How to Lose $20 Million on a $30 Million Secured Loan

By Gerald M. Sherman

The expensive story of a loan gone bad.

January 23, 1998, was a great day for Joe Goldman, CEO and owner of Color-Tex International, Inc. He had just closed on his acquisition of North Carolina Finishing, Inc. (NCF) from Pillowtex, Inc., and it looked like a great deal. NCF was his largest vendor, and there were sure to be tremendous savings to be gained by owning the company. Best of all, a regional bank provided financing equal to 100 percent of the $15 million in cash needed to close the deal. Further, the bank didn't require a personal guarantee on either the debt for this new company or the $15 million line of credit Joe already had in place for Color-Tex.

Joe couldn't possibly have imagined that he was about to embark on a harrowing three-year journey through losses, loan workout groups, the sale of his bank, the sale of his companies and bankruptcy court. Similarly, the satisfied lenders couldn't have envisioned that their very aggressive, or perhaps more than very aggressive, approach to this transaction was going to lead to a huge loss. In the end, a financial institution that acquired the original lender lost more than $20 million of the $30 million in loans to Joe's companies. For a secured lending transaction, this result is completely outside of any reasonable parameters of performance.

What happened? This article will show how lending practices that were, at best, very aggressive and, in all likelihood, very questionable combined with fundamental weaknesses in the borrower's businesses to create a huge loss, a loss far more typical of a "new economy" loan than a secured financing for an "old economy" diversified textile group.

The Growth of Color-Tex

Color-Tex International, Inc. was originally founded in 1918 as New England Bias Binding Company (NEBB) by Joe Goldman's grandfather, Nathan. Nathan was a Russian emigrant with little formal education who had enormous ambition and a strong work ethic. The company originally focused on the manufacturing of bias binding, an upholstery and clothing trim item manufactured from fabric. The company created a niche by providing quick turnaround service to hundreds of clothing and furniture manufacturers in New England. Sumner, Joe's father, joined the company in 1950 after completing college. While generally profitable, the company attained peak sales of only $750,000 annually prior to the time Joe joined the company. Both Nathan and Sumner were shirtsleeves, old-time businessmen who controlled everything and everybody within the business.

Joe Goldman was always very bright and energetic. From time to time, he had worked at the family business and was always interested in the possibility of joining the company full time. After completing his MBA at the University of Chicago in 1977, Joe worked for PPG and Schlumberger in Dallas through 1979. Two years with large companies was enough to convince him that he wanted no part of the big business bureaucracy. Joe joined his dad.

While working on the factory floor to learn the business, Joe focused his thoughts on growth and recognized that the company's customer base bought many other textile products in addition to bias binding. Beginning in 1981, Joe began to build two product areas. NEBB already had a very small in-stock fabric program that enabled customers to

Gerald M. Sherman is a Managing Partner of CCR Corporate Revitalization, LLC, a loan workout and turnaround management firm based in Westboro, Massachusetts. He can be reached at gsherman@ccrcr.com*. He thanks Joe Goldman for assisting with the details of this article.*

meet their needs for relatively small quantities of cloth on a quick turnaround basis. Joe saw great potential in this area and worked to build it. The key to this business was the company's ability to carry a broad range of colors and fabric types in inventory for immediate delivery. As a result, this business increased Color-Tex's inventory substantially, requiring it to borrow much more money than it ever had in the past.

The second business line Joe started was "textile conversion." This involves the production, on a custom basis, of fabrics using either the customer's designs or Color-Tex's. This product line required investments in both silk screens needed to produce these designs and inventory. As a result, the company had to further increase its bank borrowings. Sales grew steadily and were $30 million by 1998. During this period, the company also made two relatively small acquisitions, Pearl Binding in Philadelphia and Southland Binding in Monroe, North Carolina.

In 1990, Joe acquired 51 percent of the business from Sumner, and his two sisters were given 24.5 percent each. In 1995, Joe bought his sisters out. He took this step so he could reap all the future rewards of his efforts and success. Joe and his sisters agreed on a 20-year payment schedule that gave them a monthly payment of about $8,000 each. The company was consistently profitable throughout this period but did experience periodic liquidity problems. In addition, the company was forced to change banks in the early 1990s when its lender experienced its own difficulties and asked weaker borrowers to find alternative financing. Ironically, and somewhat amazingly, the same lender successfully pursued the company's financing several years later and eventually financed the NCF acquisition.

Overall, Joe made his mark as an aggressive and brilliant sales-oriented executive. He was also a very shrewd negotiator who was willing to take risks.

The Goldman Family Dynamic

Sumner Goldman was deeply committed to his family and wanted to do everything in his power to help assure their financial well-being and security. He saw little, or no, separation between family and business issues and treated them as one. For example, as a part of the Southland Binding acquisition, Joe and two sisters also acquired the building that housed the company. The building was put in a trust, and Joe agreed to have Color-Tex pay monthly rent that greatly exceeded market rates in the area. This was one of Sumner's ways of assuring that his two daughters would receive a long-term financial benefit from the family business. Given this commitment, together with the monthly payment for their Color-Tex stock, each sister was receiving $11,500 monthly for which she made no contribution to the business. Over the years, these payments drained the company of vitally needed working capital. Sumner also remained on the payroll. While he helped out as a part-time salesperson, the company wasn't necessarily getting results from Sumner commensurate to what it was paying him.

Over the years, Color-Tex's payments to Joe's sisters were a periodic source of friction. Further, although he was no longer an owner, Sumner would regularly inject himself into various company issues, causing more friction. There were times when Sumner wouldn't or couldn't come to the office and others when he and Joe wouldn't speak. Overall, the family dynamic stressed the company financially and stressed Joe emotionally.

Joe Goldman As Manager

Over the years, Joe had no mentor in the business other than Sumner, who, while very bright, was neither sophisticated nor a natural teacher. Sumner was also an old-time, authoritarian-style businessman. As a result, he never built a team of capable middle managers. This left Joe to fend for himself and, while generally successful, he didn't have people in the business that could act as a sounding board or help him significantly expand his knowledge. Unfortunately, having only been exposed to a company with a weak and thin team, Joe never had the opportunity to experience how important it was to have truly strong managers to support his efforts.

Joe's lack of support was greatly exacerbated by the mix of his own skills, abilities, interests and weaknesses. Joe was more a big picture than detail person, wasn't very structured day to day and had a tendency to put off tough decisions. A natural salesperson, he didn't develop strong financial skills. Given these factors, activity at Color-Tex tended to be somewhat disorganized and things regularly fell through the cracks. Substandard personnel were carried far too long. In general, the organization didn't put Color-Tex in a position where it could fulfill the potential Joe created. The fact that Color-Tex was consistently profitable, albeit at a relatively low level, was really a reflection of Joe's ability to drive sales and develop new products. At the same time, Color-Tex's periodic cash flow difficulties reflected an ongoing lack of focus on the financial and operational sides of the business. In particular, inventory was growing out of control.

In 1996, recognizing his need to grow as a manager, Joe joined a group of 12 CEOs that met every month to discuss their businesses, hear informative speakers and provide advice and support one another. This group quickly became a key resource for Joe, and he came to value and rely on their input.

The NCF Acquisition

NCF was in the textile dyeing business and operated a 500,000-square-foot plant in Spencer, North Carolina. Textile dyeing involves the coloring of fabric to customer specifications. Typically, the customer would provide the raw uncolored fabric, known as "griege goods." After dyeing, NCF would warehouse the fabric until it was needed. Customers were large textile manufacturers and converters such as Color-Tex and Fieldcrest/Cannon. NCF had been Color-Tex's biggest vendor for several years when the opportunity to purchase the plant was presented. Pillowtex, Inc., a large, publicly traded textile company, was acquiring Fieldcrest/Cannon, the owner of the NCF plant. Pillowtex didn't want to tie up capital in the plant or to operate it. Color-Tex did business with both Pillowtex and Fieldcrest and was recognized as an up-and-coming company, so it was a good fit to buy the plant. To help make the deal attractive, Pillowtex guaranteed that it would purchase $5 million in dyeing services annually. With this contract, along with Color-Tex's own needs, NCF would have at least two major, long-term customers starting out. This helped make the opportunity all the more attractive to Joe.

Pillowtex placed a $17 million price on NCF but was willing to take $2 million in the form of a long-term note. With so much involved, Joe hired the regional bank's investment banking group to assist in analyzing, negotiating and financing the transaction. Its initial analysis suggested that Joe would need $4 million in working capital to put NCF in a good financial position. Accordingly, Joe requested $19 million in financing plus a $2.5 million letter of credit that was needed for NCF's electricity provider. The bank came back with a proposal for $15 million at closing plus the possibility of an additional $1 million once the deal was closed and NCF was up and running satisfactorily under Joe's ownership. The bank did agree to provide the $2.5 million letter of credit that would be needed to close the deal. Based on the appraisals that were prepared to support Joe's request, the bank believed the collateral was stretched thin, even at the level it proposed. At the same time, the bank's proposal was structured very attractively. Joe approached several other banks with his request, but they all responded that they couldn't match, let alone better, the original bank's proposal.

Before making a decision, Joe sought advice from many of his business associates. He relied heavily on recommendations from the group of CEOs he met with monthly. They were particularly enthusiastic about the deal; they saw no real downside, only the opportunity to grow a much larger business. Interestingly, the only advisor to argue against the acquisition was Joe's CPA. He cautioned Joe to keep in mind that NCF had very high fixed operating costs. Given the limited capital the company would have, he was concerned that it would face substantial cash pressures during a downturn in business. Joe chose to overlook those concerns and closed the deal.

Structure of the Acquisition Financing

The structure of the financing was the core problem that led to the bank's extraordinary loss for an "old economy" loan. The bank provided 100 percent of the cash needed for the acquisition cost—300 times the $50,000 Joe invested in the business—plus the $2.5 million letter of credit. While that alone would be considered very aggressive from a banking standpoint, several other aspects of the transaction were of greater significance:

- No personal guarantees were required.
- The loans were not cross-collateralized.
- Corporate cross-guarantees were not required.

The lack of personal guarantees, cross-collateralization and cross-corporate guarantees should, at a minimum, be considered not just liberal but outside typical practice for borrowers with the general profile of Color-Tex and Joe Goldman. Given this structure, Joe seemingly had little to lose. Of greater significance, he was put in a position where he would have a relatively strong negotiating position if and when circumstances declined. At least in theory, Joe could walk from one company but continue with the other with little downside. In the case of NCF in particular, a shutdown would be very unfavorable to the bank due to the nature of the equipment and real estate collateral securing the NCF loans.

What Happened After the Acquisition?

Within a short period after the acquisition was completed, two significant events occurred. First, activity in NCF's and Color-Tex's niche, home furnishings, began to drop sharply. Second, the bank quickly decided that it was undercollateralized. Accordingly, several months after the closing, the bank reserved for the $2.5 million letter of credit against the company's line of credit. Unfortunately, but not surprisingly, there simply wasn't enough collateral to secure the letter of credit fully and still provide NCF with needed operating funds. As a result, NCF began to experience severe liquidity problems. The bank recommended to Joe that he attempt to arrange a subordinated long-term debt placement from a state-sponsored lender, and he was successful in doing so. By the time the $4 million loan was received, however, in addition to collateralizing the letter of credit, the bank required Joe to use $1 million of the proceeds to reduce NCF's line of credit borrowings. Accordingly, NCF received little cash benefit from the financing. In fact, the transaction increased the company's borrowing costs and the state lender *did require cross-collateralization and cross-guarantees.* Overall, this transaction was not the least bit favorable for Joe or the companies.

Business continued to decline at NCF. During this period, there were two significant events. First, Joe was approached by an outside investment group that expressed an interest in acquiring the companies. Interestingly, the investment group was led by the same person that had advised Joe on the acquisition while employed as an investment banker. Second, the bank was sold to another financial institution. Shortly thereafter, the loans to both companies were placed into the acquirer's loan workout department. As business continued to decline, particularly at NCF, Joe was now confronted by a relatively adversarial relationship with a new group of hard-nosed loan recovery specialists.

Cash got so difficult at NCF that just before Thanksgiving 1999, in order to meet payroll, Joe had to make an arrangement with Pillowtex to pay within five days on about $400,000 of deliveries. The morning the wire was scheduled to arrive, Joe was advised that Pillowtex had changed its position, *on direction of its CEO,* and would not wire the $400,000 as promised. Further, Pillowtex advised Joe that because of its concerns about NCF's staying power, it was going to immediately remove its inventory that was being stored at NCF. Together, this would have meant the end for the company. Fortunately, after a harrowing day, lower-level supporters of Joe's at Pillowtex were able to learn that the CEO's decision had been made based on misinformation. Specifically, the CEO made the decision based on a misunderstanding that the $400,000 was a prepayment, while in fact it was only a very quick payment. Once the misunderstanding was rectified, the $400,000 was sent. Able to keep his sense of humor, Joe called the day a "near-death experience" and moved on. Nonetheless, damage was done. The spectacle of a fleet of Pillowtex tractor trailers driving up to NCF to take away Pillowtex inventory was chilling. As was their right, NCF staff refused Pillowtex access to the inventory and turned the trucks away. At the same time, the NCF staff knew this was a very bad sign.

Joe engaged a local investment banking firm to assist in negotiations with the investment group and search for other buyers. Discussions were held with the companies' trade union about the possibility of selling NCF to a union-sponsored employee stock option plan. As business continued to deteriorate, neither of these efforts proved fruitful. Further, while it was prepared to put $5 million in equity into the companies, the investment group was having no success finding a lender to finance the rest of the acquisition cost. The concept of a Chapter 11 reorganization was discarded for the simple reason that it was considered to be a long shot for success.

It is important to note that with the original bank financing alone, Joe could have shut down NCF and continued with Color-Tex. After the state-sponsored financing, however, that was no longer a good possibility, because that financing required cross-collateralization. Further, because of the likelihood that the collateral at NCF wasn't sufficient to secure the state lender's loan fully, a shutdown at NCF would have resulted in Color-Tex having to make good on it. That simply wasn't possible.

The acquiring bank continued to pressure Joe in every way it could. At one memorable meeting, the senior workout officer strongly reminded Joe that the bank would do "everything in its power to collect every dollar it was owed." Always able to keep his sense of humor, after the meeting Joe questioned his advisors, "Does the bank think I believe they don't want to collect every dollar they're owed?"

When it became clear that the investment group wouldn't be able to find outside financing, the acquiring bank agreed to do the financing itself. The bank's logic was simple and reasonable. After all, at least $5 million in new equity would come into the situation. Joe was willing to go along even though he would get no money up front. He did get a job, a note for $3 million and an earn-out that would pay him a considerable amount over time if the new buyer was successful. More important, Joe was relieved of personal obligations that had been created for unpaid pension payments and similar issues.

The deal closed late in 2000, and the leader of the investment group took over as CEO of the combined companies. An investment banker by training, this was his first time running a company and his inexperience showed immediately. In particular, he started to use Color-Tex's limited resources to support NCF's continued cash needs, exacerbating Color-Tex's own problems. Joe became so disenchanted that he resigned from the company and its board within 75 days. Conditions deteriorated with incredible speed, and, 100 days after the deal was completed, the companies were forced into Chapter 7 bankruptcy by a group of dissatisfied creditors.

The acquiring bank ended up losing more than $20 million on its loans to Color-Tex and NCF. In liquidation, the value of the real estate and equipment at NCF proved to be insignificant. There was virtually no market for used textile finishing equipment, and hazardous waste issues rendered the real estate virtually worthless. Further, NCF's activity had dropped so low that there was relatively little in the way of accounts receivables. In addition, there was the cost of the bankruptcy.

Joe bought back Color-Tex's inventories for a price that was more than any other buyer would pay while still getting, from his standpoint, a very good buy. In the end, the bankers at the acquiring bank came to appreciate how Joe conducted himself through the course of this purchase, and Joe was able to end up on relatively good terms with them. He obtained financing for the inventory purchase from a national finance company. The financing was much smaller, only $2.5 million, and Joe had to personally guarantee it. After a three-year trek he never could have anticipated, Joe was in business again. It was much smaller, and he had to work harder than he could imagine redeveloping good vendor relations after seeing his suppliers take huge losses. Nonetheless, he had his business and his life back.

Questions About These Loans

This is a cautionary tale but not necessarily a complicated one—at least on the surface. The lender wanted to put loans on the books, and the NCF acquisition was an opportunity to do so. Regardless of the circumstances, the Color-Tex/NCF saga raises a series of clear and pointed questions.

- Could internal pressures and politics have led to such a series of questionable lending decisions?
- Did the lenders have any understanding of the decline in the U.S. textile industry?
- Did the lenders have any understanding of the potential impact of the industry's decline on the liquidation value of NCF's production equipment?
- Did the lenders understand that Joe was much more marketing genius than manager?
- Did the lenders understand how leveraged and cash tight the new company would be?
- Why was the package so favorable for Joe?
- Why wasn't Joe required to put more of his own capital into the new business?
- Did the lenders choose to look the other way—or did they really miss that badly?
- Why did the bank move to collateralize the letter of credit fully only after the closing?

One always wonders when hearing about loans likes these. Yet, there's always another story to be told of a loan gone bad.

Color-Tex International, Inc.: A Time Line

1918	Nathan Goldman founds New England Bias Binding Co. (NEBB).
1950	Sumner Goldman, Nathan's son, joins company after graduating from Lowell Textile Institute.
1918–1979	NEBB grows slowly to $750,000 in annual sales.
1979	Joe Goldman joins NEBB.
1979	Joe Goldman begins his career working on the factory floor at NEBB and spends the next two years learning how to operate every machine in the NEBB factory.
1981	Joe begins to build an in-stock fabric business and starts up textile conversion services.
1990	Joe acquires 51 percent of NEBB from Sumner and renames it Color-Tex International, Inc.
1981–1998	Color-Tex sales grow to $30 million annually. The company makes two small acquisitions.
1981–1998	Color-Tex bank borrowings grow to $15 million.
1998	Joe acquires North Carolina Finishing, Inc. (NCF) for $17 million and borrows $17 million to fund the acquisition. The bank opens a $2.5 million letter of credit to complete the transaction.
1998	The bank determines that the $2.5 million letter of credit opened at the time of the acquisition has to be reserved for against NCF's collateral availability, creating an immediate liquidity crisis.
1998	Color-Tex obtains $4 million in subordinated term financing from a Massachusetts state-sponsored lender. Bank takes $3.5 million of the proceeds to collateralize the letter of credit and reduce line-of-credit borrowings.
1999	NCF experiences cash flow difficulties, and the bank asks Joe to hire a turnaround consultant. Joe begins discussions with an outside buyer to sell both companies. Buyer talks about $10 million for Joe.
1999	NCF begins to experience losses and continued cash flow difficulties. The lender is acquired by anothe financial institution. The loans are placed in the acquirer's loan workout department.
2000	NCF losses worsen. Color-Tex begins to lose money as well. Buyer continues to pursue acquisition but can't secure needed debt financing for the transaction.
2000	Sale to investment group closed with buyer investing $5 million in equity and the acquiring bank financing the balance. Joe Goldman receives no cash from closing but gets a $3 million note, an earn-out provision and a job.
2000	Within 75 days, Joe Goldman becomes disenchanted with the acquirer's management and resigns his job and his seat on the board of directors of the acquirer. The companies continue to lose money at an accelerated rate. The acquirer is forced into Chapter 7 involuntary bankruptcy *100 days from the time of the purchase.*
2001	Joe Goldman buys back selected Color-Tex inventories from the bankruptcy estate and starts Cutting Edge Texstyles, Inc., a new business continuing Color-Tex's original bias binding, stock fabric and conversion businesses. No NCF assets are purchased.
2005	Cutting Edge Texstyles, Inc. continues in business with a sales volume equal to approximately 20 percent of the peak sales of Color-Tex International, Inc.