VIEWPOINT

Despite Downturn, It's Not Yet Time For Corporate Bankruptcy Filings

By Scott Y. Stuart and Nicholas F. Kajon

Scott Y. Stuart

Nicholas F. Kajon

Ladies and gentleman, welcome to the great downturn of 2008. Or is it the great recession, or even depression? Perhaps it is nothing more than a bursting bubble. If the message from these words conveys market confusion, then mission accomplished. The long-anticipated downturn is here, but whether it will morph into a positive environment for the restructuring world is yet to be seen.

There is no doubt that the economy is bad. There is really no other way to describe it. In the bad lands of this downturn, however, the soothsayers of the turnaround world, all geared up for this moment, are all but confused and stymied by the factors that brought the economy to this moment.

Take, for example, covenant-lite loans, all defining asset securitizations and of course hedge fund investments on a loan-to-own basis. Those days may be over, but the fallout may not be felt until after the economy begins to recover from this down cycle. It is submitted that this economic downturn, different from any other, may very well lead to deferred restructurings after this moment has passed. In other words, the hangover effect of the liquidity era may outlast the downturn, with the hangover being the gravy for the restructuring community.

This theory may be difficult for some to accept, but the facts surrounding this downturn seem to give credibility to the schism that defines this cycle. The most basic of facts is that corporate bankruptcy filings, while up since the dry spell of the last two years, lag significantly behind filings in the downturn of 2003. This is particularly interesting considering how battered the economy seems to be compared to the 2003 downturn, with forecasts indicating the unpredictability of this current downturn likely to continue well into 2009.

While many factors are influencing the moment, there are a few obvious ones which stand out from the rest. The level of secured debt and multi-tiered balance sheets make traditional Chapter 11 cases difficult to impossible because there may be nothing left to restructure. The 2005 changes to the Bankruptcy Code have made Chapter 11 far more expensive and difficult and less friendly to management, who ultimately decide the form the restructuring will take. Hedge funds may attain blocking positions and thus preclude confirmation of any plan of reorganization proposed by management. As a result, quick sales in an out-of-court context still have allure, and to the extent that Chapter 11 is utilized, prepacks and 363 sales are more prevalent than traditional restructurings for the reasons discussed herein. Moreover, covenant-lite loans are keeping distressed companies alive because nothing dire has yet been breached, something that can continue for some time. Thus, by the time a default is finally triggered, today’s sick company may be tomorrow’s corpse.

Add to this, at least for the moment, that a significant portion of the distress in the marketplace is tied to hedge fund investments. As of a few weeks ago, even the long term dynamics of that environment changed when a Federal District Court in New York in the CSX Corp. case made a ruling regarding required investment disclosures, setting in motion the beginning of possible regulation to the hedge fund sector. This, of course, could radically alter how hedge funds invest and attempt to manipulate and control the destiny of a company. Similar regulatory type actions were recently taken in the United Kingdom, where the Financial Services Authority issued a set of regulations regarding short selling during rights issues.

The last factor yet to play into this cycle, and one to which little attention has been paid, is the effect state and city municipalities will have on a slowing and contracting economy. As recently reported by the New York Times, state and city governments are at the back end of this economic downturn, not yet having to reduce spending from the $1.8 trillion contribution they make to the national economy. In the article, it was reported that state and local municipal spending could be reduced at an annual rate of $50 billion. Once this happens, it is asserted there will be zero or negative economic growth in 2009.

continued on page 12

VIEWPOINT

continued from page 11

The perfect storm for this downturn, whatever the so-called experts call it, has passed. The focus must now turn to the implications of the economic downturn for restructuring professionals. Prior economic slowdowns and recessions had fairly immediate effects on industry and were followed by a fairly predicable corporate-bankruptcy-filing cycle. That is not the case today, and notwithstanding a rather grim economic forecast, it appears it will be when the economy begins to recover that industries hanging on from the end of the covenant-lite liquidity era will falter. If this occurs, while the restructurings that cannot yet happen are forced to occur, an economy otherwise poised to recover could relapse into stagnation. There is, however, a silver lining.

While the time may not be right at this moment for deals to get done, loans to be made and business failures to be made right, a bit of economic confidence combined with signs of global economic stability may be just what is needed to allow the natural and inevitable cycle of corporate bankruptcies to occur. If it is understood that this is likely to occur, and the economy is not pulled backwards, industry will again prosper and the use of Chapter 11 will be a tool put to good use at a better time with sustainable positive results.

(Opinions expressed are those of the authors, not of Dow Jones Newsletters.)

Scott Y. Stuart, an attorney and turnaround professional for 20 years, is a managing director with Donlin Recano & Company, a leading noticing, claims, balloting and distribution agent and provider of information organization and virtual data room services. He can be reached at sstuart@donlinrecano.com or 212-481-1411.

Nicholas F. Kajon is a shareholder of Stevens & Lee P.C., and a member of the bankruptcy and corporate restructuring group in New York. He can be reached at NFK@stevenslee.com or 212-537-040.

Frontier (continued from page 4)

The airline has also reworked its deal to buy seven jets from aircraft maker Airbus, which will pump $7.5 million into its coffers.

In addition to selling off some of its jets the company has scrapped its money-losing its code-sharing agreement with Republic Airways Holdings Inc., an Indianapolis-based carrier.

While record fuel prices have grounded a number of smaller airlines, Frontier insists it will reorganize and continue flying. However, the airline continues to lose money, posting $48.5 million in losses in the months of April and May alone, according to recent bankruptcy court filings.

Frontier filed for Chapter 11 bankruptcy protection on April 10 after First Data Corp., which processes credit-card and debit-card transactions for the airline, said it would boost the collateral required under the processing agreement by more than $75 million. **DBR**

Airlines (continued from page 9)

through a big carrier's hub.

Singapore Airlines has significant premium traffic on the world's longest scheduled route — about 18 hours from Singapore to Newark Liberty airport. To make more money on each of those flights, the carrier is replacing the economy-class section with higher-paying business class seats. Even Chief Executive Chew Choon Seng says the route is exceptional. "We have to be very selective in choosing routes so we can recover our costs," he said.

Continental Airlines Inc.'s strong hub at Newark similarly generates rich enough traffic that it can offset the high cost of its 16-hour nonstops to Mumbai and Delhi, says Jim Compton, executive vice president for marketing. **DBR**