefit of the board and/or senior management.

**CARRAGHER:** The other conflict that can arise is that the interest of management and the board can diverge. Management wants to continue the enterprise, maybe with a new owner. The board wants to preserve its existing investment. Many lenders willing to make loans to distressed companies are investing lower in the capital structure. They're investing for control of the company. By turning to those distressed debt providers, you're facing the prospect of turning over control of the company to a new owner.

**O'DONNELL:** If you bring in a restructuring officer or consultants, the board is not relieved of their responsibilities and duties. Courts have penalized boards that have merely rubberstamped restructuring plans proposed by others. The board is still bound by its due diligence and fiduciary obligations.

**MODERATOR:** Let's talk about transactions in this market. What kind of unique concerns and due diligence issues exist now that valuations are all over the map?

**DAVIS:** Deals were slowing down before TARP. In this credit freeze scenario, most transactions have been radically altered in terms of their pace and prospects. Two years ago, term sheets were getting done quickly, often within a week to ten days. Most of those deals were bank-sponsored. Now, we're in a whole new world. Borrowing cash is off the table. That now raises the importance of seller-financing techniques, where promissory notes are constructed and the sellers don't walk out of the closing with mostly cash. Another form of acquisition currency is for the acquiring company to give equity. And a third form of acquisition currency is a joint venture structure businesses, combine certain assets and create a new equity position in an ongoing operation. Each of these possible acquisition currencies poses a much more complicated negotiation path for the parties. Because cash isn't coming in and the seller isn't being taken out right away, there are many more commercial terms that have to be worked through so that parties can safeguard their interests. Similarly, from the perspective of the parties past the term-sheet stage to the definitive contract stage and then to closing, there is the phenomenon of mutual due diligence. The seller that is taking back a note from the buyer needs to understand the buyer's business and ability to pay. The seller who is taking back stock of the acquiring company similarly would be doing due diligence on the acquiring company in a manner quite similar to the acquiring company's due diligence of the target company. The same would be true in the joint venture setting. So, term sheets are going through more iterations. Parties are being much more cautious, and have more issues to address.

**O'DONNELL:** Deals are so much more complex when they involve taking stock or debt as consideration, as opposed to cash. If I'm buying your car and we both agree that it is worth \$2,500 and I pay you in cash, you walk away with the cash and I walk away with the car. I don't care what you do with the cash, and you don't care what I do with the car. But if I'm giving you a note, and you're taking a security interest in the car, we're joined at

the hip even though the deal is closed.

**GOLD:** If you're going to try a joint venture and your company doesn't have institutional experience with that mechanism, be careful. Joint ventures can be traps for the unwary. Even if the economic terms of the deal are very carefully considered and very artfully negotiated, one thing the parties sometimes neglect to consider is whether each side is equally committed to the deal in terms of sweat equity. It is not uncommon to find out later, if the deal goes bad, that one side was in it for the economic upside but actually expected the other side to do all the work. Surprisingly, joint venture agreements sometimes neglect to spell out a precise division of responsibility. The result can be that the parties end up litigating what terms like "best efforts," "reasonable efforts" and "good faith" were intended to mean under the particular facts and circumstances.

**DAVIS:** There's a huge emphasis that needs to be placed on the unwind in the event that that marriage in the joint venture is unsuccessful, or when it has served its purpose and it is time for the parties to go their separate ways. There needs to be very specific focus on who gets what assets. And that, too, is a very tax-sensitive process.

**CARRAGHER:** The other transaction we are seeing more of is the acquisition of distressed assets through bankruptcy. That process is very different. From the buyer's standpoint, there's very little opportunity for due diligence. They only have 30 days to look at documents, and have very limited access to management to ask the questions you would normally ask about the company. You have to operate with imperfect information, yet there's a need to move in quickly, size up the business, and make an unconditional offer.

**GOLD:** There will be buying opportunities in commercial real estate. There are unfinished projects in various stages of development or construction that are stalled for lack of financing. Perhaps the project started with a construction loan, partially funded, but there is no take-out financing and the construction lender will make no further advances. Both the developer and lender are stuck in limbo. The unfinished project is sitting there. That may be a buying opportunity for somebody with cash who wants to invest a long dollar. Sooner or later such opportunities are going to help jump-start the economy. Real estate is going to be seen as an attractive investment again at some point.

**CARRAGHER:** The board needs to be alert for and adept at responding to opportunities for strategic acquisitions. There are good companies that are failing because of liquidity problems, because they can't get the credit they need to maintain their business. The business may simply be too large for the size of its credit line, and they need to sell. If you get the right team of people to help you do that compressed due diligence, and be the first one to the table to make an offer, you have a good chance of winning that bid at a bargain price.

**MODERATOR:** Let's assume our client has so far stayed out of bankruptcy and is not in need of an immediate workout. What is the one thing that general counsel needs to do before he or she goes home this weekend?

**O'DONNELL:** My general rule is to pay attention to the basics. Watch your receivables, customers and suppliers. In this economy, a company needs to be on alert in terms of watching their own business very closely. You won't minimize the nicks, but you can try to eliminate the big problems, of, for example, a customer getting way ahead of you on credit. If you can manage those, you're going to be better able to weather the storm.

**DAVIS:** General counsel have to do their basic knitting, but also see the bigger picture, and be vigilant on both fronts more than ever. There definitely are opportunities out there, because there are a lot of good assets and good companies that are affected by these hard times. This gives rise to potential negotiation opportunities and the ability to acquire assets and enter industries that companies otherwise have no access to.