GOOD COMPANY/BAD COMPANY STABILIZATION AND EXIT STRATEGIES

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To be published in the Turnaround Management Association's Journal of Corporate Renewal

With the onset of the recession and the government's efforts to stabilize the financial system and salvage key industries, the good company/bad company approach to restructuring has become more frequently used to salvage companies or optimize value. Recently, General Motors and Chrysler adopted this approach to create viable go forward entities, and to segregate less desirable brands, underperforming plants and assets, and billions of dollars in retiree and health-care obligations in primarily run-off bad companies.

As more creative restructuring strategies are needed in these recessionary times, the good company/bad company approach has recently been adapted to purely private transactions. For example, we have used the good company/bad company approach to sell a company which, in its original form, could not be sold or even liquidated for acceptable value. By forming a good company, selling it, and requiring the buyer to assist in the liquidation of the old company, the value realized by the seller was significantly increased. Proceeds from the transaction were almost double that of a straight sale or liquidation.

In today's tight lending environment, companies are increasingly facing situations in which refinancing is not possible and selling or liquidating fails to create sufficient value. In such circumstances, the so-called "extend and pretend" approach may seem like the only option; however, creative use of a good company/bad company strategy may be an appropriate solution to allow for an optimization of value.

ORIGIN AND USES

The good company/bad company concept originated during the Great Depression, when the government first acquired devalued assets of failing banks, enabling the viable part of the bank to shed its underperforming portion and move ahead with assets that still retained value.

The concept was further refined during the savings and loan crisis of the 1980s.The government seized the savings institutions cleaning out the stockholders, paid down debt to make them viable, transferred bad assets to the Resolution Trust Corporation (RTC), and resold the good entity to new investors. The RTC's subsequent sale of bad assets allowed taxpayers to reclaim the cost of recapitalizing the financial institution.

More recently, with the onset of the recession, various companies have used the good company/bad company approach to avoid liquidation or optimize value. A widely-known example is the General Motors bankruptcy in which this strategy was used to sell the good company that was created, with the largest creditors, the U.S. Treasury, footing the bill to liquidate the bad company. This approach, however, can also be used in a variety of ways outside the bankruptcy process and without government intervention.

GENERAL MOTORS USE OF THE GOOD COMPANY/BAD COMPANY APPROACH

Restructuring a company into a good company and a run-off bad company frequently occurs as part of the Section 363 sales process in Chapter 11 bankruptcy proceedings. Section 363 allows debtors to sell assets free and clear of liens, and in many cases, the buyer will actually create or significantly impact the good company/bad company structure by cherry-picking liabilities to assume and leave behind. The liabilities that remain behind, in essence, become the bad company. For a Section 363 to be approved, however, there must be sufficient assets to allow for liquidation of the bankruptcy estate or the bad company.

In the General Motors case, the good company/bad company structure was initiated by the debtor. The 363 process was based on the purchase of a new General Motors, established by the debtor in consultation with its constituencies. The new General Motors was to have $125 billion less in liabilities, one-third of the manufacturing facilities and half the brands of the old company.

In the Section 363 sales process, the new General Motors was sold to Vehicle Acquisition Holdings, 60% of which is owned by the U.S. Treasury, which made a credit bid of almost $50 billion of debt to acquire new General Motors. The United Auto Workers received a 17.5% stake, unsecured bondholders received a 10% stake, and both received warrants in new General Motors.

Originally, the new General Motors had not intended to assume liabilities, but the company was forced to take on certain product liabilities and accidental liability claims. The new General Motors also agreed to fund the Voluntary Employee Beneficiary Association trust with a $3.5 billion note and a grant of 9% preferred stock.

The U.S. Treasury agreed to provide $1.175 billion to fund the wind-down of assets left behind in bankruptcy. The Treasury had initially proposed $950 million in funding, but creditors argued that this would be insufficient to fund environmental claims and pay administrative costs, so that unsecured creditors could pursue recoveries on their claims in the estate or run-off company.

When a government entity is unavailable to fund the bad company, such funds must be made available by the buyer or the 363 sale must otherwise be structured to leave sufficient cash or allow use of sufficient proceeds from the sale to wind-down the bad company.

USE OF THE GOOD COMPANY/BAD COMPANY APPROACH OUTSIDE OF CHAPTER 11

The Section 363 sales process is not always an option to create a good company/bad company structure, which complicates the distribution of assets. The Section 363 process may be prohibitively expensive and an alternative restructuring process must be adopted, such as an Assignment for the Benefit of Creditors, Article 9 foreclosure, state law Receivership or an out-of-court wind-down.

1. Selling Off the Bad Company

The simplest use of the good company/bad company approach is to sell-off bad assets or divisions draining cash. These assets may be sellable to a strategic buyer who can meld the division into its

operations and make it profitable. This approach is particularly useful when the division is unrelated to core operations, has negative cash impact and could be sellable to strategic buyers. As many companies end up distressed due to additional business lines unrelated to their core competencies, this approach may be a useful first step in improving cash performance.

There are numerous advantages to selling off the bad company. The sale of the parts, particularly when unaligned with the core business, will yield more proceeds than the whole, strengthening the company's financial position through the sale. A company without pressure to unload bad assets, for example, has the ability to hold these assets in order to optimize value. With the bad assets removed, the good company may be able to more easily raise additional capital, and the entire management team can concentrate on building the core business.

2. <u>Restructuring the Company Into Good and Bad and Subsequently Selling</u>

Often, it is impossible to successfully restructure a company by selling bad assets or under-performing divisions. The bad assets may be intermingled within the company that such classification fails to easily work. In addition, the bad assets, without creative placement with certain good assets, cannot be sold or liquidated at acceptable values. Accordingly, the sale and restructuring process requires dividing the company, giving life to the good company and marketability to the bad company.

A company can be carved in a number of ways to create a bad company that can be absorbed by the assuming market. When considering segmenting the company, it is important that the divisions of the company be established, to make them attractive to potential buyers and investors. For example, if the company were to be divided into three segments, two of the segments may contain the better selection of business/assets, while the third selection is desirable enough to be sold or financed.

In addition, the bad company can receive funding from the good company, provided by equity, creditors or a combination of both, depending on the financial interest of the various constituencies when the new company is structured. If equity is struggling, the onus of funding will fall on the secured creditors. However, if equity is available, a vigorous negotiation by the constituencies of the company typically occurs to establish the amount of funding for the bad company and determine roles and responsibilities. Funding may also be obtained from proceeds obtained through sale of the bad company or other assets.

Attention must also be given to improving the good company. Removing bad assets alone will probably be insufficient. After all, the same management that acquired or created the bad assets is likely making the stronger segments of the company perform sub-optimally. A turnaround professional can help create a better good company by improving performance, through such mechanisms as establishing clear performance measures and tracking systems, facilitating communication both internally and externally, and identifying the key impediments to growth. Regardless of the management's competency, an outsider usually can best identify how to improve performance.

3. <u>Selling The Good Company and Having the Buyer Help Liquidate the Bad Company</u>

A good company/bad company approach also can be used in a liquidation context. Ordinarily, the bad assets are identified and sold, while the good assets are retained. However, a good company/bad company approach can even be used even when the entire company is sold. A company can be sold on the basis that the buyer acquire certain assets from the valuable parts of the company and assist in the liquidation of the bad company.

A company, that sold products related to the housing industry, for example, suffered a precipitous decline in revenue, making that company unsellable under ordinary terms. As a result, a creative auction process was established with requirements that the buyer (i) acquire certain M&E, assume the lease, and hire most employees, (ii) purchase certain pre-identified inventory from the "bad" company when needed at pre-determined prices, and (iii) collect invoices of the "bad" company before it collected invoices from the same customer. The bidding process revolved primarily around (i) the amount upfront payment for M&E, (ii) the price to be paid for bad company inventory and the quantity to be purchased, and (iii) the dollar amount of receivables collected before the good company no longer had to first collect the old invoice from the old customer. The sale on this basis ultimately yielded double what the minimum bid price had been in the initial attempt to sell the company in a more traditional manner.

CONCLUSION

In today's difficult refinancing and sales environment, many companies have adopted a "wait and see" strategy, hoping that performance will improve as the recession ends. However, such a strategy is often a gamble. Will improvement in the macro economy result in better company performance? If so, will the macro economy improve soon enough to avoid insolvency? Rather than taking these risks, it is often far more prudent for a troubled company to determine whether a good company/bad company approach can quickly enhance company performance, strengthen cash flow, and avoid a complete shutdown in this difficult time.

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