

FROM LIQUIDITY TO LIQUIDATION

BY MATT MILLER

Many themes underlay the past 10 years of insolvency and bankruptcy: Easy money begat monumentally high and ultimately unsustainable debt levels that collapsed under their own weight. Derivatives became a Frankenstein-like experiment that spun monstrously out of control. Bubbles inflated, stretched, burst. Entire sectors imploded. The federal government emerged as arbiter, capital provider of last resort and major shareholder in failed companies deemed too big to fail.

The 10-year period that encompasses the history of The Deal covers a tremendous range of conditions, from a utopian belief in new-age technology and economics to frozen credit markets and lingering fears of another Great Depression. Many of the storied names in U.S. business and finance disappeared; others remain severely distressed. And for every marquee name that noisily failed, so too did thousands, large and small, that disappeared without a whimper. Last year's mammoth insolvency wave swamped Europe and parts of Asia as well. An entire country, Iceland, went broke, as did some of Europe's largest banks, manufacturers and retailers. Bankruptcy became an essential component of the unfolding global horror story. "It was the full-on economic equalizer," says Laura Davis Jones, Wilmington, Del.-based name partner and veteran debtor counsel at Pachulski Stang Ziehl & Jones LLP.

Bankruptcy serves as both the receptacle of corporate and financial failure and the institutional and legal mechanism of cleaning up. Of all the kinds of transactions The Deal chronicles, bankruptcy-related events most clearly reveal the results of missteps, mismanagement and poor decision making. They also show the varied response to crisis. David Heller, the Chicago-based attorney who heads the global finance department at Latham & Watkins LLP, says it best: "What we've realized over the last 10 years is that bankruptcy isn't some kind of constant medium. It adapts to the needs of the time," he says. "Bankruptcy is uniquely Darwinian."

One constant runs through, however, this ever-changing dynamic. The story of bankruptcy this past decade is in many ways the story of liquidity. At times, this torrent of cash and



credit gushed out of control, like some broken water main. In the past year or so, it narrowed to a trickle. Both extremes wreaked havoc. "Liquidity -- or the lack there of -- creates the problem in many cases," says Heller. "It goes too fast, then everything seizes up."

Too much liquidity sowed the seeds for the current cycle of bankruptcy and distress. Abundant liquidity offered easy and available credit to acquire assets at inflated values and then more debt to paper over any financial shortfall.

"It always fascinated me that thoughtful, sophisticated corporate executives or private equity firms would believe that the solution to resolving the problems of a company that was 7 times leverage was to add another turn and a half leverage,"

says Henry Miller, the chairman and managing director of New York investment bank Miller Buckfire & Co. LLC, with more than a trace of sarcasm.

Too little liquidity threw all sorts of companies over the edge. "It's simple. If you don't have access to capital, you're not going to survive," Jones says.

Liquidity this decade was either absent or overly abundant, but rarely, it seems, in any kind of "normal" equilibrium. When talking of bankruptcies, many practitioners divide the decade into two distinct periods: The first was the dot-com bust that began in late 2000, accentuated by huge fraud-related failures and a telecom collapse a year later. The second was last year's systemic failure of the financial system, which was "credit-market led as opposed to equity-market led. It was generalized, not just sectoral," says Edward Casas, a restructuring specialist who heads Navigant Capital Advisors LLC.

Mass liquidation marked the dot-com fall. Most Internet-related concerns simply disappeared. "When those imploded, they didn't have brick and mortar, they didn't have assets to sell," says Jones. "There was nothing left to restructure." Plus, she and others stress, the Internet bubble was largely equity-driven.

The accompanying telecom collapse was a different story. With expectations of unlimited demand, telecommunications companies piled billions of borrowed dollars into laying fiber and building exchanges. At one point, one-third of all high-yield debt was plowed into telecom, according to one investment banker.

When it became obvious supply far exceeded demand for years to come, the entire telecom sector crumbled, most notably WorldCom Inc. and Global Crossing Ltd., in many cases in a miasma of Enron-like fraud charges. According to a study by Cecilia Wagner Ricci, an economics professor at New Jersey's Montclair State University, 49% of all competitive local exchange carriers filed for Chapter 11 between January 2000 and September 2002. Still, cuts in that cycle were mostly clean, especially compared with what's happening today.

The two cycles were, of course, linked by excessive liquidity, spawning twin bubbles. As the dot-com bubble burst, the Federal Reserve Board began to prime liquidity by reducing interest rates. An unprecedented wave of available cash began to wash through the system, whether through petrodollars, sovereign wealth funds or high commodity prices. All this was worsened by the rapid adoption of securitization, which stoked lending. The end result was years of easy money and an extraordinary liquidity bubble. For everyone from real estate owners to private equity shops, from consumers to corporations, debt became the drug of choice.

Then, as one restructuring banker puts it, "liquidity just disappeared." That sudden shift took down financial institutions and threatened businesses across the entire corporate landscape.

In some ways, it looks like a simple case of cause and effect. Pile on too much debt, no matter how beneficial the terms, and eventually there'll be trouble in River City. "The more you leverage the world, the more restructurings there will be," declares Jeffrey Werbalowsky, Houlihan, Lokey, Howard & Zukin Inc. co-chief executive and global co-director of its restructuring practice.

The liquidity issue may distort the bankruptcy process itself. When money flows, a bankrupt company can obtain financing that offers an operational runway, providing time to work through problems.

With even superpriority debtor-in-possession loans and exit financing hard to find -- that is, a lack of liquidity -- more bankrupt companies get forced into quick asset sales or liquidations. That's what has happened in the ongoing recession.

Take retailers Linens 'n Things Inc., which liquidated late last year, and Circuit City Stores Inc., which took the same path earlier this year. "They didn't have access to new money," says Jones, who maintains that quick asset sales represent the "only exit strategy lenders are now willing to fund." In times past, "somebody would have bought them."

In this environment, even companies that escape liquidation can pay a huge price. Consider Lyondell Chemical Co., which obtained a mammoth \$8.5 billion DIP financing early this year. Half the \$6.5 billion term loan is, in fact, its existing debt rolled up the priority ladder and carries a stratospheric interest rate of LIBOR plus 1,000 basis points.

Had the debtor rejected those terms, it would have been liquidated, restructuring professionals say. Bankruptcy restructuring "is entirely dependent on liquidity. It's the lifeblood," says Heller, who adds: "A lot of restructuring is a function of when you're lucky enough to go bust."

Looking at bankruptcy filings alone, however, misses important aspects of the mechanisms of corporate distress, especially in the current environment. Credit may be hard to find at a reasonable price, but attempts at out-of-court restructurings are more commonplace, in many cases precisely because of the absence of liquidity. "There tends to be at least some effort in most situations to accomplish solutions that avoid Chapter 11," says Miller. "Even though the financing markets have largely been absent, the conversion of debt to equity out of court has become much more prevalent, sort of a back to the future, which is what took place in the mid-to late '80s."

But multiple debt tranches and collateralized debt obligations complicate creditor agreement. "A complex capital structure makes [creditor agreements] virtually impossible" in a consensual, out-of-court restructuring, says Navigant's Casas.

Adds **William Derrough** (pictured above), the managing director and co-head of recapitalization and restructuring for **Moelis & Co. LLC**: "Given the increased utilization of credit default swaps and other derivatives, executing a traditional debt-equity swap out of court can be nearly impossible."

The role of liquidity is central as well to the more narrowly defined world of bankruptcy law and its arena, the bankruptcy court. This past decade has featured a transformation of the bankruptcy process, occasionally accompanied by high drama.

One obvious highlight -- or lowlight -- is Lehman Brothers Holdings Inc. It became easily the largest-ever bankruptcy, with assets and liabilities each exceeding \$600 billion, when it filed last Sept. 15. Four days later, bankruptcy lawyers and other hangers-on jammed into a downtown Manhattan court for a marathon hearing to dismantle Lehman under Chapter 11 through a blisteringly fast and unprecedented sale to Barclays Capital.

Harvey Miller, the dean of the bankruptcy bar and a partner at Weil, Gotshal & Manges LLP, stood as Lehman's debtor counsel. In his usual modulated tones, with just a slight tinge of strain to his voice, Miller explained to U.S. Bankruptcy Court Judge James Peck that institutions had summarily pulled Lehman's credit lines. Value was eroding by the hour, and there was real concern that any additional delay would mean there was nothing left to reorganize. "It was the melting ice cube," Miller recalls.

Lehman sold its investment bank and headquarters under Section 363 of the Bankruptcy Code, which allows for asset sales free of liability. That mechanism gained popularity even before the credit crunch and is now common. Weil's Miller bemoans this trend and believes the Lehman sale marks "a logical extension to the atmosphere we've seen in bankruptcy courts."

Quick 363 asset sales also marked the megabankruptcies this year of General Motors Corp. and Chrysler LLC.

During the week *The Deal* first published, the biggest Chapter 11 bankruptcy involved WestStar Cinemas Inc., which owned Mann Theatres. Bruce Bennett, a prominent Los Angeles-based bankruptcy lawyer, served as debtor counsel. Bennett recalls the initial filing was eventful only because Hurricane Floyd struck the East Coast, and the clerk's office at the U.S. Bankruptcy Court in Delaware couldn't open. That delayed filing for a day. (The era of electronic filing had yet to arrive.)

The bankruptcy itself "wasn't a big deal. It was emblematic of the time. Everyone [in cinemas] was getting clobbered," Bennett recalls. However, "never was there any suggestion that it would be forced to liquidate. Never was there a suggestion that there would be material job loss. It did take a while for a deal to get done. But a deal got done. The cinemas still exist."

Those days seem quaint and almost genteel. "Restructuring has become a much more technically complex process," says Moelis' **Derrough**.

To begin with, the classic reorganization is far less common. In part, that's because companies piled on so much debt that they left few if any assets with breathing space. "In the older days, the cold cuts of the market were cut very thick," says James

Bromley, a New York-based partner at Cleary Gottlieb Steen & Hamilton LLP. More recently, "assets have been pledged two, three times. ... The margin for error is razor thin."

The 2005 changes to the Bankruptcy Code made reorganization even more difficult, especially among retailers. Most notably, the new law shortened the time for accepting and rejecting leases.

"The so-called reform of the Bankruptcy Code in 2005," says Kenneth Buckfire, a Miller Buckfire co-founder, "made it far more creditor and bank friendly than it had been before."

Funding is a central issue. Again, liquidity is key. Before the late 1990s, money center banks dominated creditor ranks and, by extension, the bankruptcy process. But with the rise of hedge funds as distressed investors and creditors in the beginning of this decade, that old order was upended. No longer were lenders solely interested in getting loans repaid. Some creditors saw debt as a mechanism to gain control of the company itself. "Loan to own" became the new buzz.

Those new lenders cranked up the liquidity even more, providing a market for second- and even third-lien debt issuance.

As valuations fell dramatically over the past year or so, many junior lenders found themselves out of the money. "We have seen the overleveraged secured capital structures that have been constructed in the last few years for cyclical companies blow up repeatedly," says Houlihan's Werbalowsky. What that means, he continues, is that "the senior-most secured creditors who are in the money call the shots and often opt for liquidation, which can take the form of prompt sales, and second- and third-lien creditors are getting wiped out in historically large measure."

Robert Lawless, a professor at the University of Illinois College of Law, calls this "the emergence of the dominant creditor," which he maintains is a dominant theme in bankruptcy today.

DIP financing illustrates the liquidity phenomenon within bankruptcy. Until the collapse of the credit markets, companies could use Chapter 11 to finance themselves through a rough period. A DIP loan "really dictated the course of the bankruptcy," says David Skeel, law professor at the University of Pennsylvania Law School. "That became the paradigm."

As money flowed more easily in the middle years of this decade, DIP loans became not only more plentiful, but cheaper. DIPs were once the exclusive domain of senior lenders. Restructured companies found lenders were actually vying to provide DIPs, sometimes offering rates lower than existing debt.

After last September's financial meltdown, the DIP market collapsed. That, in part, reflects lack of funds and in part a basic lack of collateral. "DIP financing used to be considered money good," says Casas. "In this environment of massive deleveraging, in parallel with a significant volatility in valuation, there's real concern whether it's money good or not."

“In the old days, you could just do a DIP, but you still had to have free assets,” adds **Derrough**. “Some of the limitations put on the debtors are the debtors’ own fault.”

The DIP market has begun to come back, although senior lenders are again the only ones making money available. “You’re seeing prepetition to DIP to exit financing all in one go,” says Jeff Stegenga, managing director and chairman of North American restructuring at Alvarez & Marsal LLC.

Those DIPs tend to be short-term and reflect the truncated nature of Chapter 11s. “There’s a defined trend in the nature of the filing itself,” Stegenga says. “It’s prepackaged, pre-arranged, prenegotiated.”

Bankruptcy tends to be a lagging economic indicator, “the last layer in the economic downturn,” says Skeel, the closest we have to a historian of U.S. bankruptcy.

So much liquidity during the run-up to the current bust cycle means that lag time may be more pronounced than usual.

Lenders extended easy credit to the riskiest of borrowers. Companies that in other times would have failed have been able to stay solvent and hang on far longer.

“Businesses in difficulty always had a way to raise money,” says Skeel. “Companies had nine lives.”

What’s more, loans were being issued with few or no covenants. So defaults often don’t take place until loans mature. Companies aren’t pressured to file for bankruptcy in the interim. In fact, “most lenders do anything they can to put off the day of reckoning,” says Anders Maxwell, managing director at Peter J. Solomon Co. LP. “It’s denial syndrome. Not so much companies as creditors are playing a serious game of kick the can down the road.”

Stegenga says he’s even seeing debtors threaten bankruptcy as a way to better pressure for DIP financing. “They’ve become aggressive,” he says.

All this means the fallout from last year’s financial catastrophe and the credit frenzy that preceded it will linger for years to come.

“The dominoes are still falling,” says Maxwell, who for years before the collapse had been one of the most outspoken critics of the culture of easy money. “The process has just barely begun. ... You’re looking at at least a decade of major restructuring.”

What’s more, predicts Werbalowsky, “for all of these massive, supposedly once-in-a-lifetime restructuring situations, the one thing you can count on is it will happen again.”

Which is why they call it a cycle.

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