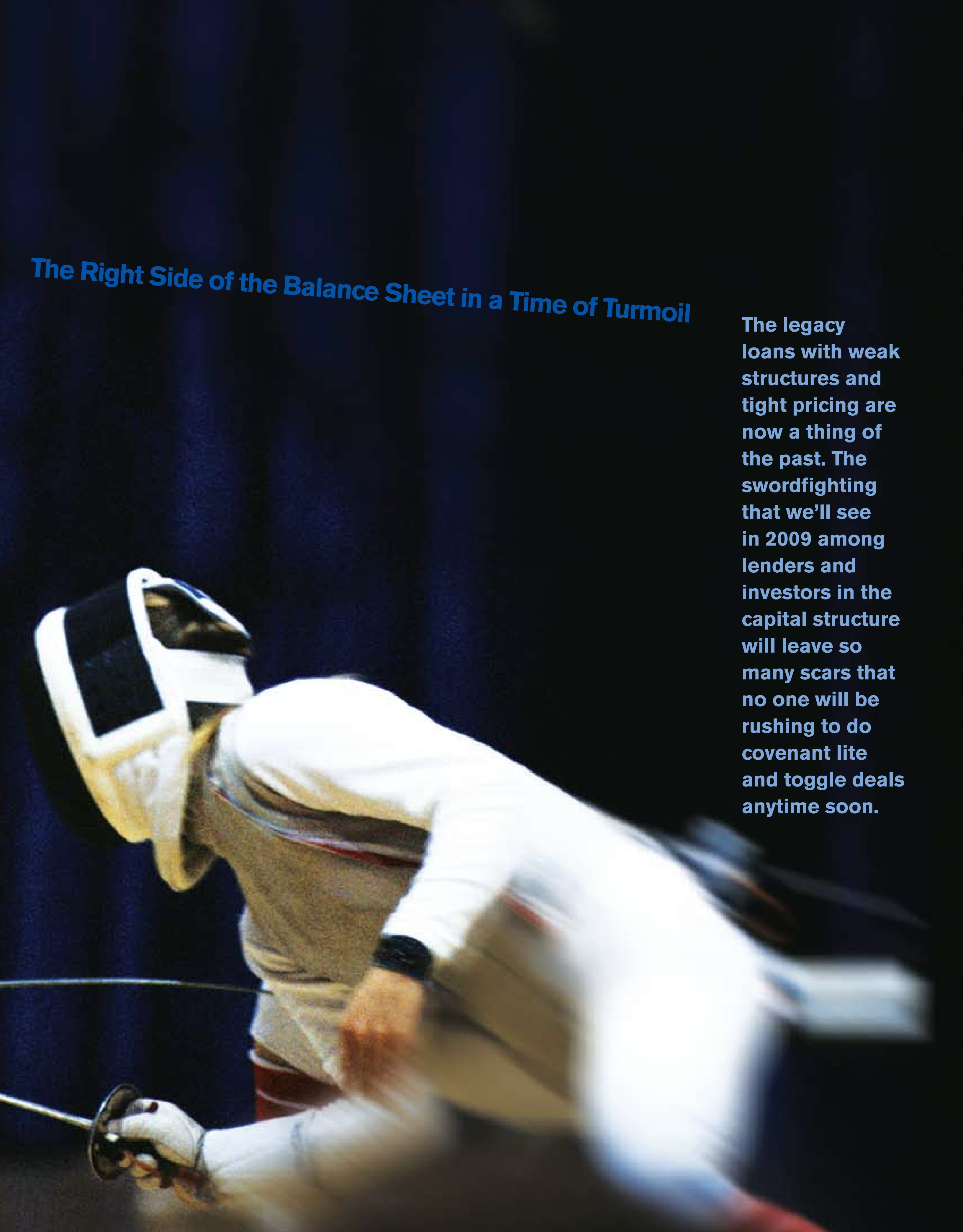
DRAW YOUR SWORDS *en garde*



The Right Side of the Balance Sheet in a Time of Turmoil

The legacy loans with weak structures and tight pricing are now a thing of the past. The swordfighting that we'll see in 2009 among lenders and investors in the capital structure will leave so many scars that no one will be rushing to do covenant lite and toggle deals anytime soon.

BY HUGH C. LARRATT-SMITH

One of the recurring themes running through many discussions today among lenders, private equity investors and restructuring advisors is how capital structures will fare in the escalating turmoil of the financial markets.

A key aspect of this down cycle that caught many people off guard was the fact that the deterioration in the credit and equity markets preceded the deterioration in the economy, instead of the other way around. Typically in a down cycle, the economy shows signs of weakness, which then triggers a downturn in credit and stock markets.

In this down cycle, the speed and the magnitude of the deterioration of the credit and equity markets has not been equaled since 1929. AIG, Fannie Mae, Lehman Brothers, Freddie Mac — until September of this year, these names were synonymous with financial stability and strength. Today, they are roadkill.

The upshot of the financial turmoil is that banks and other financial institutions are in a capital preservation mode. Yet many lenders and investors have a huge overhang of loans that have loose structures and slim pricing, and they will have to deal with the legacy of the surplus liquidity for many years to come.

Compared with the last two downturns in 2001 and 1992, today's capital structures of many borrowers are like wedding cakes with numerous layers and many flavors. Indeed, one industry pundit suggested that comparing today's capital structures to those ten years ago is like comparing a Picasso painting hanging in the Louvre to the portrait of George Washington hanging in the National Gallery in Washington, D.C.

Unless a company has been forced to refinance in the past 12 months, and in the process take on a more conservative capital structure, its balance sheet may still resemble this multilayered, multiflavored wedding cake. With loan structures, some of the terms and conditions that amplified the credit boom are now amplifying the credit crunch. Indeed, many borrowers are still enjoying the fruits of the unprecedented liquidity during the 2003 – 2007 period when capital was raining down from the clouds.

For example, the high-water mark for second-lien deals was Q2 2007, when over $14 billion in syndicated second-lien deals got done; this compares to $1.5 billion in Q1 2008, according to Reuters Loan Pricing Corporation. Look at mezzanine money: deals were closed and priced at 11%, with some of the interest cost on a payment-in-kind basis in the 2003 – 2007 period — today, compare that to mezzanine money that's 17% – 18% plus warrants. Let's not forget PIK toggle notes — they conjure up the same kind of emotions as leisure suits or disco music.

We hear stories from asset-based lenders that borrowers are reluctant to switch lenders in today's environment for the sole reason that they have a deal far sweeter than what they got several years ago. For example, in 2005 – 2007, ABL transactions did not have LIBOR-floors — today, this feature is far more common.

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However, some of the aggressive structures of the 2003 – 2007 period are now starting to catch up with lenders. (Some private equity groups and borrowers will look fondly back to this golden period when problems uncovered during due diligence could get quickly swept to one side, or dividend recaps took place before the ink was dry on the original deals).

Take the casual-dining restaurant sector, for example. Private equity groups were aggressively buying restaurant chains at ever-increasing multiples from 2003 through 2007 with extremely high leverage and spreads over LIBOR. The balance sheet was stretched as tight as a snare drum. Some lenders were willing to accept the business plan of the private equity group with little downside financial modeling built into the underwriting. Why? Because the private equity group promised to "be there" if the borrower hit a turbulent patch of air. "Furthermore, the financial institution felt that if they didn't do it, someone else would do the deal and they'd be left on the sidelines. If you wanted to hit budget, lenders had to play in an overheated and aggressive market," according to Ken Wendler of Atlas Capital Advisors in New York. Often, the restaurant chain had a good brand name that lenders could take comfort in. In fact, some lenders were willing to make trademark loans based on a valuation/appraisal of the restaurant brand.

Fast-forward to today. Restaurant deals are keeping many lenders up at night. The perfect storm of high gasoline prices, a weak job market and soaring materials costs, like cooking oil, meat and wheat, have knocked many casual-dining chains on their heels. Many deals have gone on the watch list of lenders in anticipation of two to three years of poor performance and, in some cases, the unwillingness of private equity groups to put any more money into the deals, behind an already highly leveraged situation where their positions might already be in jeopardy.

Although it may be true that borrowers are reluctant to switch lenders in today's environment, many are now finding they have no choice. With continued liquidity issues, many lenders are taking advantage of default scenarios to show their borrowers the door. Asset-based lenders that have kept their "powder dry" are finding many opportunities to grow their portfolios with "classic" ABL borrowers. Pricing has certainly become more attractive as "floors" have been instituted in many deals and margins have increased, according to Dan Krauss at Hahn & Hessen in New York. "Many transactions that were 'nestled' in the commercial departments of banks are being 'transferred' to their ABL groups. This move sometimes entails substantial culture shock to the borrower, which is not used to conventional ABL requirements such as cash dominion, collateral formula–based borrowing bases and extensive reporting and examination/inspection rights. We certainly expect this trend to continue," say Krauss.

A Rolling Loan Gathers No Loss

Part of the increase in aggressive loan structures can be laid at the feet of hedge funds. The lack of regulation allowed some hedge funds to advance funds into troubled situations in order to avoid default with current lenders. In some situations, hedge funds were even granted warrants or ownership in the company. One agent told us that a hedge fund advanced funds to a troubled borrower through a side agreement so that the borrower wouldn't trip a covenant, over the objections of the lender group. This allowed managers to continue doing what they were doing, even though they were simply adjusting the angle of the aircraft as it plummeted into the ground.

ALTHOUGH IT MAY BE TRUE THAT BORROWERS ARE RELUCTANT TO SWITCH LENDERS IN TODAY'S ENVIRONMENT, MANY ARE NOW FINDING THEY HAVE NO CHOICE.

We hear of other situations where the company hits an air pocket, and the private equity group offers to buy the senior lenders out at severe discount. The resulting heartburn from this type of move by the private equity group slows the decision-making process down in the senior lender group. An unsettling thought for some alternative-finance lenders is private equity groups buying up the senior debt of a portfolio company at a discount, then putting the squeeze on the second-lien, subordinated debt and mezzanine layers. The immediate response that comes to mind is equitable subordination — the private equity group's piece of debt might be deemed to be equity. However, there are instances in the marketplace where private equity groups have set up special-purpose entities that are 49% owned by the private equity groups. This structure is intended to avoid cancellation-of-debt tax issues, but they also may avoid equitable-subordination issues. This issue may only be decided in the courts, but the threat of it has unsettled some lenders that are sandwiched between senior debt and equity.

Now, some senior lenders are specifying tight anti-assignment language in loan agreements, so that the company's ability to swap out stringent lenders for more compliant lenders is blocked. However, this type of restriction was absent in most legacy deals.

Every business cycle seems to bring along with it purportedly new and novel legal theories that attempt to impose liability on lenders for their conduct in dealing with borrowers. Says Krauss, "The capital structures which have been created over the last five years have given counsel for creditor committees and trustees fertile ground for asserting causes of action against providers of capital that may be wearing multiple hats on the right side of the balance sheets. As in previous cycles, we are finding that lenders acting as prudent lenders need not fear that courts will buy into the lender-liability fad du jour. The courts have made it very clear that claims against debtholders for recharacterization of debt as equity or equitable subordination of their claims (which are distinct claims under the Bankruptcy Code) will not be sustained except in very unusual circumstances."

"For example, in recharacterization cases, the courts have held that great weight will be given to characterization of the transaction by the borrower and the lender and to the actual incidents of the underlying agreements and instruments. The courts will also consider the circumstances of a borrower in distress and recognize the legitimate concerns that a lender will have at that time in making a loan to such a borrower. So, for example, a fairly recent case held that it was not appropriate to recharacterize a loan as equity, made in a distress situation even where the lender acquired board designation rights," says Krauss.

According to Hahn & Hessen, the doctrine of equitable subordination should not be of concern to a lender properly exercising its rights as a creditor with respect to a borrower. As far back as the late 1980s, there have been attempts to impose "lender liability" on lenders based on the doctrine of equitable subordination (which permits a bankruptcy court to reprioritize a claim in bankruptcy). Suffice it to say that the danger typically surfaces when the lender's status begins moving from that of a third-party creditor to that of an insider participant in the borrower's business affairs. In addition, to sustain a finding of equitable subordination, inequitable conduct on the part of the lender must also be shown. In the case referred to above, the court found that minority board involvement by the lender did not in and of itself result in the lender having "control" over the borrower, nor did having a designee sit on the board result in the lender being an insider.

A principal concern is that many intercreditor agreements are untested, and the outcomes will only be decided in a court of law. Again, this keeps lenders up at night because of the inherent unpredictability of some judges.

According to Krauss at Hahn & Hessen, "The negotiation of intercreditor provisions continues to consume much of a transactional lawyer's time in documenting financing transactions. It has also been more the custom, rather than the exception, in the last two to three years for the bankruptcy heavyweights of the respective counsels' firms to weigh in regarding the crafting of the bankruptcy-related provisions of the intercreditor agreements. The senior-lien lender is clearly interested in retaining as much control and flexibility as possible in a bankruptcy proceeding, while the junior lien holder is looking to benefit from its status as a secured creditor following the commencement of a bankruptcy proceeding. Each side in this battle continues to rely on legal reasoning, deal leverage and, of course, the ever-present doctrine of market to push its position."

It's interesting to note that the market status of various provisions seems to have tremendous elasticity depending almost exclusively on the status of the lender as senior or junior. Where courts will come out on the enforcement of these provisions in a bankruptcy proceeding is anyone's guess. "Two recent decisions have come out differently on the issue of whether an intercreditor agreement can alter the voting rights of the junior lender. As we know, intercreditor agreements attempt to deal with a myriad of issues involving alteration of a junior lienors' rights in a bankruptcy proceeding including voting rights, adequate projection, post-petition financing arrangements, section 363 sales, etc. In order to get deals done, creditors have accepted the uncertain risk of how courts will enforce these provisions. It is not clear how these issues will in fact be judicially resolved," says Krauss.

Strange Bedfellows

Capital structures became more complex as the decade wore on, because lenders beefed up their syndication desks, which became very effective at laying off risk. Capital pools such as CLOs became increasingly active in the commercial-finance marketplace, often buying $5 million or $10 million slices of syndicated deals with little due diligence. Their investment philosophy was simple: if they bought large numbers of small participations, then diversification would take care of the rest. (It was the classic portfolio theory. But like many theories, it has not stood up well in practice.)

Consequently, many syndicated loans have an agent that holds very little of the deal. In larger syndications, armies of CLOs represent the majority of participants in a deal, which can make restructuring very difficult. Adding to this problem is that most CLOs have no new capital to invest in a restructuring — all they can offer is a deferral of interest and principal, and waive defaults. This lack of "dry powder" means that CLOs may not be in a position to hire professionals to assist with any restructuring or see a restructuring through. The CLO may compensate for this by simply being obstructionist or selling its debt to a "loan-to-own" shop. Added to this is the compensation structure for management and the warehouse-funding mechanics of many CLOs, which incentivizes management to avoid defaults/write-offs and keeps the management fees coming.

There are signs in the marketplace that some hedge funds are trying to corral orphaned participations in transactions with the view to gaining control or at least a seat at the bargaining table. This is particularly vexing to second-lien lenders, which may not relish the idea of a bare-knuckles brawl with first-lien lenders that have a completely different set of objectives.

Other trouble spots occur when a lender group has lenders that bought into the deal at a price below par. What happens when one party thinks the loan is worth 98 cents, and others think it's worth 68 cents, based on their valuation of the business? That's when all of the parties may be exposed to some potential weaknesses in the intercreditor agreements. How about a senior bank group consisting of a traditional bank, a second-lien shop, and a private equity group that is a "loan-to-own" player? Or the senior lender that went into the original deal at par but gets a call from someone at the same bank's distressed trading desk who just bought in at 80 cents and wants to vote down the latest amendment? These situations often result in a stalemate while the company stagnates. They also make for very strange bedfellows.

We've heard about some situations where lenders in the same lending group are hiring their own individual legal counsel. The potential waste of time and money is very clear.

In the days of simpler capital structures, the entrance of distressed players into the fulcrum security historically would accelerate a transaction because the distressed investors often would buy in at a sufficiently low price that they would be willing to trigger a crystallization at a 20% – 30% return on that purchase price. The advent of multiple layers to the capital structure blurs the clarity as to which security is truly the fulcrum security, and it may make negotiations more difficult. This is especially true if some of the investors bought in at prices above that which the distressed players are willing to accept. Compounding matters is proliferation of second-lien paper, which in some instances may restrict the ability of a company to secure debtor-in-possession (DIP) financing or set the stage for a priming fight.

Sleeping with One Eye Open

Some borrowers may take advantage of stalemates in the capital structure, turning a deal into a zombie. We have seen situations where the participants in the capital structure are duking it out while management tries to play one side against another. Or there are those instances where managers get so distracted trying to please each participant in the capital structure that they take their eye off the ball from a day-to-day management perspective. They may have that deer-in-the-headlights look, afraid to make a decision involving business risk because they are afraid of displeasing the party that ultimately gains control.

In many underperforming companies, the incumbent managers do not fully appreciate how quickly the downward spiral can accelerate. Consequently, they are less likely to take the drastic steps needed to salvage the company. Once they are behind the curve in cost cuts, it can be difficult to regain control of the situation. Yet a complex capital structure can muddy the waters to the point where no management is effective.

IN MANY UNDERPERFORMING COMPANIES, THE INCUMBENT MANAGERS DO NOT FULLY APPRECIATE HOW QUICKLY THE DOWNWARD SPIRAL CAN ACCELERATE. CONSEQUENTLY, THEY ARE LESS LIKELY TO TAKE THE DRASTIC STEPS NEEDED TO SALVAGE THE COMPANY.

We saw one troubled company where a hedge fund bought into the capital structure at 10 a.m. one morning by purchasing a $5 million piece of the bonds, which had a total face value of $75 million. By 3 p.m., the hedge fund managers were on the telephone with the debtor's CFO, demanding nonpublic information by 5 p.m. or they would take action. The CEO and the CFO started to spend at least one hour each day placating this group, which was, at best, slightly in the money, but not by much. Management became obsessed with personal liability and all of the issues arising from running a company in the zone of insolvency. The hedge fund's attorney badgered the company's law firm, which cranked up the monthly legal bills for the debtor. Management became ineffective in the day -to-day management of the company because the managers were so distracted.

As the Water Hole Starts to Get Smaller, the Animals Begin Looking at One Another

Mad dog behavior on the part of a lender in the capital structure may add to costs and delays. We witnessed one instance where a manufacturing company's EBITDA had dropped from $15 million to $9 million and looked like it was headed further south. The private equity group conceded to the two senior lenders that the situation looked grim. One of the two lenders had a portfolio manager who relished the role of a mad dog. The other lender was represented by a gentleman. Every conference call was a screaming match, with obscenities and name-calling. On one call, the mad dog hung up on the other participants. The private equity group remarked that they wanted to take the mad dog out behind the shed and shoot him. The gentleman was able to convince the private equity group to step aside, which was the right thing to do. The private equity group told the gentleman that, if he was not one of the two lenders, they would have done everything in their power to poke the mad dog in the eye with a sharp stick — or in business terms, not handed "the keys" to the lender group.

One theme that seems to run through water-cooler conversations about hedge funds is the notion of shorting a company while buying into its debt. The recent SEC investigation into short selling touches on an issue that has raised suspicions in lender groups that unregulated lenders and investors have shorted a company through derivatives while having a long position in the company's debt.

The SEC's ongoing subpoena of hedge funds may be quite revealing about who has been shorting whom. According to *The Wall Street Journal*, the battle between regulators and short sellers has a long history — dating back at least to the South Sea Bubble of the early 18th century — and short sellers have usually won. It's hard to prove that short sellers manipulate markets or that they perpetuate false rumors that pummel stocks. Notwithstanding this lack of transparency in the marketplace, the suspicions that someone who is long in the senior paper is taking a short position in the stock can exacerbate tensions among lenders.

Mark Twain: Differences of Opinion Make For Good Horse Races

So it's clear that much of the sword fighting will take place around the issue of where the fulcrum security is located in the capital structure. This, of course, all rests on valuation and collateral.

In determining the fulcrum security in a company — who's in the money — it's important to look at collateral.

Who is collateral-good in the capital structure? Inventory, machinery and equipment , and real estate appraisals have been very strong in the last five years, what with the strong economy in most sectors. However, we hear from a range of lenders that appraisals are starting to soften, even for retailers where appraisals have usually been dead on.

Over the past two years, a significant number of plant closures have occurred across a broad spectrum of domestic industries, according to Steve Krakower at Continental Plants, a New York City equipment appraisal and liquidation firm. Difficulties in the automotive industry have forced the closure of metalworking and plastics facilities. The woodworking industry has seen the loss of a significant base of operations relating to both furniture manufacturing as well as the slowdown in housing construction. The textile industry, already down to a small fraction of previous levels of manufacturing after a series of closures throughout the past two decades, continued to experience significant plant closures. The closing of these facilities has created a surplus of used machinery in these markets, forcing down machinery value and necessitating the sale of assets into new markets. Only very late-model machinery continues to maintain its value in the domestic markets.

USED MACHINERY IN THE METALWORKING INDUSTRY HAS SUFFERED LOSSES OVER THE LAST TWO YEARS DUE LARGELY TO THE CLOSURE OF NUMEROUS AUTO PLANTS. THE CLOSING OF THE AUTO PLANTS HAS FORCED MANY SECOND-TIER MANUFACTURERS OUT OF BUSINESS AND PLACED AN ABUNDANCE OF MACHINERY ON THE MARKET.

Let's Look at Some Sectors

Used machinery in the metalworking industry has suffered losses over the last two years due largely to the closure of numerous auto plants. The closing of the auto plants has forced many second-tier manufacturers out of business and placed an abundance of machinery on the market. Late model computer numerical control (CNC) machinery (five years old or less) has been selling well but has dropped off in the last six months, according to Gary Treisman of Trader Machinery. Newer machinery is still able to be sold domestically. More and more of the older, conventional metalworking machinery is being converted to scrap in lieu of sufficient buyers.

Stock parts manufacturers in all segments of the metalworking industry are suffering. Job shops providing high-precision work, small orders and short-timeframe jobs are getting by but hardly prospering.

The woodworking industry, specifically furniture manufacturers, have suffered losses and experienced decreasing orders since mid-2006. For example, Ethan Allen has eliminated all of its U.S. manufacturing operations over the last several years. Furniture Brands International will be down to 17 plants within the next year from 34 plants just four years ago. During July alone, three major furniture plants have been closed, affecting over 1,000 employees.

According to Krakower, "This has lead to a decrease in machinery values across the board. Used machinery values in general are down by as much as 30%. CNC machinery less than five years old is still generating interest in the U.S. Older machinery is difficult to sell. Niche operators are doing well. Stock furniture manufacturers are suffering due to cheap imports."

The present demand for used textile machinery in the domestic market is at an all-time low, with the exceptions of late-model carding, ring-spinning and weaving machinery. Users consist of those remaining manufacturers that are trying desperately to compete by upgrading their machinery whenever possible and with the greatest economy.

In the past 24 months, we have continued to see a significant number of plant closings in this beleaguered industry. Over 100 facilities have closed and over 40,000 jobs have been lost. Machinery values average 10% to 15% less than one year ago and as much as 25% lower than two years ago.

As with metalworking, the domestic plastics industry has experienced difficulties relating to the automotive industry. In addition, sharp increases in the cost of resin over the past few years have severely affected the industry. Numerous plant closures have resulted in a surplus of plastics machinery in the domestic market, including injection molding, extrusion and blow-molding equipment. This surplus has naturally put significant pressure on machinery values, reducing values for all but very late-model equipment, according to Krakower.

"Recoveries on retail inventories are holding up reasonably well, given the turbulence that some retailers are now experiencing," says Tom Scotti at Gordon Brothers Group in Boston. For example, the recoveries on Linens 'N Things have been satisfactory. The exceptions are big-ticket items such as furniture and "nice-to-have" products like jewelry — a case in point are the Wickes Furniture recoveries, which did not hold up well in the recent liquidation. According to Gordon Brothers Group, its Recovery Volatility Indicator is "high" for assets in the home-improvement and building supplier, consumer electronics, textile equipment and jewelry sectors.

Let's Look at Valuations

EBITDA, in most sectors of the economy, is showing cracks. Unless a borrower is heavily dependent on exports and therefore has enjoyed the five-year decline in the dollar, most companies are now being affected by rising materials, transportation and energy costs. The EBITDA modeling done in the 2004–2007 period was exuberant in many cases, with no buffer built in for shocks.

Take the recreational vehicle sector as an example. In 2005, aggressive EBITDA growth was built on twin ideas: the baby boomers were inheriting record amounts in this generation of wealth-transfer, and people who spend $100,000 to $250,000 for a vehicle are not concerned with the price of gas. Therefore, baby boomers would flock to RV dealer showrooms. One factor that has pushed the RV sector into the ditch has been the drying up of financing for RVs, which is a development no one would have imagined in 2005. Many people who bought RVs in the past decade, especially in the industry's post–September 11 boom, financed the purchases with home-equity loans. Many prospective buyers can't get such loans in today's tight credit market.

Other factors have crept into the picture that are putting downward pressure on EBITDA.

Take the consumer products sector. In the latest round of buyouts since 2002, private equity firms bought companies that were domestic manufacturers once upon a time. These companies then morphed into design/import companies, importing everything from towels to garden hoses. They outsourced manufacturing to China and rode the low-cost train to profitability. Now, with the Chinese currency rising inexorably in the last two years — the baloney in the sandwich between the Chinese factories and the American retailers — the importers are under significant pressure. Recent changes to Chinese labor practices are putting significant upward pressure on costs. And some consumer products companies don't know if the retailers are friend or foe — will the retailer go directly to China, or perhaps visit the importer's new product booth at the giftware show, then have knock-offs made behind the company's back?

Look at gaming machines — the one-armed bandit. Two years ago, the casinos were lined up to get hold of these machines. Fast-forward to today. Some casino developers are folding in their cards as a chaotic U.S. credit market deals them a losing hand on the building boom that has turned much of the Las Vegas Strip into a construction zone.

The gaming machine manufacturers are being told that the casinos need fresh graphics on the machines in order to keep their casinos humming — faster, faster. The constant switchover to fresh graphics is now killing the EBITDA of the one-armed bandit companies. As a result, figuring out who holds the fulcrum security at many of these manufacturers is difficult.

Two Halves of the Clamshell

The valuation clamshell has two parts: EBITDA and multiples. This clamshell is key to determining who holds the fulcrum security in a sword fight.

Let's look at multiples. You would think that with all the issues in the credit markets, the average EBITDA multiple in LBO deals would more closely reflect current economic and credit conditions, and have reset downward. However, that does not seem to be the case, according to Robert Blumenfeld of Bryant Park Capital and president of the New York City Chapter of the Association of Corporate Growth. "Beginning in Q1 2005, EBITDA multiples increased from 6.9x to an exuberant high of 10.3x in Q3 2007 (taking place just prior to the credit meltdown in the summer of 2007). Since then, current EBITDA multiples have ranged from 8.7x in Q4 2007 to 8.3x in Q3 2008. So what's happening? Why have EBITDA multiples not ratcheted down to levels that reflect current economic conditions similar to those prior to 2005? Is it really a buyer's market? Yes and no, depending on the quality of the company," says Blumenthal.

Most business owners have an inflated sense of their companies' worth, and this is supported by a feeding frenzy of equity investors looking to put their funds to work. This has not only provided a false support level, but it has also inflated the values of secondary investment opportunities. Currently, sellers seeking yesterday's valuations are sitting on the sidelines with the belief that the good times will roll again.

Additionally, it's estimated that there is $820 billion in uninvested capital held by U.S. buyout firms, with an additional $1.6 trillion of cash sitting on corporate balance sheets (Moody's) chasing alpha. So there's still plenty of money around for the right deal.

RIP: Real Estate OpCo – PropCo

One of the big question marks surrounding valuation is real estate. Commercial retail real estate values appear to be on a downward slide. For example, certain mall owners looked like clever bargain shoppers in recent years when they bought dozens of stores operated by Mervyn's in hopes of finding new tenants at higher lease rates if the big retailer collapsed. With the recent bankruptcy filings of Mervyn's, Linens ' n Things, Steve and Barry's and scores of chain restaurants, coupled with an economy that's foundering and fewer retailers expanding, those bets are turning out to be less sage than first thought. With banks facing capital pressures, the wave of new bank-branch expansion is also slowing dramatically. Finding new tenants to occupy the spaces could be difficult in a deteriorating retail environment.

So the new lending environment may be lukewarm to deals where the operating credit is associated with an entity that is different from the operating company ("Opco-Propco deals"). This collateral structure was the hallmark of some retailer and restaurant deals that were done in the heyday, but it's hard to see much enthusiasm in the marketplace for this structure in today's softening commercial real estate marketplace.

Toe-Tagging the Borrower

Some struggling companies are choosing to liquidate via Chapter 7 rather than try to restructure in bankruptcy court. Many companies are caught between a slowing economy, a lack of bankruptcy financing options due to industry consolidation and the credit crunch, and the legacy covenant-lite lending agreements that allowed their financial situations to worsen before creditors could intervene.

This lack of covenants has raised the fear that companies will deteriorate to the point of no return while the lenders look on in horror. For example, the historically low interest rates have enabled many borrowers to have mediocre performance but make their interest-coverage covenants with ease. We saw one situation where the lack of covenants allowed a $1.1 billion company to operate on daily availability of $1 million. This company had suffered an erosion of EBITDA from $80 million to $2 million, and the lender group had limited power due to the covenant-lite structure of its loan.

In the collapse of Metromedia Restaurant Group (owner of the Bennigan's and Steak and Ale concepts), the company bypassed Chapter 11 altogether. After filing for Chapter 7 bankruptcy, the parent company of these national chains immediately closed 200 restaurants. According to *The Wall Street Journal*, the liquidation filing represented one of the largest Chapter 7 bankruptcies of a restaurant chain in recent history and was the most extreme example yet of how midprice , sit-down restaurants are experiencing one of their worst periods in decades. The chains had been in negotiations with lenders since last year to stave off a filing, while closing 75 restaurants and looking for a buyer. The abrupt shutdown caught employees and customers by surprise; on a Monday, managers at Bennigan's and Steak and Ale were called or e-mailed and told not to open restaurants on Tuesday morning. Employees were told there wouldn't be enough money to pay them for the rest of the week, according to *The Wall Street Journal*.

Indeed, some lenders are worried that some companies will go straight from the line-lending groups into liquidation, forestalling the involvement of the workout group of a bank until the borrower needs to be toe-tagged. Usually, the tripping of a covenant allows the lender to request that a turnaround firm be hired by the company. Most lenders agree that getting a turnaround firm into a borrower as early as possible is a good idea. The turnaround firm can translate the borrower's story into language that the lender can understand and work with. But it's hard for a turnaround firm to do much with a company that's been toe-tagged.

LOOKING BACK AS THE YEAR DRAWS TO A CLOSE, IT IS HARD TO BELIEVE HOW MUCH THE COMMERCIAL FINANCE LANDSCAPE HAS CHANGED OVER THE PAST YEAR.

Looking Ahead

Looking back as the year draws to a close, it is hard to believe how much the commercial finance landscape has changed over the past year.

Commercial finance shops that were industry leaders for decades have been hamstrung by liquidity and cost-of-funds issues. New players have arrived in the marketplace — both start-ups as well as banks getting into ABL and leveraged finance deals — unburdened by legacy deals that were poorly priced or aggressively underwritten. The job market has been a merry-go-round of change, with entire teams moving from one commercial finance shop to another.

The financial crisis that began 15 months ago has entered a new, far more serious phase. Hopes that the damage could be contained to a handful of financial institutions that made bad bets on mortgages have evaporated, according to *The Wall Street Journal*. New fault lines are emerging beyond the original problem — troubled subprime mortgages — in areas like credit-default swaps, the credit insurance contracts sold by AIG and others. There's also a growing sense of wariness about the health of banks.

Hedge funds could be among the next problem areas for banks and the financial marketplace. Many hedge funds rely on borrowed money to amplify their returns, and some banks are getting worried about the ability of hedge funds to manage their loans in a down market. With banks under pressure, many hedge funds are less able to borrow money now, pressuring returns. The recent Chapter 11 bankruptcy of hedge fund SageCrest in Greenwich, Connecticut, may presage more hedge fund failures in the next 24 months.

Few financial crises have been sorted out in modern times without massive government intervention. Increasingly, U.S. officials are coming to the conclusion that even more might be needed. Some people fear that the dwindling ranks of investment banks, coming at a time when commercial banks are pulling back on their own use of capital, will prolong the credit crunch.

What this means is that the legacy deals with weak structure and pricing are now a thing of the past. And the sword fighting that we'll see in 2009 among lenders and investors will leave so many scars that no one will be rushing to do covenant-lite and toggle deals anytime soon. **TSL**

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