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Our Orange County Winter of Discontent

"Now is the winter of our discontent, made glorious summer by this sun of York."

To recast Shakespeare's opening lines in *Richard III*, the fallout of the financial crisis on Wall Street has dried up credit for mid-market and small businesses throughout the country, creating our own Orange County winter of discontent. The "bulge bracket" investment banking world, the source of much capital to mid-market businesses, has been devastated, and giant commercial lenders with long and proud lineages, such as Wachovia and Washington Mutual, have been or are being forced into mergers or receivership. As the financial world tries to right size its balance sheet by "deleveraging," other banks and financial institutions previously active in the market are curtailing lending activities and are even calling loans on previously desirable company clients, forcing their borrowers into the arms of "hard money" lenders or more uncertain fates. While the federal government has tried to restore liquidity through, among other things, the Emergency Economic Stabilization Act of 2008, almost half of the $700 billion Troubled Asset Relief Program ("TARP") established by that legislation has already been committed; yet members of Congress and others are already complaining that too little is going in the form of additional loans to small and medium-sized businesses.

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The consequences of this market turmoil are resulting in many of our Orange County businesses needing to become familiar again with a previously dormant government power, the Federal Deposit Insurance Corporation, and to devise strategies to address their own liquidity challenges, as well as those of their customers. However, this same financial crisis also presents planning opportunities for companies to maximize profit upon the return of the inevitable economic "glorious summer."

The return of the king

In the early 1990s, Orange County businesses became all too familiar with the FDIC and its sister corporation, the Resolution Trust Company, which handled the receivership and liquidation of hundreds of failed banks and savings and loan institutions. Both had a sizeable presence in the county. Due to the robust economy during the following decade in which fortunately very few financial institutions failed, the FDIC consolidated operations and closed its Orange County office, and the RTC went out of business entirely. From July 2004 through February 2007, not a single U.S. bank or thrift failed; however, 22 institutions have failed between that time and November 7, including such former heavyweights as Washington Mutual ($307 Billion in assets) and Pasadena-based IndyMac ($32 Billion) and local institutions such as First Heritage Bank in Newport Beach ($254 Million) and Security Pacific Bank in Los Angeles ($561 Million). Well, over a hundred troubled banks are reported to be on the FDIC's unpublished "watch list" and are at risk of failure. The FDIC is now signing a lease for a large amount of space in Orange County to serve as a focal point for their efforts to liquidate failed bank assets in California and other Western states over the next several years.

As a receiver of failed institutions, the FDIC has extraordinary powers somewhat similar to that of a bankruptcy trustee. The FDIC steps into the shoes of the failed bank and may either elect to liquidate its assets or transfer some or all of the bank's assets to an acquiring institution or to a new "bridge bank" as it did with IndyMac. The FDIC's powers include the ability to:

- Repudiate any "burdensome" contract within a reasonable period of time.
- Request a temporary stay of legal proceedings.
- Enforce any contract that the bank had with a third party in spite of any existing contract provisions providing for contract termination, default or exercise of remedies due to the bank's insolvency or the appointment of a receiver.
- Avoid fraudulent conveyances of bank assets or interests.
- Merge the bank with another institution and transfer assets and liabilities without prior approval of any counterparty to any of bank's contracts, a court or government agency.
- Allow, disallow and settle claims against the bank.

Accordingly, businesses dealing with troubled banks must plan for the possibility of FDIC receivership. For example, the FDIC could disaffirm a working capital line of credit, a letter of credit given by a company's customer in exchange for goods or as credit enhancement, or a lease of property. Moreover, under the *D'Oench* legal doctrine and special statutory rights, the FDIC as receiver can ignore "side agreements" or other agreements that bank representatives have signed that have not been properly documented or approved by the bank's board or loan committee. Given these powers, businesses who have the ability to choose their financial sponsors or with whom they do business should do their due diligence as to the stability of their existing bank, as well as the banks of their key customers.

No preference, please

As the banks are providing less financing for businesses, companies may look to their own suppliers to solve working capital challenges through extended payment terms. Some of these arrangements may be consensual, such as a vendor agreeing to credit flexibility for a key customer to demonstrate its commitment to a long term relationship. Certainly, many companies will just unilaterally decide to "stretch" their payables. However, businesses which either elect or acquiesce in longer payment cycles expose themselves to increased risk of not only not only being paid on outstanding receivables if the customer files for bankruptcy but also actually having the bankruptcy trustee of the customer reach back and demand the return of money paid prior to the bankruptcy filing as a "preference."

Under Section 547(b) of the Federal Bankruptcy Code, a preference is a payment (or a transfer of an interest in property) received by a creditor within an enumerated period of time prior to the bankruptcy filing on account of an existing debt which results in the creditor receiving more than it would in a Chapter 7 bankruptcy if the payment hadn't been made. The purpose of the preference statute is to discourage preferred treatment of favored creditors as a company slides into bankruptcy. In arms' length dealings, the preference look-back period is 90 days; however, if the payment is to someone who is deemed an "insider," such as an affiliate of the creditor, the preference look-back period is one year. Typically, creditors of the bankrupt company will hear of a preference through a letter from a bankruptcy trustee demanding that the creditor either pay up or be sued in a preference action in bankruptcy court.

Fortunately, the Bankruptcy Code provides a number of defenses which, with proper planning, can be used to hold off these attacks. One of the most important defenses is the "ordinary course of business" defense under Bankruptcy Code Section 547(c) (2) which provides a defense if the creditor can demonstrate that the payment was of a debt incurred in the ordinary course of business of the debtor and the creditor and the payment was ordinary between the creditor and the debtor or the payment was made in accordance with ordinary business terms in accordance with industry norms. Companies can significantly reduce the risk of a preference through a number of business practices, such as properly documenting all transactions, establishing written agreements with their customers, monitoring payments to avoid the need for last-minute extraordinary "dunning" actions, applying payments to the most recently received invoices, etc. Also, companies should be careful in responding to a bankruptcy trustee's inquiry—they should not make admissions which may harm the defense nor should they just assume that they have to give up the money.

Opportunity knocks

While running a business during a recession presents its challenges, it also provides numerous planning opportunities for future growth and profit. First, FDIC liquidation activities which include not only loan portfolios sales, but also sales of real estate, equipment and anything else that isn't bolted down, present the prospect of lowering business costs, as do landlords willing to provide preferred lease terms. Lower valuations of businesses may allow for more effective estate planning and for the granting to key management equity in the business on a tax advantaged basis.

Businesses with access to capital might successfully expand geographic reach, product offerings or market share through acquisitions of financially weaker competitors or troubled companies. One cautionary note, however: Acquiring a business through a purchase of assets can result in claims of creditors of the selling business against the buyer. There are many statutory provisions and legal doctrines which in fact may make the acquirer subject to "successor liability."

Accordingly, acquirers should consult with legal counsel well versed in mergers and acquisitions and insolvency matters. For example, counsel may recommend the utilization of certain techniques such as a "pre-packaged" bankruptcy or an "ABC" (assignment for the benefit of creditors) transaction to mitigate the risk of creditor claims.

For those businesses in which the owners will be looking for an exit through a sale of the business or other "liquidity event" in better times, a down economy is the time to plan ahead. Successful sales of companies often take years of planning to address systemic issues with the business and proper legal and tax structures. Owners considering a successful exit should avoid missing the window of opportunity when a robust merger and acquisitions market returns. This is the moment for shareholders to conduct business and legal due diligence on their own businesses and fix weaknesses, such as any holes in the management team, customer concentration issues, absence of contracts (or poor contracts) with key customers or vendors, protection of intellectual property rights, etc.

The good news about the business cycle not yet being repealed is that eventually the "glorious summer" of economic and financing activity will return. When it does, and the financial wizards of Wall Street begin to encourage Main Street to "re-leverage," hopefully we will all temper our enthusiasm about the use of debt with the sage advice of Lord Polonius in Shakespeare's *Hamlet*:

Neither a borrower nor a lender be;
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.

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