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RECEIVERSHIP NEWS

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*President,
Mosier & Company, Inc.
3151 Airway Ave, Ste. A-1
Costa Mesa, CA
tel: 714-432-0800
fax: 714-432-7329
rmosier@mosierco.com
www.mosierco.com

MORE THAN ONE WAY DEPARTMENT

The Consensual Receivership: Improving the Odds for a Financially Successful Remedy

BY ROBERT P. MOSIER*

Is it really possible to convince embattled management to stipulate to the appointment of a receiver to take financial control of a troubled company? The answer to this and related questions, and the results that can be obtained in such a receivership may surprise you.

This is a "consensual receivership," one where (among other things) existing management remains in place, but operates under financial and operational controls established by a court-appointed receiver. The reason for such a receivership? Improved operating results – management refocuses on running the business (under the receiver's overview), while the presence (and actions) of the receiver reestablishes company credibility in the minds of its secured and unsecured creditors, and even its equity holders.

All of this is, of course, contrary to the conventional wisdom that upon appointment a receiver should immediately "clean house" – sweep out all of those persons believed to be responsible for any fiscal shortfalls or other business problems presaging the appointment of a receiver. This clean-sweep approach is certainly popular and is standard procedure for many receivers. Mass removal of management certainly is appropriate (arguably mandatory) in a regulatory receivership, where management is accused of having violated federal or state regulatory statutes, of having defrauded investors, or where company assets have been converted or squandered. Retaining prior management in such a case generally impedes the work of the receiver, and may even result in additional statutory violations. But even in regulatory receiverships selective retention of some personnel to help identify and locate assets may be advisable, depending on the level of cooperation of the defendant and its employees.

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Automatically cleaning house at the commencement of a case is clearly not the optimum way to manage selected receiverships, however. Prime situations for consensual receiverships include: (a) a troubled operating company that is a turnaround candidate; (b) a business embroiled in an ownership dispute, where partners or equity owners are being cut out of the financial picture; and (c) a company dissolution, where the business can't be turned around and is the victim of an economic downturn. In each of these cases, using existing management often brings value to the receivership estate and improves recoveries for both secured and unsecured creditors and, sometimes, even for equity holders.

What are the ingredients for successful creation and use of a consensual receivership? Here are a few non-exclusive requirements:

— An underlying lawsuit

— A cooperative plaintiff

— Supportive plaintiff's counsel

— A Defendant that buys into the receivership option

— A business that is a good candidate for a turnaround

The first requirement for the consensual receivership is perhaps the most easily fulfilled – getting the lawsuit filed. Lawsuits typically aren't filed until less extreme attempts to remedy the existing problem have failed. The best consensual receiverships are pre-planned, where the filing of the lawsuit and the appointment of a receiver by consent of the parties occur simultaneously. This is not a requirement, however. Even where an action amenable to a receivership is already pending, the intervention of a court-appointed neutral with turnaround experience may provide new opportunities for the company and its creditors.

In the case of a collection action, why should a plaintiff bank that is already suing on a defaulted loan sponsor a receiver's appointment and allow use of its receivables and inventory collateral in the receiver's attempt to turn the business around? This is the financial institution's judgment call. If the answers to these questions (or at least some of them) are "yes," then the option for pursuing a consensual receivership exists. Some in-house special asset groups won't have the fortitude or patience to allow a turnaround to be attempted — but some will.

The bank will have to believe that its recovery is likely to be greater with the intervention of a consensual receiver than without, and that the participation of existing management of the troubled company (under proper supervision) will enhance the recovery process.

A Bank's Collateral May Be Backstopped

The bank will have to be willing to wait a little longer to see some positive results on this defaulted credit. Can the receivership process be "backstopped" so that the institution's position does not significantly deteriorate if the process falters? Yes, intelligent controls may be placed on the receiver's use of the bank's collateral.

To orchestrate a consensual receivership plaintiff's counsel has to be willing (and able) to work with the defendants and their counsel early on, as workout alternatives are explored, in order to keep the relationship from degenerating into a spiteful one. This often is not easily accomplished. Many financial lawyers believe that projecting an aggressive, single-minded "mean and ugly" (my term) image is the best way to achieve their client's (the lender's) agenda. Disappointment for all concerned may well be the end result where a plaintiff's lawyer's combative style clashes with the cooperative principles of a consensual receivership. Having the right counsel representing the plaintiff can be key.

Why would a defendant's management team ever give up financial (and perhaps operational) control of a company, turning over the core components of the operation to a receiver? The answer is the same for the defendant as it was for the plaintiff – an improved result for all concerned. The passage of time in a deteriorating situation typically results in the defendant losing credibility with its lender and trade creditors. Too many promises that were not (often could not) be kept cause these parties to become skeptical of management. A manifestation of this worsening relationship is where the lender tightens the financial reins, denying the company any fiscal flexibility to fund a recovery effort. The appointment and presence of a consensual receiver may provide fresh credibility and buy some badly needed time and fiscal breathing room. If the Internal Revenue Service is about to seize a business for failure to pay payroll taxes, the appointment of a receiver may prevent the IRS from making its seizure.

A receiver may also be able to implement an informal hiatus on the making of third-party creditor payments and a informal stay (something like a bankruptcy stay, though not as absolute or automatic) against the filing of collection actions (1) by obtaining an order requiring all potential third-party plaintiffs wishing to file an action or who wish to continue pursuing existing collection actions to first seek permission to proceed from the receivership Court, and (2) by pointing out to such potential (or actual) third-party plaintiffs that the defendant's assets are already eclipsed by senior liens, making their contemplated collection actions essentially a waste of time and money. These steps can buy valuable time for the troubled company.

What is the best way to convince management of the benefits of turning financial control over to a receiver? This generally requires a series of meetings between the potential receiver and management so they may get to know one another and develop a level of trust. The receiver must convince management that he is going to be part of the solution rather than an impediment to the company's operation (therefore becoming part of the problem). It must be made clear that the potential receiver will be an officer of the appointing court, however, and that he or she cannot "cut a deal" or promise how things will be under a receivership. This is ultimately the appointing judge's call.

Refocusing Management on Business Operations

The Receiver can outline an agenda wherein (a) existing management will run the company and sell more products, and (b) the receiver will take charge of the cash flow and deal with creditors. This refocuses management's attention on business operations (usually a boost to the business) and removes from management the burden and distraction of dealing with creditors (a task management is generally ill-equipped to handle). It is a safe bet that the management that grew the

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business is better-equipped to grow sales than would be a new receiver, who will likely not have as sophisticated an understanding of the business or its customer base as does the existing owner/management.

Are some businesses better turnaround candidates than others? Absolutely. A key variable is how far down the scale toward a bankruptcy filing has the company fallen. This is a balance sheet test, but if the company is in default to both secured and unsecured creditors, and is in default on its payroll taxes, a turn-around is a tall order.

The number and variety of options available to a receiver in an attempted consensual turnaround rapidly diminish as the company slides toward liquidation. The following chart shows insolvency on a 1-10 scale along the bottom of the chart.

During the early stages of financial difficulty, management usually remains in charge and exercises typical options, such as replacing a president, vice president or selling a division. If this doesn't work, the bank or banks holding the secured debt generally recommend association of a traditional turnaround firm to aid management (or to replace it). Assuming that this doesn't reverse the company's declining performance, the next step (generally around five on the above scale) is the commencement of collection litigation by the secured or unsecured creditors, or both. At this point management is embattled and has generally lost all credibility. As the company's financial woes force it into the judicial system, one of the remedies available to secured creditors is to seek the appointment of a receiver. This usually occurs around points six or seven on the bottom axis. If management is intent on maintaining complete control of the company, a next step often is filing a petition under Chapter 11 of the Bankruptcy Code (where a receiver, if already appointed, may or may not be kept in place by the court). The last step on the decline into oblivion (number 10) is shut down and liquidation.

Note that this progressive (regressive?) scale shows a full range of rehabilitative options available in the early stages of financial trouble. However, as time passes and the company's situation worsens, the number of options available drops off rapidly. By the time of judicial intervention, step five or so, the hypothetical scale suggests that the options available to management to turn around the company's fortunes (and probability of success) are only one fifth of what they were during the early stages of the insolvency. And note how quickly they approach zero.

Industry Sector Should Be Healthy

In evaluating future options, and where the company is likely to end up in this process, it is helpful to consider the nature of the business and, or its economic sector. If the industry sector in which the troubled company participates is healthy and growing, the potential for a successful turnaround is far greater (for example, a troubled cable installation company operating in an environment where the entire nation has to be re-wired with two-way cable). If the industry sector is shrinking or headed for extinction (many high-tech companies in 2001, for example), the prospect for a successful turnaround is diminished. Key concerns include the underlying reasons for the business's financial woes and existing management's ability (and willingness) to take direction from a receiver.

The skeptic may ask: "Since existing management caused the problem, why is it advisable for a receiver to leave management in place (while taking control of the finances)? Isn't this leaving the proverbial fox in the hen house?" Not really. It must be remembered that the goal of the receivership is to improve creditors' recovery by turning around the business. The appointment of a receiver is a temporary remedy.

An allied question is "Why can't the receiver operate the business alone?" The answer is that the receiver usually can, but seldom with the level of expertise and knowledge possessed by existing

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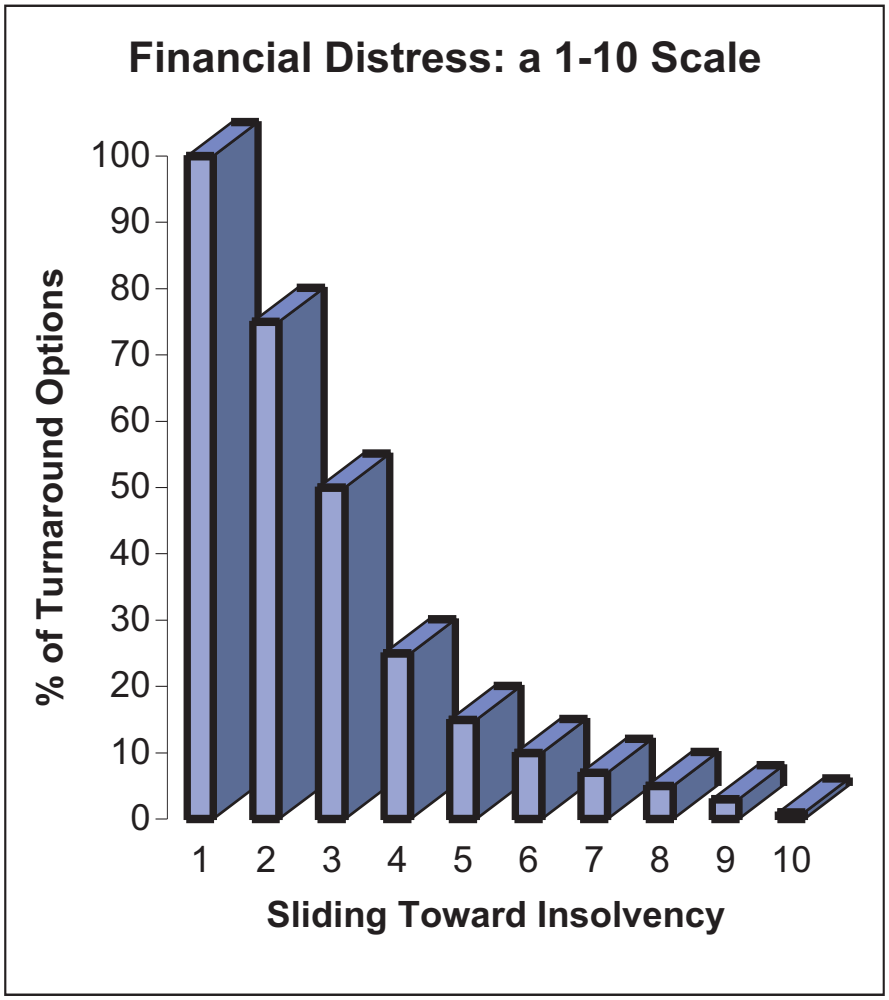

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management. A receiver can bring in substitute management, but the concomitant learning curve requires time and consumes money — time and money the company no longer possesses.

The consensual turnaround receiver's first agenda item is to build a cash reserve. The receiver must impose/obtain an informal hiatus on payment of the pre-receivership bills of both secured and unsecured creditors. Though this may force the company to a cash-on-delivery operating basis, creating a cash reserve is essential for a company to operate.

Next, the receiver has to impose cost reductions – cutting all but essential expenses. This will likely include layoffs, reductions in salary, closing nonessential unprofitable operations, and eliminating all perks – including those boats, planes and fancy cars the company CEO thought essential.

The time to develop a secured creditor repayment plan comes after (1) the company has accumulated a one-month's supply of cash (to handle short-term emergencies), (2) revenues begin improving, and (3) the cost reduction plan is stabilized.

Finding Alternative Financing

This must be a sensible payment plan that can be met while alternative financing for the now-stabilized business is sought. How quickly this can be achieved will generally depend upon the strength of the balance sheet and the ability of management to grow revenues. Once the secured creditor repayment plan is in place it is time to focus on the accumulated unsecured debt. The payment concept is the same as for secured debt, except that a cents-on-the dollar payment plan is an option. The key to success is showing creditors that they will ultimately recover more under such a plan (and retain a paying client) than they would if the company failed and was liquidated. Once these payment plans are in place, initial payments are made, the business is stabilized and, perhaps, new long-term financing has been obtained, the receiver may seek to return control of the business to existing management.

Here is a quick real-life illustration. Bank grants Company a $3 million working credit line, secured by its rolling stock, inventory, accounts receivable, and general intangibles. Company, which sells aftermarket large-frame computers – used IBM computers and those of other manufacturers, is doing well. Its founders are three former IBM executives – two "techies" who were in technical support and a third who was in sales. Initially it was a match made in heaven. Sales soared, and the Company had a very bright future.

The two techies became overwhelmed with their success, however, and wanted to start a new business that emphasized providing contract services, rather than sales. After an extended negotiation, the two techies agreed to sell their share of the Company to the salesman for $5 million – $1 million in cash and a secured note (subordinated to the Bank's secured credit line) for $4 million. The Company could afford the projected payments over time at its then current operating levels.

With the former partner techies out the door (and with them the checks and balances on company operations they had provided), the salesman finally was able to implement creative programs that he had long dreamed of. Even more important from his perspective, he gave the sales force raises, increased bonuses while decreasing performance requirements, and implemented a more liberal expense policy. Predictably, profits began to sag, and the salesman (who was not a finance guy) soon lost financial control of the Company. The Bank's line of credit was consumed, and soon moved into default. The alarmed salesman's attempts to undo the liberalized compensation packages failed: all his experienced salesmen and saleswomen walked out the door, leaving the company in even more precarious straits.

The Bank filed suit for possession of its collateral – the inventory and A/R – and sought imposition of a receiver to protect it. After two meetings with the Company's principal – the former salesman – a consensual receiver was appointed. The president/salesman was delighted to turn over financial control (of the sinking ship) to the receiver and refocus his energies on selling used computers – his specialty. Both the Bank's counsel and the Company's counsel agreed on the plan.

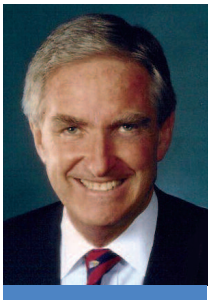
A quick assessment of the Company's prior successes compared with the current dismal financial outlook told the story and suggested the solution. The principal difference was the absence of the two techies, and the strategy they had contributed to the company's prior operations. After a couple of phone calls and a few in-person meetings (with and without counsel present), the consensual receiver's pitch to the group was easy: either the techies returned and resumed their place in management (the trio again managing the company), or the techies would lose their $4 million subordinated note, the salesman would lose the Company, and the trade creditors would likely be shut out by the Bank, leaving them with the sole option of bringing suit on personal guarantees.

As you might guess, after a brief negotiation the deal was put together. Both the Bank and the trade creditors were thrilled with the prospect of a return to profitability. The deal worked. Within one year the company moved back into the black, became current on the Bank debt, and paid unsecured debt. The consensual receiver was discharged and the Bank gave the Company its "Borrower of the Year" award at the end of the first 12 months of the successful turnaround.

Difficulties and Rewards

This case illustrates the difficulties and rewards of a consensual receivership. The challenges of convincing the Bank to hold off on its collection efforts and of convincing current management to surrender financial (and operational) control were difficult to achieve. There are other illustrative cases, some more difficult, some less. But all underscore the point that the consensual appointment of a receiver and corresponding retention of management while the receiver controls the purse strings can pay a big dividend – one that is generally much greater than that achieved by automatically dismissing current management and slugging it out with other creditors in a dark room.

**ROBERT P. MOSIER is a Southern California trustee and receiver & principal of Mosier and Company, Inc., a firm that has specialized in managing and turning around troubled companies for more than 25 years. He is also the publisher of the Receivership News.*



Robert P. Mosier