

# Maintaining the Support of the Bank Syndicate When Disaster Strikes

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The telephone call comes through to you as agent for the bank lender group late in the afternoon. It's from the chief financial officer of a portfolio company so you have the receptionist put it through. The call begins with "Something bad happened."

As the CFO explains some financial reversal, credibility—both the company's and yours—instantly evaporates. As you struggle to compose an e-mail to the bank group members, you can sense that the credibility you had is replaced by questions, lots of them. Everyone wants to know what's going on.

Emotions quickly come into play as some lenders respond angrily to the company's dilemma. They are angry that the company stumbled. But they are particularly upset at the element of surprise.

The first question in everyone's mind is "Was it fraud?" Whenever a company encounters a sudden financial setback, the question of fraud occurs. Why?

Although there may be no "smoking gun" of deliberate fraud, lender anger may actually increase if they suspect the borrower knew or should have known earlier about the problem and failed to disclose it. Typically, syndicate members don't know the borrower as well as the agent does. Further, if the problem occurs early in the life of the loan, no one is very well acquainted with the company. Without any other knowledge of the character or activities of the company, dark suspicions arise.

Even if the bank syndicate could eventually get over the fraud hump, there lies another serious question. Does this company know what it is doing? If not, are they competent to take appropriate measures to address the problem?

Beyond the fraud and competency questions, another issue awaits. Does this company make money? If the company's problem actually reveals that it had been losing money for quite some time, the question is whether the business model followed by management makes any sense.

These issues also raise questions for the bank syndicate itself. The most pressing question is whether or not the lenders will take a loss on their loan facility.

With or without a calculation on the potential loss, lenders are also mentally scrambling to determine the best exit strategy. Is it cut and run? Is it ride out the storm? Or is it something more complicated, perhaps involving an increase in their loan and thus an increase in their exposure to loss?

All of these questions are urgent and important. Unfortunately, both the company and the agent are frequently without satisfying or complete answers.

Several things are needed all at the same time: information, analysis, third-party validation and communication.

Information is needed not only to answer the urgent questions of the bank syndicate, but also to enable both the company and the

syndicate to make timely and considered choices about what to do.

Typically, the answers to the syndicate's questions are not readily available. Some due diligence and analysis is needed. Run rates need to be established. Assumptions need to be validated. Projections need to be checked against the run rates and assumptions. Operations need to be examined as do marketing efforts, sales, and gross margins. "Hidden costs" such as returns, credits, and discounts need to be factored in. Management's whole approach has to be looked at.

If company management tries to do the analysis themselves, they tend to lose valuable time. Why? No matter how thorough and accurate their assessment, they almost never overcome their original loss of credibility. Every word and every nuance is examined, not for the information conveyed, but to reinforce the lender's impression that company management is either lying or incompetent. As a result, little progress is made on resolving the company's financial problems. Frequently their problems worsen.

To save time and supply some instant credibility, the bank agent may engage a turnaround consultant or suggest that the company engage a turnaround consultant. Bringing in the third party can spread salve on the wound by calming tempers and getting the bank group to work with the company, at least pending completion of the consultant's due diligence and report.

If the consultant is professional and calm, he can not only take an unbiased look at the facts, but also suggest an objective approach to the problem that will consider the strengths and weaknesses of both the company and the syndicate.

Of particular importance, the consultant can promote communication. Companies tend to become very guarded in their communications about financial problems, particularly if the word "fraud" has been uttered. Unfortunately, "clamming up" is very counterproductive. If the company's poor communication is viewed as a lack of cooperation, the bank group may react harshly.

Another communications problem is lack of substance. This problem is particularly acute for CEOs and CFOs who are either gifted speakers or former lenders. They can mistakenly believe that if they simply say the right things, the syndicate will go along. Yet because of the failure of actions to match their previous words, their "communication" often makes the situation worse. What is actually needed is solid information and real action.

Is the battle over once the turnaround consultant

gets to the bottom of the problem? Not at all! The issues are just beginning. Is more cash needed? What if syndicate members bail out through buyout triggers? What if they sell their loan to someone with a different agenda?

Getting more cash to keep the company afloat may be a challenge. When surprises occur, the company often needs more cash to keep operating and preserve going concern value. But several factors may make it difficult for syndicate lenders to provide that much-needed cash.

Every lender knows the "safe" rule that "the first loss is the best loss." If he decides to take the loss that will result from the company's collapse due to lack of additional funds, he can at least avoid a lot of second-guessing. However, this does not mean that the loss and the original decision to lend will not be criticized.

The most difficult problem for each member of the bank syndicate is the loss of credibility from the company's surprise problem. Not only did the company lose credibility with the bank group, but each member of the bank group lost credibility within their own organizations. This credibility loss makes going back to the well with each bank credit committee very difficult. If multiple cash calls are required, each successive request for funds can be more difficult than the preceding request.

Requests for additional cash can be complicated by the documents governing the bank syndicate for a particular loan. If the request for more money is an over-line request, or if the problem created certain defaults under the loan agreement, approval may require consent of each and every bank member. In turn, each bank member may require approval from its respective credit committee with unpredictable results and bothersome delays.

The credibility problem can be reduced somewhat if the turnaround consultant can quickly develop an action plan that informs each bank credit committee how the loan will eventually work out. Then the successive cash calls will seem less like a series of bad surprises.

Buyout triggers can be another challenge for the syndicate. Lenders typically syndicate a loan in order to, among other reasons, spread the risk. If lenders are able to bail out when financial problems occur, the risk falls on remaining lenders. In one recent engagement, the syndicate banks were offered the opportunity to cash out when the company filed bankruptcy. When the dust settled, only the bank agent remained. Although the agent's loan was ultimately paid down in full, the increased risk was uncomfortable.

Discounted loan sales can also be a challenge for the bank syndicate. When lenders consider exiting a sour loan, they are occasionally willing to sell the loan at a loss rather than risk a greater loss down the road. The new takeout lenders often have diverse agendas that can change the dynamics of the bank group. Some such lenders specialize in using their loan as leverage to takeover or sell the company. Others may simply be on a different timetable, perhaps lacking the patience for an extended workout period. Still others may not have the inclination to respond favorably to a new cash call or default.

The way that the bank syndicate typically makes a satisfactory resolution is to build a shared exit strategy with the company. What is a shared exit strategy? A shared exit strategy is an action plan that is achievable by the company and recognizes the respective positions and concerns of all stakeholders. This strategy does not mean that everyone gets everything they want. However, the strategy recognizes that it may be unrealistic to totally ignore one or more categories of stakeholders, including company management, bank syndicate, company owners or investors, bondholders and the like.

For example, bondholders may be subordinated to the bank syndicate, but they don't expect to be left out of a reorganization. The same is true for owners or investors assuming the company still has positive net worth.

How does the turnaround consultant put together a shared exit strategy? Primary tools include a detailed plan and a liquidation analysis.

What are characteristics of a detailed plan? First of all, a real plan is in writing, not verbal. Second, the plan is more than a set of numbers. By this time, the bank group has typically seen several sets of financial projections, none of which the company has achieved. Given the credibility problems discussed earlier, a financial model without more substance will be dead on arrival.

A real plan shows what action the company will take to achieve its projections. The plan includes detailed written assumptions. Even more, the plan lists specific milestones and timetables. This facilitates monitoring by the syndicate as well as execution by the company because company managers sing better from the same song sheet. The plan also assigns clear responsibilities to individual managers. This holds managers accountable for results, while giving the bank agent points of contact if progress is not being made.

A liquidation analysis is another helpful tool as the turnaround consultant develops a shared exit strategy. What does the liquidation analysis show? Typically, the

analysis shows how cash is realized and how the loans are addressed in various scenarios, such as going concern, orderly wind-down, and forced liquidation. Normally, no one is interested in a forced liquidation because it guarantees less for all stakeholders. However, the liquidation analysis helps the stakeholders avoid a meltdown and strive for a better result, unless they are totally out of the money in all scenarios.

Furthermore, the liquidation analysis helps everyone see the situation more clearly and rationally. Once they see how they stand, they can then be more confident in taking action on a doable plan. Importantly, company management and ownership need to see the liquidation analysis first. Typically, they haven't thought through their position prior to the analysis and are not taking the need for action seriously.

Until a shared exit strategy is developed, syndicate members do not abandon interest in bailing out. In fact, their interest in bailing out is sometimes intensified when they perceive resistance from the agent. It would be easy to misunderstand the agent's actions. Besides monitoring and managing the loan, the agent is also sensitive about the need to maintain as many loans on his bank's books as possible and to maintain banking relationships with borrowers. The agent is not going to be inclined to call a loan and end banking services at the first sign of trouble.

However, loan agreements typically provide leverage to other syndicate members when the agent or company asks for a restructure of one or several loan terms. Changing some loan terms generally requires 100% approval of all syndicate members: loan facility interest rate, loan amount, collateral advance rates, release of collateral, and financial loan covenants. Sometimes, the loan agreement allows some limited term changes by the agent without bank group approval, such as, for example, release of collateral up to, say, \$75,000. Of course, waivers of covenant defaults also typically require 100% approval. If just one of the syndicate members balks, the existing terms of the loan cannot be changed. Therefore, it is usually time for negotiation and compromise when one of the syndicate members asks for an alteration of the proposed new terms.

Furthermore, there are a number of common techniques that syndicate members use to make life miserable for the bank agent in a search for an exit strategy or a bailout. Frequently, syndicate lenders complain to and about the agent. For example, in a clothing maker where our firm developed an exit strategy, there was a steady drum beat from the syndicate. Although the loan was ultimately paid in full upon execution of the exit strategy,

the pressure on the agent was relentless.

In other situations, the syndicate members complain about the agent's failure to communicate, even if they get a telephone call every day. They complain that the agent does not inform them before taking action. And they complain that the agent does not send them information, even if he sends copies of everything he receives.

Other typical tactics of the unhappy syndicate members are second-guessing the decisions of the agent, asking the agent for more information, delaying decision making, and not communicating with the agent. This last tactic is very dangerous. It can kill the company if a syndicate bank cannot be reached on payroll day or at some other critical event.

As one might imagine, the foregoing techniques are not particularly effective and can occasionally be counterproductive. Much more efficient and effective is the shared exit strategy. The key word is "shared" because the strategy works for everybody. Similarly, everybody works together to maximize realization on assets employed by the company.

Nevertheless, there are occasions when it is wise to pay to exit. The discounted loan sale mentioned earlier is, in essence, a payment of loan principal in exchange for the certainty and timing of the exit. Since the buyers of these loans are normally sophisticated, the wisdom of the seller is sometimes questioned. This is particularly so considering that discounts not only increase but also decrease as a function of time. Frequently, the seller's analysis was inadequate because he had neither the time nor the resources to perform the analysis. A turnaround consultant's analysis can be very helpful in such a case.

Another category of payments to exit seeks to gain the cooperation of management. These payments are difficult where resources are limited and other stakeholders, including trade creditors and equity holders, may not be paid in full. Sometimes, management may be paid a success fee for achievement of certain levels of return on assets. Alternatively, management may be paid a consulting fee where someone else takes over the exit. For example, a major shoe retailer sought to pay down its debts by the sale and liquidation of 453 stores in 23 states. When the CEO left to take a consulting position with the store inventory liquidator, our firm was asked to take over as interim CEO so the entire process could continue forward quickly and efficiently. The syndicate was paid off completely and substantial funds were paid to subordinated lenders and trade creditors.

There are numerous ways the syndicate can utilize the turnaround consultant to facilitate the process. The

third-party consultant can work for the borrower as its crisis manager or chief restructuring officer. In the alternative, the syndicate can hire the turnaround consultant directly for the purpose of monitoring the collateral and providing input to the syndicate and the company on how the syndicate's collateral should be handled in order to maximize realization on the assets and minimize expenses and time.

While the tendency of the syndicate is to expect the worst when a financial surprise occurs, good surprises can also occur. Sometimes, off-balance-sheet assets can dramatically bring up the values a company realizes. Intangible assets, which are often considered worthless in a liquidation analysis, can bring surprising results. Trade names are a good example. Many of our firm's clients have created bidding wars over their trade names.

For example, a major lingerie company was headed for a loss on its loan until a bidding frenzy on the company name yielded millions of dollars. Was that just good luck? Not at all. One always gets "luckier" when one has a good plan, a good liquidation analysis, and a shared exit strategy.

No matter how grim the situation appears when the "something bad happened" telephone call occurs, it will usually make things go smoother with the bank syndicate to put together a shared exit strategy. Making decisions and taking action without the exit plan will be more difficult and riskier. No matter what happens, a well-executed disaster typically pays more bank syndicate debt and unsecured debt than a free-for-all.

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