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CORPORATE &
BUSINESS

CLIENT ADVISORY:

SUGGESTIONS FOR DISTRESSED COMPANIES IN THE CURRENT DOWN ECONOMY

Given the current state of the economy, we thought it might be useful to provide some suggestions for companies that have been more adversely affected by the current economy. Admittedly, distressed companies have fewer options, but the following suggestions may be useful.

Dealing with lenders

In the current economy, it is critically important to pay your lenders on time and in full each month. However, timely payment may not be enough to avoid problems. The loan documents governing most credit facilities include a host of non-payment "covenants" or promises made by the company to its lender. Typical non-payment covenants include maintenance of minimum debt service coverage ratios, minimum working capital requirements, minimum net worth requirements, prohibitions on junior liens, limits on third party borrowing, providing quarterly and year-end financial statements, etc. In good times, some of these non-payment covenants may not have been enforced to the letter of the loan agreement, even though they give rise to technical defaults. However, in the current economic climate, it is much more likely that the company's lenders will pay close attention to non-payment defaults.

If you have not done so already, this is a good time to put together a "Compliance Checklist" for each loan agreement, equipment lease, etc. This document should list everything the company has agreed to do during the term of the loan and the due dates for compliance. Compliance Checklists are a good idea for all important contracts because they provide a quick reference and avoid the need to revisit lengthy and complex documents several times each year. If it appears that the company will trigger a technical default by failing to comply with its non-payment obligations, opening a timely and candid dialogue with the lender is usually more productive that simply waiting for a default notice from the lender.

Other sources of debt financing

When it comes to borrowing money, many private companies have never gone beyond their bank lenders. While that may not be problematic in a borrower-friendly economy, times have changed. Bank interest rates are still relatively low, but that is of little value if the bank's lending criteria preclude getting or refinancing a bank loan. For that reason, companies may want to look at other financing alternatives.

Regardless of the size of your business, if your customers are large credit-worthy companies, factoring or similar forms of asset based lending may be a viable alternative to the traditional bank line of credit. A typical factoring arrangement would involve assigning your accounts receivable to a "factor" or other asset-based lender. Your customers would send all of their payments to a "lock box" controlled by the lender. The lock box requirement obviously reduces the lender's risk since the money does not flow through the company's account before being paid to the lender. The lender would advance a specified percentage of your current accounts receivable and in some cases, may make an additional payment to the company when the receivables are actually collected.

Even if you do not have customers whose credit is sufficiently strong to satisfy an asset based lender, you may still be able to borrow or refinance an existing bank loan through a finance company. Finance companies are not subject to the same level of federal and state regulation as banks and accordingly, may be able to craft lending solutions for borrowers who would not qualify for traditional bank financing.

The final category of potential lending sources for distressed companies is private investor loans or so-called "hard money loans." Locating potential lenders in this category is as simple as searching "hard money loans" on the Internet. However, with this category of lenders, proceed with caution. Get references and carefully consider all of the terms. These loans are very expensive and are generally suitable only as a short term "bridge", where the company is confident of its ability to repay the loan at or prior to maturity. Although there are many reputable companies making special situation loans, there are also a considerable number of predatory lenders in this category, whose approach is often characterized as a "loan to own". Rather than make an offer to buy the company outright, they may agree to make a loan on aggressive terms, require a security interest on all of the company's assets and then exercise their rights and move against the collateral if the terms of the loan are not strictly complied with.

Selling the business

It is inevitable in this economy that some companies will not be able to survive as stand alone businesses. If a sale of the company appears to be the only realistic alternative, here are some things to keep in mind:

First and foremost, be realistic. A distressed company is like the proverbial gallon of ice cream left out in the sun. It can only be saved if you move quickly. Companies in this position have neither the time nor the bargaining power to command top dollar and it is often imperative that the deal be closed quickly before key employees and customers start to leave in significant numbers. Consider offering clients meaningful discounts for prompt payment and offering key employees a "staying bonus" if they remain with the company for a specified period of time designed to get the company through closing. Lastly, try to negotiate an earn-out to bridge the gap between what you may believe the company is worth and what a buyer is willing to pay in the current economy. Earn-outs can be an effective way to bridge the company valuation gap, but the devil is in the details. In general, the best approach is usually to base the earn-out on a financial metric that cannot readily be influenced by the buyer, who will be in control of the business during the earn-out period. For example, if the earn-out is based on a gross revenue target, it is likely to be less problematic than an earn-out based on pre-tax profit, which can be impacted by numerous variables, like executive compensation.

If we can provide further information on any of the foregoing topics, please feel free to contact us.

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William F. Miller is a Partner with Pannone Lopes Devereaux & West LLC and a member of the Corporate & Business Law Team. He is a highly skilled attorney with more than 30 years of experience who focuses his practice on corporate and business law matters, including mergers and acquisitions, angel, venture capital and private equity financing, commercial contract matters, intellectual property protection and licensing, and entity and investment fund formation. Mr. Miller frequently advises early stage technology companies, manufacturers, service and distribution companies as well as investors in such companies.