HAPPY DAYS FOR DISTRESSED DEBT INVESTORS

Opportunities—and risks—are great, yet experts warn that things could get complicated.
It's our great pleasure to present you the highlights of the second annual Distressed Investing Conference, co-produced by the Turnaround Management Association and The Deal. Over 550 corporate renewal professionals and financial and corporate dealmakers gathered at the Wynn Las Vegas on January 23-25, 2008, and enjoyed an unrivalled opportunity to exchange ideas and hear the latest trends on distressed investing from leading experts in the field.

This report details the keynote and panel discussions that took place over both days. From an examination of the state of the leveraged markets, the most pressing issues facing distressed debt traders, the CLO, derivative and SWAP markets and the opportunities presenting themselves in China to the Founders Panel, which gathered the founders of significant distressed investment funds, we hope this report gives you insight and ideas on how to benefit in the next phase of the distressed investing cycle.

TMA and The Deal are already planning our next Distressed Investing Conference to be held in Las Vegas in January 2009, at which we hope you will be able to join us. Mark your calendar for the third annual Distressed Investing Conference for more news in the dynamic world of corporate restructuring and finance.

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HAPPY DAYS FOR DISTRESSED DEBT INVESTORS IN 2008

Opportunities—and risks—are great, yet experts warn that things could get complicated as the economy struggles

What a difference a year makes! When the distressed debt investment community gathered in early 2007 for the first annual Distressed Investing Conference, talk centered on how the amazing amount of liquidity in the markets was making it tough to earn a buck.

At this year’s event, again co-produced by the Turnaround Management Association and The Deal, you could almost hear the more than 500 participants humming the tune Happy Days Are Here Again. Last summer’s subprime mortgage crisis turned off the credit spigot and changed the game.

“Even healthy companies are having trouble getting financed,” noted Marc Leder, Sun Capital Partners Inc., “and the troubled companies really can’t get financed at all, or with a lot of difficulty .... But, we’ve seen this before. This happened back in 2001, even late 2000, and the way I and my colleagues who invest in distressed companies responded and reacted is through structuring the deals differently. In a lot of deals over the last two, three, four years in a good financing environment, we would go into any deal and we’d be an all-cash buyer, knowing we could get third-party financing after closing.”

That’s no longer the process. Leder told those attending a panel discussion that Sun Capital is working on many deals now in which lenders are overleveraged and the company is underperforming. “It wasn’t a great company, and it shouldn’t have had this kind of leveraged capital structure to begin with. They [lenders] know there is no chance they’re going to be taken out of the deal. So, what they’re looking to do is to bring someone in to provide new capital.

“In a lot of deals we did in ’01, existing lenders stayed in place. We would invest equity into the company to provide liquidity. We would take a large majority ownership position. There would be no impairment to any creditors, no write-offs, maybe some lowering of interest rates ... but the whole structure of the deal has changed from a controlled sale for cash to an equity investment to recapitalize a company that never should have been so leveraged to begin with.”

Collateralized loan obligations (CLOs) took a back seat following the summer crisis, and nontraditional investors, such as hedge funds and distressed debt funds, assumed a dominant role in the markets. “One of the things we saw last fall after the market did correct,” explained Matt Gerdes, managing director of Freeport Financial, “was some [price] stabilization ... as some of the relative value players, the nontraditional investors, high-yield hedge funds crossed over and provided some support, seeing a lot of value there relative to their core asset classes.” He noted, however, that stabilization was short-lived, as high-yield spreads have widened.

The recession may be a spoiler

Many experts speaking at the conference warned that the current recession could hold some surprises this year and next, and urged investors to tread carefully. Several speakers noted that Moody’s Investors Service predicted that the global default rate on high-yield, high-risk bonds will jump more than fivefold by the close of 2008 because of a weaker economy.

The Moody’s report also expected the default rate to reach 5 percent in 2009, which compares to the 26-year low rate of 0.9 percent posted at the close of 2007. The ratings agency also noted that the percentage of issuers with debt trading at distressed levels at the beginning of 2008 was 11.5 percent, the highest level since July 2003. A year earlier, the rate was 4.2 percent.

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Sometimes the simplest questions are the most difficult to answer.
The size of loans that may face trouble was also a worry among experts speaking at the conference. “If you look at the average size of what a leveraged loan looked like in 2007, it was going for $1 billion,” explained Jim Jeffries, managing director, Wachovia Securities Inc. “If you go back to the beginning of the last cycle in 2001, it was around $350 million, maybe $400 million. So, we’re at least three times bigger based on that stat.”

**Complex covenants and liens**

The deals not only were big, but they also were complicated in structure. “We see a different creature in the leveraged loan market, that of covenant lite and second lien,” Sean Lynch, director of credit and co-manager of the Sutter high-yield fixed-income team at Wells Capital Management, told the audience attending a panel discussion that he moderated. “Obviously, second liens did not exist at all in the 2000 time and covenant lite, as we all know, has expanded to at least one-fifth portion of the market.”

These mega deals have involved a diverse cast of investors, which may pose another problem in a turnaround or restructuring scenario. “We’re dealing with capital structures now that have become much more highly complex with the introduction of a lot of different lenders, which changes the dynamic that a turnaround manager needs to go through,” notes Jeff Zappone, CTP, senior managing director of Conway, MacKenzie & Dunleavy Inc., adding, “I’d say the turnaround and workout that we classically had done in years past is gone and it’s never going to come back.”

Creditors may face new troubles. In a panel discussion that focused on recent court cases and settlements involving creditors who sat on creditor committees and also traded in the securities of the company in question, listeners learned that it may not be wise for sellers of distressed debt to assume that a big-boy letter is protection enough from post-sale lawsuits. Such letters are generally provided by sellers who have nonpublic knowledge about a company to buyers who agree that they are “big boys” and understand the situation.
THE WHY AND HOW OF TURNAROUND

Keynoter Jerry York says a committed management team that takes the long view can overcome the failure of poor strategy

Noting that “a turnaround is sort of the flip side of distressed investing,” Jerry York, CEO of Harwinton Capital LLC, a private investment company, and keynote speaker at the second annual Distressed Investing Conference, described what he viewed as the reasons companies fail and the most effective ways to rescue them.

Basing his remarks on his personal experience with turnaround situations at Chrysler Corp., IBM, Apple and Tyco International, York referred to the wrong strategy or business model and poor execution as the “symptoms” of a disease that consists of poor governance, a culture that tolerates poor performance, inadequate management and a major shift in industry conditions.

Pre-turnaround conditions
York dissected the pre-turnaround condition of the four companies. Regarding strategy issues, he said, “Chrysler had an overall good strategy. IBM’s was severely flawed. Apple essentially had no strategy, and Tyco’s was pretty good but excessively risky. In terms of the business model, both Chrysler and IBM were too slow and costly. Apple had serious distribution problems, and Tyco was too costly because of the redundancies that existed in the back office and manufacturing areas.

“Occasionally, Chrysler had done reasonably well, but had been left vastly behind in passenger cars, had huge market share losses. IBM was behind in everything virtually, except mainframes and a small, at that time, services business that was still smaller than EDS at that point. Apple had major manufacturing footprint issues, and Tyco was operationally sub par.”

York termed the pre-turnaround boards of Chrysler and IBM as strong and independent, but chided the management of the automaker for lack of teamwork and the technology company’s leadership for inflexibility. York was CFO of Chrysler and joined IBM in 1993 as CFO under Lou Gerstner.

Apple’s board seemed unable to move the company forward despite a depth of Silicon Valley expertise, and its management under Gil Amelio “clearly lacked the passion for the Mac platform that you need when you’re a small player compared to a big gorilla like Microsoft.” York became an Apple director in 1997 after Steve Jobs rejoined the company. As for Tyco, a company he described as “a single-legged strategy acquisition machine,” its directors were in awe of the CEO and did not ask serious questions of him, he said. York joined that board in 2002 after the company was in crisis.

Japanese competition was the industry change that hurt

Chrysler, he said, while at IBM it was the “titanic industry changes taking place in the IT space” in the early 1990s. Microsoft’s market domination was the issue for Apple, but Tyco “was largely very well-positioned asset-wise.”

Turnaround results
All four turnarounds delivered on their promises. At Chrysler, York termed the success spectacular. “The share price bottomed out in 1990, ’91 at about $9, and in 1993 when that particular turnaround had been successfully completed, the stock was at $45.” Daimler-Benz, which purchased Chrysler in 1998, “totally screwed up that acquisition,” York said. “There is no reason that could not have worked out, and worked out beautifully.”

Noting that Chrysler is now in its third major restructuring of the past 15 years, York said it was because they had not adequately addressed their competitive disadvantages against Asian carmakers.

IBM is another success story. “The stock bottomed out at $10 on a split adjusted basis in 1993 and it’s at $103 currently … they [IBM] have exhibited the ability to change and not just wait until they get in crisis again,” he noted.

York attributed Apple’s turnaround to Steve Jobs’s refocus on better product design and product innovation, particularly the hugely popular iPhone. “The thing sitting on your desk does not have to be an ugly gray or beige box. It can be an attractive industrial design. Interestingly, Dell is now starting to emulate that 10 years later. By the way, Michael Dell in 1997 said that Apple should not be turned around … and today Apple’s market cap is greater than Dell’s by a substantial amount.”

Tyco’s turnaround, while successful, has not been played out, CONTINUED >
according to York. “This was a company in severe crisis ... and we had a huge credibility rebuilding job to do. I went on the board in November of 2002. I was the second new director and five months after that, the board had been changed 100 percent. Last count I saw of the top 200 executives in the company, 190 were from outside the company. So, we did what we had to do to get our credibility back.

“Part of the strategy was just to say to all of the organizations, ‘No more acquisitions. Run what you have, straighten it out, maximize the return to the shareholders, and let’s see how well you can do that,’” he recalled. The benefits of the decision to break up the company, which took effect last year, are unknown. “... It’s too early in the game to see how well that’s going to work out because two of the three management teams of the new pieces are new to Wall Street, and Wall Street is going to take a bit of a wait-and-see attitude to see how these new management teams do,” York said.

The elements of success
Senior management with passion and determination is the essential ingredient for a successful turnaround, according to York. “You’ve got to have somebody who has looked at the situation and said, ‘It is absolutely, vitally necessary that we take drastic action. There are no sacred cows, nothing is off the table, and we’re going to do whatever we have to do to fix this place.’”

Communication is vital. “You’ve got to sell it to the troops. You’ve got to continuously be out there communicating ... what we’re doing and why we’re doing it,” he said. Symbolic gestures count, too. “The top dogs have to set the example,” York said. “You can’t have a scrumptiously appointed executive dining room, limousines all over the place. Tone setters are very important.”

Finally, York praised the benefits of benchmarking. “It’s incredible the amount of information you can get your hands on, if you really work at it,” he said. “At IBM we had 12 initiatives. We tracked all of these monthly. We tied them to the financial statements so that you couldn’t claim cost reductions in this area but, by the way, costs are rising over here. And, of course, measure and report it frequently.”

One point that is often ignored, according to York, is that turnarounds are like successful diets: long-term success requires constant vigilance. “Turnarounds cannot be considered one-time events and must be followed by continuous improvement approaches and high levels of strategic adaptability. If you don’t do that, then you’re just going to go from one crisis to another one to another one.”

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EXPERTS ADVISE PATIENCE AND CAUTION FOR DISTRESSED DEBT INVESTORS

The better deals will likely come along later, but that doesn’t mean investors shouldn’t start shopping now.

The current climate in the credit markets and the accompanying economic slowdown have changed the psychology of the distressed investment market, primarily because predicting “the bottom” has become more difficult, according to our experts.

“This is a marketplace that has made incredible corrections in very short periods of time,” said David Matlin of Matlin Patterson, while speaking on a panel of distressed fund founders. “The psychology has totally changed. The mantra that you’re supposed to buy in the dips, I think, has completely unraveled after the subprime debacle.”

Patience was well regarded as a strategy in this environment, since “good companies with bad balance sheets” won’t start to appear until later in the down cycle. “The best deals we’ve done have been investments made late in a recessionary period or crisis period,” said Michael Psaros, KPS Capital Partners LP.

“We have found that it is the worst companies in their respective industries that are the first ones to get sick. And, the best companies in their respective industries are the last ones to capitulate. So, we’re very content to just sit and let the opportunities come to us,” he added.

Psaros, therefore, cautioned investors against overenthusiasm for buying a distressed company’s debt during the beginning of an economic downturn. In particular, he noted that traditional middle-market leveraged-buyout (LBO) metrics are difficult to apply to a very distressed, underperforming company or one operating in bankruptcy, and as a result, traditional LBO funds must be wary.

Opportunities exist
Opportunities nonetheless present themselves. Psaros, whose firm focuses on manufacturing, said that sectors such as auto parts will be hard hit, but since his firm has solid portfolio companies in auto parts, “we’re going to build them out because now is the time to buy.”

Mark K. Holdsworth of Tenenbaum Capital Partners LLC concurred, noting that some of his firm’s older portfolio companies are now poised for growth. “We have very healthy businesses with great balance sheets, so I’m telling my managers that now might be the time to pick off some weaker competitors and do some acquisitions.”

He also predicted that European companies that bought North American manufacturing divisions or subsidiaries at high prices and failed to make a go of these investments are anxious to sell now, creating another opportunity.

Operations take on new importance
The distressed debt investment industry in 2008 is far different from that of 2001-02, another difficult economic period, our panelists noted. Tenenbaum’s Holdsworth described the industry during the early part of the decade as “almost kind of a cottage industry, much smaller. We had sophisticated well-known players back then, but it was really a specialized niche within the alternative asset space. Today it’s much more mainstream.”

The result is a more competitive marketplace with major players and deeper pockets. To be able to snap the best deals, therefore, it’s essential to differentiate yourself as an investor, and our panelists believed that a strong track record of operating portfolio companies is essential in doing that.

“To be really differentiated in this market, I think you have to be prepared to own and operate a business,” said Holdsworth. “If you’re providing a rescue financing, sometimes those go south and you end up owning the business. Sometimes, you’re accumulating bonds in the open market and you end up owning the business, perhaps by design. So, you have to be ready for that.”

Operating a distressed business is no picnic. Our panelists noted that success rests on selecting solid management and designing appropriate compensation programs for them, implementing effective cost cutting, and learning to work as a team with other owners.

“I’ve noticed that the deals are so big, the companies are so big, and the amount of distressed debt in the balance sheets of these companies is so big that it’s going to be hard for any one firm to end up in a real position of control. So, we have to learn to get along with everybody,” said Holdsworth.

Mark Leder of Sun Capital Partners, Inc. offered this advice about operating companies. “The two most important lessons I’ve learned over many years and many deals is that when you’ve

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got a struggling company, you cannot move too quickly, but you can absolutely move too slowly.”

Hedge funds investors may be at a disadvantage when plans go awry and they end up as owners. “I don’t see the hedge funds having the ability and the people to sit and work on more than one of these deals in their portfolio at a time,” noted Matlin of Matlin Patterson. “I think there’s going to be a lot of opportunity.”

Foreign investments and investors
Panelists did not view Europe and Asia at present as strong markets for distressed debt investors, particularly because of the different legal and financial systems. “As we look out in Asia, it’s very quiet,” said Matlin “Until China meaningfully slows down, they’re not going to pull down Southeast Asia with them. We’ll see what happens after the Olympics.” He noted that Australia is “starting to hiccup,” and he thought that 2009 may open opportunities in Europe as those economies slow down in response to the United States picture.

Holdsworth also saw possibilities growing for investing in Europe, but cautioned that laws and creditor rights are very different from those of the United States. “If you’re going to go over there, you’d better do your homework and your research on the laws because you can find yourself in some pretty sticky situations with no way out,” he noted.

Yet, panelists pointed out that foreign investors have not been timid about making alternative investments here in U.S financial firms. An example cited was the Kuwaiti investment in Citigroup in January. “The United States today is the most sophisticated financial market in the world,” said Holdsworth, “particularly with respect to alternative investment products like private equity and distressed debt investing. So, it’s an opportunity to get a front row seat in terms of seeing how it’s done.”

Foreigners are not the only ones seeking an education. “You’re going to continue to see state pensions and endowments also making investments in firms, again for a lot of the same reasons: the learning process, access to the financial minds, and, obviously, profit,” Holdsworth added.

The ranks of limited partners are expected to remain virtually unchanged, according to our panelists, all of whom reported few defections among LPs. “There’s an extraordinarily high level of re-upping by LPs,” said Leder of Sun Capital. “We tend to lose between zero, one and two LPs per fund. So, we’re in the neighborhood of 99 percent re-upping.”

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NEW PLAYERS EMERGE IN LEVERAGED CAP MARKETS

Yet, hedge funds and other new investors may face surprises as economic storm clouds gather.

The leveraged capital markets of 2008 look different from those of last year, our experts say, as the dominance of collateralized loan obligations (CLOs) has given way to hedge funds, high-yield funds and distressed funds. This infusion of new buyers following the subprime crisis of July 2007 helped to stabilize the market for companies seeking financing, but will that last as the economy continues to slow?

“Your had a new set of buyers step up, which were the hedge funds and other nontraditional leveraged loan buyers,” explains Sean Lynch, director of credit and co-manager of the Sutter high-yield fixed-income team at Wells Capital Management, who moderated a panel entitled, Leveraged Capital Markets: What’s Hot, What’s Not?

“That helped to stave off the amount of defaults and the ability to take down debt for institutional banks that still had deals on their books.” Lynch, however, sees trouble ahead. “Over time, we should see the default rate pick up quite significantly,” he adds.

Covenant lite loans
According to the panelists, a new wrinkle that may affect predicted workouts and restructurings is the new and more complex structures now in play. “We see a different creature in the leveraged loan market, that of covenant lite and the second lien,” says Lynch. “Obviously, second liens did not exist at all in the 2000 time and covenant lite, as we all know, has expanded to at least a one-fifth portion of the market.”

Lacking traditional financial triggers, covenant lite loans may lead to situations in which lenders are unaware of a company’s distress until too late. “If you’re the owner of an asset,” says Jim Jeffries, managing director of Wachovia Securities, “you may be in a situation where your first chance to have a discussion about the credit is really as it’s hit a liquidity crunch and is close to hitting the wall. That’s vastly different from the last cycle, in which there were maintenance covenants that had teeth and you could get back to the table, reset yourself, and agree or disagree with the plan based on where the business was headed.”

Workouts rest on the perception that a company still has value, and our panelists believe the new structures may affect that negatively. “Our rule of thumb is that you’ll get one hopeful bite at the apple from a private equity source to protect, preserve, and defend their investment,” says Edward Siskin, executive managing director of Crystal Capital. “The problem is that if you’re down at the end of the line, where there isn’t any more perceived value, sometimes they have to be crazy to put up the money .... The whole recovery, I think, and workout strategy is compromised.”

Diverse workout interests
Another issue affecting future workouts is the number of lenders involved in these structures. “We’re dealing with capital structures now that have become much more highly complex with the introduction of a lot of different lenders, which changes the dynamic that a turnaround manager needs to go through,” notes Jeff Zappone, CTP, senior managing director of Conway, MacKenzie & Dunleavy Inc., adding, “I’d say the turnaround and workout that we classically had done in years past is gone and it’s never going to come back.”

CLOs are seen as bringing similar problems to troubled companies in the future. “My biggest fear as a second lien lender,” says Siskin, “is the diversity and the number of CLOs that are in the credit. So, when you need a restructuring done, a simple amendment done, trying to get all of the votes together in a quick period of time sometimes is a nightmare.”

How will private equity firms that find themselves in these situations behave? “The funds for Blackstone and KKR or any PE firm that now has CLOs outstanding, we haven’t seen that

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they’ve had to do this yet, but will their goals be the same as those of the other lenders in the group?” wonders Rob Polenberg, research analyst at Standard & Poor’s Leveraged Commentary and Data. “Are they in it to own the company on the other side? Are they going to make the restructuring or the bankruptcy or whatever process they’re going to go through more difficult? Nobody knows.”

The size of some of the companies that may find themselves in these complicated situations is another worry. “If you look at the average size of what a leveraged loan looked like in 2007, it was going for $1 billion, the average-sized facility,” explains Jeffries of Wachovia. “If you go back to the beginning of the last cycle in 2001, it was around $350 million, maybe $400 million. So, we’re at least three times bigger based on that stat.

“And, you’ve got multitudes more investors involved in these credits. I think that in some respects it’ll create a wonderful opportunity for some people because the structured vehicles may get in a situation where they’re for sellers, and that will create some technical supply-and-demand problems in the market where you can find real value,” he concludes.

Opportunities for 2009
There are always ways to turn lemons into lemonade, and our distressed investing experts see opportunities in certain manufacturing sectors, such as automotive parts, and the retail sector, which experienced a lackluster holiday shopping season in 2007. “You’re basically looking at transportation, distribution, consumer products,” says Zappone. “We know what’s going on in the home building sector now … and those of us with experience in automotive know we’re going to see a lot of high activity and high distress. But, you know, with that you also see a lot of opportunities in the marketplace.

“The companies who basically got their deals done and got them done early, who have enough liquidity to withstand the downturn and are operating efficiently are going to be opportunistic buyers

“When this whole thing shakes out, there are going to be some much stronger companies.”

in the marketplace. When this whole thing shakes out, there are going to be some much stronger companies. But, there’s going to be a period of severe distress within these basic economies and old-school industries, including retail and consumer products,” he concludes.

While concurring with the outlook for these basic industries, [Crystal’s] Siskin cautioned about companies dependent on raw materials such as basic metals, resin and oil-price-related materials because of the inability to pass along cost increases quickly to consumers. “If you sell carpet to Home Depot or Lowe’s,” he says, “they’re not going to accept 20 percent increases in price, even though your raw material costs might have gone up twice that … So, you really can’t buy into EBITDA growth, and, quite frankly, maybe we should take those models down because of the time lag of passing those costs to your customer.”

While certain sectors like retail, automotive and real estate will likely founder in the year ahead, institutional investors have learned the value of diversification. “In the last cycle, you saw that telecom was 15 percent of people’s holdings,” says Zappone. “Right now, there’s no sector that holds over 10 percent in anybody’s specific holdings. So, I think that because of diversification there is some insulation in terms of how steep it will hit at least the CLOs and some institutional investors.”

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WHEN CREDITORS ARE TRADERS, GRAY AREAS ARISE

With the supposed protection of big-boy letters now in question, creditors must weigh the benefits of serving on committees.

As the number of defaulting companies rises, debtholders must be careful about serving on creditor committees because recent court decisions and lawsuit settlements appear to place committee membership in conflict with trading activities, according to members of a panel discussion entitled, Distressed Debt Trading in Volatile Markets.

In the past, many traders believed that “big-boy” letters offered protection in these cases. In explaining the purpose of these letters, Edward Weisfelner of the law firm Brown Rudnick said, “The concept is that if I’ve been exposed to material nonpublic information by virtue of having been an insider or having participated in some committee function, either official or unofficial, the theory is that I can sell my bonds so long as the seller understands and evidences that he’s a ‘big boy.’ In other words, he understand that I was privy to material nonpublic information, he understands I know a lot more about the investment than he ever could, and, nevertheless, he’s prepared as a ‘big boy’ to enter into the transaction I’m offering him at the price that we’ve agreed upon.”

Such a letter was thought to insulate the seller from any legal action the buyer may decide to take post-sale, but recent legal actions have raised new issues. “The more interesting question,” Weisfelner continued, “is whether or not from the perspective of the marketplace taken as whole, and enforcement action by the Securities and Exchange Commission, the big-boy letter is going to insulate me from Federal regulators.”

Panel moderator Glenn Siegel of the bankruptcy group of Dechert LLP concurred, noting that theoretically the big-boy letter “may work in the context of a two-party transaction, but the question is whether or not that gets you much more and whether or not that absolves you from liability with respect to all other issues.”

Must big boys be passed on?

To illustrate the point, the panel detailed several recent cases, including the lawsuit that was settled in 2007 involving Solomon Smith Barney (SSB), now Smith Barney, and R², a Texas hedge fund. SSB, a member of the noteholder protective committee in an out-of-court restructuring for telecom company World Access, decided to sell its bond holdings in the failing enterprise. SSB contacted Jeffries Group to locate a buyer, and they found R². When it sold the bonds to Jeffries, SSB provided a big-boy letter, but Jeffries did not pass that along to the hedge fund. As a result, when the investment proved a failure, R² sued on the grounds that proper disclosure was not made.

Although a settlement of the case precluded a court opinion, there are lessons to heed, panelists said. “It teaches us that as between the parties to a transaction, in the actual case R² and Jeffries, the existence of a big-boy letter ... isn’t a shield to liability,” said Weisfelner. “The concept is the potential fraud in the marketplace. Jeffries, having taken, in effect, tainted bonds and put them out in the marketplace without telling people that they were coming from people who had material nonpublic information, in effect was defrauding the market. I think that was the theory, at least, of the lawsuit,” he added.

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[Dechert’s] Siegel added, “The position is, and this is the position the SEC takes, that the fact that there is trading going on with material nonpublic information distorts the pricing on the bonds and that there are people out there who are selling and making money on the fact that they know something that somebody else doesn’t know.

“And, that by itself is enough to give rise to a securities law violation, and the fact that the counterparty to that individual trade has waived it through a big-boy letter doesn’t solve the problem because those trades are out there in the marketplace. They set the price of the bonds and they’re not based on correct information. That’s the position that the commission is taking these days. How often they’re going to do anything about it, I don’t know,” he said.

Traders are definitely caught in the middle, according to panelist Matthew Carter of UBS Investment Bank. “It’s tough to disseminate if you transact with a big boy and sell it on. Typically, what we like to do is pass the big boy on. But, say you buy $10 million from somebody and start piecing it off, at what point can you clearly say that these bonds aren’t tainted?

“Essentially, it makes me, even though I don’t know anything, have to pass on the big boys all the time, which people really don’t want to take on. It pretty much will take me, as a market maker, out of the situation. So, we tend to try to avoid dealing with these.”

Are ethical walls enough?

Another issue of concern for distressed debt investors is that of trading behind so-called ethical walls. In the Federated Department Stores bankruptcy, negotiations among the creditors committee, some large holders and the United States Trustee resulted in an order being entered that allowed trading as long as an “ethical wall” was set up between the trading unit and the members of the creditors committee in that particular instance. These large investors wanted to protect their ability to continue buying and selling securities on direction of their clients even though the firms were represented on the committee.

“The problem with this is that it works for very large financial institutions that can segregate their trading and, for lack of a better word, their fiduciary function within the same institution,” said Siegel. “It’s not quite as effective if it’s involving a small hedge fund where there are only a few people involved.”

Ethical walls impose other problems, too. “It’s an expensive proposition in terms of demonstrating compliance on a periodic basis with the office of the U.S. Trustee,” noted Weisfelner, adding, “The notion that the guy on the far end of the trading platform who sits on the committee doesn’t talk to the guy on the other far end of the trading platform who’s buying and selling securities sometimes takes a little bit of suspension of disbelief.”

The pros and cons of committee service

Distressed debt investors, therefore, would do well to remain abreast of issues regarding service on creditor committees. “The issue that faces the creditor constituency is whether or not they want to opt to serve on an official committee, the view being that serving on a committee affords you an opportunity to influence the outcome, assist in negotiations, and otherwise be here to look out for your investment,” Weisfelner said.

“There is a significant cost, however, in serving on a committee and that is the inability, at least according to the rules we’ve been talking about, to buy or sell securities or otherwise profit from your position as a member of the committee,” he added.

Many may feel that opting to serve on ad hoc committees, as opposed to formal committees, solves the problem, but panelists disagreed. “There is often a tension between taking an active role in a restructuring ... and maintaining the ability to trade,” said Weisfelner. “It’s almost inevitable that once you get to a certain stage in the proceeding, where ultimate decisions on cutting a deal have to be made, that, in effect, members of ad hoc committees have to jump over the fence and become restricted.”

...the existence of a big-boy letter isn’t a shield to liability.”
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CLOs: DOWN BUT NOT OUT
CLOs have proven to be a solid asset class that will survive the current market turmoil

While collateralized loan obligations (CLOs) may no longer dominate the leveraged capital markets, their vast holdings continue to make them a presence, according to members of the panel, CLOs, Credit Derivatives and SWAPS—What They Are, Where They’ve Been and How They’ll Impact the Next Wave of Restructurings, moderated by Jeff Marwil, partner of Winston & Strawn LLP.

“CLOs … historically have been a very stable market with low default rates, even through credit downturns,” said Robert Contreras, managing director and deputy general counsel for Deerfield Capital Management LLC. “That is demonstrated by the very limited number of downgrades by the rating agencies—only 98 downgrades across approximately 6,000 tranches.”

Expressing the opinion that in the current market CLOs are “the baby that’s been tossed out with the bathwater,” Gregory Cooper, founder and managing director of Denali Capital LLC, defended the asset class, too. “The rating agencies take a very strong viewpoint and stance when structuring a CLO. We have a lot of different covenants, if you will, that we have to maintain, such as spread, weighted average rating factor. They’re structured to the point where there are mandatory diversification triggers built in. It’s different from CDOs [collateralized debt obligations]. A CDO is basically a bunch of mortgages from one geographic area. They got blown out of proportion and they’ve kind of lost their way.”

Fellow panelist Matt Gerdes, managing director of Freeport Financial, noted that liquidity is an issue right now for CLOs. “The CLO asset class is a solid asset class. There’s a lot of capital that’s been invested there over the last several years and that capital is long-term capital that’s performing well for its equity holders and its debt holders.

“CLOs … historically have been a very stable market with low default rates even through credit downturns.”

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“The issue really is liquidity to fund future growth in the market. So, a lot of the CLO asset managers have been frozen by the large investment banks and money center banks that provide warehouse financing, just given the volatility in the market and the lack of a take out of those warehouse lines down the road.”

The perfect storm
The CLO market finds itself in turmoil, according to Cooper, because of “a perfect storm that showed how interconnected a lot of capital markets are.” In summarizing the events of the past year, Cooper said, “The reason the CLO market has been hurt the way it has been is because when the subprime market started to come to fruition in July, it caused the investor base for the CLO liabilities to literally dry up overnight. And, when that happened, any investors that were left were requiring wider spreads.”

This caused investment banks that were warehousing deals in anticipation of future CLO closings to find themselves with billions of dollars in assets sitting on their balance sheets and few options for moving them on. “There are leveraged buyouts that sponsors committed to earlier in 2007, and they’ve reflected multiples that are one, two, in some cases three, times higher than what the company deserved to be getting it for,” Cooper said, “and the banks had committed financing, in some cases with no covenants, with spreads that are 150 to 250 basis points out of market.”

Private equity firms have been caught in the squeeze, too. “You’ve got all this private equity money that’s been raised, needs a home, but they can’t get their deals underwritten,” Cooper said, “So, they have to go back and restructure their deals, their purchase agreements, with the sellers. In a lot of cases they have to renegotiate, and it takes a while ... So, a lot of deals just get taken out of the marketplace, which is a good thing for the PE groups because they can’t get them financed now anyway.”

PE firms also find themselves struggling to finance the needs of their portfolio companies and may find themselves in unfamiliar workout territory as a result. “Private equity firms enjoyed the

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Excess liquidity that was created by all these CLO managers who came into the business in the last two years,” Cooper noted. “They’re not going to like it when a deal does have an issue and they find out that there are 110 lenders in the deal and they..."

...the universe of managers that can get new deals done is probably 20 or 30 different managers.”

There’s enough capital to get some of these things done."

The outlook for large cap structured products is less optimistic because of higher capital requirements and tighter terms. “You’re not going to see [play out] the old adage ‘the three of us and a Bloomberg could get started in this business,’ which you saw as recently as January 2007,” Cooper said. “Scale is going to matter. I think every structuring agent out there will tell you that the universe of managers that can get new deals done is probably 20 or 30 different managers.”

Where’s the money now?

With lenders reluctant to finance or refinance acquisitions and loans, where can borrowers turn? “From our perspective in the middle market,” says Gerdes, “I think there is a market. It’s not efficient, but there is a market to get things done.” Cooper agreed. “The markets are open.... There is a lot of money overseas, a lot of pockets of money in the States that want to get put to work in the loan asset class. It is an attractive asset class, and we’re in a cyclical business.” The lesson of the current situation, according to Cooper, is “you just don’t turn a loan into a bond overnight, which is really what happened over the last 18 months. Senior secured loans became secured bonds with no covenants.”
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CHINA’S NEW BANKRUPTCY LAW OPENS POSSIBILITIES

While a more Western legal code will help open markets, cultural differences make implementation a slow process.

China’s efforts to modernize its bankruptcy laws are a hopeful sign for distressed debt investors, but they are baby steps that won’t translate into easy deals any time soon, according to members of the panel, Distressed Investing in the Middle Kingdom, moderated by George Kelakos, managing director, Kelakos Advisors LLC.

The Enterprise Bankruptcy Law, which took effect on January 1, 2007, incorporates many bankruptcy and reorganization concepts found in the United States but is often lacking important implementation details.

Nevertheless, while noting that until now the only option for foreigners in China was purchasing nonperforming loans, Helena Huang, a Hong Kong-based partner at Kirkland & Ellis LLC, pointed out two potential opportunities afforded by the new law. First is that it offers the ability of the debtor or the administrator to sell substantially all of a bankrupt company’s assets in bankruptcy and, secondly, it includes the ability of the debtor or administrator to borrow in the ordinary course of operating the business.

“In the past couple of months when I was in China talking to some of the judges and restructuring professionals,” Huang said, “I could sense that the Chinese restructuring community is very interested in this, although they don’t know exactly how to implement it.”

Cultural barriers remain

Changing laws is one thing; changing cultural attitudes is quite another. “The new bankruptcy law in my view does not and will not do one thing and that is to change the traditional cultural attitude of the Chinese against bankruptcy,” said Alan Tang, who heads up the Restructuring Group of Grant Thornton in Hong Kong.

Frank Mack, CTP, of Conway, MacKenzie & Dunlevy Inc. concurred. “In China there is a big emphasis on cultural issues as opposed to in the United States, where we have a focus on a framework of laws and practices. In China you have 5,000 years of history, which is not easy to break.”

Tang noted, however, that the 2007 law emphasizes restructuring, which the predecessor 1986 law did not. “The new law extends the scope from the state-owned enterprises to basically all types of businesses, including foreign investment enterprises in China,” Tang explained. “Under the old law, only the state-owned enterprises were allowed to be bankrupt. But now under the new law all enterprises are subject to this law. And, as I said, the emphasis is on restructuring and, therefore, the opportunities are huge.”

The advent of restructuring was welcomed by panelist Phil Groves of DAC Management LLC, the first foreign buyer in China of nonperforming loans from the asset management companies. “Under the old rules, the government had great power to direct and oversee the bankruptcy process, so one of the effects of the new law, although we haven’t seen it in practice, is that the government can’t do that willy-nilly any more.”

This change will be beneficial. “It makes it a lot more interesting for the restructuring professionals and the buyers that we now have another way to exit our loans other than just chasing people around with a stick, so to speak,” Groves said.

“In the early years,” he recalled, “almost all of the value of the collateral was real estate. So, the only type of restructuring you might get was that you might end up with some property or a building or a hotel. But, we’re starting to see a lot more debtors coming to us now saying, ‘Why don’t we restructure? We have this new bankruptcy law.’ They have no idea what it means. They just know it’s out there, so you’re going to see a lot more restructuring work, I think.”

One of the main stumbling blocks to investing in China is the amount of bureaucracy inherent in the system. “One of the worst things,” said Tang, “is the influence, if not the intervention, of the government … There are different levels of government—provincial, central—and then there are also different departments and divisions within government. “It’s sometimes confusing, if not frustrating, for overseas investors negotiating with the Chinese to find out that the real decision maker is not sitting across the table. You’ve got to go through a lot of these rounds of meetings before you really get close to the true decision maker.”

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The importance of business relationships when operating in China cannot be underestimated. Groves described how his firm uses different attorneys in each city in which it wants to do business. “When you enter a new city to buy things, find the attorneys who are related to the judges and the mayor and who know the sellers very well ... because almost your entire acquisition, restructuring and sale process is going to be dictated by how well your attorneys know everyone,” he said, adding that he was not implying that there was anything illegal going on. “It’s all just heavily relationship driven,” he explained.

Courts become more sophisticated
The courts, of course, will play a significant role as bankruptcy and restructuring become more widely used, but the quality of judges handling these cases across China varies. “If you go to China, you’re going to see a huge disparity among the qualification of judges,” Huang said, noting that judges in larger cities like Beijing and Shanghai also handle commercial matters and so are more sophisticated about business transactions. Judges in smaller cities, however, are not so conversant with business laws and “would not make a decision until they get some kind of OK from the local government or relevant agency,” she added.

“But, I actually see the situation improving and changing day by day,” Huang said, “and I know that ever since the adoption of this new bankruptcy law, the Supreme Court of China and the courts at various levels have hosted many seminars and training sessions for judges.” She also saw as a positive sign the fact that the Supreme Court has actively solicited opinions from restructuring experts worldwide in an effort to develop implementation rules.

“I have a lot of hope for the detailed implementation rules,” said Huang, “and I can see that a lot of little issues people are talking about may show up in the detailed implementation, which could help a lot in the real practice.”

Perhaps [Conway MacKenzie & Dunleavy’s] Mack had the best advice when he said, “Things move very slowly in China ... so you have to have patient money.”
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