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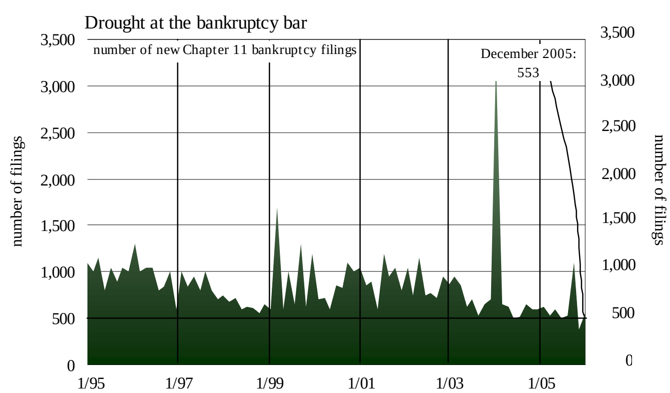
Missing Bankruptcies

"[There are] capital flows around the market from what *feels* like limitless sources—from CDOs, CLOs, hedge funds, private equity and recycled foreign trade surpluses."—Victor Consoli, head of corporate credit strategy at Bear Stearns, quoted in the May 11 *Financial Times*.

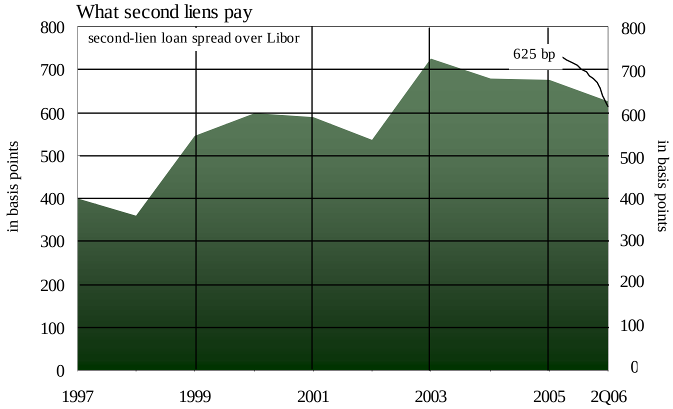
Going broke takes some determination in 2006. Low interest rates and intrepid lenders give many a failing company a stay of execution. The readiest sources of such dispensation are not necessarily banks (which still bear scars from the crack-ups of the early 1990s), nor thrifts (which came a cropper in the late 1980s), nor junk-bond mutual funds (which splattered with the banks). They are, rather, this cycle's composite of those most aggressive lenders of yesteryear, namely, the hedge funds. Which fact affords thoughtful members of the bankruptcy bar the leisure in which to contemplate the sources of their reduced incomes—and gives the readers of *Grant's* the opportunity to prepare for the coming shambles in credit.

Fewer public companies filed for Chapter 11 protection in 2005 than in any year since 1994, according to PricewaterhouseCoopers, and no reacceleration is yet in evidence in 2006. Strong cash flow is the wholesome reason for this bankruptcy famine. Debtor companies tracked by the analysts at Standard & Poor's Leveraged Commentary & Data show *20%* year-over-year growth in EBITDA (earnings before interest, taxes, depreciation and amortization). Changes in the bankruptcy law that took effect in October may also have contributed to the relative paucity of filings. But the elixir called "liquidity" is the most powerful bankruptcy deferral force of all.



Liquidity is a state of mind and a state of finance, commingled. To say that liquidity is abundant means that interest rates are manageable and lenders are compliant. Both have been true, until almost the present day. Tuesday's *Wall Street Journal* reports on the *72%* jump in investment-grade bond issuance in the first half of this year, on the rising preponderance of bond-rating downgrades to upgrades, and on the increased application of borrowing proceeds to the payment of dividends and fees to promoters and equity holders of the leveraged business (never mind actually investing in said business—we don't seem to do that anymore). Lloyd Greif, a Los Angeles investment banker, writing in the July 7 *American Banker*, chided lenders for pushing more and more debt on less and less cash flow. "The greed factor has kicked in," he writes, "as lenders see that they can collect fees not just once or twice, but sometimes several times from refinancing leveraged buyout deals over and over again."

No surprise, then, that the "breakout loan product of 2006" is one called "covenant-lite," according to Steven Miller, managing director at S&P's LCD. The name derives from the near absence of the contractual language that reduces a borrower's flexibility to take on additional debt or otherwise weaken the position of its secured creditors. So far this year, says Miller, 28, covenant-lite loans have come to market in the grand total of $13 billion. In the nine previous years, 1997 to 2005, the market absorbed only $8.4 billion of them. The frisson of fear that rippled through world markets last month did not entirely bypass the credit markets. And lenders have resumed demanding some basic minimum of covenant protection, Miller adds. You may be wondering, what happens to the borrower who violates one of these interest-coverage or



leverage tests? Why, on 14 occasions through the first five months of 2006, also according to LCD, borrowers prevailed on their forbearing lenders to grant them a waiver. In a less-forgiving credit market, some number of these covenant violators would have wound up in bankruptcy court.

No two credit cycles are the same, of course. A distinguishing feature of this one, according to Robert J. Rosenberg, global head of the insolvency practice at Latham & Watkins, is the loan-dispensing hedge funds, "and their willingness to refinance almost anything, frequently with a 'loan-to-own' strategy." Loan-to-own? A stratagem, Rosenberg explains, in which the creditors actually expect a default. In fact, they hope for one, after which their debt will be transformed into equity. It is a sign of these still hopeful times that the loan-to-own practitioners assume their new equity will be worth significantly more than the pre-bankruptcy debt.

In separate developments last month, Goldman Sachs hired a star bankruptcy lawyer, and the federal bankruptcy court in Wilmington, Del., added four new judges, raising the size of that judiciary staff to six. Both actions were anticipatory. As it is, there is scarcely a cloud in the sky of corporate finance. "It's as if you were a trusts and estates lawyer and they declared a moratorium on death," muses William J. Rochelle III, a partner in the New York office of Fulbright & Jaworski, where he specializes in bankruptcies and corporate reorganizations. "As soon as a company catches cold, somebody throws money at them. So they don't wind up in bankruptcy—just with more leverage."

A credit market so unruffled as this one is naturally open to innovation. Of particular concern to the underbilling bankruptcy bar is the "second lien." In days of yore, banks supplied the senior debt, junk-bond buyers the subordinated kind. The second lien, a junior kind of secured loan, made its appearance a couple of years ago. It pays more than senior secured debt (Libor plus 625 basis points vs. Libor plus 279, according to the latest tally by S&P's LCD). But acquisitive hedge funds like it for another reason: Second-lien holders command a better place at the restructuring table than subordinated lenders do. Hence the melodious phrase, "loan to own." Some control-seeking lenders regard second liens as equity-in-waiting, pure and simple. They buy it in hopes of a bankruptcy (as a number of hedge funds did in the case of J.L. French, the failed auto-parts supplier). Never mind that, by definition, those companies are on the road to Chapter 11—or, rather, would be except for the openhandedness of a liquidity-soaked market. Last year, $16 billion of such debt came into the world, and $13 billion has followed in 2006 already.

Once upon a time, of course, banks did the credit work, made the loans and—when the credit work left a little something to be desired—performed the workout. Now, increasingly, says Rosenberg, hedge funds are front and center. If they don't actually originate loans, they participate in loan syndications. "And they continue to buy and take out the other, more traditional lenders at the first sign of trouble," he adds. "They continue to trade among themselves, refinance and frequently end up owning."

"In a few cases last year," reported an article in the January 5 *New York Law Journal*, "second-lien holders have successfully held the restructuring process ransom, demanding to be paid in full or compensated with supersized interest rates. Even so-called 'silent seconds,' who agree in intercreditor agreements to defer to senior debt, are challenging the notion that first-lien holders can dictate strategy and terms. Some judges have rendered rulings sympathetic to those challenges."

Rosenberg demurs: At this point in the cycle, Mr. Market is judge and jury. "I don't want to overstate it," he says, "but it is almost a case that the up-front negotiation, and what you agree to in terms of rights or non-rights in terms of the second lien, almost becomes irrelevant. ... [T]here is so much liquidity that, if the seconds don't like it at the end of the day, they just go into the marketplace and buy up the first."

Yes, Rosenberg acknowledges, the airline and auto-parts industries have done their bit for the bankruptcy bar. Calpine, Adelphia and Refco have filed, providing billable hours to himself and his colleagues. But the so-called middle market, "the bread and butter of your insolvency professionals," has been eerily underrepresented in bankruptcy proceedings. The super-accommodative lending environment has borrowed time for innumerable bankrupts of the future.

But this cycle, too, will end, Rosenberg predicts. "And it will end with some spectacular hedge-fund failures. That will be the turning point."