Your Middle Market Customer has been Acquired by a Private Equity Firm…What Now?
By John A. Thomson Jr.

The ownership structure for many middle market companies is rapidly changing. Companies that were once owned and operated by entrepreneurial families or teams of businessmen who built the business, managed the business and had a controlling stake in the company's financial success are now being acquired by hedge funds, private equity firms and family offices.

Community bankers have traditionally thrived on close relationships with their customers that they have forged, oftentimes over decades, with businessmen in their communities. When a Bank's middle market customer is acquired by a private equity firm or family office, those relationship ties often vanish. Going forward, bankers may find themselves dealing with a customer whose business operations are being driven by decision makers who are located in a different region and have no prior relationship with the Bank or the banker.

Private equity funds and family offices generally acquire middle market businesses as part of a portfolio of companies. The new owners may have little emotional attachment to the continued operation of the business or the company's relationships with its existing lenders. If the business does not perform and generate upside income, the new owner may make a sterile, mathematical decision to shut the business down. This is a different world for community bankers, who have become accustomed to working with company owners that have a stake in the business and a continuing commitment to "make it work". To the contrary, once a fund acquires a business, the prior owners, who generally had personal guaranty obligations to the Bank, likely have no say in the future of the business.

To prospectively avoid this situation, community banks should always include "due on sale" or "change in controlling ownership" clauses in all of their loan documents. This will allow a Bank to have some input into the process by which middle market customers are acquired, as it provides the Bank with an opportunity to force the new owner to either secure replacement financing within a defined time frame or execute a contractual guaranty of the loan. Without these protections, community banks may find themselves with a distressed loan and few means to keep the new owners engaged and focused on a successful repayment.

If a customer that is owned by private equity becomes distressed, and the credit facility is downgraded, banks must move quickly to protect their interests. The obvious goal is to maximize the return from the business and the collateral without engaging in costly litigation. Unfortunately, there is often no clear and defined road map to assure success.

1) **Aggressively Assessing the Company's Financial Situation.** When an acquired company falls into distress, the Bank's response needs to be immediate and focused. The Bank must secure updated financial information, including reports on the trailing month-on-month operating income and the status of its collateral. This is particularly true if the collateral includes accounts receivable and inventory. The Bank should demand a face-to-face meeting with the new ownership group, no matter where they are located, to assess what the new owner is willing to do in the short and intermediate term to stabilize the company (including infusing new capital).

   This can be a delicate negotiation. If the company is not performing, and the Bank begins making difficult and costly demands on the new owners, this could accelerate the new owner's decision to abandon its investment and let the company die.

2) **Marketing the Company as a Going Concern.** If the customer has a history of positive earnings, or proprietary products or processes that are likely to generate income in the future, it may be beneficial to market the company through a competent investment banker, particularly one that specializes in distress situations. If the Bank has obtained a contractual guaranty from the new owner, this should incentivize the new owner to continue to operate the company in the short term while the investment banker conducts a sale process.

If the company cannot be sold as a going concern, it may be possible to sell the company's most profitable divisions or business lines separately. While this may impair the new owner's overall equity position, this may be the best strategy to produce sizeable cash proceeds that can pay down the loan facility.

3) **Liquidating the Company's Assets.** Liquidating the company's collateral assets, coupled with aggressive collection of the company's accounts receivable, may yield satisfactory results. Liquidation is generally more productive early in the distress cycle, before the company has cannibalized itself by liquidating assets to sustain unprofitable operations. This is no time for bankers to scrimp on costs. Spending resources on a competent auctioneer or other liquidating agent can pay big dividends over a haphazard effort to sell the collateral without adequate exposure to the market.

4) **Pursuing Collection Remedies.** Banks always have the option of filing suit to collect on note obligations and contractual guaranties of repayment. Litigation is a lengthy process, however, as it generally take no less than a year to bring a matter to trial, and obtaining summary judgment adjudicating liability and amount due can be equally time consuming. If the bank has secured a contractual guaranty from the new owner, a lawsuit and its attendant costs may help keep the new owner appropriately focused on assisting the bank to maximize recovery.

5) **Selling the Company in Bankruptcy**. Companies can be liquidated through a Chapter 11 bankruptcy, as Section 363 of the United States Bankruptcy Code allows the sale of a company, or its assets, "free and clear" of liens … a "363 Sale". In order to complete a 363 Sale, however, the company must have the resources to operate under the restrictions imposed by the Bankruptcy Code until a sale process can be concluded. The Bank must carefully analyze prior to encouraging the new owners to file whether the upside from a bankruptcy sale will outweigh the substantial costs now associated with an operating Chapter 11 bankruptcy.

Private equity firms and family offices purchase middle market companies with the intent to grow the business and increase its revenue. Some of the acquired companies will, however, inevitably run into financial difficulties. If a Bank reacts quickly when the acquired company falls into distress, and quickly engages professionals to assist the Bank throughout the process, a Bank can dramatically improve its outcome for this credit.

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