

# Dow Jones Daily Bankruptcy Review Roundtable: Scoping For Distress

August 24, 2011

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Dear Reader,

Bankruptcy attorneys, turnaround experts and distressed investors are part of the regular retinue of sources for our stories, but their insights on the wider outlook are usually discarded from stories about specific companies or cases. At the same time, conference panels are local by nature so that the discussions they offer are available only to those in the room at the time.

The DBR Roundtable, now in its second year, brings the open-ended format of the conference panel to the more accessible format of the newsletter. Back in July we invited a select group of our sources to our offices in New York City to chew over the forces currently prevailing on bankruptcy and distress: Europe's sovereign debt crisis, the "wall of maturities," municipal distress and more.

Our four panelists, comprising two attorneys, one banker and an investor, had plenty to say that went beyond the talking points we threw out. They brought up the increased aggressiveness of some creditors, the impact of collateralized loan obligations, and the onset of distress in the healthcare sector.

The hour was crammed with discourse, so if you delve into the edited transcript you will find more. We hope that you find this as interesting as we did when we moderated this year's session.

—The editors of *Dow Jones Daily Bankruptcy Review*

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## Roundtable Participants

Maria Boyazny, chief executive, MB Global Partners

Stephanie Wickouski, partner, Bryan Cave

Robert Nabholz, managing director, Duff & Phelps

Adam Rogoff, partner, Kramer Levin Naftalis & Frankel

## Moderators

Nicholas Elliott, managing editor, Daily Bankruptcy Review

Mara Lemos Stein, special writer, Daily Bankruptcy Review

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*MB Global Partners*



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**Elliott:** All of us around this table spend a lot of time looking for the dark clouds on the horizon, so let's start with a kind of devil's advocate question. At the moment you have very low interest rates, you have the high-yield market that reopened after the credit crisis pretty aggressively, companies that have been able to refinance their debt that perhaps a year and a half ago you would have thought would have gone into bankruptcy. So where are the signs of trouble? Are there any?

**Boyazny:** I think there are major issues going on. In the last cycle, even by [International Monetary Fund] estimates, the world financial system had some \$4 trillion of bad assets that they needed to dispose of and they probably disposed of a third of them, so we basically still have bad assets. They might be mismarked on the balance sheets of various financial institutions globally, but they're still on those balance sheets.

While we still had all those bad assets we launched into another credit binge. That's driven by lots of factors we're all familiar with, the rates and the stimulus, the enormous amount of liquidity that went into the system. As a result, again, capital flew to risky issuance, because essentially it was encouraged, and we're creating additional problems.

The issue is that because we didn't fix anything fundamentally from the 2008-2009 situation and we propped up [companies] even more, you have a very broken structural foundation and what should have happened is a more fundamental clean-up of global balance sheets. Instead what happened was that not only are financial institutions and some corporate balance sheets polluted—other than your blue-chip corporations that are flush with cash, but everybody below that is not in great shape—but we also transferred some of those problems to sovereign balance sheets and muni balance sheets became contaminated.

So I think, unfortunately, the system has a lot of cancerous-type characteristics to it. It just seems to me that we're dealing with a very sick patient and we've been keeping him on life support without fundamentally addressing the problem.

**Elliott:** Do you think there will be just a steady unwinding of those bad assets or could there be a more cataclysmic event?

**Boyazny:** It seems like we had Dubai, then we had Greece, and we had Ireland, and Spain, and very likely candidates to come next, so I think that we will have these periodic events. If we have another two really substantial events, we can have some major pricing adjustment and spread widening. Absent that, it will be slow, years of institutions and governments making some money, trying to take some losses. So you have a very long, long healing process going on for years. But if you have a couple of more significant shocks, I think that would readjust the supply-and-demand dynamic.

**Rogoff:** One aspect that I think is going to impact it from a bankruptcy perspective, particularly in the U.S., is that I'm seeing creditors fighting a lot harder, whether it's in court or out of court, for their recoveries. Look at the [Pension Benefit Guaranty Corp.], which has had to take on significant terminated plans and underfunding, they're taking a much more aggressive role in cases today than they may have taken a handful of years ago in prior cycles. And that's because they continue to take on losses as more and more underfunded pension plans, which are being affected by what's happening in the market, are being forced to be terminated.

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—Boyazny

That's a major pressure point on companies, manufacturers, service providers. Unions, particularly larger unions, for the same reason are becoming much more aggressive in having to fight for the recoveries for their constituents, particularly as businesses are downsizing and people are being terminated. The point is you're seeing a lot more inter-creditor fighting over a diminishing asset base that the debtors may have, and it can affect what restructuring values are going to be, who's entitled to share in those values.

As a corollary to this, we all know that we've seen in the last couple years a lot of prearranged, or at least pre-agreed-to, bankruptcy situations. Because money was available in the market people went into a bankruptcy hoping just to emerge in a reorganized-for-sale basis, but some of the larger cases are actually derailing even after they've filed. Blockbuster is a good example of a case that went in as a pre-discussed, prearranged bankruptcy, and then because of concerns over the fact the fix was a financial fix and not an operational fix, turned into a 363 sale. A lot of that came about because of not only the fact that the company itself operationally didn't address what its real issues were, but also that creditors started taking a harder look at it.

So when you look at the big players, whether they're institutional investors involved in a situation like Blockbuster, whether they're the interests of the PBGC and unions, I think

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there's a lot more concern over protecting your recovery. Unlike what we've seen in the last few years where you've been able to do restructurings without having to use bankruptcy, I think this infighting is going to result in more cases, particularly when you look at what's going on in the country as a whole, and then in the world markets.

**Wickowski:** I agree with Adam. I'm seeing among creditors less of an ability or tolerance to absorb loss. For instance in a context where maybe five years ago creditors, in the same circumstance, would have settled for 20% on the dollar, now they want 50%. It may be internal issues that those financial institutions or creditors are so situated that they have basically less of an ability to absorb loss.

I think that, ironically, it may be counterproductive, because I think what's happening is forcing more fights in the bankruptcy court and forcing cases into bankruptcy that maybe wouldn't have gone there five years ago, which ultimately raises everyone's cost.

**Elliott:** And is that partly a function of the recovery in the markets as well—a company that's in bankruptcy now has more options, possibly has multiple bidders, there's more chance of actually restructuring, so creditors feel like they can fight over more?

**Boyazny:** I think it's also partially a function of the increasing sophistication of the restructuring system and the players too. We now have gone through multiple cycles over the past couple of decades. I think people have a better understanding of the process, there's slightly more acceptance of the process. The players that have been attracted to the restructuring process overall, in or out of court, are increasingly more sophisticated. Generally as the industry overall becomes more mature, the expectations, at least from a creditor standpoint, become higher.

**Nabholz:** I think it's also a function of the amount of capital that's out there and it's that same chasing of yield that we see in the mainstream leveraged loan market, the mainstream high-yield market. There's just so much money out there. The reality is paper is bid up so high that the opportunity to get a recovery just isn't there. I heard someone say that 92 cents [per dollar] is the new 60, meaning paper trading at 92 signals significant distress, which was kind of surprising.

Back to the very first question of where are we going, where we are in the cycle, it's a very, very odd time. [If] you look [at] it as a pilot or a driver, you're looking at all of your gauges and you see some very conflicting evidence. I was just reading that the equity markets, when you factor in accumulated dividends, are at an all-time high. I mean, people see the S&P being flat over the decade, but if you accumulate all of the dividends we're at an all-time high. We've hit all-time lows in terms of spreads, in terms of yields.

You look at those things and say we're in two and a half, three wars, we have oil hitting \$100, 9%-plus unemployment rates, the sovereign crisis, we have the balance sheet issues that Maria was referring to. It's just very, very surprising, and you've got no defaults. The month of May there were zero defaults in the leveraged loan and high-yield markets for the first time since 2007.

**Elliott:** The other thing that comes up a lot is this so-called "wall of maturities." I wanted to get your opinions about how significant that still is. Looking back at a story we ran in December, we pointed out that in the leveraged loan market last year the number of loans that had to be refinanced by the end of 2014 declined from \$418 billion to \$277 billion. On the high-yield side, the number of bonds maturing in 2011-2013 that had to be refinanced was reduced by 12%. So that wall has obviously come down a fair bit. Is that still, though, potentially a big catalyst for defaults and bankruptcies?

**Boyazny:** If you look from 2012 to 2014, in total just less than \$400 billion was extended, and that was extended primarily, as we all know, because the loan market was refinanced by the high-yield market. But still, even with the refinancing, post-refinancing, as of the end of April the maturities across leveraged loans and high yield in 2013 through 2017 were \$1.2 trillion.

**"There's no doubt that these are very bizarre times that we are living in—It's like the four horsemen of the apocalypse are riding into town but they're wearing Bermuda shorts and Hawaiian shirts."**

—Rogoff

So you still have a very significant overhang. The high-yield market has [pushed out] maturities, but you still have bank debt maturities. U.S. banks have announced \$699 billion of asset dispositions and European banks have announced over \$1.5 trillion of dispositions. So these are things that they've officially said they were going to sell, partially because some of them have been nationalized or almost nationalized.

All taken together, it's a pretty significant overhang. In Europe you have obviously much smaller numbers, because the high-yield market is very small, but the leveraged loan market is about \$1 trillion as well. Taken in context together with the whole pretty weak macroeconomic backdrop, you have some serious [issues].

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**Rogoff:** What's underlying this question is the fact that as there have been maturities, capital has been there to refinance or extend it out. There's no doubt that these are very bizarre times that we are living in—It's like the four horsemen of the apocalypse are riding into town but they're wearing Bermuda shorts and Hawaiian shirts.

One of the areas that we'll talk about later is municipal [debt], the need for municipal restructurings. There are a lot of factors that go into that, not the least of which is that there's a limited way of raising revenue without selling assets and at some point you can't privatize a city or a state. And yet, despite the constraints that have forced municipal distress, banks are making private loans to municipalities. There are very substantial private loans, because in part there's capital that's there and they're trying to figure out how to put that capital to use. [That] scares bondholders who may already have existing bond debt because of the impact that could have. [Capital] is even being put to use in an area that everybody acknowledges has some level of toxic to it. I'm not literally referring to toxic in the environment, but just that municipal restructurings is a very difficult area.

**Lemos Stein:** One thing I'm curious about in regard to the wall of maturities is that many of the deals recently are 'amend to extend.' Is this some practice that you've seen in previous cycles, and how many times can that happen?

**"As active as the refinancing markets have been, they've been also very nondemocratic. They've been very open and welcoming towards the better-quality [companies]. It's the people that are in better shape that arguably have been able to refinance out."**

—Boyazny

**Wickowski:** This is something that has happened in previous cycles but not to this degree. In my career, I've never heard people compare this country to Japan the way it has been now.

**Nabholz:** I think you've got two issues around the wall and amend-to-extend. Number one, the traditional capital structure, particularly in a buyout before the financial crisis, was bank debt and then you have bonds. The reality is you can't extend out beyond the bonds. There's no way the banks are going to have

a maturity outside of something that's subordinate to them. So there are limits to that and there would need to be refinancing of the junior part of the capital structure, and there has to be asset value to cover that junior part of the capital structure.

The second thing about the wall that I'm keeping an eye on from a technical standpoint is [collateralized loan obligations] and CLO creation. All the vintages of 2006 and 2007 are able to reinvest when they get paid off, but soon that reinvestment period is going to stop, so that's a source of capital that's going to come out of the market. It's a big technical factor that's going to come out, particularly from the leveraged loan market, that just won't be there to support the refinancing of that wall.

**Boyazny:** The portion [of loans bought by CLOs] historically has ranged. In some cases in the middle part of the last decade and last year it was as much as 65% or 70% was bought by CLOs, and I think more recently it's dropped off, but still it's now in the 40% range. So it is a significant part of the market and especially as they stop reinvesting that's going to affect [the loan market] drastically.

To your point, as a historical comparison, if you remember when the Fed took rates to historic lows the previous time in the early 2000s [it was] the same thing – high-yield market issuance skyrocketed. Again, people were searching for yield and many of them take, due to structural reasons or broader reasons, they take more of a shorter term view. So when rates are very low, they try to find yield.

Issuance was very high at the time and then you saw that there was a crisis, of course a lot of other things contributed to the magnitude of the crisis that we had, and then boom, by 2007 housing started unraveling and then everything else beyond that. You're seeing a lot of similar patterns, but the issue is that some of the remnants of the first crisis of the early 2000s haven't been fully fixed. Then you had obviously trillions of dollars, it's a couple trillion dollars as we discussed, of assets not worked through from the 2007-2009 crisis.

And unfortunately even as active as the refinancing markets have been, they've been also very nondemocratic. They've been very open and welcoming towards the better-quality [companies]. It's the people that are in better shape that arguably have been able to refinance out. And so [companies behind] the \$1.2 trillion that's still maturing through 2017 are actually the ones that couldn't get refinanced. So there's kind of a negative selection bias built into that.

**Rogoff:** These are wonderful insights looking at a very macroeconomic perspective, but if you look at what's happening in the middle market, it becomes "amend to extend to what end?" For a lot of middle-market companies there has to be a purpose—I don't think you're just bridging to see if things get better. You're either bridging to go

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through a refinancing, or you're bridging towards some sort of a sale process. We all have seen in the last several years, and I don't think this is going to change, that restructurings and particularly bankruptcies have become distressed M&A opportunities. There is a lot more focus in relying less upon just academic analysis of a company's worth or valuation as opposed to "put it to the test, let's market these assets."

Going back to the middle market, it has to be "what's the purpose of buying the time?" If the purpose of buying the time is to either refinance the debt or move it to a sale process, you're going to see much shorter extension periods. They're going to keep it as "we'll push this thing out for a handful of months, but I want to see where we're going."

**Nabholz:** That's a good point, Adam. As I think of the cases that are in [bankruptcy] now, the recent trend has really been toward a sale. Blockbuster went in, converted to a sale, TerreStar went in with a plan, converted over to 363. A lot of people are just going in with straight 363. Deb Shops just filed the other week with that as well. Sbarro went in with a prearranged and is now choosing between either a plan or a sale.

Years ago there was more tolerance to allow for a reorganization process to play its way through, maintaining exclusivity and negotiating with your creditors, having valuations coming in, but trying to figure out how to do a restructuring. And then over time, in part because the market created this opportunity, more and more situations open themselves up to a distressed sale.

If you're sitting in a court process now you're being asked to evaluate a restructuring plan that has valuations underlying it and creditors coming in and saying "We want to test that, put it to the market, let's do a 363 marketing if only to see if the valuation that's being offered in the restructuring plan is the right one. If nobody comes in and we don't find the right price to sell it to someone, we'll look at whether or not a restructuring, a traditional restructuring plan, makes sense, but at least open the door for a marketing that can lead to a 363."

In the cases I've been involved with, [creditors] are fine with the concept of selling the assets in a process that makes sense, and then they're just going to be fighting for how that gets allocated. One of the issues that comes up in the sale process [is] which creditors are going to be a part of the go-forward with the buyer. The unions might want to support a going-forward transaction if there were protections that are provided for the employees that are being picked up, or maybe a spinning off of a pension plan and that being assumed by the buyer. So these inter-creditor fights are about how to get most value out of these assets even if it's not just sharing out of the actual cash proceeds that come in.

**Elliott:** Let's move on to talk about Europe. We've had a series of downgrades across Europe and there's a pretty likely Greek default. How serious could the impact be in the U.S.? Is there a big fallout if that affects Ireland, and then Spain gets into new trouble and Italy, or is it really isolated to Europe?

**"The mess [in Europe] keeps us looking comparatively good."**

—Nabholz

**Boyazny:** Indirectly yes. Directly it's not going to cause U.S. middle-market bankruptcies, but it's going to cause additional sales. If anything it's going to accelerate the process of balance sheet clean-up, because the financial system is very intertwined. When we had subprime losses coming through in 2007, who were the big holders? Sure, there were U.S. banks, but there were little Portuguese banks, there were banks in Northern Europe, there were effects all over the world. We're working on a European middle market situation and Japanese banks were big holders of that European middle-market paper. So I think the financial system is very intertwined and especially the U.S. and European systems.

**Nabholz:** Let me be a little, I don't want to say cynical here, that the mess that is Europe at the sovereign level is actually a good thing for the U.S., because we look better on a comparative basis. If you think about it, right now \$1 of out of every \$10 of our GDP is deficit finance. Of that 10% of the GDP, with QE2 [the second round of quantitative easing by the Federal Reserve] we printed 70% of that debt. So we're cranking the monetary press with the Keynesian pedal to the metal and the one data point, that is the dollar, is still holding up. The mess [in Europe] keeps us looking comparatively good.

**Lemos Stein:** Does this risk in Europe open any opportunities for distressed investing, even though the markets there are so much smaller than here?

**Boyazny:** Oh, absolutely. I mean volatility, at least from a distressed investor standpoint, volatility is a great thing, because it facilitates various asset sales and then dispositions. There's been more fear in the credit markets recently as we all know. Additional fear and macro problems obviously are helping facilitate the process, and that's where distressed and credit managers step up as essentially buyers of the last resort.

**Rogoff:** People looking to invest in Europe need to be very careful that they understand what their downside exit is going to be because the bankruptcy systems are not the same, the restructuring systems are not the same. Someone that may

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decide to buy a distressed Italian company may find out that after they own that company that there are actually criminal laws that tie to the owners and operators if that company ultimately becomes insolvent. So I think the word to the wise is while there may be tremendous opportunities there, you need to make sure you understand what your exit is going to be if it doesn't work out, because their restructuring system isn't necessarily as digestible as our Chapter 11 system, and our Chapter 11 system is not easy to digest.

**Boyazny:** That's why so many historically have been out of court. Some of those countries adopted more of a U.S.-style Chapter 11 system, meaning treating enterprise as a going concern, as opposed to just an outright liquidation.

**Rogoff:** But that costs you, because in order to stay out—not that a court proceeding doesn't have its costs, because it does—but in order to keep things in an out-of-court basis you may need to start putting in more capital to sustain an operation or you may need to convert and take a greater loss than you anticipated just to bring that result about.

**“I think the one area where there is going to be some significant municipal bond defaults and restructurings is not in the area of general obligation bonds, which is the actual municipalities, but the special revenue bonds...”**

—Wickouski

**Boyazny:** Yeah, I mean it's not an easy and straightforward case, but I think also this volatility in Europe could lead to asset sales by distressed institutions. It might be the sellers who are going to be distressed, not as much as the assets, just like it was in the U.S. in late 2008 and 2009.

**Elliott:** Is the European distress showing up yet as a source of business for you?

**Rogoff:** It actually is. We've had a couple of large distressed U.S. players who have been contacting us about opportunities both in Europe and in Asia right now that are not necessarily connected to the U.S. Actually a lot of issues are arising now with investments in Chinese companies, particularly given some of the issues about auditing and financial accuracy.

**Elliott:** Adam, you touched on the issues in municipalities. It's an area where there are very diverse opinions. You have people like Meredith Whitney, the analyst, saying

there's going to be an enormous amount of distress, but the ratings agencies have been playing it down, saying that there isn't any sign of that and that so far municipalities are mostly meeting their obligations and that's set to continue. Stephanie, you have any thoughts on that?

**Wickouski:** I think it's unlikely that there would be a large number of actual bankruptcies in the sense of Chapter 9 proceedings. There's no ability of the states at this point in time to file for bankruptcy. For local governments, most of the activity thus far, with a couple notable exceptions, has been workouts. There are a variety of reasons for that including factors really unique to local government and the nature of the creditors and the nature of their operations. So I think it's unlikely that Chapter 9 is going to get utilized to any great degree.

**Rogoff:** I agree, it's a backdrop for trying to work things out, whether you have bond debt or whether you're trying to work things out with your unions. By the way, a municipality can be everything from a city down to a water authority, so I think depending upon what we're talking about in the scope of the operations that could be a Chapter 9 entity, the greater the likelihood that you may see it used. It will be harder for a city [to file for bankruptcy], but it may be less of an issue if you are a-

**Nabholz:** Toll road.

**Rogoff:** A toll road, or-

**Nabholz:** The monorail in Vegas.

**Rogoff:** Exactly, which should be in Chapter 9 but isn't. So it depends on the nature of the borrower. But I think that Chapter 9 is definitely unique—there's not a lot of history with it. I think people are a little intimidated by what the results could be, because Chapter 9 incorporates certain concepts from the bankruptcy code Chapter 11, but then certain concepts aren't incorporated, like you can't force the sale of assets, because you're not supposed to force a sovereign to put its assets up.

And so I think the fact that it's not often used, it's become this gun and you don't know if it's loaded or not loaded, but it's being utilized to try to bring concessions—whether from your bondholders, your labor, whatever your pressure points may be.

**Wickouski:** I agree with Adam. I think the one area where there is going to be some significant municipal bond defaults and restructurings is not in the area of general obligation bonds, which is the actual municipalities, but the special revenue bonds, where the state authorities are simply conduits to facilitate financing to hospitals, schools, concerns of that nature. And I think particularly in the hospital area, people are anticipating that there's more trouble, and there have been several bankruptcies already this year.

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**Boyazny:** Yeah, I definitely agree with that. Revenue bonds, which are hundreds of billions of dollars, are certainly a big, big, big potential area for dislocation. That includes projects even like stadiums.

**Nabholz:** One of the complexities there is that each state has its own [rules]—it's almost like you have 50 different jurisdictions. You don't have a federal bankruptcy code, and there's really not an established way for the professionals to be paid.

**Elliott:** Well, that can't be good if you don't get paid. What about industries? Last year, we talked a lot about commercial real estate. There are obviously still a lot of problems there, but any other industries that you think are particularly prone to distress at the moment?

**Rogoff:** Yes, as Stephanie had mentioned, we've been focusing for the last couple of years and continue to put a heavy focus on health care. The pressure on hospitals, nursing homes and long-term care providers is tremendous. There are outdated infrastructures, needs for new investment in technology, and pharmaceutical costs have been increasing. At the same time that their expenses are going up they're under tremendous pressure—especially if you are an acute-care community hospital—because Medicare and Medicaid are seeing massive cuts. Two billion dollars alone is the cut in Medicaid for New York State projected for this year.

So you have cuts coming from your government sources, because they have their own issues. You may not have the leverage of negotiating with your private insurance payers to get better rates. You have lower utilization, because as technology advances people are just staying in hospitals less time than they used to. And so you've got lower reimbursements, you have higher cost structures. There's going to have to be consolidation and closures while preserving patient care, and then looking at which systems actually can be revitalized.

One last aspect of this is that it depends on what state you're in. We talk about capital that's available in other industries to come in and help bring about a turnaround [but] you can't have that in New York State for a hospital, because it has to be a not-for-profit. You can have it in Massachusetts, which is why you've seen a number of acquisitions by Cerberus and other private equity investors coming in to convert non-profits into for-profits as a part of a restructuring. Healthcare has been and will continue to be an industry that needs some focus over the next few years.

**Wickouski:** I agree with all that. If you talk to the CEO of any national healthcare system, hospital system, they would tell you that the thing that keeps them awake at night is cost cutting and the pressure that they're going to be under. I think that inevitably there's going to have to be more of a use of the bankruptcy process over the next couple of years in the healthcare area.

**Nabholz:** Well the one area that's been very active this year has been the retail sector. You've got Borders, Blockbuster, A&P, Nebraska Book, Perkins & Marie Callender, Sbarro, Deb Shops. I think one of the key things there is the lease portfolio that the companies have. They can effect, as Adam said earlier, an operational restructuring in court that can't be done out of court. That's why we've been seeing a lot of filings in the retail sector and probably will continue to see them.

There's any media that you touch, whether it's Borders with books, Blockbuster with DVDs [or] Yellow Pages.

**Elliott:** Maria, any ideas to add to that?

**Boyazny:** I agree with what's been said, and a sector that needs real restructuring that might not be for a varied set of financial and political reasons is the financial sector. Talk about one that should really be cleaned up. I think that one will be more of a gradual de-levering process.

**“Foreclosures need to come in and I think buyers are unwilling to step into the market and the clearing price is being artificially propped up.”**

—Nabholz

**Elliott:** Is that a particular part of the financial industry? What do you have in mind exactly? Do you mean everything from hedge funds to insurance companies or particular types of institutions?

**Boyazny:** Well, I would say banks. We well know there are 888 community banks and small banks just on the [Federal Deposit Insurance Corp.]'s watch list. But I think even in the larger banks, if you actually take an honest look at the balance sheets and mark all their real estate holdings and muni holdings to market...The problem with that is that then all of us in the room and the readers—the taxpayers—are then on the hook.

**Nabholz:** Is your name Meredith [Whitney] or Maria?

**Elliott:** And the housing market is still going down, so is that another to watch?

**Boyazny:** I was about to mention everything related to housing. If you look at some of the construction-related and most of the housing-related subsectors I think they are going to be in a tough period for a while, because I think housing will take several years to clean up. We still have a very significant

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shadow inventory in housing, houses that should be foreclosed but haven't yet been foreclosed for a number of reasons. In some cases servicers actually purposely don't foreclose on a significant number of homes in the same area to avoid a contamination effect and work them out one by one.

**“A sector that needs real restructuring that might not be for a varied set of financial and political reasons is the financial sector. Talk about one that should really be cleaned up.”**

—Boyazny

**Wickouski:** I'm also curious from the financial point of view what your take is on the impact of the legal difficulties that have been associated with the foreclosure process. For instance, there's a recent decision by the Second Department in New York which dismissed a foreclosure on the basis that the Mortgage Electronic Registration System lacks standing because they don't have the underlying note.

As a legal matter, you really need to have the original note to be a foreclosing plaintiff. It's been kind of ignored for the most part, but the Second Department recently said in—I think it was the Silverberg case [Bank of New York vs. Silverberg]—that MERS had no standing to foreclose. This is certainly going to create some delay—I mean it's one thing to make a decision not to foreclose too much in one area, but this is going to present a wrinkle in actually accomplishing a foreclosure.

**Boyazny:** I think all of this just delays the inevitable problem, because the only real solution is reduction of principal. If one in every four homeowners has negative equity, that's the only real true solution. The question is who's going to eat up that loss. All of these delays just mean it's going to be the public sector that's going to eat up that loss. In a true restructuring, however [it would be] the private sector.

**Nabholz:** It's another headwind to the economy that the pricing mechanism, the market's pricing mechanism, is being held back. Foreclosures need to come in and I think buyers are unwilling to step into the market and the clearing price is being artificially propped up.

**Boyazny:** And then just to top it all off is the fact that the Fed's now one of the largest holders of mortgage-backed securities and would need to over time get rid of them. So you add all that on top of everything we discussed. Tell me why I should be a buyer of any credit at these levels.

**Wickouski:** It does seem that a lot of the things we talked about today are all aspects of the same animal if you will: the difficulty in ascertaining value; the uncertainty of value; the basic burden on the Federal debt because of propping up the financial institutions that are ultimately hurt by the delay and the uncertainties in the housing market. These things are all part of the same picture.

**Boyazny:** Maybe what we should do what Credit Suisse did—remember when they paid their employees from a toxic asset pool? Maybe we should pay our U.S. creditors from a pool—give them foreclosed homes across the U.S. and that will be our payment.

[Laughter]

**Rogoff:** If you look at this and really take the big picture, there are three major sources of funding to help prop up companies: government funding, but government has its issues right now whether it's federal or state; consumer spending but consumer spending continues to have its issues, demonstrated by the fact that retail bankruptcies have not gone down; and then just the ability of financial institutions to come in and overpay or pump capital in to sustain an operation, and that's suffering its own constraints right now.

What other sources of funding are there? It's people, it's government, and it's private investors, and I think what we're seeing right now is a constraint on all three of those sources of capital. And how is that going to start rippling down to companies in their operations?

**Boyazny:** But what's a further complication is then we have [the involvement of] the IMF or the World Bank, these international institutions, which are a combination of contributions from all countries. So you have some weird redistribution going on where supposedly the stronger countries such as us are helping the weaker countries, where we need help ourselves. The issue with these international financial institutions has to be solved too, because if we're bankrupt we cannot be funding other bankrupt people. And you need a much more comprehensive solution and a country-specific solution.

**Nabholz:** Nick, I'd like to go back to your question though of where there's going to be activity going forward. If I were here a year ago I would have brought up the [leveraged buyout] class of 2006 and 2007. It's interesting that over the past 12 months the private equity sponsors behind these companies have used their considerable financial engineering skills to pull a lot of these companies back from the brink. The Clear Channels, the TXUs, the First Datas, the Freescales, the Avayas of the world, they've used the covenant packages that were on those deals. They've taken full advantage of all the opportunities.

# Dow Jones Daily Bankruptcy Review

## Roundtable: Scoping For Distress

August 24, 2011

They've also, through the strength of the debt markets, been able to term out, extend maturities, and a couple of them have gone public. Basically the private equity sponsors are taking them public at about 50 cents on the dollar of what they paid, taking a markdown, obviously not selling the stock and hoping that it recovers. So I don't see the mega-LBO class of 2006, 2007 being on the table going forward.

**Elliott:** So that one's been solved?

**Boyazny:** It's very scary if you look at buyout portfolios. The difference [between buyout and venture investments] was supposed to be that across the portfolio buyout firms were supposed to have more stable returns, where in venture you expect a couple winners and then maybe hopefully break even and a lot of losses. If you look at these buyout portfolios they look venture-esque in those vintages of 2006, 2007.

**Elliott:** And that leads on to what I guess we should make our final question. I did want to ask about fraudulent conveyance. There was a story actually in the Wall Street Journal today that Dynegy, which is trying to restructure its debt, held a special call with bondholders to reassure them that if they agree to the financing and then the company goes bankrupt they're not going to get sued for the leverage that they put on the company. Is it something that's a significant issue in bankruptcy would you say?

**Rogoff:** It's probably a consequence of the fact that people are being more vigorous with trying to protect their recoveries. Underlying a fraudulent transfer is the viewpoint that today's creditors were somehow put worse off by something that may have benefited someone in the past, whether they were creditors that got refinanced out or monies that went in a capital payment to someone.

There's just been a lot more litigation in bankruptcy cases on whatever grounds as people are trying to obtain a higher recovery. If one of the traditional tools that have been out there is going to be fraudulent transfer and other types of litigations that can be brought, even claims against management for breaches of fiduciary duty, people are going to start seriously looking at those claims, going to D&O [directors and officers] claims where a source of recovery is D&O insurance.

Creditors have traditionally wanted to pursue the investigations, realizing that the ultimate recovery may not come from the individual officers and directors, but it may come from tapping into the D&O insurance. That—looking where there may be funds to try to enhance the pot, whether it's a fraudulent transfer from an LBO or other transaction or it's pursuing investigations against individuals to get at insurance—people are starting to be more vigorous about pursuing, in part because recoveries from other sources in bankruptcy cases haven't been as rich.

**Nabholz:** That's a good point. When a class of creditors has—if you give them nothing they've got nothing to lose. So they try to latch on to whatever legal arguments are out there. I think the market was galvanized last year with the original Tosa decision, which was at the bankruptcy court level and I guess it was overturned at the district—we're still waiting at the appellate level if I'm not mistaken. I guess it's bubbling around in Tribune, it's bubbling around in Lyondell, so I think there's some precedents that will be out there that will help define it. My understanding is it's still a somewhat undeveloped part of the law right now and there are very different views in different circuits out there.

**“If you look at these buyout portfolios they look venture-esque in those vintages of 2006, 2007.”**

—Boyazny

**Wickouski:** I think also in the legal community there have been changes such that there are lawyers and law firms who are more interested in taking litigation on behalf of creditors in a bankruptcy situation on an alternative fee arrangement or a contingency, sometimes even a pure contingency basis. That drives up the risk for anybody outside of a bankruptcy doing a transaction and questioning whether they have liability of a disgorgement or unraveling in a bankruptcy.

**Rogoff:** I agree. We represented a creditors' committee in a large case and one of the big assets that the creditors got under the plan was a litigation. The decision was made to put it out for bid on a contingency fee basis, and we thought that very few people would show up for the engagement and for the pitch, and there were a tremendous number of firms that were pooling together. From recollection if you added all the different law firms that were making a pitch on it, you probably had 25 firms in various associations that were looking to take on a big litigation on a purely contingency fee basis. It wasn't even clear that the fees, or rather the expenses, were going to be covered.

**Elliott:** Okay, we're out of time. Thanks again to the four of you for joining us.

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