

Global Financial Restructuring

Client Alert

Global

BAKER & MCKENZIE

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Our Global Financial Restructuring Team brings together an interdisciplinary team of lawyers with the combined experience needed to address and resolve the complex issues currently confronting clients. Through our extensive network of 68 offices worldwide, we provide expertise and seamless service to clients across multiple jurisdictions and practice areas including Financial Restructuring and Creditor's Rights, Purchase and Sale of Distressed Assets, Distressed Debt Trading, Derivatives, Structured Finance, Real Estate, Dispute Resolution, M&A, Post Acquisition Integration, Tax and Employment.

Our experienced lawyers have guided clients through the turbulent times over the last three decades, including the 1980s debt crisis in Latin America, the early 1990s debt crisis in the US and Europe and the 1997 Asian financial crisis.

Baker & McKenzie represents both buyers and sellers of distressed debt in the secondary markets and is an active participant in the LMA, APLMA and LSTA. If you should have any questions or would like to receive more information, please contact the current Baker & McKenzie LLP attorney with whom you work, or any of the individuals listed below.

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We will be running a series of webinars related to these alerts. If you would be interested in these webinars please contact GFRwebinars@bakernet.com

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Distressed Debt: The Next Investment Cycle

In a market beset with an unprecedented combination of crisis, volatility and uncertainty, analysts, investors and even casual observers all seem to agree about one thing: distressed debt is back. Savvy investors have always been able to source high value distressed opportunities, but today's financial markets offer the promise of an explosion in distressed debt investing not previously enjoyed by those seeking opportunity in the midst of crisis.

This *Client Alert* takes a brief look at (i) the market for buying and selling distressed loans, (ii) the upward distressed trading cycle, (iii) some typical investment strategies employed by market participants, and (iv) potential distressed investing opportunities for clients.

The Secondary Market for Distressed Debt

The market for buying and selling both par and distressed debt emerged in the mid-1980's and, in tandem with the growth of the corporate loan market, has grown steadily in size, sophistication and standardization ever since. Generally speaking, the term *distressed debt* refers to the debt obligations of a financially troubled company facing an increasing risk of default. In market terms, a particular company's financial distress (which may result from a variety of factors ranging from short term financial issues to substantive operational or competitive problems) is reflected in the price that a market participant would be willing to pay to purchase the debt. In general, the discount to par follows the severity of the distress: the higher the risk of loss, the deeper the discount.

Today's market is truly global and consistently trades on standardized purchase and sale documentation and trading protocols that have been promulgated during the last decade by three major trade associations: the Loan Market Association ("LMA") based in London, the Asia Pacific Loan Market Association ("APLMA") based in Hong Kong and the Loan Syndications and Trading Association ("LSTA") based in New York. Each of these associations has contributed greatly to the growth and development of highly liquid and transparent debt trading markets globally.

The Trading Cycle

Prior to the summer of 2007, borrowers enjoyed an extended period of excess liquidity in the marketplace. Bearing witness to the surplus of capital in the loan markets were “PIK loans,” “toggle loans” and “covenant lites.” Borrowers were able to demand low cost funds for highly leveraged business models with little or no collateral coverage. Traditional credit and lending policies were pushed to liberal boundaries as innovative, but high risk, financing structures emerged in all market sectors.

The excess liquidity that spurred the boom lending market, however, all but disappeared in the aftermath of the subprime meltdown that started in the second half of 2007. Since then, the credit crisis has expanded globally across product lines and has affected virtually all financial institutions, including commercial banks, investment banks, hedge funds and financial guarantors.

As a result, lenders have returned to more traditional and conservative credit policies with an appetite for less leverage and more protection. Unfortunately, this policy reversal means that many borrowers – whether corporates, middle market companies or structured vehicles – face increased refinancing risks and, therefore, an increased risk of default. The overall lack of liquidity available to borrowers coupled with volatile commodities prices, falling equity values and adverse currency fluctuations only serve to compound the default risk faced by borrowers and create an environment ripe with distressed opportunities.

Historically, the distressed trading markets have followed a typical “boom-bust” cyclical pattern. Put another way, distressed trading opportunities have typically emerged amidst the fallout of soft lending practices and overzealous investment policies. The recession economies of 1990 and 2002 offer the most recent examples of the distressed opportunity cycle and 2008 appears to be falling in line with the historical pattern. According to data collected by the LSTA from twenty-three of its largest buy-side and sell-side member institutions, and published by the LSTA on its website (www.lsta.org), the trading volume of loans priced at *less than 80% of par value* reached a record high of \$13.2Bn in the first quarter of 2008. The explosion in distressed trading volume rolled directly through the second quarter and reached yet another historical high, \$15.7Bn – a “quarter over quarter” increase of nearly 19%. For loans trading at *less than 90% of par value*, the figure grows to approximately \$51Bn for the second quarter. By comparison, the total trading volume of loans priced at *less than 90% of par value* was approximately only \$27Bn for all of 2007.

Traditional Strategies

As efficiency, transparency and liquidity have consistently improved in the secondary markets, financial institutions, hedge funds and other strategic investors have utilized the secondary market trading platform for a variety of focused investment objectives. Some of the traditional alternatives employed by participants in the secondary markets include:

Exit Strategy – Lenders, such as commercial banks, may elect to sell their loans at a discount to par in the secondary market as an alternative to a protracted workout with a distressed borrower. The selling lender frequently views the

Exit Strategy as a means of mitigating long term recovery risk and avoiding the costs and expenses that might be incurred in a complex workout or bankruptcy proceeding.

Trading Programs – Hedge funds, investment banks, and other strategic investors may pursue a program of selling, buying and re-selling debt in troubled companies with a view toward making short term gains based upon fluctuations in the market price of the target debt. Those who manage Trading Programs rely upon high volume trading and deft execution of trades utilizing the market's standard trading documents.

Long Term Value – Other hedge funds, investment banks and strategic investors will seek to maximize long term value by purchasing the distressed loans of a troubled company on a discounted basis with a view toward participating actively in a consensual, out-of-court restructuring process or a reorganization or rehabilitation of the company's affairs in an insolvency proceeding.

New Private Equity – As a variant of the *Long Term Value* strategy, some investors may acquire the loans of a troubled company in order to gain control of the company's equity either by trading the outstanding debt for equity in a restructuring sale or by accepting equity as repayment of the loans as the company exits an insolvency proceeding.

Recent Developments and Current Opportunities

Corporate Defaults – Credit spreads have been widening and many analysts anticipate a significant increase in the corporate default rate. If so, significant distressed investing opportunities will present themselves across the spectrum of distressed strategies.

Middle Market – Many companies with otherwise good business models may find themselves confronting significant liquidity issues as a result of being over-leveraged in the midst of the credit crisis and may become strategic targets for investors seeking long term value or equity control.

Financial Institutions – Many of the debt obligations of financial institutions are trading at distressed levels gaining the attention of distressed debt trading programs at hedge funds and other financial institutions. The Lehman companies, with insolvency proceedings pending in several jurisdictions around the globe, are the most immediate example.

Portfolio Transactions – Some investors are purchasing and aggregating pools of loan assets for subsequent portfolio sales and related transactions. The most notable examples are commercial and residential real estate loans. Other example include opportunities to acquire loan assets currently housed in underperforming structured vehicles.

US Bailout Plan – When the Emergency Economic Stabilization Act of 2008 was signed into law on October 3, 2008, it authorized the Secretary of the Treasury to implement, among other things, a Troubled Assets Relief Program ("TARP") to acquire distressed commercial and residential mortgages and related mortgage-backed securities. Some debt market analysts – as well as holders of distressed mortgage loans – speculated that TARP might serve to

establish a new market for the purchase and sale of distressed mortgage loans (as well as other mortgage-related securities). On November 12, however, the Treasury Department announced a change in strategy and now appears to be moving toward direct investment in the banking and financial markets rather than following a course of acquiring distressed assets from financial institutions.

US Bankruptcy Amendments – Recent amendments to the US Bankruptcy Code have placed time constraints on certain actions of debtors (such as the time within which the debtor has the sole and exclusive right to propose a plan of reorganization) and have increased certain of the debtor’s liquidity needs during the course of the bankruptcy proceedings. The net result may have the effect of enhancing the opportunities for strategic investors seeking long term value or equity control where distressed companies battle the demand for increased liquidity in an accelerated restructuring process.

Trade Settlement Delays – Following the explosion in debt trading activity around the globe, the secondary trading markets are simultaneously experiencing increasing settlement delays. The LSTA, LMA and APLMA, for example, promote a settlement standard of “T+20 days” for distressed trades. Nonetheless, average trade settlement times have increased dramatically in recent months. The LSTA has recently published data that shows average settlement times reaching T+40 days in the second quarter of 2008.