

Impact of current credit markets on highly leveraged companies with declining EBITDA

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When the US sub-prime mortgage originators began to fail at the beginning of 2007, most observers expected the effects to be isolated to a narrow segment of the US residential housing market. During the first three quarters of 2007, credit expansion continued unabated in higher-quality credit markets. Looking back, the Blackstone initial public offering of June 2007 may serve as the high watermark of the credit expansion. Shortly thereafter, the overall credit market began to contract in August 2007. Real estate developers, construction companies and building suppliers were immediately stressed. More broadly, the commercial paper market began to shut down. Many central banks injected massive liquidity into their respective monetary systems in an effort to calm the markets.

At the time, most observers chose to view the credit downturn as a temporary bump in the road. Such rosy prognostications for a quick recovery had wilted by the first quarter of 2008. By then, the clear adverse effects of the credit crisis had manifested in segments of the US economy beyond real estate. US gross domestic product remained flat and not since 1990 had consumer confidence indices and the Standard & Poor's 500 Index fallen so precipitously. As of early 2008, however, the sub-prime contagion had not broadly infected corporate earnings beyond those of commercial and investment banks. Nonetheless, rising energy and food costs significantly impaired discretionary consumer spending, a major driver of the US economy in recent years, thereby beginning the erosion of growth in certain sectors of the US economy. As at the time of writing, the credit crisis has claimed its latest and most prominent victim – Bear Stearns, a financial institution that survived the Great Depression.

The failure of the sub-prime mortgage market was the result of an unprecedented boom in all corners of the global credit market from 2002 to 2007. The single most important driver of this fever pitch was the maturation of the securitised loan market, which enabled investors to spread and diversify risk while obtaining a higher yield. Lenders utilised securitisation to originate loans and then sell them off to investors, rather than hold the loans on their own books. The hunt for higher yields in a low interest rate environment inspired numerous innovations in financial engineering. A veritable alphabet soup of complex structures, such as collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and collateralised mortgage obligations (CMOs) (all of which are vehicles of pooled loans), offered investors higher and steadier returns at what was believed to be lower risk. Increasing defaults in sub-prime mortgage-backed securities scared investors away from these structures and lending activity in general.

The leverage glut

Chief among the riskiest commercial loans are highly leveraged loans and financing for leveraged buy-outs (LBOs). 'Highly leveraged loans' are defined as loans that leave companies with debt comprising at least half to

three-quarters of their asset base. LBOs, on the other hand, are buy-outs secured by a target's assets and often involve taking a public company private. Private equity firms drove the activity in these sectors to their greatest heights in 2007. The US market for leveraged loans and LBOs reached \$680 billion and \$210 billion respectively in 2007, dwarfing the volume of prior years.

Many LBOs involved record-high debt-to-earnings before interest, taxes, depreciation and amortisation (EBITDA) multiples, approaching eight to one in many instances. In the aftermath of such extremely leveraged deals, a climate of declining earnings in certain sectors has left dozens of companies at risk of default. The prevalence of such scenarios raises the spectre that many highly leveraged US companies will be left with no resort other than informal restructuring solutions or forays into Chapter 11.

While high leverage is not uncommon to the international markets, foreign companies rely to a greater extent on traditional lending and are less likely to have the same level of debt exposure as their US counterparts. Moreover, the economic fits experienced in the United States as a result of the credit crisis have not broadly infiltrated the earnings of foreign corporations outside the financial sector. However, for those foreign companies that do reach a distressed state, in most jurisdictions flexible out-of-court restructuring remains the preferred method of resolving creditors' claims.

The problem

The moribund credit markets have left leveraged borrowers without a practicable strategy for either servicing or refinancing their onerous debt burdens. Private equity sponsors had feverishly piled debt onto these companies, assuming that they would smoothly achieve a rapid exit via a sale or refinancing. However, the return of stringent lending standards has restricted the pool of potential buyers for such portfolio companies. Many buyers are unwilling to part with the equity commitments necessary to obtain acquisition financing. Indeed, many recent transactions have failed to close because of a hesitation on the part of the buyer or lender, with some deals ending up in the courts, where the parties do battle over the meaning of a critical phrase in the transactional documents.

Corporate earnings have shown signs of weakening in the homebuilding, retail, casual

dining and automotive industries, all of which are heavily dependent on discretionary consumer spending. Earnings pressure, coupled with suffocating leverage levels, will lead a number of companies to restructure their debt or seek to remedy their woes in a judicial setting. If the key economic indicators demonstrate a broader worsening of the economy, it is possible that we may see the trend of declining earnings growth spread to other industries that up until now have been insulated because of their diverse exposure to foreign markets.

Staving off default

Highly leveraged companies have a number of strategies to avoid defaulting on their obligations. Given the limited financing available to enable large acquisitions by private equity firms, many principals are turning to their operating partners and internal operating managers to shore up their newly acquired portfolio companies. Private equity firms will be tested and the best will succeed through turnaround ingenuity, not financing magic. However, not every company will be able to increase cash flow significantly. There will certainly be many companies that have obtained financing on the basis of unreasonably optimistic projections that will not be easily met.

Some companies will have to sell assets in order to pay down debt. However, declining asset values, weak markets and restrictive lending make this route problematic. For example, only the largest companies have been able to raise capital through spin-off transactions.

Restructuring strategies

Ultimately, many highly leveraged companies will have to come to terms with their ailing balance sheets and turn to their lenders to resolve their insolvency and/or illiquidity issues. Out-of-court restructuring may provide the best option for many companies. The typical restructuring scenario results in a lender's agreement to forbear from exercising remedies under a credit agreement. Such an agreement often leaves troubled companies with no choice but to pay additional fees or increased interest, or to provide additional collateral. It is also common for lenders to require borrowers to adhere to stricter financial covenants and a regime of frequent financial reporting.

Enterprise dynamics

Forbearance agreements vary in duration. Often a lender's willingness to cooperate depends on the stability of the value of its collateral. For example, certain homebuilders have been able to reach long-term pacts because of the durability of their underlying assets. Although declining home sales have left homebuilders with a glut of unsold homes and thousands of acres of land in varying states of development, the durability of real property has influenced some lenders to forbear until markets normalise, knowing that the assets will not disappear or decline to minimal value.

On the other hand, leveraged companies with a high proportion of their collateral base consisting of inventory and equipment will have greater problems achieving a long-term restructuring agreement with their lenders. Their dependence on the sale of goods and the inherently fleeting nature of their collateral will force lenders to act quicker and more aggressively to preserve value. Already wary lenders are reluctant to be left with warehouses full of unsold and unwanted products. In order for restructuring solutions for highly leveraged companies to have any chance of successfully increasing cash flow, they must be implemented promptly and involve a high degree of creativity and cooperation among the parties.

Another issue that may pose a challenge in the next wave of restructuring pertains to highly leveraged companies that have been heavily dependent on loans with so-called 'covenant-lite' structures. In response to historically low corporate default rates and the desire to serve buy-out firms, which emerged as the most lucrative repeat customers in the recent business cycle, the lending marketplace became as highly competitive as ever. In order to compete for business, banks issued debt accompanied with little to none of the protection typically afforded by financial covenants that govern the extent of a borrower's leverage and ability to service the debt. Had these loans had the usual financial covenants, leveraged companies might have experienced default events far sooner. Instead, the non-occurrence of such defaults may cause such companies to remain fundamentally distressed long before they are ever forced into a restructuring. One possible harmful consequence of the covenant-lite trend is that highly leveraged companies will have little value left to restructure when they do indeed default, leaving all parties with no option but to skip the restructuring or reorganisation phase and head straight towards liquidation.

Procedural complexities

Certain newly emerging dynamics are bound to complicate the restructuring process for highly leveraged companies. Since such companies are borrowers under syndicated loans, many actions require the consent of lender groups consisting of 50 to 100 debt holders. Soliciting and obtaining the consent of a majority of a lender group consisting of entities with diverse and often divergent viewpoints may add a frustrating layer to an already challenging restructuring process. However, some debt holders are CLO fund managers, who often are overly willing to forbear in order to avoid defaulting under their CLO documents.

Further, many leveraged loans consist of multiple tranches of debt. Often loans are structured into first and second-lien (and sometime third-lien) tranches, paying a higher interest rate to junior debt holders in return for the subordinated position. Many leveraged companies may have a valuation that will cause second-lien lenders to be out of the money. Original holders may sell to distressed debt investors looking for fulcrum securities. Such investors may be less cooperative in a restructuring, hoping to push the debtor into bankruptcy in order to have the opportunity to convert their stake into a potentially valuable portion of the equity in the reorganised enterprise. Moreover, tension between first and second-lien holders regarding each tranche's respective rights may escalate and prolong inter-creditor squabbles, souring the parties' appetite for a mutually agreeable restructuring. The next wave of restructurings may indeed have its fair share of inter-creditor issues that may add unnecessary delay, complexity and prohibitive expense, thereby threatening the viability of an already deeply challenging process.

Bankruptcy

When creditors provide a modicum of breathing room and it becomes evident that a quick turnaround is not possible, there is often no choice but to pursue reorganisation under Chapter 11 of the US Bankruptcy Code. Although it is not yet clear how substantially US corporate bankruptcies will rise in 2008 and 2009, most practitioners expect an increase in activity. Regardless of the magnitude of the coming cycle, a number of factors will impact on the bankruptcies of certain highly leveraged companies.

A critical issue is that companies will not find Chapter 11 to be the haven it once was because of the new provisions added to the Bankruptcy Code in 2005. Most of the important features affecting corporate bankruptcies involve shortened time periods for many key milestones, the most significant of which are discussed below. These changes will force companies either to engage in the reorganisation process efficiently and expeditiously or to face the prospect of liquidation.

Automatic stay

One of the most important concepts in US bankruptcy and reorganisation law is the automatic stay, which is essentially a moratorium on collection activity that gives the debtor breathing room. With this protection, debtors are given the right to reorganise without confronting the pressure of lawsuits, asset foreclosures and the enforcement of other creditors' rights. The automatic stay is extremely broad in scope and applies to almost any type of formal or informal action against the debtor or its property. The courts often enable debtors to expand the automatic stay to non-debtors – specifically, directors and officers in their individual capacities and parties to which a debtor may have potential exposure as an indemnitor.

Executive compensation

In prior bankruptcy cycles, debtors were able to retain key executives during the duration of a case by obtaining court approval of retention-based bonuses and severance plans. The 2005 revisions to the Bankruptcy Code have dramatically curtailed a debtor's ability to utilise this tool. Compensation plans may include retention-based incentives only in certain limited circumstances and pursuant to a monetary cap. Courts have scrutinised such plans in recent cases and have struck out many that have had retentive effects. In future cases, courts may be receptive only to performance or success-based bonus plans, which may not be sufficient to persuade key managers to remain with a struggling enterprise.

Contract rejection

A debtor's major operational tool is the ability to assume or reject contracts and leases. Highly leveraged companies may find this right especially valuable because it provides the freedom to

implement drastic changes in their operations with relatively limited downside risk. Debtors in the retail sector often find this tool especially useful, allowing them to eliminate numerous leases at underperforming sites quickly.

As valuable as this right is for debtors, it is not unlimited. The revised Bankruptcy Code introduced a temporal limitation to the process. Debtors will have only four months to reject non-residential real property leases. This restriction will add additional pressure on debtors, requiring them to focus on their long-term business plan much earlier in a case than has historically been the norm.

After a contract is rejected, a debtor's contractual counterparty is entitled only to an unsecured claim for the damages resulting from the rejected contract. Furthermore, the Bankruptcy Code caps the extent of damages available to non-residential real property landlords. This provision has the benefit of further limiting a debtor's ultimate exposure upon rejecting an unwanted lease.

Another boon to debtors is that the claims resulting from lease and contract rejection are often paid at significantly less than face value. Debtors routinely object to such damages claims. This process encourages the parties to settle such claims for less than a claimant may have anticipated. Further, such claims are pooled with other unsecured claims and paid after the claims of secured creditors and certain special classes of unsecured creditors. The result in many cases is that unsecured claimants are often paid a minimal portion of their claims from a small pool of assets remaining at the close of the case.

Asset sales

Chapter 11 affords companies the right to sell assets outside the ordinary course of its business free from certain liabilities or interests if the sale is based on a "good business reason". In addition, if a company requests relief from the bankruptcy court to sell assets free and clear of existing liens, it will have to obtain the consent of the secured party. Companies may experience success with bankruptcy auctions because they often attract buyers which are all too happy to acquire assets free and clear of liabilities.

Debtor-in-possession financing

Bankruptcy enables highly leveraged companies to attract debtor-in-possession financing from lenders secured by liens that would be otherwise

unavailable outside of bankruptcy. In the event that a debtor is unable to find financing that is unsecured or secured by unencumbered assets, a bankruptcy court may approve debtor-in-possession financing that is secured by liens that are senior or which prime already existing liens. Such priming liens effectively usurp a company's pre-bankruptcy secured lender from its senior position. For this reason, senior secured lenders are often eager to negotiate with a troubled company to provide debtor-in-possession financing. The nature of this process affords many debtors the opportunity to obtain the vital financial lifeblood that is critical to a successful reorganisation.

The plan process

A debtor's ultimate goal in Chapter 11 is to confirm a reorganisation plan. A plan sets forth the terms and conditions of a debtor's emergence from bankruptcy protection. The plan proposes a particular treatment of creditors' claims and sets forth the manner by which the debtor will fund the distribution scheme that pays such claims. One requirement of a plan is that it must classify the claims of creditors into one or more classes. Generally, creditors are grouped into classes based on the common attributes of their claims or interests, and on whether the plan alters or impairs their legal, equitable or contractual rights. Given the impairment that most unsecured claimants experience, the plan process involves a significant amount of negotiation between the debtor and unsecured creditors.

The plan proposed by the debtor is served on creditors with a court-approved disclosure statement that provides material to inform their voting decision. Among the conditions to confirmation set forth in Section 1129(a) of the Bankruptcy Code is the acceptance of the plan by all impaired classes. If an impaired class rejects the plan, the debtor may still seek to confirm the plan under the more onerous cram-down requirement of the Bankruptcy Code, which imposes the additional burden on debtors to prove that the plan is fair and equitable and does not unfairly discriminate against the dissenting creditors.

Under the revised Bankruptcy Code, debtors have an exclusive right to file a plan of reorganisation for only 18 months. In prior years, certain cases languished interminably in Chapter 11 as courts granted debtors serial extensions of the exclusivity period. This change will motivate interested parties to initiate the plan process very

early in a case. However, these limitations may also serve to embolden creditors to be less cooperative in the plan negotiation process in order to allow a debtor's exclusivity period to lapse and then file their own competing plan.

Fraudulent transfer risk

Companies that were LBO targets may carry a certain degree of fraudulent transfer risk into a Chapter 11 case. A fraudulent transfer involves a transaction pursuant to which the transferor receives consideration that is of a significantly lesser value than what it exchanged. A bankruptcy case offers a bankruptcy trustee or a creditors' committee the right to seek damages from third parties that benefited from such transactions. In addition, fraudulent transfer statutes test the transferor's financial condition as it resulted from its participation in the transaction. To the extent that a transfer caused a transferor's distressed financial condition, it may be more likely to be deemed fraudulent.

LBO targets often utilise acquisition debt to pay existing shareholders and are left to service the entire debt obligation. Courts routinely find that such financing arrangements offer the target insufficient value in return for the debt obligation. The more challenging portion of the claim concerns the financial condition component of a fraudulent transfer claim. Proving a cause-and-effect relationship between an LBO and a target's gradually worsening financial condition is difficult. If a transferee can point to reasonable financial projections from the time of the LBO and other external economic factors that affected the debtor, such as a contracting marketplace, it has a better chance of emerging from such actions with no liability.

However, as with all litigation, fraudulent transfer claims are costly. With this in mind, creditors' committees often lodge such claims with the exit strategy of extracting a settlement that enlarges the pool of funds available for distribution to unsecured creditors.

International trends

While many segments of the US economy are in distress as a result of overleveraging and loose lending practices, the international front has not been as adversely affected. The primary reason is that leveraged loans comprise a smaller share of foreign lending markets. Furthermore, while

foreign stocks have trended down in early 2008, earnings weakness has yet to be as sustained as it is in certain US segments.

Nonetheless, certain factors indicate that foreign companies will begin experiencing distress in 2008. Any significant and sustained downturn in US consumption in 2008 and beyond will have the greatest impact on exports. The most affected countries would be China and other manufacturing centres in Asia. As an early indicator of this trend, in the first quarter of 2008 the Chinese government recorded a dramatic rise in uncollectible debts from US customers. Although the 2008 Olympic Games in Beijing may serve to buoy the Chinese economy until the end of the year, certain Chinese companies may be vulnerable in post-Olympics China and it remains to be seen whether the newly implemented Chinese bankruptcy law will serve as an adequate tool to solve the problems that debtors and creditors may face.

Another factor is that in the last decade finance has emerged as a truly global, interconnected system. To the extent that a systemic weakness takes hold, there is the potential that financial contagion will affect financial institutions around the world. However, it is also possible that foreign banks with healthier risk profiles will continue lending at a modest pace and thus counteract some of the recent problems associated with loose and risky lending practices in the United States. There are also reports that middle-market banks are viewing the tightening lending standards implemented by overexposed lenders as an opportunity to surge ahead in the league tables by stepping in to do deals with the ample capital they have accumulated in recent years.

While deal-making was in hibernation in the United States in early 2008, many substantial investments were made by certain uniquely positioned sovereign wealth funds (SWFs). With over \$2.5 trillion in funds under management, SWFs are state-owned funds that seek to diversify revenues for nationalised activities, often with minority stakes in existing enterprises. Supplanting the role of hedge funds and private equity firms, SWFs are prevalent in oil-producing states and have recently made a number of large investments in global financial institutions that had been financially stressed as a result of write-downs and losses attributable to the sub-prime crisis.

SWFs have clearly ameliorated the financial condition of many global institutions. To the extent that any severe global downturn is avoided, SWFs' stabilising investments may be a significant favour.

These large investments have shored up many capital-hungry institutions that are critical to global finance. That SWFs have been able to step in when leverage-dependent hedge funds and other investors could not has certainly been a welcome antidote in otherwise rocky economic times. Only time will tell whether the aggressive bets made by SWFs pay off and whether they will expand their direct investment programmes to a broader array of companies.

As of early 2008, foreign markets have not shown the clear symptoms of an economic downturn; nor are such markets free from the downbeat jitters resulting from troubles in the US economy. However, just as in the United States, foreign real estate markets are the first markets showing signs of declining values and distress. In fact, the distress of highly leveraged listed property trusts in Australia has roiled the markets there. Property markets in the United Kingdom have shown more weakness than in continental Europe, and some commentators believe that property values will begin to soften in China and other emerging markets that previously saw major upward spikes in property values.

It is inevitable that if highly leveraged foreign companies start to feel the pinch of declining earnings, there will be a modest amount of restructuring activity in foreign jurisdictions. Most foreign jurisdictions offer flexible restructuring regimes that do not require court supervision. The absence in most foreign jurisdictions of debtor-friendly statutes similar to Chapter 11 means that if creditors cannot agree on a plan to reorganise a failing company, there is often no choice but to liquidate.

Conclusion

Leveraged lending tends to go through cycles of tighter, then looser, underwriting standards. The United States is certainly coming off one of the loosest cycles ever. Lending institutions will likely recover in time, but it is not clear how highly leveraged borrowers will fare. Many companies were purchased at suffocating leverage multiples and will have difficulty meeting projected earnings in an environment of rapidly cooling economic activity in the United States. Companies facing a limited runway to implement improvements to operations and cash flow or those that hold assets of rapidly declining values will undoubtedly face a challenging restructuring climate. Some of these companies may have fiscal wounds that will fester under the cover of debt instruments with

'covenant-lite' structures, which may preclude the occurrence of defaults that often catalyse the restructuring process. Such firms may end up on the liquidation block. Those companies that identify their problems early and work to solve such problems in close collaboration with their creditors may have the best chances of emerging from the restructuring or reorganisation process as healthier enterprises.

As of early 2008, the restructuring prognosis outside the United States is less clear. For one thing, foreign companies are less leveraged and are less likely to fail because of onerous debt structures. Broad, externalised trends will be the most common reason that foreign companies find

themselves in need of restructuring. Although significant adverse economic trends have yet to infiltrate foreign markets firmly, it is possible that the United Kingdom, continental Europe or Asia may be a cycle or two behind the United States. As such, foreign insolvency practitioners should keep a close eye on restructuring outcomes in the United States because collaboration, novel structures and ingenuity may be prerequisites for success both in the United States and abroad in the coming cycle.

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