

# Special Report

## Value-Added Program Makes Credit Due

by Jim Mayer

People who work in the intensive care field of business—crisis management, corporate renewal and bankruptcy—are inundated with media rhetoric using the term "workout." However, since fewer than two in ten workout cases succeed, a lot of so-called workouts just aren't workouts.

Many workouts really fail because they are, from the beginning, disguised "closeouts." A workout requires cooperation among all the creditors needed to nurse the reborn company back to health. The fact that creditors of varying types wrote off in excess of \$100 billion in bad debt last year indicates there is room for improvement.

### When a Workout is a Workout

The best workout prospects occur when a debtor is open and communicative with all creditors. A troubled company threatens both secured and unsecured creditors, but all too often, each creditor isolates its decisions and communications.

Trade creditors are often witnesses to the leading edge of insolvency. Secured creditors, taxing authorities, bondholders, government entities and others often see the warning signs later, but they too, must be prepared to communicate their apprehensions to the debtor management before succumbing to a closeout mindset.

### The All-Important Creditor

Management must seek to understand lender limitations and needs, especially those which are regulated by government or quasi-government entities. In developing secured creditor communications, management must engage lenders, accept recommendations for outside remedial assistance and allow secured creditors to assess freely, but appropriately, the company's financial position. Management must also attempt to communicate the same information to trade creditors.

Most important is communication among the different types of creditors. Secured creditors do not normally lend troubled companies' additional funds to buy life-giving inventories. The suppliers hesitate to place product if the lend-

er might foreclose. Governmental entities and taxing authorities refuse to exercise forbearance if viability is not reasonably assured.

### Here Come the Professionals

Third-party facilitators, including lawyers, accountants and consultants, are necessary. Most creditors will cooperate, renegotiate or even compromise if treated realistically. That means the lawyers should understand the politics, personalities and parameters of the companies they represent.

Management consultants are underutilized at best. They are generally referred into troubled, but salvageable, companies by secured creditors. Many of these practitioners do a yeoman's job in adequately surveying the causes and effects of a troubled client and in securing the necessary control of cash and direction of management. But what value-added procedures are offered to help create new credit? Workout consultants must seek and develop value with control to create an environment conducive to the creation of credit.

### Value-Adding: Credit is Due

The creation of trade credit, necessary for a workout to succeed, is a difficult task without asset control and loss prevention. Accounts receivable lenders can effectively "lock box" remittances, but, since all creditors benefit from an ongoing concern, secured creditors should be willing to create agreements which protect the trade creditors' interests. Some management consultant firms have developed a value-added tool for unsecured suppliers.

The Controlled Distribution Service (CDS) allows trade creditors to place product in the debtor's location on a title-retained basis within a locked and segregated subleased area. Product is received in economic shipping units, but released in smaller quantities by a third-party on an as-needed basis. Memo invoicing and collections can be handled and controlled by the provider of the service. Since the debtor pays for this service, the only cost to trade creditors is maintaining a managed inventory outside their main locations.

Consultants have developed inter-creditor agreements, allowing product released from the CDS control area to flow into production or shipping, creating receivables which generate a cash advance. This is then paid by agreement to the supplier, less the debtor's margin. As a result, the trade creditor can introduce limited credit sales and receive timely payment through a non-lien, or non-purchase money procedure. This allows a rehabilitating debtor to get product and credit without disturbing secured credit lines.

A final ingredient is the "claw-back." As product is released, a memo invoice, plus additional payment toward the antecedent debt is clawed back. Literally, the debtor works out its debt. Vendors help create goods the debtor sells, and the lender thereby increases its receivables. The trades get direct remittances with antecedent debt claw-backs and the debtor maintains credit with cash flow, albeit somewhat reduced. While claw-back is clearly a preference payment, few debtors will sue for preferences when all parties have gained from it.

### When CDS Won Through

A troubled wholesale distribution company was facing a complete COD environment typical in a closeout. Through a consultant-lawyer team an agreement was made for the lender to liquidate its lien inventory, and 80% of the resulting proceeds would pay down the inventory component of the borrowing base. As the lien inventory was reduced, vendor-supplied inventory would flow into the CDS locked and secured program. The lender would then assist, through continued receivable financing, in creating cash to pay suppliers.

As CDS product was released and sold, it paid down delinquent trade creditor balances while keeping the company in business. Later the trade suppliers were allowed a lien on subsequently acquired inventory by virtue of a purchase money security interest.

*Jim Mayer is a Certified Management Consultant and President of Diversi-Corp, Inc., a Dallas, TX-based national consulting firm.*