THE BURST BUBBLE

The Extraordinary Rise, Transformation and Collapse of the Financial Markets from 2003-2007 and How It May Change Workouts, Restructurings and the Chapter 11 Process in 2008 and Beyond

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Attorneys, financial consultants, investment bankers, accountants and other professionals that specialize in working with, or advising creditors of, financially distressed business enterprises are now dealing with the onset of the long-anticipated correction in the financial markets. The liquidity that in the past few years cascaded over the corporate landscape, sweeping aside in its wake long held standards of deal structuring, risk assessment and risk pricing, has receded. The blowback now promises to be severe (as shareholders of Bear Stearns can attest).

So far we've only seen the tip of the iceberg. The default rate on non-investment grade credits still has increased only incrementally from the extraordinarily low levels to which it fell in 2006-07, standing at 1.5% as of the end of March. However, by the end of 2008, Moody's predicts that it will have risen past its historical average of nearly 5%, as the slowing (if not contracting) economy leads to violations of financial covenants, and companies are unable to access new sources of capital to refinance maturing facilities.

This article will briefly look at the severe changes that have swept through the financial markets and at the effect that such market changes are having on the bankruptcy and restructuring process itself. That the credit crisis which has followed the bursting of the liquidity bubble will increase defaults is both intuitive and well-documented. But what does this really all mean to those of us who must now once again descend into the trenches and extract value out of business failure?

In the short term, reduced liquidity makes it not only more likely for companies to get into trouble, but also much harder to get out. Successful reorganizations cannot be consummated because promised exit financing may not be available. Already, one large debtor, Solutia, was forced to sue its committed exit lenders to compel them to undertake their funding commitments so that the confirmed plan of reorganization could be consummated; only following an extraordinary bout of brinksmanship were the parties able to settle (and Solutia able to emerge). Delphi's reorganization is similarly in limbo as of the writing of this article.

The longer-term impact will stem from the exponential increase in complex financial instruments that were virtually non-existent during the last business downturn, but that are

commonplace today. Most notably, the effect of the $46 trillion credit default swap market (up from less than $2 trillion in 2002) has not yet been deeply felt. Going forward, however, nearly every large case will feature, and be affected in myriad ways by, creditors holding identical claims but with sharply divergent interests, due to the explosion in the use of these derivatives over the past few years.

WHY LIQUIDITY DISAPPEARED SO QUICKLY

A Simplified Look at CLOs

The problems with collateralized debt obligations ("CDOs") - securities that are linked to the ongoing subprime mortgage implosion – generated (appropriately) most of the media coverage and (also appropriately) initially precipitated the long overdue reevaluation of risk pricing in the credit markets. Far less noticed has been the virtual evaporation of the market for collateralized loan obligation ("CLOs") - securities backed by high yield corporate loans. However, the failure of this market will have the greater impact on bankruptcy and restructuring practice in 2008-09.

CLOs were the booster jets that propelled the easy corporate credit environment and the private equity boom. Leveraged loans increased from $13.6 billion in 1996 to over $556 billion in 2007, with CLO purchases – nearly $0 before 2003 – fueling most of that growth (accounting for at least 65% of the market) over the past few years. Investor demand for CLO paper helped drive down lending costs, which in turn led to larger financings and greater leveraging. Whereas a few years back a corporation was viewed to be highly leveraged if it took on debt equal to 4 to 5 times earnings before interest and taxes, leverage of 8, 9 and even 10 times earnings became relatively common in the recent frenzied environment.

The buying of bank debt for pooling and securitization freed up lenders' balance sheets and permitted the financing of an ever increasing number of deals. The music has now stopped, however. CLO issuances dropped from $127 billion in the first half of 2007 to $20 billion in the second half, with less than $1 billion in December 2007. The market so far in 2008 has been almost completely dormant.

The disappearance of the CLO market has substantially reduced the demand for high yield corporate debt, and borrowing costs are rapidly rising. At the same time, banks are facing substantial exposures from over $150 billion in leveraged loan commitments entered into during 2007's halcyon days that cannot be sold in the current market environment, thus further reducing capital available for lending to (or refinancing of) troubled companies.

WHY UNCERTAINTY IN THE FINANCIAL MARKETS WILL NOT SOON FADE

Credit Default Swaps

As stated, the damage to the financial markets stemming from the proliferation of CDOs derived from subprime mortgages was the major financial story of 2007. The corresponding story in 2008 will be the losses caused by the proliferation of credit default swaps ("CDSs").

Credit default swaps originated as protection the holder of a credit risk could purchase as a hedge against a borrower's default. A holder of General Motors bonds, for example, can effectively insure against a default by GM by purchasing protection in the form of a CDS from a willing counterparty. As with so many other types of innovative financial products, the use of CDSs exploded in the past few years. They have become a simple way for investors to take long or short positions on particular companies or industries without having to buy or sell the actual underlying bank debt or securities.

In a low default environment, selling default protection through CDSs presented huge revenue opportunities for banks and hedge funds. But as defaults continue to rise through 2008 and into next year, payment obligations will be triggered under CDSs, and buyers of default protection will look to their sellers. Because these trades are unregulated, there is no way of knowing at this time how many, and to what extent, banks, funds, and other investors are going to be exposed to CDS payment demands. However, it will soon become painfully clear as to how many of the default protection sellers (especially smaller hedge funds and other alternative investment vehicles) properly assessed and priced their risks and adequately reserved against losses.

Of equal concern are the exposures of the CDS buyers who believe themselves to be properly hedged against specified losses (not the least of which, for many large institutions, are their positions as CDS sellers that they prudently sought to match), but who may instead find their protection to be worthless because of their counterparty's inability to pay. In other words, many banks and other large investment vehicles, while having to meet their obligations as CDS sellers, may, as CDS buyers following a default by the same borrower, find themselves unable to collect from sellers that overextended themselves. Given the immense size of the CDS market, the term "counterparty risk" will likely move alongside "subprime borrower" as a disquieting addition to the financial lexicon. In the meantime, uncertainty in the financial markets will last until investors are satisfied that there are no more substantial losses that remain undisclosed.

EFFECT ON BANKRUPTCY AND RESTRUCTURING PRACTICE

Short Term – The "Hotel California" Effect on Companies Seeking to Emerge From Chapter 11 (Solutia, Delphi)

New sources of capital are the lynchpin of most successful Chapter 11 reorganizations. The battle in most cases is joined over the establishment of the new capital structure based on the predicted future cash flows of the reorganized entity and memorialized in the plan of reorganization. Obtaining confirmation of such plans has traditionally been the culmination of months or even years of hard work. However, once that understanding has been reached, there has historically been a ready market of lenders willing to extend the senior levels of new debt to companies that typically, at the end of the Chapter 11 process, have been substantially deleveraged, have jettisoned burdensome contracts, and hold comfortable cash positions.

Recently, though, some large Chapter 11 debtors have been finding, to their dismay (and their constituents' dismay), that reaching the agreement among the major competing creditor groups on the terms of a plan (and even getting the plan confirmed) has only been the lead-in to another difficult battle – achieving plan consummation, even where loan commitments were previously obtained. In the current environment, exit financing has become both difficult to obtain and prohibitively expensive, and has delayed Chapter 11 exits in some of the largest cases. For these companies, Chapter 11 has become somewhat similar to Hotel California – much easier to check out than to leave.

Solutia

Solutia's prospective lenders provided Solutia with a commitment letter dated October 25, 2007 for loans aggregating up to $2 billion to fund Solutia's obligations under its Chapter 11 plan and provide it with post-bankruptcy working capital. The lenders expressly agreed that the commitment was not conditioned on their ability to syndicate the loans. However, the letter did contain (typically) "material adverse change" (MAC) language regarding Solutia's business and (far less typically) a so-called "market MAC," i.e., a provision that excuses the lenders from performing if there has been "any adverse change . . . in the loan syndication, financial or capital markets generally that, in the reasonable judgment of [the lenders], materially impairs syndication of the Facilities[.]" Solutia's reorganization plan was confirmed on November 29, 2007, and it planned to emerge from Chapter 11 in February 2008.

However, in late January the lenders realized that market conditions were such that they were about to fund a very large loan facility that they would not be able to move off of their books without incurring substantial losses (on top of the large losses already being faced from the leveraged acquisition loans of 2007 referred

to above). The lenders invoked the market MAC clause and refused to fund the loans. Solutia could not move forward and consummate its plan; it was stuck in Chapter 11, and a painstaking reorganization that took four years to reach hung in the balance.

Solutia had no alternative but to bring an action to compel the lenders' performance, and the matter was contested on an extraordinarily expedited basis. An evidentiary hearing was held less than a month after the commencement of the suit.

Only after a three day mini-trial did both sides step back from the brink. The bankruptcy judge did not appear to be too receptive to Solutia's contention that the so-called "market MAC" provision was somehow not valid because it was mere "boilerplate" language that had never been enforced. On the other hand, she seemed highly skeptical of the lenders' contention that, as bad as the loan syndication market was in February, it had "materially" worsened since the commitment letter was executed in late October.

For the lenders, the best outcome clearly was to obtain some concessions to make this deal less painful and to preserve their legal arguments for another day. After making some changes to the financing terms, the lenders agreed to drop their contention that a MAC had occurred in the loan syndication markets.

This interlude succinctly encapsulates the current turmoil in the financial markets. Putting aside the pure legal question of whether a "material adverse change" had in fact occurred, the plain fact that major institutional lenders were willing to bear the reputation risks of invoking a rarely used provision to back out of a firm lending commitment aptly summarizes the lending environment of 2008.

Delphi

Delphi's plan confirmed on January 25, 2008. The plan is predicated on $6.1 billion in bank loans and an additional $2.55 million in equity capital from a group of hedge funds and investment banks. As with Solutia's lenders, Delphi's banks found that they could not place the debt based on the commitment terms. However, unlike Solutia, the commitment of Delphi's bank lenders was conditioned on a successful syndication of the loans. Delphi had no choice but to renegotiate the loan terms.

Among other changes to the deal, General Motors, Delphi's former parent and largest customer, agreed to provide a portion of the financing. The new arrangement was approved by the bankruptcy judge overseeing the Delphi case in March, and Delphi moved forward towards its goal of consummating its plan by April 5, the deadline under the terms of the new equity investment.

Unfortunately for Delphi, the changes in the loan financing necessary to persuade the banks

to move forward has, for the time being, caused the equity investors to back out. The investors failed to appear at the scheduled closing on April 4. Although the investors claimed that Delphi had breached a number of provisions of the investment agreement, the failure of the deal to close appears to be based on their unhappiness with the changes necessitated by the failure of the original loan terms to attract syndicate lenders.

In a filing with the SEC dated April 9, Delphi announced that it is ready to "consider and pursue any and all available equitable legal remedies" against the investor group. As of this writing, it remains to be seen whether Delphi and its prospective investors will be able to resolve their differences, or whether it will take another contested evidentiary hearing in an incredibly compressed time frame before Delphi is finally able to exit Chapter 11.

LONGER-TERM – HOW CDSS MAY AFFECT BANKRUPTCY & RESTRUCTURING PRACTICE

As discussed above, CDSs will extend and add to the volatility and turbulence in the financial markets. As defaults approach, and once they occur, the financial incentives created by CDS positions will cause changes in the way workouts and bankruptcies take place.

In the first place, CDSs are typically sold for a stated term. "Credit events" that trigger the protection buyer's right to seek payment are usually limited in scope to payment defaults and the commencement of bankruptcy. If the stated "credit event" does not occur within such time, then the buyer's right to payment expires.

In a workout situation, this could lead to the holders of the same class of debt having widely divergent interests. Simply put, if certain holders have hedged their exposures to the borrower through the purchase of CDSs, their interests may well be better served by the failure of the negotiations and the commencement of a bankruptcy case, particularly if the CDSs are set to expire. Taking this one step further, such creditors could have incentive to file an involuntary case in order to ensure their ability to collect from their protection sellers.

Among other things, this will certainly raise substantial issues about creditor disclosures. The effort to wield Federal Rule of Bankruptcy Procedure 2019, a procedural device for disclosing when an entity or committee purports to represent the interests of more than one creditor, against so-called "distressed investors" became a hot topic last year. The upsurge of CDSs will exacerbate the already raging debate about the proper use and scope of Bankruptcy Rule 2019.

In the Northwest Airlines Chapter 11 case, the court required an *ad hoc* group of equity holder hedge funds to disclose not only the amount of their holdings, but also the times when acquired and the amounts paid. The court

agreed with the debtor that the plain language of Rule 2019 does not distinguish between a group of creditors or interest holders acting solely on their own behalf and a committee purporting to represent the interests of others in a fiduciary capacity. Even though subsequently, the court in the Scotia Development Chapter 11 case reached the opposite conclusion and ruled in favor of the distressed investors, the same tactic has been either threatened or used in several other large cases. Debtors are seeking to turn Rule 2019 into a weapon to compel disclosure in bankruptcy cases by distressed investors (typically hedge funds that pursue a strategy of buying debt in bankrupt companies) of the details of their claim purchases. Such motions have been fiercely contested, as many hedge funds view this information, which includes the time of purchase and the amount paid (and which should be irrelevant to the treatment afforded such debt or interest), as proprietary and confidential.

Those battles, however, are likely to be minor skirmishes as compared to the fights that will take place regarding disclosure with respect to CDS positions. Information regarding whether a creditor's true economic interest stands diametrically opposed to the debtor and other creditors of the bankruptcy estate is clearly of much greater relevance to a debtor's chances for a successful reorganization than simply knowing the discounted price at which a claim or interest was purchased. Although it is arguable that current disclosure requirements, under both the Bankruptcy Code and Rules and applicable non-bankruptcy laws are inadequate to address this dynamic, as CDSs are contractual agreements with third parties and not claims against the debtor, it is unlikely that bankruptcy courts are going to stand by passively if they believe that a creditor has a greater interest in seeing a troubled enterprise fail than succeed.

More fundamentally, the proliferation of CDSs challenges the essential dynamic of any workout or bankruptcy – that ultimately, there exists a common interest among the debtor and its various creditors and interest holders in maximizing the value of the enterprise. The great divisiveness of most reorganizations lies in the means to achieve this end – i.e., standalone reorganization, expeditious sale of assets, short-term gains versus long-term potential, identity of management – but not in the end itself. This raises questions regarding a number of basic tenets and assumptions of the Bankruptcy Code. In addition to rethinking disclosure mechanisms, provisions regarding creditor classifications and treatment, plan voting rules, and confirmation requirements may need to be reconsidered.

CONCLUSION

Even if, contrary to current indications, the U.S. economy escapes a significant downturn in 2008, the collapse of the liquidity bubble and the painful process of sorting through the losses caused by the excesses of recent years will dramatically affect workouts and Chapter 11

cases. Troubled companies and their creditors must face a world in which new sources of capital will be in shorter supply. The reverberations from the massive growth in the market for credit default swaps will not only continue the uncertainty that has contributed to so much of the current volatility in the financial markets, but also may test certain foundational assumptions regarding the reorganization process. Bankruptcy and restructuring professionals are facing new and unique challenges that will last throughout 2008 and beyond.

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