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Transaction Gone Bad? You CAN Avoid the Courtroom

BY Paul Bent, Esq.

Throughout the history of U.S. commercial finance, deals have occasionally gone bad. Borrowers default, markets change, collateral loses value—sometimes even the best planned and executed deal may turn out to be the biggest problem in a company's portfolio.

And historically, when a transaction has turned out for the worst, the standard procedure for the lender has been first to try to work out some sort of resolution directly with the borrower and then, failing that, to call the lawyers; time to go to court. Conventional wisdom says litigation is the only way to force the borrower to meet at least most of its obligations and to book something positive from the deal.

Too often, though, this "standard" procedure does not meet the lender's real business objectives. After spending a great deal of money, executive time, and management resources, the result may be simply a substantial write-off and a ruined relationship with a borrower.

But there may be an alternative to the conventional approach: mediation. As an alternative, mediation is economical, fair, confidential and neutral—and gaining popularity. The Department of Justice (DOJ) has seen an 82 percent increase in the number of cases resolved using alternative dispute resolution (ADR) over the past seven years. In 1995, there were 509 processed cases using ADR. This figure leapt to 2,866 in 2002, according to the Department's Office of Dispute Resolution.

In mediation, a neutral, experienced professional meets directly with the parties and their counsel and helps them find a way to resolve the issues that threaten to derail their deal or push them into litigation. Unlike an arbitrator, a judge, or a jury, the mediator does not make a ruling or impose a decision on the parties. Rather, the mediator meets with the parties and their counsel, both in joint sessions and separately, in confidential private caucuses, to dig into the issues and details underlying the dispute and

understand everyone's real motivations and interests in the deal. Using this information (but keeping it confidential), a skilled mediator can work with all sides to help fashion a livable resolution for all. The result of mediation is a settlement agreement that is reached and documented by the parties themselves; and, although the terms of the settlement agreement itself are typically admissible and enforceable in court, the underlying details of the settlement remain private and confidential.

Case in Point

For illustration, let's consider a highly complicated, multi-party transaction: a large ticket leveraged lease. Here, the lessor has leased $80 million of equipment to the lessee, borrowing 70 percent of the total cost from a third party lender. The lessee is a substantial wholly-owned subsidiary of a large publicly-held conglomerate, but the lessee's parent is not a party to the deal.

The initial lease term was eight years. So far, at two different times, the lessee has missed making its rental payments; but, after gentle reminders from lessor's counsel, these were cured and the rent is now current.

The deal was done six years ago in a lessee's market, at fixed pricing very attractive to the lessee. Today, the lessor could do the same deal at a significantly higher yield. What's more, the equipment's residual value has deteriorated dramatically: the lessor's advisors believe it is probably worth today only about 50 percent of booked residual.

The lessor recently learned that the lessee has transferred the equipment and the lease obligations to one of its corporate affiliates. Although such transfers are allowed under the lease, the lessee is required to give notice, provide credit information on the assignee, and satisfy other covenants controlling transfers, none of which it has done. The lessee believes the assignment complies with the terms of the lease and that only the notice and other technical matters need to be cured. Under the lessor's reading of the lease, however, the assignee does not meet the requirements to assume the lease obligations. And, since it finds the lessee in default (and given the lessee's payment history), the lessor has threatened to give a notice of default and demand remedies under the lease.

Although they have made half-hearted attempts to discuss the problem, both lessor and lessee have decided they're probably not going to work this out by themselves; the lawyers have been called. Meanwhile, the lender has not made its views on the matter known to either side.

Sometimes Digging in the Heels Kills the Deal

This scenario is no doubt familiar: the parties harden their positions; the lessor is motivated to get out of the deal, but still needs to think about a possible squeeze by the lender; the lessee believes it can easily cure the problem and that the lessor is being unreasonable.

Traditionally, either of two things may then occur. Confident that an event of default has actually occurred, that the lender can be brought on board and that the lessee is in a weak position, the lessor digs in its heels, declares a default, and hopes to pay off the lender and recover most of its equity (and its attorneys' fees) when the lessee loses in court. Alternatively, the lessee, thinking it can prove that no actual event of default has occurred, that the lessor is acting in bad faith and that the lender may effectively stop the lessor, digs in its heels, forces the lessor to declare a default, and hopes to save the deal (and its attorneys' fees) when the lessor loses in court.

In either case, the deal is dead and litigation is not far behind. After months—or even years—of expensive discovery, management time, and uncertainty, a judge and jury who don't know a leveraged lease from a checking account will make a decision. Although each party assumes it will prevail, the costs of getting to the end of this road (even for the winner) are substantial—and the risks of being wrong are enormous.

Could an Alternative Work?

What if, rather than "dropping the hammer" when the lessee defaulted, the parties had brought in a mediator who specializes in deals and disputes of this kind? First in joint sessions, then through confidential private caucuses, the mediator would assess the underlying agendas of the lessee, lessor and lender.

The lessee has a really good deal and wants to keep it. There are only two years to go, and they're confident they can

Why Mediation Works

Mediation works in complex corporate finance because:

- ***It is entirely confidential.*** Only the mediator knows what is said in confidential caucuses—allowing for frank discussion of underlying issues, agendas, and interests and of the consequences of various alternative resolutions.
- ***It is completely neutral.*** The mediator has no agenda except get the issues resolved to the parties' mutual satisfaction. The mediator's compensation is shared equally among the parties.
- ***It is fair.*** The mediator does not decide any issues or make any rulings. Although each party may ultimately give some ground, the final resolution must be acceptable to everyone at the table; and it can therefore form the basis for a long-lasting agreement and the preservation of the parties' business relationship.
- ***It is economical.*** Fees and expenses of the mediator are typically a fraction of the cost of going to court.

make the rest of the rent payments. They really want to end up owning the equipment, especially at the lower residual in today's market. However, there is concern that the lessor may be right about the transfer being an event of default, and the lessee would like somehow to make the lessor see that it's not a big enough problem to bring down the entire deal. They might even be willing to move the equipment back and try to undo whatever damage was done, and even to pay some additional rent.

Without saying so publicly, the lessor wants very much to get out of this deal. In today's market they are completely under water, and the transfer issue gives them an excellent excuse to exit. But they don't know where the lender is going to come out on the question of terminating the lease. If the lender triggers the default, given the current equipment residual, the lessor is likely to get squeezed completely out of whatever payoff is made.

The mediator finds that the *lender* would like to declare a default under the loan sooner rather than later. They want to recover everything they can from the lessee. However, they're not sure the lessee's transfer of the equipment constitutes an event of default under the loan, as distinct from the lease. Consequently, they're open to a mediated solution that will either keep the deal in place to term or will get them out now with their economics intact.

Having developed all of this background through confidential private meetings with the parties, the mediator now has the basis for helping craft a workable resolution of the issues. Key to this process is the mediator's ability to provide a "reality check" as to the expected outcome under various alternative courses of action. Because the mediator is neutral as to the outcome of the dispute, this process of reality testing often provides the parties with their most objective view of the matter, and helps them form their own insights as to the best course of action.

There may be a number of ways to structure a resolution that the parties can all live with. Each alternative may have certain drawbacks for each party; but overall they will provide a workable global framework for putting this matter to rest, without the costs, tensions and long-term risks of a protracted stand-off or, worst case, of litigation. For instance:

- Recognizing that the current market would offer better equipment cost but much more difficult lease pricing, the lessee may be willing to "cure" its default by increasing the lease rate factor (rental pricing) for the remainder of the term to something between the contract rate and the current market rate. The present value cost of this increase may still be acceptable, and the lower residual value (purchase cost) of the equipment would still be available.

- If allowed under the documents (and if the after-tax economics work properly), perhaps the lessee would consider prepaying the equipment residual, allowing the lessor to pay down (or pay off) the remaining debt balance, book the remaining rental payments entirely as income (thereby enhancing its yield) and avoid a battle over the equipment repurchase at lease expiry.

- Once the mediator digs into and focuses the parties on the underlying issues, it may turn out that the lessee's transferee is indeed a better credit than the lessee itself, and the lessor may have an opportunity to extend the lease with the new lessee on more favorable terms, in which case the default may be "cured" simply by analyzing the transferee's financial statements, getting the lender involved in the process and amending the basic lease documentation.

To sum up, mediation offers a way for all parties to salvage something from the deal, without the mounting costs and increasing risks of litigation. The parties together can bring in a professional mediator, a person who is experienced and conversant in the specific area of finance involved and who is an expert at helping businesses resolve disputes. If the mediation of a substantial dispute is successful, the relative costs in time and money are *de minimis*. And even if the mediation is not successful, this small amount of time and money is well spent in making a serious effort to craft a negotiated settlement before taking on the cost and risks of litigation.

Paul Bent, Esq. is a professional mediator whose 23 years of experience as a corporate attorney and investment banker form the basis for his mediation practice. He is with the Alta Group and is a specialist in resolving conflicts. Reach Paul at pbent@thealtagroup.com.