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*Financial Crisis – Law Firms*

# California: Where The Fiscal Crisis Is Writ Large

*The Editor interviews **Frank Reddick**, Co-chair of Akin Gump's corporate practice and Member of the firm's management committee.*

**Editor: Frank, you have more than 25 years of experience in mergers and acquisitions, corporate finance and public company representations. Have you ever seen a time like the present in terms of turmoil in the financial markets?**

**Reddick**: Nothing like we're experiencing right now. Over the course of my years of practice, we went through the dot-com crisis in the late 1990s and early 2000s, which certainly caused substantial turmoil in the financial markets and some sectors of our economy. Back in 1987, the stock market crash had the greatest impact during my professional life in terms of market effect, but I would not compare any of those times to the depth and breadth of the turmoil created by the current fissures in the financial markets.

**Editor: Your state of California was on the brink of financial disaster until the recent bond offering. Could you distinguish it from that of other states which have to end the year with balanced budgets?**

**Reddick**: California's budgetary process is impacted by a number of unusual factors. While there is a requirement that the governor present a balanced budget once a year, there is no requirement that the state actually end the year with a balanced budget. Our governmental leaders have less political flexibility since all budgetary measures require a two-thirds vote in both houses of the legislature. Due to limitations imposed by Proposition 13 in the 1970s, the state has only a restricted flow of revenues from property taxes. And ballot propositions adopted over many years have resulted in mandated expenditures, resulting in reduced discretionary spending. All of these factors have resulted in an increased use of debt to address budgetary issues in this state. We can see these factors coming into play again this year. Original revenue projections are turning out to be overly optimistic. Demand for services in a down economy has resulted in expenses at a higher level than anticipated. The result is that California is again facing a significant budget deficit for the year. We've gotten over a short-term hurdle with the bond issuance – those are short-term bonds, seven to eight months long, that provide a bridge to address short-term cash needs, but the funds are insufficient for a long-term fix. The press reports that the governor will be bringing the legislature back into session in an attempt to fix the shortfalls that have developed since the budget was enacted.

**Frank Reddick**

**Editor: What was the total amount of that bond issue?**

**Reddick**: Originally the state went out for $4 billion. There was actually significant demand for the issue because pricing was higher than typical; the interest rates that were paid were 3.25 to 4.25 percent depending on the maturity of the bonds, which is a very high rate for tax-exempts. The state sold approximately $5 billion in the final outcome. There was a press report this morning that indicated that the state intends to go back and issue an additional $2 billion, providing for a total of $7 billion.

**Editor: How do you see the ripple effect of financial turmoil at the national level trickling down to the states and municipalities?**

**Reddick**: It is impacting all of the traditional sources of revenues for municipal and state governments. Property taxes are dependent upon the value of housing, which of course has taken a significant turn to the negative. With lower spending in the retail sector, sales tax revenues are declining. In California, we've historically relied on the value of stock option and other equity grants to employees to increase our tax base. Revenues from that source are dramatically declining. These declines are hitting both states and municipalities across the board. Here in California effects at the state level are putting pressure on the state to reduce support for municipal governments. This is a very tough time for both state and municipal governments. We are definitely feeling it here.

**Editor: How are your clients' credit lines and reliance on commercial paper affected? Are some industries that you counsel in much better shape in terms of their ability to weather the storm? What about those large cash generators such as communications companies?**

**Reddick**: Our clients are experiencing the drying up of credit either from traditional bank sources or in the commercial paper



***Please email the interviewee at freddick@akingump.com with questions about this interview.***

market. This crisis is putting a significant damper on any type of growth strategy across corporate America, whether that growth strategy is in the form of mergers and acquisitions, the purchase of capital equipment or expansion into new markets. Reduced availability in the commercial paper market is forcing companies to turn to higher-cost sources. Even companies that are well capitalized with liquid assets are taking a more cautionary approach to growth strategies as they wait to see how this economic crisis plays itself out.

In terms of which industries are in the best shape to weather the storm, it is hard to generalize because it really depends upon the company, its liquidity sources and needs and its current debt-load. But industries that are probably in better shape than others include information technology and commodities (such as energy, steel or agriculture). Health care is one industry that tends to be recession-resistant, although it is being impacted as well but not to the same extent. The media and entertainment industry, including the communications industry, have historically been resistant to recessionary pressures as well.

**Editor: How has this affected the California system of colleges? Are they cutting back or charging more tuition?**

**Reddick**: This has got to be a perfect storm for the California state college system. Increased unemployment, reductions in the size of personal portfolios and retirement nest eggs and the general financial distress on Main Street have resulted in an increase in the number of high school seniors who are looking at the state colleges. At the same time, budgetary pressures are reducing revenues in real terms. Less available financial aid for students is adding to the mix. The University of California recently announced double-digit increases in tuition and other fees. Since 2002, tuition at California state universities has increased 113 percent. The other impact deals with students themselves. Students and their families are finding it more difficult to arrange for student loans and other financial support in this environment, which is affecting the ability of students to remain in school and puts pressure on the colleges to keep tuition increases in check.

**Editor: Do you have clients who are viewing the present situation as a buying opportunity, such as private equity and distressed debt funds?**

**Reddick:** We do. It is a maxim that every down market creates distress for some and opportunities for others. Certainly those funds that are sufficiently capitalized with liquid assets on hand do have opportunities in the distressed debt and asset markets. While leveraged buyouts are way down, strategic acquisitions that rely on less leverage are filling in some of the gap. We are seeing opportunities in the acquisition of mortgage-backed securities and LBO debt originally issued in the heady days of 2006 and 2007. Companies that have opportunities for expansion, that have liquid balance sheets, find this to be a very opportune time for selected M&A transactions.

**Editor: In the past you have represented clients in the mortgage servicing and subprime lending areas. Is the government of California providing any relief measures to ease their pain?**

**Reddick**: There aren't any programs that are as broad-based or as aggressive as some of the programs that have been discussed at the federal level; however, the state has adopted a number of programs addressing the industry over the last few months. For example, the Community Stabilization Home Loan Program provides funds to first-time home buyers who purchase homes out of foreclosure in communities that have been most significantly hit. The idea behind that program is to promote home ownership while supporting the local communities that have experienced the greatest impacts from the down real estate market. Recent legislation has provided some homeowners more breathing room by increasing notice periods prior to instituting foreclosure actions. There was a $5-6 million fund authorized by a recent statute that funds retraining programs for workers that have been displaced in the mortgage brokerage and servicing industries.

**Editor: Have there been any public works programs?**

**Reddick**: There have not been any as yet, but there are several on the upcoming ballot that would provide jobs and essential infrastructure improvement in the state. Many of those are prompted by larger issues than just this more recent problem in the mortgage area.

**Editor: What are some of the attributes of California, such as its educated work force, ports and agricultural industries, which should continue to bring businesses to the state?**

**Reddick**: You have hit on some of the key factors. In addition, California boasts some of the nation's most prestigious universities, such as Stanford and Caltech. Silicon Valley and other leading high-tech centers employ over one million workers. Agriculture and exploitation of natural resources are still part of the backbone of the California economy. The state is well positioned as an international trade hub, due to its numerous shipping ports and extensive transportation network. Southern California is the largest manufacturing center in the United States, home to companies that produce apparel, computers and electronics, toys, and medical products. These are all among the many factors that allow California to attract venture capital and direct foreign investment. And you cannot discount the fact that California is consistently ranked as one of the favorite places in which to live, with San Diego, San Francisco and Los Angeles considered as top cities.

**Editor: What stimulative measures taken by the federal and state governments will be most effective in getting Californians (and all Americans) back to work?**

**Reddick**: I think the key thing here is going to be fixing the financial markets – specifically putting us back in a position where credit is more available. We can't expect to return quickly to the credit markets prevailing over the last few years. But until we get to a point where banks are lending freely to one another and corporate America is able to access funding for traditional growth strategies, we cannot expect to see a turn in the employment figures. Another key factor is getting the consumer back into the markets. When those two events occur, I think we will see people getting back to work.

**Editor: What advice are you providing your clients as to conserving cash, drawing down fully on their bank lines, other measures to weather the storm?**

**Reddick**: A few weeks ago the question of availability of current bank lines was one that we were watching very closely. A number of our clients drew down on lines in order to build a cash cushion in the event cash became less available. But this trend seems to be tapering off. However, we continue to advise our clients to be conservative in their liquidity planning, particularly with respect to short-term cash requirements. They need to reexamine their cash forecasts to make sure that they have a cash cushion. Until more certainty is found in the commercial paper markets and stability comes to the larger credit markets, this is simply a prudent exercise of business judgment.