PART

One

The General Landscape of Distress Investing

CHAPTER 1

The Changed Environment

Three earthshaking events have resulted in a markedly changed financial environment since the late 1980s and early 1990s: first, financial innovation; second, new laws and regulations; third, the 2007–2008 financial meltdown. The past three decades have witnessed a tremendous amount of financial innovation that has led to significant changes in the levels of debt, the types of credit market instruments, and the overall capital structures of nonfinancial U.S. corporations. These changes accelerated after the late 1980s. Such innovation has also been responsible for the acceleration of the claims' transformation process—loans into securities issued by structured investment vehicles (SIVs) like collateralized loan obligations (CLOs), for example—that has had important effects on the traditional roles of financial intermediaries and the creation of new credit markets.

After the 1999 Gramm-Leach-Bliley Act and prior to the 2008 financial meltdown, commercial banks tended to act more like underwriters and distributors than like financial intermediaries and investors. These banks no longer take the credit risks that they used to take in the 1970s and early 1980s, albeit they switched to instruments with vastly increased credit risk for their portfolios of consumer loans, including residential mortgages and consumer credit card debt. The development of securitization and financial derivatives markets has contributed to a major transfer of credit risk from commercial banks to other types of market participants, who have assumed active and growing functions in new markets for claims that were the traditional realm of regulated banks. New derivatives markets include credit default swaps (CDSs), which are bets, mostly by speculators, on the probabilities of money defaults on individual debt issues. Before the financial meltdown of 2007–2008, and even after, hedge funds speculated on the credit quality of an issuer using credit default swaps with very large amounts of leverage, and literally influenced market perceptions of the creditworthiness of issuers even though they might have been less knowledgeable than a bank or a credit rating agency making such assessments.

Another outcome of innovation was the development of new primary and secondary markets that have improved the liquidity for traditional and transformed claims. The creation of the original-issue below-investment-grade bond market in the 1980s and early 1990s and of the leveraged loan markets are but two examples of such transformation. With increased participation by nontraditional market participants, more liquid, efficient, and potentially unstable secondary markets have also developed. As an example of increased efficiency, back in early 1980s one could buy secured loans of distressed companies at about 40 cents on the dollar, whereas after the early 1990s and before the 2007–2008 financial meltdown one would have to pay 85 or 90 cents on the dollar for the same loans. As an example of the potential funding instability, almost 70 percent of the par value outstanding of leveraged loans is held by nonbank institutions like hedge funds, collateralized debt obligation (CDO) trusts, and the like.

Financial innovation has not been the only driver of change in the distress investment environment. The legal environment for reorganizations has also changed with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which made changes to the Bankruptcy Reform Act of 1978. Among the many changes with respect to business bankruptcy reorganizations, the 2005 Act has imposed new time limits on the debtor's exclusive right to file a Plan of Reorganization (POR), has shortened the time period during which debtors can decide whether to assume or reject nonresidential real estate losses, has attempted to limit executive compensation paid under key employee retention plans (KERPs), and has enhanced the rights of trade vendors. The administrative costs of a Chapter 11 reorganization have become quite onerous to many estates, and as a consequence we see a larger number of prepackaged and/or prenegotiated filings today.

These are just a few of the important forces that have shaped and continue to shape today's distress investment environment. In this chapter we try to give the reader a broad perspective on some of these trends and changes both during the period from 1990 up until 2007 and after the 2007–2008 financial crisis.

TRENDS IN CORPORATE DEBT GROWTH AND LEVERAGE BEFORE THE FINANCIAL MELTDOWN OF 2007–2008

Over the past 60 years, U.S. nonfinancial corporate credit market debt outstanding grew, on average and in real terms, faster than the gross domestic product (GDP). Corporate debt grew at an annual real rate of 4.1 percent, whereas GDP grew at an annual real rate of 2.7 percent for the same period. Growth was volatile and generally tied to the business cycle (see Exhibit 1.1),

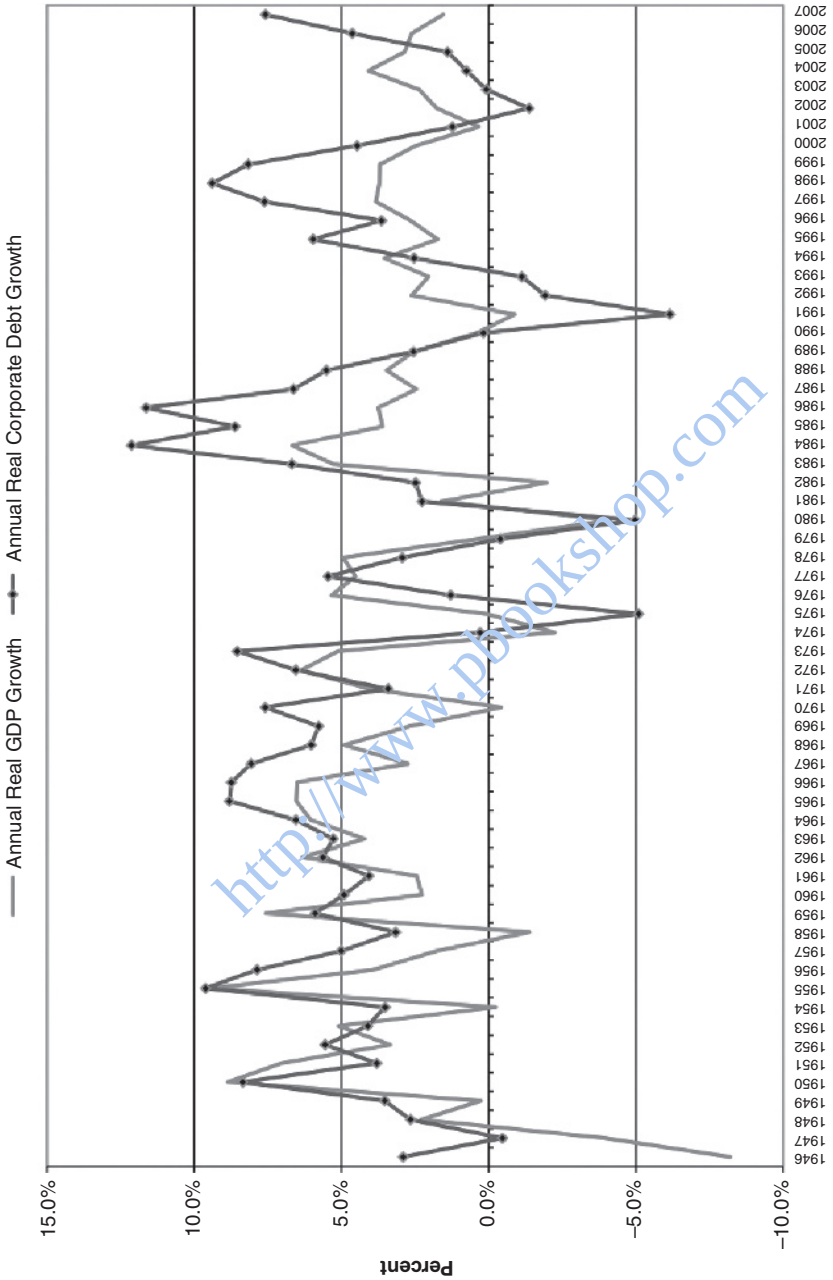

EXHIBIT 1.1 Annual GDP Growth Rate versus Corporate Credit Market Growth Rate, 1946–2007

but in the last 30 years the credit cycle became considerably more volatile than it had been in the previous 30 years.

For the 1945–1969 period, the volatility of the real rate of growth in GDP and corporate debt measured by their standard deviations were 4.00 percent and 2.39 percent respectively, whereas comparable numbers for the 1970–2007 period were 2.37 percent and 4.45 percent. Today, larger credit contractions are associated with much shallower slowdowns than in the past. The increased levels of leverage used by corporations brought about this larger volatility in the corporate credit cycle. In 1979, credit market debt at nonfinancial corporations was only 17.8 percent of assets, but by the end of 1990 it had grown to represent 26.2 percent of assets, surpassing the previous high level of 24.4 percent in 1970 (see Exhibit 1.2).

Increased levels of leverage were made possible by easier access to credit markets, which in turn resulted in an overall deterioration of creditworthiness. Understanding how these new levels of leverage came about is quite important to understanding the current distress investing environment. At the heart of this change in financial leverage was an unprecedented amount of financial innovation and regulatory change.

JUNK BONDS AND THE LEVERING-UP PERIOD

The leveraged restructuring movement and the development and growth of the original-issue below-investment-grade bond market played a major role in the levering-up process of the 1980s. The highly successful going-private transaction of Gibson Greetings, Inc. in 1982 and the astonishingly quick placement of $1.3 billion of junk bonds for Metromedia in 1984 signaled the beginning of a trend. From 1984 to 1989, use of proceeds for share purchases accounted for more than 80 percent of the net issuance of corporate bonds and bank loans put together.[1] Although below-investment-grade bonds had been around for a long time, a large proportion of the amount outstanding during the 1970s was investment-grade debt that had been downgraded to below investment grade—fallen angels—and represented only a small fraction of the total corporate bond debt outstanding.

Junk bonds are generally unsecured obligations (debentures), with covenants that are much less restrictive than those of bank loans. Primary offerings come to market either as registered issues or under the exemption of Rule 144A that allows public companies to issue quickly and avoid the delays of a public registration.[2] Deals that do not have registration rights are usually exchanged for an identical series of registered paper, which enhances their liquidity. Typical holders of this paper include mutual funds, pension funds, insurance companies, collateralized debt obligation (CDO) structured

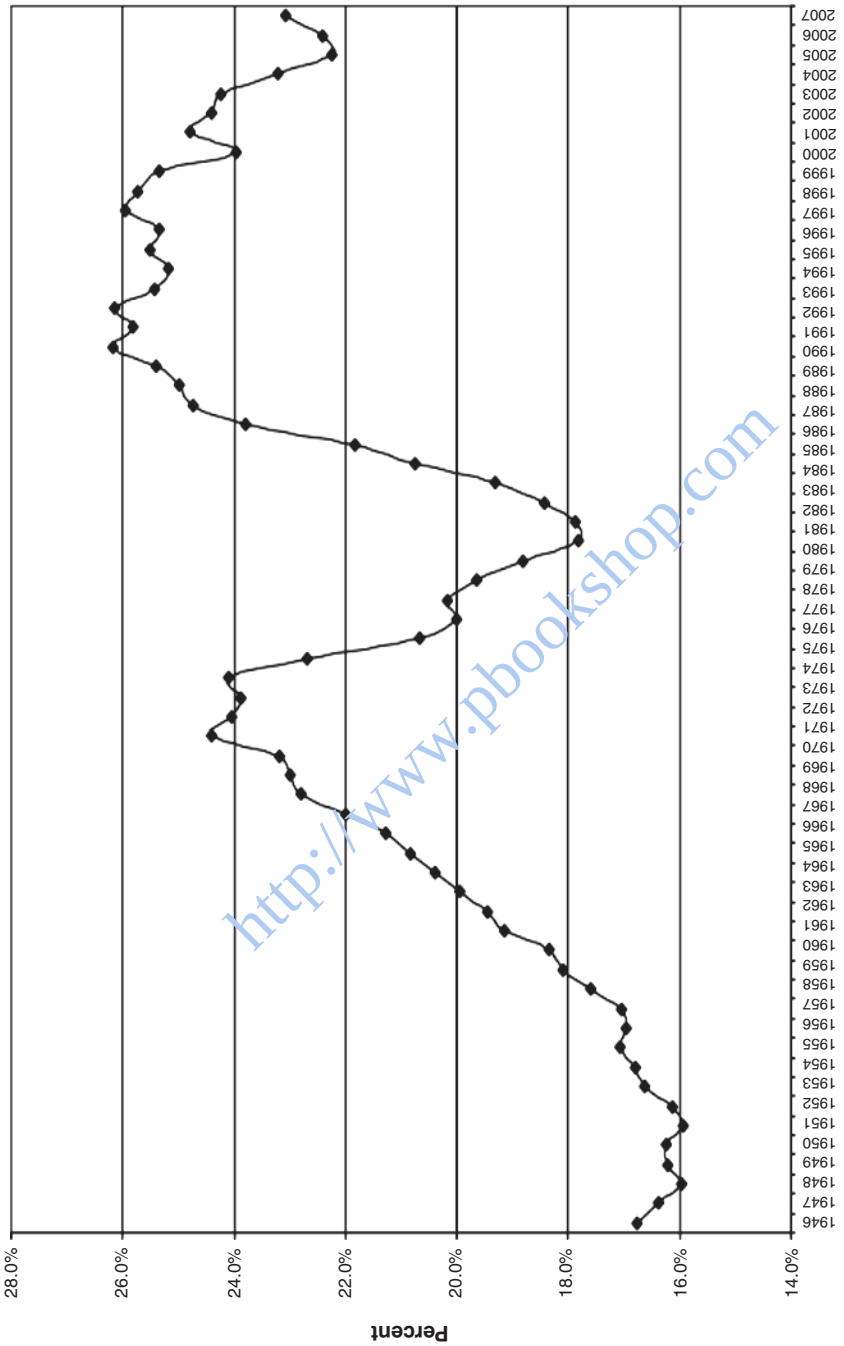

EXHIBIT 1.2 Nonfinancial Corporations' Credit Market Debt to Total Market Value of Corporate Assets, Based on Federal Reserve Data

vehicles, and hedge funds. Many of the junk bonds are subordinated issues that rank junior to senior unsecured debt. In bankruptcy, senior unsecured debentures are always put into a class of unsecured claims with payment priority below bank loans and other secured senior debt to the extent of the value of the security behind the secured debt. By the early 1980s, the junk bond market had become the preferred financing mechanism for leveraged buyouts (LBOs) and other mergers and acquisition (M&A) activities. By 1989, junk bonds represented 20 percent of the total amount of bond debt outstanding at U.S. nonfinancial corporations.

A parallel development to the growth of the junk bond market was the development of its younger cousin, the mezzanine finance market. Companies that were too small to tap the bond market became the users of mezzanine debt. Mezzanine debt issues are much smaller and are almost always privately placed, highly illiquid, and bought with the expectation of being held to maturity. Like junk bonds, mezzanine paper is unsecured and virtually always subordinated in right of payment to bank loans and other senior debt.

Two other phenomena occurred during the levering-up decade: the substitution of junk bond debt for bank lending, and the easing of credit underwriting standards. By the end of 1990, outstanding bank debt stood at 21.5 percent of total credit market debt, a substantial decrease from 26.2 percent at the end of 1985 (see Exhibit 1.3). This decrease was matched by an increase in total credit market debt represented by bond debt, most of which was below investment grade. By 1990, outstanding bond debt had grown to 39.8 percent of total credit market debt from a low of 35.7 percent in 1985, while total credit market debt represented by both bank lending and bond debt remained virtually unchanged in 1985 and 1990.

The substitution appears even more dramatic when one looks at the net issuance of credit market debt for the two five-year periods ending in 1985 and 1990 shown in Exhibit 1.4. Net new bank loans represented only 13.2 percent of total credit market debt issuance during the 1985–1990 period, compared with a 27.4 percent figure for the 1980–1985 period.

Although outstanding bank debt grew in excess of 5 percent per year, its share of the corporate capital structure declined. These statistics show an aggregate picture for the U.S. nonfinancial corporate sector. Confirming this aggregate trend, an influential study of buyouts in the 1980s showed that while bank debt represented upwards of 70 percent of all debt used in such transactions during the first half of the 1980s, it represented only 55 percent by the end of the decade.[3]

The reduced participation of bank lending in corporate capital structures was a result of the competitive pressures faced by banks in the past two decades. The role of commercial banks in channeling deposits to

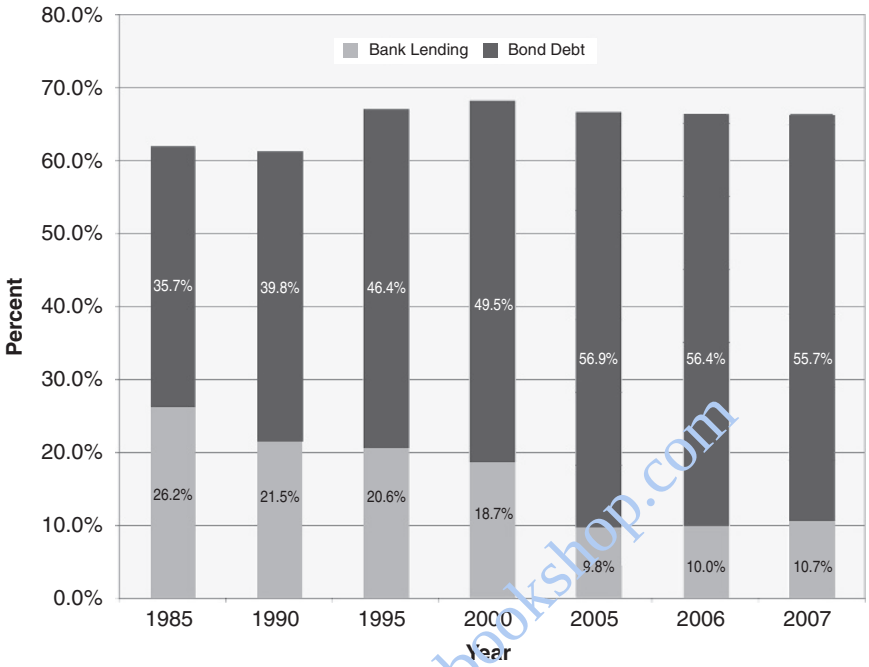

EXHIBIT 1.3 Percentage of Total Corporate Debt Accounted for by Bank Lending and Corporate Bond Debt, Based on Federal Reserve Data

corporations was being eclipsed by lower-cost funding alternatives. On the liability side, both deregulation and the emergence of money market funds largely eliminated large banks' ability to fund themselves at below-market rates. On the asset side, large corporate borrowers started to reach investors directly through the commercial paper market and the public market for below-investment-grade issues. As we shall discuss later in this chapter, the principal role of many commercial banks started to shift from that of a financial intermediary and investor to that of an underwriter and distributor.

At the time when U.S. corporations were levering up their balance sheets and substituting junk bond debt for bank debt, credit underwriting standards were easing considerably in the below-investment-grade market. One sign that standards were loosened was the emergence of financial innovations designed to reduce cash interest payment burdens. One such innovation was the payment in kind (PIK) bond, or bunny bond, which reproduced itself instead of paying cash interest. Another sign of such deterioration in credit standards was the reduction in the required cash flow support per dollar of debt, which translated to much higher ratios of debt per dollar of cash flow

EXHIBIT 1.4 Composition of U.S. Nonfinancial Corporate Credit Market Net Debt Relative Issuance, Based on Federal Reserve Data

Total Credit Market Net Debt Issuance (billions)	1975–1980 $338.9	1980–1985 $707.7	1985–1990 $917.9	1990–1995 $388.6	1995–2000 $1,630.2	2000–2005 $718.6	2005–2006 $422.4
Net Debt Issues Accounted for by:							
Bank Loans	25.6%	27.4%	13.2%	14.5%	15.4%	−47.1%	13.1%
Bonds	33.0%	30.1%	46.8%	89.8%	55.0%	103.5%	50.5%
Loans from Finance Companies	12.2%	8.0%	11.6%	7.7%	8.5%	2.9%	4.0%
Commercial Paper	5.4%	6.2%	4.9%	10.4%	7.4%	−25.7%	5.5%
Other Loans	5.7%	11.6%	12.4%	−19.9%	−0.2%	11.1%	−7.7%
Asset-Backed Loans	0.0%	0.0%	0.5%	6.5%	3.7%	−0.2%	0.4%
Tax-Exempt	11.6%	11.5%	−1.3%	3.0%	1.2%	3.1%	2.7%
Mortgages	6.5%	5.2%	11.9%	−14.8%	9.0%	55.9%	25.2%

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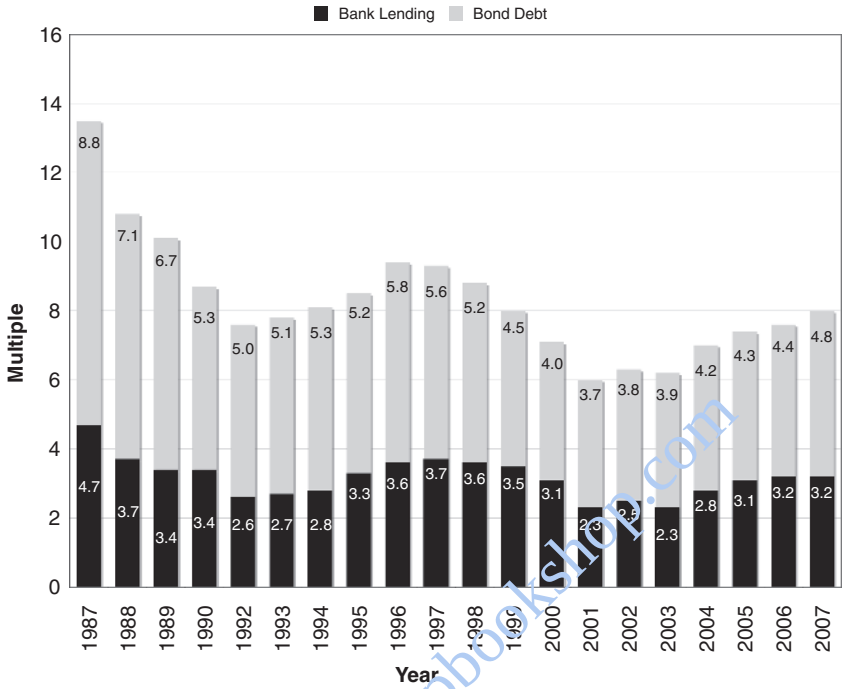

EXHIBIT 1.5 EBITDA Multiples for Bank Debt and Nonbank Debt, 1987–2007

measured by earnings before interest, taxes, depreciation, and amortization (EBITDA). In Exhibit 1.5 we show the average EBITDA debt multiples prevalent for bank and nonbank lending (mostly subordinated bond debt) for the 1987–2007 period. The very high multiples of the late 1980s are a very clear indication of the easing of underwriting standards.

It turned out that the levering-up trend of the 1980s, coupled with the substitution of high yield debt for bank lending brought about by relaxed underwriting standards, created the stage for the large supply of distressed credits of the early 1990s. Although there is controversy about all the factors that ultimately contributed to the sharp decline of liquidity in the high yield market, McCauley et al. in 1999 suggested the following as the plausible contributors:[4]

- Bank regulators' policies frowned on highly leveraged transactions at the end of 1988 and beginning of 1989.
- Passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) forced savings and loans to liquidate their portfolios of junk bonds in late 1989. The Resolution Trust Corporation (RTC) rapidly disposed of junk bonds in 1990.

- Junk bond mutual funds investors redeemed about 5 percent of investments in such funds in September and October 1989.
- Campeau Corporation defaulted on an interest payment on its Federated Department Stores junk bonds in September 1989.
- RJR Nabisco's bonds were downgraded.
- Drexel Burnham Lambert bankruptcy in early 1990 removed a major source of liquidity from the market.

The final onset of the early 1990s recession brought about a very sharp increase in the default rates for high yield debt. A much deeper recession in 1980 had brought about substantially lower default rates in the below-investment-grade bond market, a sign that the creditworthiness of issuers was much higher in 1980 than in the 1990s (see Exhibit 1.6).[5]

From 1990 on, the levering-up trend abated and debt-to-asset ratios remained relatively stable (around 25 to 26 percent) until 2001 when leverage started to decline, reaching a low of 22 percent in 2005. The rapid growth trend of the high yield market had subsided during the early 1990s recession but promptly resumed after 1992.

However, unlike the 1980s when the bulk of junk bond issuance went to finance acquisition-related activities, in the 1990s these bonds were used for other purposes, including the refinancing of previous junk bond issues. By the end of 2005, junk bonds represented almost 36 percent of the corporate bond debt outstanding held by nonfinancial corporations.

The financial innovations of the 1980s facilitated the levering up of the capital structures of nonfinancial corporations, and this process resulted in a marked change in the composition of their credit market debt. Junk bond debt began to represent an ever-increasing mezzanine portion of the capital structure of U.S. nonfinancial corporations. Increased leverage and relaxed credit standards contributed to the deterioration of creditworthiness of the late 1980s that brought about the large supply of distressed credits we saw in the early 1990s. Moreover, financial innovation facilitated the shifting of credit risks from banks to other less regulated market participants who had become large providers of credit. The fundamental reasons responsible for the increased volatility of the credit cycle were in place throughout the 1990s and remain in place today.

THE SYNDICATED LOAN MARKET AND LEVERAGED LOANS

The trend toward further substitution of bond debt for bank debt did not abate until the end of 2005 when corporate bonds represented 56.9 percent

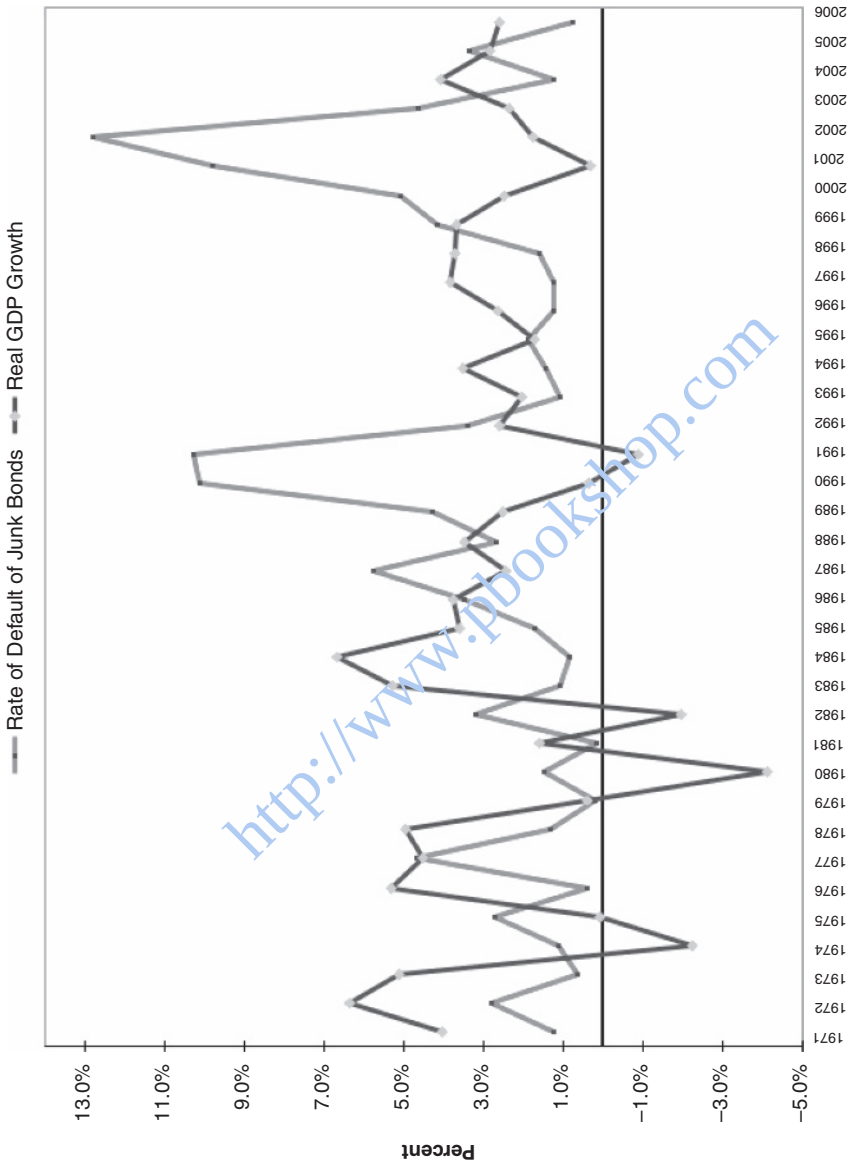

EXHIBIT 1.6 Relationship between Real GDP Growth and Default Rates on Junk Bonds

of the outstanding credit market debt and bank loans were only 9.8 percent (see Exhibit 1.3). The apparent disintermediation was simply a reflection of the fact that commercial banks gradually stopped taking the credit risks that they had taken in the seventies and the eighties. The below investment grade portion of corporate capital structures was abandoned by banks and taken over by mutual funds, pension funds, insurance companies, and other institutional investors, but it took two decades for banks to effect such transformation and at its heart was the emergence of the syndicated loan market.

Syndications had been around for a while. Syndicated lending in the 1970s and early 1980s consisted of loans extended by large commercial banks to sovereign borrowers. The large number of sovereign defaults following Mexico's default in 1982 effectively closed the syndicated market to emerging market borrowers. The essential change between syndications and the newer syndicated loan market was the role of the lead agent bank. Historically, the lead agent was a representative of the bank group and it negotiated terms and conditions on behalf of the other banks.[6] This role changed with the development of the syndicated loan market where the lead agent began to act more like an investment bank, viewing the issuer as the client and lenders as investors.

The syndicated loan market represents the bridge between the private and public debt markets, providing corporate borrowers with an alternative to high yield bonds and illiquid loans. It also allowed borrowers to access a larger pool of capital than any single lender would be prepared to make available. The boom in leveraged buyouts (LBOs) and mergers and acquisitions (M&A) of the mid-1980s drove the development of this market. Syndicated loans became a way to raise senior financing for LBO transactions that were far too large for any one bank to fund. During the credit crunch of the early 1990s, banks sought to reduce their exposure and sold off both performing and nonperforming distressed loans. Selling some of their loan exposures to other intermediaries was a means of keeping their credit and liquidity exposures manageable, keeping their capital requirements down, retaining the lion's share of structuring and underwriting fees, and getting a portion of the credit spread. This was the birth of the syndicated loan secondary market.[7] By 1997, 25 dealers were actively trading loans, Standard & Poor's (S&P) had started rating them, the Loan Syndication and Trading Association had been created, and dealer mark-to-market pricing was available.

Syndicated loans usually are floating-rate instruments with payments set at a spread over a benchmark rate like the London Interbank Offered Rate (LIBOR).[8] This spread compensates the syndicate members for the liquidity and credit risks assumed. The main two types of loan facilities are revolvers,

where borrowers have the right to draw some portion of a credit line, and term loans, which are loans for a specified amount with a fixed repayment schedule. These loans can be either secured or unsecured and contain more numerous and stricter covenants than bonds.

Based on either credit ratings or the loan's initial rate spread over LIBOR, syndicated loans are classified as either nonleveraged or leveraged. For example, leveraged loans are defined by the Loan Pricing Corporation (LPC) as those with BB, BB/B, B, or lower bank loan ratings. Other organizations (e.g., S&P) define leveraged loans as those with spreads of 125 basis points or higher.[9] The overwhelming majority of the volume in the secondary market is accounted for by leveraged loans.

The primary syndicated loan market has grown from roughly half a trillion dollars in commitments in 1989 to a peak of two and a quarter trillion dollars in 2007.[10] In the beginning, primary participants were foreign banks; next came insurance companies, and by the late 1980s other institutional investors joined the market.

These institutions that are lenders not affiliated with banks, such as CLOs, CDOs, mutual funds, and hedge funds, have taken on larger positions in the syndicated loan market. They have increased their share of total commitments to 15.9 percent or $548 billion in 2007 compared to only 2 percent or $14 billion in 1996 and held almost 70 percent of the syndicated loans par value outstanding, the bulk of which was in leveraged loans (see Exhibit 1.7).[11] These nonbank institutions tend to hold the poorest credit quality paper also. According to Federal Reserve National Shared Credit data, nonbank institutions held 56 percent of nonaccrual loans in 2006, with U.S. banks holding only 16 percent. This is just another indication that banks' corporate loan portfolios are of much higher credit quality than those held by nonbank institutions.

Throughout the past two decades, commercial banks have gradually abandoned participation in the riskiest portions of the U.S. nonfinancial corporate capital structures. Such lending and the risks thereof have been shifted to the public and nonbank financial institutions through the below-investment-grade bond market, the mezzanine market, and the high-leverage syndicated loan markets. At the heart of this large credit risk shift has been the relentless process of financial innovation through which new investment vehicles and markets were created that greatly improved access and liquidity for lenders and borrowers alike. The preeminent lenders in these markets have been nonbanking institutions like mutual funds, insurance companies, pension funds, CDO trusts, CLO trusts, and hedge funds. These new developments have introduced the likelihood of larger degrees of volatility in funding in the face of normal credit cycles since these sources of funding are seen as less stable than traditional ones.

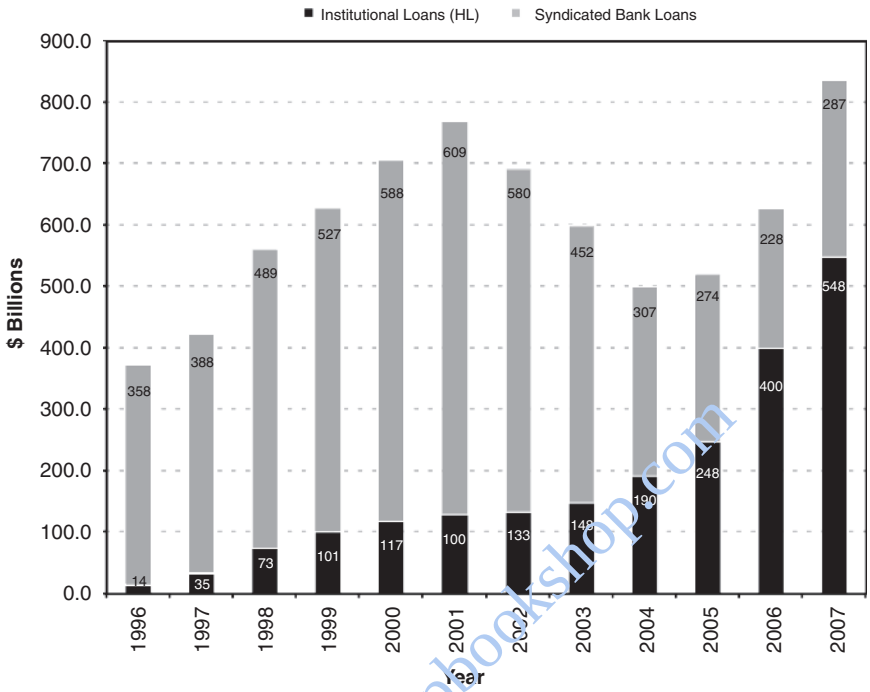

EXHIBIT 1.7 Syndicated Loan Outstanding Amounts by Institution

Banks, however, have continued to lend to the most senior part of the corporate capital structure and have become the originators and distributors of the lower-quality credits to institutional investors.

FINANCIAL MELTDOWN OF 2007–2008

The earthshaking consequences of the current financial crisis have altered dramatically not only the market for distressed securities but also the operations and feasibility for various companies that need access to capital markets either to refinance existing obligations or to raise funds for expansion. Put simply, the capital markets had frozen up as of late 2008. Access from conventional sources became unavailable. The U.S. government has become virtually the only source of access to capital markets for most U.S. financial institutions and the three U.S. auto assemblers: General Motors, Ford, and Chrysler.

Going concerns, whether they prosper or suffer losses, rarely pay off debts as they mature in any dynamic sense. While an individual debt issue does mature, the going concern retires that debt by refinancing rather than reducing the amount of debt on its balance sheet. For prosperous, expanding businesses, increased earning power permits the company to carry increasing amounts of debt.

The 2007–2008 financial meltdown brought this corporate ability to refinance old debt or to incur new debt to a screeching halt. The capital markets froze up. Thus almost any company needing relatively continuous access to capital markets, even ones only seeking to refinance, found itself in deep trouble. This included good companies as well as less well-managed companies. In the fall of 2008, the list of companies in trouble because of lack of access to capital markets, as well as those that either liquidated or had to be rescued on bases that massively diluted existing stockholders, included those found in Exhibit 1.8.

The problems of lack of access to capital markets in 2007–2008 have been exacerbated by the growing strength of bear raiders (i.e., short sellers), who probably have never been as powerful as they are now, even compared with the pre-1929 era. The problems have also been further exacerbated by certain aspects of generally accepted accounting principles (GAAP), which, under rules promulgated by the Financial Accounting Standards Board (FASB), require investors in credit instruments and creditlike instruments (e.g., credit default swaps) to use mark-to-market accounting under FASB 133 and FASB 157.

EXHIBIT 1.8 Companies in Distress Because of Lack of Access to Capital Markets in 2008

Good Companies	Deeply Troubled Companies
Ford Motor Credit	AIG
General Electric	Bear Stearns
Goldman Sachs	CIT
JPMorgan Chase	Citigroup
Merrill Lynch	Fannie Mae
Morgan Stanley	Freddie Mac
	General Motors Acceptance Corp.
	Lehman Brothers Holdings
	Reserve Funds
	Wachovia Bank
	Washington Mutual

Bear raiders now have more weapons than they have ever had before to bankrupt or near-bankrupt companies needing continual access to capital markets, and where customers and counterparties can withdraw business from a target company at no cost or at low cost. Five weapons available to the bear raiders are:

1. Lack of an uptick rule on the New York Stock Exchange since 2007. This seems relatively unimportant.
2. Well-developed options markets permit short sellers to establish positions at little or no cost: buy put options (i.e., options to sell securities at a fixed price) and collect a premium by selling call options (i.e., options to buy securities at a fixed price).
3. Another relatively new short technique is to buy credit default swaps and go short the underlying common stock. As CDS prices rise (i.e., spreads widen), the market sends a message that the probabilities of money defaults on a company's credit instruments have increased. Buying CDSs, of course, increases their price. As the implied probability of a money default increases, the price of the underlying common stock tends to decline.
4. Indexes can be used as a low-cost method of going short.
5. The Internet and business television can be used to broadly air opinions as well as unfounded rumors and all types of analysis. While corporate managements are restricted by securities laws in what they can say and when they can say it, bear raiders are not subject to these disciplines.

These relatively new forms of communication seem to be the most important reason why bear raiders are so much more powerful now than they have ever been heretofore.

Bear raiders are not content merely to condition markets. They also try to ruin businesses as going concerns. Bear raiders will try to get customers and counterparties to flee from troubled issuers, as was the case for Bear Stearns and Lehman Brothers Holdings. The bear raiders also will exert as much pressure as they can on rating agencies and regulatory authorities to drive companies out of business. For example, in the case of monoline insurer MBIA, Inc., the bear raiders attempted to convince the Securities and Exchange Commission that MBIA should be prohibited from publicly marketing new securities issues; attempted to convince the New York State Insurance Department that MBIA was insolvent; and attempted to convince (apparently with some success) the rating agencies—Moody's Investors Service, Standard & Poor's, and Fitch Ratings—that MBIA and Ambac Financial Group, Inc. ought to lose their AAA credit ratings.

Mark-to-market accounting is wholly appropriate when appraising a group of common stocks held in a trading portfolio. Here market prices, or models based on simulated market prices, are the best single measure of what the portfolio of securities that might be sold at any time is worth; and changes in market prices are the best measure of portfolio performance. However, mark-to-market accounting is utterly inappropriate for portfolios of performing loans that are likely to continue to be performing loans and are held in portfolios where the intent is to collect interest income from the particular instruments until maturity. This is what most financial institutions do—depository institutions, insurance companies, finance companies, and pension plans.

As is noted in the following discussion, two of the performing loans recommended by the authors are MBIA 14 percent surplus notes selling around 49, and affording a yield to call at January 15, 2013, of 39.9 percent; and Forest City Enterprises 3 5/8 percent senior unsecured notes due on October 15, 2011, selling around 53, and affording a yield to maturity of 28.0 percent. The authors believe after careful analysis that the great weight of probability is that both instruments will remain performing loans. MBIA is extremely well capitalized after receiving capital injections of around $2.8 billion in 2007 and early 2008. Forest City enjoys cash flow of well over $600 million per annum from the ownership and management of high-quality office buildings, shopping centers, and apartment residences. These cash flows exceed by a comfortable margin debt service requirements and corporate overhead. If this analysis that the loans will remain performing loans is correct, market prices can be completely ignored in appraising what the future performance of these securities will be as long as the holder is not dependent on borrowed money for which these securities are collateral, and the holder is not forced to sell the security prior to maturity or call. The return will be in the neighborhood of, say, 37 percent to 38 percent for the MBIA notes and 26 percent to 27 percent for the Forest City notes. The reason the effective returns are less than the yield to call or the yield to maturity is that both yields assume that interest received will be reinvested at the 39.9 percent and 28.0 percent rates; this seems unrealistic. If the MBIA notes are not called in 2013, we will rely on the current yield, which is 28.6 percent. However, after the 2013 call date, the interest payable on the MBIA surplus notes becomes a floating rate of three-month LIBOR (3.42 percent at the time of this writing) plus 11.26 percent. This high rate of interest after the call date gives us confidence that MBIA will use maximum efforts to have the surplus notes called. Efficient market theorists justify mark-to-market accounting by stating that it is the best measure of both the probability of default and how the issuer will fare in a reorganization or liquidation in the event of default. There is virtually no evidence of which we are aware

attesting to the validity of this efficient market theory view of securities markets, especially distressed debt securities markets.

The U.S. government capital infusion into companies denied access to capital markets became absolutely essential in 2008 as the financial crisis unfolded. The terms by which the government is buying $700 billion of securities from these issuers under the Troubled Asset Relief Program (TARP) seems quite reasonable: 5 percent preferred stocks, which step up to 9 percent after five years, plus 10-year warrants that allow the government to invest 15 percent of the amount of preferred stocks purchased at a price equal to market value on the date of the transaction. However, some of the pre-TARP transactions seemed to be at exploitive prices, to wit JPMorgan Chase acquiring 100 percent of the equity of Bear Stearns at a price of $10 per share. After collecting huge commitment fees and selling preferred stock with a double-digit dividend rate to AIG, Fannie Mae, and Freddie Mac, the government reserved for itself 80 percent of the equity of each company. The U.S. government, of course, was absolutely within its rights to seize private property. The question, though, is should the government be required to pay a fair price, not a price unilaterally determined by the government? This issue may very well surface after the present financial crisis has passed. There is also the issue of how much control the U.S. government ought to exercise over those financial institutions in which it has invested. Under TARP, there seems to be little in the way of elements of control for the government. The 5 percent/9 percent preferred stocks are plain-vanilla instruments allowing the government to elect two directors if quarterly dividends go into arrears for six quarters.

During past financial crises (the late 1980s and early 1990s), most performing loans have remained performing loans. This is likely to be the case in the current financial crisis. However, distress investors want to be able to feel that they will fare reasonably well if the debt instrument becomes nonperforming and the investor as a creditor participates in a reorganization or, less likely, a liquidation. Insofar as the distress investor owns a performing loan, the investor measures the return by current yield, yield to an event, and yield to maturity. If the investor is to participate in a reorganization or liquidation, return is measured by the dollar price of the security as a percentage of the dollar value of the perceived workout in the reorganization or liquidation in an estimated time period. In our three recommended securities, the authors believe there is a 70 percent to 90 percent probability that each loan will continue to be a performing loan. If participating in a reorganization, it is hoped that our credit instruments will be converted largely into the common stocks of companies that will be well financed and might even have attractive tax attributes in the form of a long-lived net operating loss (NOL) carryforwards. General Motors Acceptance

Corporation (GMAC), which we also recommend, would be a reorganized finance company or depository institution regulated as a commercial bank; MBIA would be a reorganized insurance vehicle (one of the authors reorganized Mission Insurance Group in the early 1990s and it is now Covanta, the nation's leading converter of waste to energy); and Forest City would be a reorganized real estate investment builder.

With lack of access to capital markets for GMAC and lack of access to an AAA rating for MBIA, both companies are effectively in runoff; that is, their assets are being converted to cash. The key to the runoffs in terms of the remaining performing loans can be found in the question: "Will the cash being generated in the runoff exceed by enough margin the losses to be realized on bad assets so that the loans can be paid at maturity or call?" The authors think this is the likely case. An additional problem in GMAC may be that the company is providing support for Rescap, its troubled mortgage-lending subsidiary (GMAC is mostly auto finance). GMAC seems to be providing such support on arm's-length terms. Insofar as GMAC may be, in effect, providing subsidies to Rescap and receiving in return inadequate or no consideration, GMAC creditors appear to have a cause of action against GMAC under the fraudulent transfer statutes. Counterbalancing this possible negative for the GMAC senior unsecureds is the probability that GMAC will be eligible to receive from the U.S. government a TARP investment in GMAC preferred stock. The relevant statistics for the three distressed issuers in October 2008 are shown in Exhibit 1.9.

The current financial meltdown seems to offer compelling evidence that unless financial markets and financial institutions are strictly regulated, fraud, corruption, and incompetence seem inevitable. The authors can only speculate on what the new regulatory schemes will encompass.

Interestingly, in the 1950s one of the authors wrote a master's thesis in which the gravamen was that trading on the floor of the New York

EXHIBIT 1.9 Relevant Statistics for Distressed Issuers in 2008

Issue	Current Price Percent of Par	Current Yield	Yield to Maturity	Yield to Event
Forest City $3^5/_8$% Due 10/15/2011	53	6.8%	28.0%	NM
GMAC $7^3/_4$% Due 1/19/2010	62	12.5%	54.1%	NM
MBIA 14% Surplus Notes Due 1/15/2033	49	28.6%	28.6%*	39.9%

*Assumes a 14 percent interest rate after the 2013 call date.

Stock Exchange does, in fact, simulate the conditions necessary for pure and perfect competition. Transactions take place at the price where the demand and supply curves intersect; there are myriad participants in the market, none of whom by themselves can influence prices; and all participants have access to the same information. The thesis then went on to state that, in actuality, this simulation of pure and perfect competition could be achieved only by erecting a draconian police state where there were comprehensive regulations overseen not only by government agencies but also by private self-regulatory organizations.

PRINCIPAL PROVISIONS OF THE 2005 BANKRUPTCY ACT AS THEY AFFECT CHAPTER 11 REORGANIZATIONS OF BUSINESSES

By far the most important and far-reaching impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) affects individuals seeking relief under Chapter 7 or Chapter 13 of the bankruptcy code. An extended discussion of the effect on individuals of BAPCPA is beyond the scope of this volume. Suffice to say, BAPCPA for individuals is far wide of the mark sought to be achieved for businesses seeking relief under Chapter 11 or Chapter 7 of the bankruptcy code. The general aim of Chapter 11 for businesses is to make the debtor feasible within the context of maximizing present value for creditors, who receive such value in accordance with a rule of absolute priority where no creditor of a class is given priority over other creditors in that class unless such other creditors so consent. In contrast, BAPCPA for individuals seems designed to maximize return for creditors while paying minimal attention to making the debtor feasible. Various provisions speak to the belief that the individual debtor is unintelligent (needs counseling) and neither the debtor nor his or her attorney is to be trusted (required filings and attestations). Most provisions of BAPCPA went into effect on October 17, 2005—both business and individual.

The 13 principal provisions of BAPCPA as they affect businesses are:

1. Period of exclusivity:
   - The debtor's exclusive right to file a plan of reorganization (POR) may not be extended beyond 18 months, and the exclusive right to solicit acceptances for a POR may not be extended beyond 20 months.
   - Under the old law, there was a 120-day exclusive period for a debtor to file a POR and a 180-day exclusive period to solicit acceptances. These periods were routinely extended. In Chapter 11 cases such as

Johns Manville and McCory Corporation, exclusive periods lasted seven or eight years.

2. Prepackaged plans:
   - Solicitations commence prior to filing for Chapter 11 relief may continue postfiling.
   - Under the old law, solicitations of votes had to be completed prior to the commencement of a case. Section 1125 prohibited postpetition solicitation of votes until a disclosure statement was approved.
3. Executory contracts and unexpired leases:
   - Assumption of an executory contract or unexpired lease by a debtor requires three elements:
     1. Cure of defaults (clarified under BAPCPA).
     2. Compensation for actual monetary losses (clarified under BAPCPA).
     3. Assurance of future performance.
   - Rejection of an executory contract or unexpired lease is treated as a prepetition breach by the debtor. Damages are generally treated as a prepetition, unsecured claim. There are certain limitations on rejection damages.
   - Under BAPCPA, the deadline for the assumption of nonresidential real property leases is 210 days. Under the old law, the debtor had 60 days to assume or reject a nonresidential real property lease, but this was usually extended indefinitely.
   - Under BAPCPA, if there is a subsequent rejection of a previously assumed lease, the lessor may claim two years' rent as an administrative claim. Damages in excess of two years' rent are treated as general unsecured claims limited to the greater of one year's rent or 15 percent of the remainder of the lease, not to exceed three years' rent.
4. Employment contracts—one year's salary.
5. Preferences:
   - Under BAPCPA, transfers in payment of debts incurred in the ordinary course of business will be excluded from avoidance if (1) made in the ordinary course of business or (2) made according to ordinary business terms.
   - Under the old law, exclusion from avoidance depended on the transfers being (1) made in the ordinary course of business and (2) made according to ordinary business terms.
   - Under BAPCPA, a transfer cannot be considered avoided with respect to a noninsider. (If a transfer is avoided, the consideration received from the debtor has to be returned.)
   - Under BAPCPA, purchase money security interests are deemed perfected contemporaneously with the granting of a security interest if

perfected within 30 days after the debtor obtained possession of the underlying property. Previously, there had been 20- and 10-day periods rather than 30 days.

6. Fraudulent transfers:
   - Under BAPCPA, there is now a two-year look-back period rather than one year.
   - Under BAPCPA, the constructive fraudulent transfer definition has been expanded to include transfers and obligations incurred for less than a reasonably equivalent value to or for the benefit of an insider under an employment contract and not in the ordinary course of business.
7. Key employee retention plans (KERPs)—No KERP payments are permitted unless:
   - The executive has a bona fide job offer from another company at the same or greater compensation.
   - The executive's services are essential.
   - The compensation is not greater than 10 times the mean retention amount paid to nonmanagement employees, or if no such payments were made, no more than 25 percent of similar payments made to the executive during the prior year.
   - Any severance payments to insiders have to be part of a program generally applicable to all full-time employees and must be no greater than 10 times the mean severance payment given to nonmanagement employees.
   - The restrictions imposed on KERPs have been easily evaded by executives of companies in Chapter 11 by substituting "incentive plans" for "KERPs."
8. Tax claims:
   - Interest on tax claims is determined under applicable nonbankruptcy law. Priority tax claims must be paid in regular installment payments not to exceed five years from the commencement of the case. Previously, there had been a "six-year stretch."
9. Creditor committees:
   - Under BAPCPA, the creditor committee must provide nonmembers in the class access to information, and must solicit and obtain comments from such parties.
10. Investment bankers as disinterested persons:
    - Under BAPCPA, an investment banker who advised the debtor on a prepetition basis can be retained postpetition as an adviser who is a disinterested person. Under the old act such retention was not possible.

- Under BAPCPA, the investment banker need only demonstrate that it does not hold an interest adverse to the debtor on the matter for which the investment banker is to be retained.

11. Reclamation claims:
- Under BAPCPA, the seller of goods to a debtor (a debtor is defined as a firm that has secured Chapter 11 relief), or soon-to-be debtor, has reclamation rights allowing the undoing of a transaction by having the debtor return goods received. The seller now enjoys a reclamation period for goods received up to 45 days prior to the Chapter 11 filing date, with an additional 20 days after the filing date if the 45-day period expires after the commencement of the debtor's case. If the seller fails to provide notice of its reclamation claim, the seller still may assert an administrative expense claim for the value of the goods received by the debtor within 20 days prior to the commencement of a case.
- Under the old law, a seller of goods could assert a reclamation claim within 10 days after a debtor's receipt of goods, unless the 10-day period expired after the commencement of a Chapter 11 case, in which case the seller had 20 days after the debtor's receipt of goods to assert a reclamation claim.

12. Adequate assurance to utilities:
- Under BAPCPA, there exists a specific listing of six steps a debtor may take to establish adequate assurance of payment of a utility during the pendency of a case:
  1. Cash deposit.
  2. Letter of credit.
  3. Certificate of deposit.
  4. Surety bond.
  5. Prepayment of utility consumption.
  6. Mutually agreed-upon security.

13. Ancillary and cross-border cases—new Chapter 15:
- The new Chapter 15 supplants the former Section 304 of the bankruptcy code. Chapter 15 incorporates into federal bankruptcy law the Model law on Cross Border Insolvency drafted by the United Nations Commission on International Trade Law (UNCITRAL). Foreign proceedings are classified as either foreign main proceedings or foreign nonmain proceedings. Foreign main proceedings exist in the debtor's center of main interests. Upon recognition of a foreign main proceeding insofar as U.S. property is concerned:
- The automatic stay will apply.
- Adequate protection rules will apply.

- Rules governing postpetition transfer of property and the postpetition effects of prepetition security interests will apply.
- Unless the court rules otherwise, foreign representatives may operate the debtor's business and use, sell, or lease property of the estate like a U.S. debtor.
- In its discretion the court may grant virtually all other relief available to a debtor in a typical Chapter 11 case, other than the ability to invoke U.S. avoiding powers. Under old Section 304, the court did not have the power to authorize asset sales or financing, reject contracts and leases, issue securities without a registration statement, or invoke U.S. avoiding powers.
- Under BAPCPA, the recognition of a foreign nonmain proceeding does not result in the granting of any automatic relief. However, all of the relief available in a case ancillary to a foreign main proceeding is available in a nonmain proceeding, at the discretion of the court.
- The court must ensure that relief relates to assets that should be administered in the foreign nonmain proceeding or relates to information required in that proceeding.