

GUEST COLUMN

By Douglas L. Furth
and Andrea B. Schwartz

Douglas L. Furth
and Andrea B. Schwartz
Golenbock Eiseman Assor Bell
& Peskoe LLP



The Economics of Distressed Investing

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Distressed debt securities can present excellent opportunities for value investors, but a word of caution is in order. In addition to evaluating the economics of investing in such securities, there are features of the reorganization process that can have a significant impact on investment returns.

First, out-of-court restructurings tend to be less expensive and less time-consuming than bankruptcy cases, which can make them worth attempting. Depending upon the case, there may be business or legal requirements, such as the need to reduce trade debt or obtain bondholder consents, which are best addressed in bankruptcy. The more complex the restructuring, the more difficult it is to restructure out of court. It can be a mistake to purchase a security on the assumption that a quick restructuring can be accomplished without the time and expense of a bankruptcy filing.

Following insolvency, unsecured debt takes on many of the characteristics of preferred stock. Most notably, debt service payments usually accrue pending consummation of a restructuring. To the extent that debt is "equitized," not an atypical outcome, regular cash payments should not be anticipated absent a post-closing realization event such as a sale or refinancing. Obviously, this reality has an impact on internal rates of return.

Secured debt is more complex. While in bankruptcy, holders of secured debt instruments may, with bankruptcy court approval, receive periodic "adequate protection" payments designed to protect the holder from a decline in the value of its collateral during the reorganization process. It is difficult for even the most experienced veteran of the bankruptcy wars to predict with precision the likelihood of receiving adequate protection payments or the amount of such payments if approved by the bankruptcy court.

NOT SO ABSOLUTE

The absolute priority rule — which in theory is a bedrock principle of bankruptcy law — holds that debt gets paid in full before equity receives anything. In practice, strict adherence to the absolute priority rule is the exception. It is often less expensive to give equity a "deal tip" than it is to expend the time and incur the expense of proving in court why equity should be wiped out.

Similarly, it can often be necessary to give management "walk away money" in order to persuade them to abandon pipe dreams about reorganization and to sell the business. The old saying that a bad settlement beats a good litigation is often true. While it is not suggested that debt holders open up their wallets the minute equity barks — quite the opposite — smart investors know when it is time to cut a deal. Good distressed

debt investors will budget for deal tips and walk away money.

The good news is that bankruptcy courts are less tolerant of dilatory tactics than they were 15 years ago. The bad news is that everything still takes longer than expected. Some bankruptcy judges are better than others at putting a case on a schedule and making sure that the parties stick to it. An experienced bankruptcy practitioner can offer advice regarding the tendencies of different judges. Nonetheless, expect unexpected delays and budget for them when determining how much should be paid for a security.

PROTECTING YOUR POSITION

The purchase price for a distressed security may not be the only cost that an investor has to factor into its investment decision. Typically, these are not purely passive investments. The best way to keep abreast of and influence developments in a reorganization is to sit on a creditors' committee. This is certainly a time commitment and, due to confidentiality arrangements, may limit an investor's ability to trade out of a position.

Less frequently, more affirmative and more expensive measures may be necessary to protect an investment. Senior bank creditors may attempt to force a sale at a price that protects the banks but does little or nothing for bondholders. Legal expenses often slow down the banks and prevent a "fire sale." Ultimately, bondholders may be confronted with a choice between taking out the banks and settling for an unreasonably low return. **B**

Douglas L. Furth is a partner and Andrea B. Schwartz is an associate of Golenbock Eiseman Assor Bell & Peskoe LLP in New York.

For information on authoring a Guest Column, call Meghan Leerskov at 707-933-2800 ext. 19.