

## Source of the next bumper crop of bankruptcy filings

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At first it was rather a relief – after years of being overwhelmed with work, restructuring professionals were finally able to leave the office before sunset and at least notice the roses. Gradually, we found time to smell the flowers, then to pick the flowers and finally to plant the things. As it dawned on us that we don't even like flowers, we began looking around for the next excuse to get out of the garden. Theories about the cause of the next crop of cases are expounded at the cocktail parties and other marketing events we suddenly have time to attend. Will October 17 accelerate filings? Maybe it will be as simple as the continuing increases in interest rates, particularly when combined with over-leveraged companies created with the years of easy money. However, we are willing to go out on a limb and predict that the oil prices and the recent growth in second lien financings will be the fertilizer for the next bumper crop of bankruptcy filings and restructurings.

To predict the impact on the world economy of rapidly accelerating energy prices, one only needs to remember the cold dark days of 1973-1974. Then the rapid increase in oil prices was caused by the rise of OPEC onto the world stage and the artificial limit it was able to place on supplies of crude as a political signal that oil producing countries were no longer willing to accept a back seat on the world's economic bus. The effect in the western world was inflation, long gas lines, frayed tempers and a dramatic, but short lived, shift from the production of traditional gas guzzlers to fuel sipping automobiles.

As we write this article, oil prices in the US are showing no signs of decreasing and we see the looming prospect of \$3.50 prices per gallon of regular gasoline following Hurricane Katrina. It appears that long term structural changes are becoming embedded in the global economy, which may permanently change the landscape. The US, Japan and Europe are no longer the drivers of energy usage. The rapidly expanding economies of China and India have and will significantly increase world demand for energy. The effect on more mature markets is uncertain but the lessons of the 1970s suggest that a cut in spending will be the initial reaction of consumers to a sense of decreased purchasing power. The business sector will try to respond to the need to protect profits under pressure from the economising consumer while absorbing increased energy costs and related increased costs of production. Unlike the 1970s, we don't see political manoeuvres as the drivers in the current upward shift in energy costs. Thus, we expect this shift to have a long-term systemic downward effect on the financial results of participants in those sectors of the world's economy, that are energy dependent, and a ripple effect on their suppliers. Until convinced that cost and demand changes are not ephemeral, business is generally slow to react and will rarely take rapid corrective action. The increasing pressure on financial performance created by current oil prices will only be exacerbated by the decreasing flexibility created by second liens.

One source reported that the US market for second lien loans mushroomed from

less than \$1bn in 2002 to almost \$10bn of second lien paper issued in the first half of 2005. The story is similar in Europe, where the market has grown from virtually nothing in 2003 to €1.5bn last year, and almost €3bn in 2005. In years past, junior liens were structured with few, if any, substantial protective protections for the second lien holder. The term 'silent second' emerged because first-lien lenders were able to largely prohibit second lien lenders from having any material collateral management rights during a period of default or even a bankruptcy. Like oil prices, the rights of second lien holders are also increasing.

Standard and Poor's reports that the use of separate credit agreements for second lien loans increased "so much during 2005 that doing so now appears to be the normal and preferred means by which to document second lien structures. It also appears that almost all separately documented second liens include some form of financial covenant, while almost none of the second liens governed by a combined document include specific separate second lien financial covenants." Obviously, not all second liens create the same fertile ground for restructurings. However, we believe that the seeds of dissension have been planted if there is a relatively short standstill period before the second lien holder can act and/or the second lien financial covenants are tighter or substantially different from those in the first lien documents.

Where there was a single creditor agreement, there was often a permanent standstill which prevented the second lien lender ►►

interfering with the first-lien lender's management of the shared collateral. Permanent standstills are increasingly uncommon when there are separate credit agreements and some recent standstill provisions have a 90 or even a 45 day standstill period. Shorter standstill periods enhance the second lien lender's negotiating leverage and increase the likelihood that first-lien lenders will to preserve recovery value for all secured lenders, to the detriment of the unsecured creditors and the debtor.

On 22 August 2005, Standard & Poor's released its report *Second Lien Evolution Creates Higher Recovery Prospects – At First-Lien Lenders' Expense*, noting that some recent cases demonstrate that "first-lien lenders should not rely on absolute priority – i.e., the notion in bankruptcy that senior claims are paid in full prior to junior claims receiving any payment--as a means to estimating their recovery prospects."

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This concern was in stark contrast to the initial Standard & Poor's report *Second Liens: Secured, Subordinated, or Both?* issued only ten months earlier on 12 October 2004, which projected that approximately 88 percent of second liens would realise virtually no recovery if there was a default. In the intervening months, Standard & Poor's became "concerned that, both prior to insolvency and during insolvency, many second lien bank loan agreements may be far less silent than either we, or many market participants, originally expected."

These significant and recent changes to the landscape of second lien financing lead us to expect that holders of second liens in new restructurings will be motivated to oppose out-of-court work outs. In bankruptcy, we expect adversary proceedings, which challenge the extent, priority and perfection of first liens. Such litigation may be particularly fruitful if there are liens on real estate, subject to dozens of perfection requirements. In the plan context, second lien holders are likely to seek separate classification of their claims and to enhance leverage in a plan. The real growth area will be valuation fights – as second lien holders assert that value of their collateral supports a recovery for the seconds. Any cash collateral agreement will also be more difficult as will any additional or replacement financing. While each tool is expensive for the debtor, the real cost will be months of fighting and the evaporation of the newly non-extendable exclusivity period.<sup>1</sup>

It may not be better when debtors find themselves confronted with lenders who hold both first and second lien loans, which motivates the lenders to support a negotiated settlement which maximises the combined recovery rather than the recovery of the two lenders separately. Outside of bankruptcy, debtors may be unable to resist such pressure. Inside of bankruptcy, pressure to accommodate such settlements, rather than stripping off under-secured second liens, will force debtors to finance fights with unsecured creditors who seek to challenge such favouritism. The long-term consequences will be companies which are unable to reduce debt to necessary levels or unable to maximise the ability to convert unsecured debt to equity.

The culling of silent seconds also has an impact on out-of-court restructurings. It is

still common that the first and second lien holder agree at the time the second is created to certain consents or rights waivers. However, the increasing possibility that these may not be enforceable or may be successfully challenged by the second lien lender is already resulting in fewer and narrower waivers by the first lien holders. Even if a waiver is given by the first lien holder, separately documented second lien transactions rarely obligate second lien lenders to follow the lead of first lien lenders in terms of pre-insolvency enforcement or waivers of covenants. Second lien lenders may keep a debtor in default, preferring the fees and increase in interest rates associated with defaults – all while the debtor is trying to deal with the pressures from oil pricing. A second lien holder may also see benefits to forcing a debtor into bankruptcy. The existence of independent second lien financial covenants gives second lien lenders the tools to reap value under the threat of withholding approval of second lien covenant waivers or amendments.

The stakes are high. At the time of its initial report, Standard and Poor's reached the conclusion that "88 percent of first-second lien capital structures contained insufficient collateral value to allow second lien lenders to experience any recovery, assuming absolute priority." By the time of the second report, value of the collateral for each particular credit facility currently indicated "only 74.6 percent of second lien loans lack any prospect for recovery. However, in absolute dollar terms, the amount of par value second lien bank debt that we project to have negligible recovery prospects, given default and given absolute priority, has increased to \$7.84bn from the \$4.1bn indicated in our initial review."

Both the value of the collateral and the amount of the debt have grown. The holders of billions of dollars of second liens will have significant motivation to fight for every advantage. We believe that they will increasingly see bankruptcy as the chosen battlefield with a debtor already weakened by oil pricing and decreased consumer demands. ■

<sup>1</sup> Pursuant to the new Bankruptcy Act

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