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CIT and its borrowers in limbo

By Colin Barr, senior writer

The lender appears headed for bankruptcy, but it's unclear how that will affect borrowers such as Eddie Bauer and other small businesses.

NEW YORK (Fortune) -- CIT and its many borrowers are in limbo.

A day after the cash-strapped small business lender had its bailout hopes deflated, CIT Group (CIT, Fortune 500) appeared headed for a bankruptcy filing.

Credit ratings agency Fitch cut its rating on CIT debt, saying a default appears "imminent or inevitable."

A spokesman for the New York-based company didn't reply to a request for comment. CIT shares lost three-quarters of their value in trading Thursday and were fetching as little as 31 cents each at one point.

Though the century-old firm has sharply cut back its lending over the past year, a bankruptcy filing could add to the pressure on small businesses at a time when they have been shedding hundreds of thousands of jobs every month.

"Things don't look good for CIT," said Jerry Reisman, a partner at law firm Reisman, Peirez & Reisman in Garden City, N.Y. "But they look downright perilous for the small businessman."

Small businesses -- those employing fewer than 50 people -- have cut 1.4 million jobs since December, according to data from payroll processor ADP's latest monthly employment report. Small and midsize businesses -- those employing fewer than 500 people -- have lost 3 million jobs over the same period, according to ADP data.

Small and midsize businesses are among CIT's chief customers, and a lack of access to credit could force many out of business, Reisman said. He said many CIT customers would have trouble getting loans elsewhere in the best of times, but their pain could be acute in a deep recession in which banks aren't lending and sales have dwindled at many businesses.

"If you assume CIT customers tend to be a little riskier than the typical community bank borrower, then some of them won't be bankable," said Bill Dunkelberg, chief economist for the National Federation of Independent Businesses.

According to several news reports, CIT is trying to line up a capital infusion from private investors. But observers were skeptical about the company's chances.

Before Wednesday, Wall Street had assumed the government would provide support to CIT, given its earlier receipt of $2.3 billion in federal funds and its connection to small businesses. Investors took the Treasury Department's decision not to do so as an indication that its books have taken a sharp turn for the worse.

"Although we had originally thought CIT would have enough liquidity to survive through year-end, the recent negative press appears to have accelerated the liquidity drain with deposits fleeing and clients drawing down as much credit as possible before bankruptcy," Stifel Nicolaus analyst Chris Brendler wrote in a note to clients Thursday. "We think CIT's poor credit quality ultimately led to its demise."

Complicating CIT's outlook is the tepid market for lending to bankrupt companies, known as debtor in possession, or DIP, financing.

Getting DIP financing has become more difficult since the credit markets collapsed in mid-2007. Ironically, CIT has been a leading DIP lender. Last week it, along with GE (GE, Fortune 500) Capital and Bank of America (BAC, Fortune 500), provided a $100 million line of credit to retailer Eddie Bauer (EBHIQ), which filed last month for its second Chapter 11 reorganization in six years. A spokesperson from Eddie Bauer didn't comment.

Mark Sunshine, president of First Capital, a lender in Boca Raton, Fla., said Treasury could support small businesses without bailing out CIT investors by providing DIP financing in the event of a CIT bankruptcy filing.

Sunshine said federal financing of the bankruptcy loan could enable an orderly workout at CIT over two years or so. Without such a backstop, he said, small business customers that sold their accounts receivable to CIT in exchange for upfront cash -- a transaction known as factoring -- could find themselves in the unenviable position of seeking repayment in court along with other creditors.

"Without Treasury, it isn't going to happen," Sunshine, whose firm is a CIT competitor, said of the DIP loan.

Whether the problems at CIT end up taking another bite out of the economy will depend on how the company's case is resolved. Dunkelberg noted in a report last week that data from the NFIB's small business survey don't support talk of a credit crunch -- though that was before CIT's brush with failure.

"This could certainly contribute to a constriction of credit, but we'll just have to see how it plays out," he said.