THE ART OF Distressed M&A

Buying, Selling, and Financing Troubled and Insolvent Companies

H. Peter Nesvold

Jeffrey M. Anapolsky

Alexandra Reed Lajoux

McGraw Hill

New York Chicago San Francisco Lisbon London
Madrid Mexico City Milan New Delhi
San Juan Seoul Singapore
Sydney Toronto

Free downloads at
www.ARTofMA.com

The McGraw·Hill Companies

1 2 3 4 5 6 7 8 9 0 DOC/DOC 1 5 4 3 2 1 0

ISBN 978-0-07-175019-6
MHID 0-07-175019-3

Library of Congress Cataloging-in-Publication Data

Nesvold, H. Peter.
Art of distressed M&A / by H. Peter Nesvold, Jeffrey M. Anapolsky, Alexandra Reed Lajoux.
p. cm.
Includes index.
ISBN 978-0-07-175019-6 (alk. paper) 1. Consolidation and merger of corporations.
2. Consolidation and merger of corporations—Finance. I. Anapolsky, Jeffrey M.
II. Lajoux, Alexandra Reed. III. Title. IV. Title: Art of distressed M & A.
V. Title: Art of distressed M and A.
HG4028.M4N49 2011
338.8'3—dc22 2010029965

McGraw-Hill books are available at special quantity discounts to use as premiums and sales promotions or for use in corporate training programs. To contact a representative, please e-mail us at bulksales@mcgraw-hill.com.

This book is printed on acid-free paper.

CONTENTS

PREFACE

Every community has its hospitals, its graveyards, and its institutions offering salvation. Business is no different. Blocks from the New York Stock Exchange, where public companies go to be born, stands the Bankruptcy Court for the Southern District of New York, where companies go to die—or to be reborn.

A business does not become "distressed" overnight, nor can it recover in a day. There is a long period before, during, and, for the happy few, after bankruptcy. This book focuses on what happens *during* distress—and even more narrowly, during the purchase or sale of a distressed entity. All too often, the owner or potential acquirer of a business will perceive it as being healthy until reality proves otherwise. Few experiences are as disappointing as the recognition that a once-thriving business is going down the tubes. Such recognition can bring out both the best and the worst in business managers. One CEO may work for a dollar a year; another may cook the books. For most, the reality is something in between: an effort to save costs while putting the best possible face on things within the limits of the law.

This book is for those who, by destiny or by choice, have found themselves dealing with an unmistakably distressed property. Transacting business in such a climate requires a balance between passionate commitment and cold detachment. All parties involved must be committed to preserving as much value as possible, yet they must refrain from throwing good money after bad. There comes a time when the bankruptcy pros must take over and practice their art during the process of reorganization under bankruptcy laws. We call this the *art of distressed M&A.*

THE ART OF DISTRESSED M&A

While there are many books about the process of going public, there are not many guides to the other side of town—the difficult process of unwinding a business after years and sometimes decades or even centuries of operation.

While many investors, executives, advisors, and academics are familiar with traditional mergers and acquisitions, the world of distressed M&A remains a niche business that has been left to specialists. However, as one M&A commentator recently noted:

> For many years, the business of advising and financing bankrupt companies was small, specialized, and isolated. No more. If the insolvency wave of 2009 demonstrated anything, it's how tightly linked it is to the larger fluid deal economy. That makes the historic surge of bankruptcies in that year a watershed moment.[1]

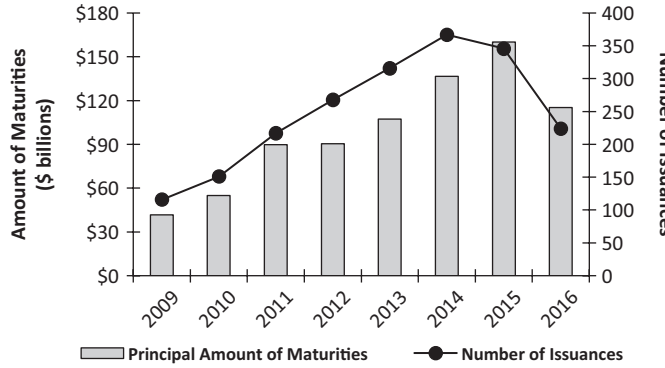
Another industry expert noted that recovering from this watershed will take time: "Even if there's an economic recovery, an up-tick, it's going to take time for us to work through all of the companies that are highly levered. . . . Recovery is one thing, but recovery from the distressed cycle I think is going to be prolonged."[2]

As we go to press in late 2010, distressed mergers and acquisitions continue to be a part of the M & A landscape after a year of notable increase. According to Thomson-Reuters Legal Advisory League Tables, M&A transactions involving bankrupt U.S. companies in 2009 rose to 17 percent of all deal volume during that year (versus 2 percent in 2008).[3] Pessimists will see *distressed* M&A; optimists will see distressed *M&A*, noticing that financial markets are willing to fund recovery. Dubbed "bankruptcy beauties,"[4] companies like Visteon, General Growth Properties, and Six Flags are making news as comebacks.

Even well into an eventual economic recovery, a thorough knowledge of the unique complexities of distressed M&A is a "must have" tool for nearly every M&A professional. Consider, for instance, the current maturity schedule of the high-yield bond market—the aggregate amount of maturities is projected to nearly quadruple from 2009's level of $42 billion before peaking at more than $160 billion in 2015. Term loan maturities appear even more draconian—being projected to rise from only $7.7 billion in 2009 to an astonishing $217.8 billion in 2014 (see Exhibit P-1).

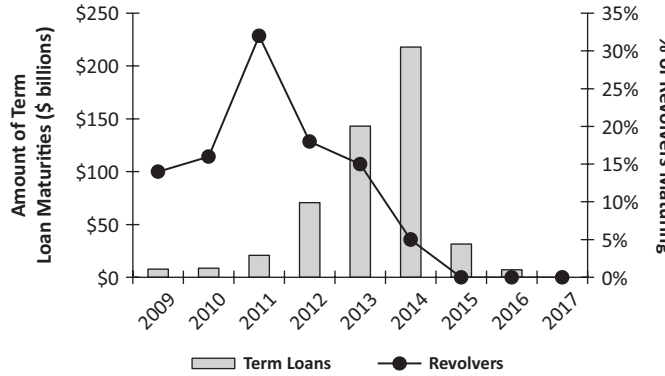
Much of this debt was issued in an environment with historically tight credit spreads and covenant flexibility—an environment that few

	2009	2010	2011	2012	2013	2014	2015	2016
Principal Count of Maturities	$42	$55	$90	$91	$107	$137	$160	$115
No. of Issuances	116	151	217	268	316	367	346	224



(a)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Term loans	$8	$9	$21	$71	$143	$218	$31	$7	$0
Revolvers	14%	16%	32%	18%	15%	5%	0%	0%	0%



(b)

Source: Deutsche Bank

Exhibit P-1 (a) Projected Annual Maturity Schedule, High-Yield Bonds (b) Projected Annual Maturity Schedule, Term Loans and Revolvers

credit professionals expect to see again in their lifetimes. In fact, the looming flood of high-yield and term loan maturities may cause another round of serious disruption in the credit markets in the 2011–2012 time frame. In a nutshell, the credit excesses of the last decade have set the stage for a protracted distressed M&A cycle.

As a result, an ever-increasing number of financial and strategic investors are being presented with deals for distressed companies. In fact, one could argue that *every* company that is in Chapter 11 bankruptcy is "for sale"—that is, it will be sold either to a third party or, in effect, to the company's creditors by the conversion of their debt into equity. Many asset purchasers have known for years that the assets of distressed businesses, including companies in bankruptcy, offer tremendous opportunities for potential buyers in many respects. But buying the assets of a company in bankruptcy is not as simple as haggling at a rummage sale. Distressed mergers and acquisitions—encompassing a wide array of transactions related to bankruptcies, restructurings, recapitalizations, and liquidations—involve seemingly innumerable issues that are typically not present in more traditional M&A of going concerns. Consider some examples:

- What issues should the management of a distressed business consider when choosing among its various options for selling assets: out-of-court restructurings, loan-to-own scenarios, debt buybacks, prepackaged bankruptcies, and so on?
- How do fiduciary duties of care and loyalty apply when directors are contemplating the purchase or sale of a distressed company? How can directors balance the interests of shareholders with other stakeholders in their deliberations?
- How does the valuation of a business that is in financial distress differ from that of a going concern? What is the legal framework for valuation that a bankruptcy court will apply during a Chapter 11 proceeding, and why is it critical to understand this?
- How should a distressed business approach cash management and debtor-in-possession (DIP) financing issues before filing and during bankruptcy?
- How can a purchaser protect against potential successor liability claims—i.e., future tort claims that, although they arose prepetition, do not become known until after the bankruptcy filing?
- Under what circumstances might the target's tax attributes, including a history of net operating losses, survive a potential sale?
- What steps can a buyer of a distressed business take to mitigate the risk that creditors may attempt to set aside the deal, post-closing, on "fraudulent transfer" grounds?

- Under what circumstances might a bankruptcy court void a pre-petition sale? What steps can a proposed buyer take to mitigate this risk?
- What are some best practices for navigating a Chapter 11 sale process without acquiring the taint of being considered "damaged goods" by suppliers, customers, and other constituents? By the same token, how can a buyer manage the risk of the loss of key employees?
- What strategies for mitigating legal risks should a buyer consider, given the complexity of a Chapter 11 process and the smaller number of representations, warranties, and post-closing indemnifications that are common in such processes?
- What are some other "ticking time bombs" that need to be detonated before getting involved in a distressed company sale?

A PERENNIAL CONCERN

Contrary to popular belief that distressed M&A is countercyclical to the overall economy, companies become distressed in all economic periods. While all industries are likely to experience more pronounced distress when the economy enters a recession, and distressed acquisitions should be more plentiful during these periods, distressed M&A occurs during robust economic periods as well.

As B.C. Forbes, the founder of *Forbes* magazine, quipped, "If you don't drive your business, you will be driven out of business." Indeed, while there has always been change in business, the rate of change has accelerated in each decade as a result of technological innovation, globalization, deregulation, financial engineering, and other factors that are designed to promote capitalism. In prior periods, executives and directors could take a cautious wait-and-see approach to managing the changes in their industry by letting others lead and learning from their mistakes. No more. Today, industry laggards who fail to adjust quickly to their markets no longer enjoy the luxury of a second chance. Complacency is penalized, and risk taking is mandatory. Increased pressures from lenders, heightened shareholder demands for returns, intensified competition with lower barriers to entry, more efficient supply chains, and higher expectations for worker productivity make effective decision making more and more complex for executives and boards of directors. As a result, fewer and fewer are getting it right the first time.

Taking calculated risks and making educated guesses may work most of the time, but not all the time. As businesses increasingly are operating in a zone of "one strike and you're out," the rise of distressed M&A is inevitable.

In this book, we seek to reveal the terminology, concepts, trends, and techniques involved in distressed M&A. While becoming conversant in these areas is an important start, distressed M&A will inevitably require the skill and expertise of advisors such as bankruptcy attorneys, restructuring advisors, and turnaround consultants, because these areas are constantly evolving. This evolution in the art of distressed M&A is being driven by new rulings by bankruptcy courts, changes in the capital markets, increasing sophistication among distressed investors, the growing internationalization of corporate entities, and regulatory updates by Congress. As a result, it is impossible to completely master every aspect of distressed M&A, which is why we characterize this area as an art, not a science.

In the first section, we seek to explain the general concepts and provide a background for distressed M&A, including the nature of business failure, alternatives for the distressed business, and recent trends and useful statistics. Our goal is to provide the big picture before getting into details. We also highlight the key differences between traditional M&A and distressed M&A.

In the second section, we delve into the bankruptcy players. While some of these players may be similar to those in traditional M&A, there are several unusual twists that arise in distressed M&A. We do not assume that the reader has a law degree, but having formal training in legal concepts concerning debtors, creditors, contracts, and bankruptcy is always helpful. In this section, we first review general concepts regarding debtors and creditors. Next, we discuss secured creditors in greater detail. We then focus on several issues involving unsecured creditors. Finally, we explain the role of advisors and other players in the distressed M&A process.

In the third section, we focus on the common pitfalls of a distressed M&A transaction, including accounting, tax, and legal issues. As the reader may be aware, we have also written other books in The Art of M&A series that provide significantly greater detail on each of these topics. Therefore, we designed this section of this book to highlight the special aspects of these topics that are involved in distressed M&A and assume that the reader either is generally familiar with each topic already or is planning on reading one of our other books as well.

In the fourth section, we integrate all of the material on the bankruptcy players and the mechanics of a distressed M&A transaction into deal

strategies, including principles of distressed company valuation, sponsoring a plan of reorganization, bidding in a 363 sale, and loan-to-own investing. Often a potential acquirer needs to consider all three of these techniques and others as well as part of an overall strategy in order to choose the best path and to adjust course as a situation develops. In this section, there are many additional terms, concepts, and issues that assume that the reader has reviewed the prior chapters. In our last chapter, we discuss financing and refinancing. Cash is the lifeblood of companies. Just as its absence can cause a death spiral, so an infusion can spark recovery. Finally, our conclusion offers some principles for business before, during, and after times of distress.

This book provides instruction from both the buyer's and the seller's points of view. As in all M&A transactions, it is essential for each side to understand the other's perspectives, motivations, and relationships in order to negotiate a deal. Unlike traditional M&A, however, distressed M&A typically involves many more twists and turns in navigating between the beginning of the process and the closing of the deal.

Unlike other texts, this book has an unusual amount of cross-references because many terms, concepts, and issues are touched upon in multiple chapters. While we naturally recommend reading this book from start to finish at least once, we expect that in practice, a reader will often move nonsequentially from chapter to chapter. Therefore, we attempted to provide a logical outline of various complex topics, but also noted when we anticipated that the reader would want to also refer to another part of the book in order to understand the overall issue.

We sought to differentiate this book from other publications on similar topics by creating a cross-disciplinary narrative that spans finance, accounting, law, tax, negotiations, and management. We distill these disciplines down to the topics that are most relevant to M&A, leaving the other issues that debtors and creditors may face in distressed situations for other authors to address. While there are other texts that may address these disciplines in greater depth than this book, we believe that this book is unique in integrating them in one package. Regarding bankruptcy, unlike the leading bankruptcy treatises, outlines, and textbooks, we focus exclusively on business bankruptcy topics and deliberately avoid consumer bankruptcy issues. With respect to the geographic scope of this book, we limit our discussion to U.S. law and domestic M&A, and do not address international and multinational issues.

ADDITIONAL INFORMATION

Our research has benefited from a variety of resources and forums. While there are many excellent sources of information on bankruptcy law and distressed M&A, we suggest three organizations in particular:

- The *Turnaround Management Association (TMA)*, which bills itself as the only international nonprofit association dedicated to corporate renewal and turnaround management. Established in 1988, TMA has more than 9,000 members in 46 chapters, including 32 in North America and 14 abroad. For additional information, see www.turnaround.org.
- The *American Bankruptcy Institute (ABI)*, one of the largest multidisciplinary, nonpartisan organizations dedicated to research and education on matters related to insolvency. Founded in 1982, ABI membership today includes more than 12,000 attorneys, auctioneers, bankers, judges, lenders, professors, turnaround specialists, accountants, and other bankruptcy professionals. The organization publishes the *ABI Journal* (10 times per year) and the *ABI Law Journal* (semiannually), among other electronic and print publications. For more information, see www.abiworld.org.
- The *Association for Corporate Growth (ACG)*, which deems itself a community for middle market M&A deal makers and business leaders focused on driving growth. The organization, founded in 1954, has subsequently grown to more than 12,000 members organized in 54 chapters throughout North America, Europe, and Asia. For more information, please visit www.acg.org.

In terms of bankruptcy data and related editorial information, we also recommend a handful of sources:

- Subscription sources such as *The Deal* (also available online at www.thedeal.com), *Bankruptcy Week* (as well as its related Web site, www.bankruptcydata.com), and www.debtwire.com.
- Government information provided to the public, such as the U.S. federal bankruptcy courts' Web site, which provides basic information on different aspects of the federal bankruptcy laws,

along with composite data on bankruptcy filings. For more information, visit www.uscourts.gov/bankruptcycourts.html.
- Finally, we suggest that readers watch for the launches of www.ArtofMA.com and www.macouncil.org, online resources that will provide additional resources and updates on broader M&A subject matter.

We hope that this book will be a useful reference for readers in many situations, including

- Executives who are concerned that their companies' futures are uncertain
- Owners who want to sell underperforming portfolio companies
- Corporate attorneys seeking to specialize in bankruptcy law
- Investment bankers interested in becoming restructuring advisors
- Seasoned operators making the transition to becoming turnaround consultants
- Hedge fund managers who want to understand bankruptcy sales for event-driven investing
- Buyout professionals who want to expand into turnaround investing
- Traditional lenders who are seeking to make DIP loans or provide exit financing
- Business and law school students who want to enter distressed M&A markets

The Art of Distressed M&A: Buying, Selling, and Financing Troubled and Insolvent Companies attempts to provide accurate, practical, and up-to-date answers to hundreds of questions that deal makers may have in this new environment. Like the preceding texts in The Art of M&A series, this one is organized in a question-and-answer format, moving from general to specific questions in each topic area.

What is your burning question of the moment? It may be as basic as "What is Chapter 11 bankruptcy?" or "Why do companies fail?" or as arcane as "What is a bankruptcy remote Entity?" Whatever you want to know about distressed mergers and acquisitions, you are likely to find the answers here—or at least a useful reference.

ACKNOWLEDGMENTS

Throughout this book, we have cited expert sources, and these are acknowledged in our notes. However, several individuals deserve special mention as reviewers of significant portions of this book. Myron "Mickey" Sheinfeld, a noted bankruptcy practitioner and scholar, kindly read Sections One, Two, and Four and provided wise counsel. Other expert reviewers and sources of good counsel included Janet Pegg, managing director, UBS Investment Bank; Deborah Hicks Midanek, principal, Solon Group; and Kevin Sullivan, managing director, Aon Corporation.

The authors wish to acknowledge the full McGraw-Hill team, including Mary Glenn, Jennifer Ashkenazi, Morgan Ertel, Pattie Amorso, and Maureen Harper. We also thank copyeditor Alice Manning, and proofreader Maggie Warren.

Endnotes

1. Anthony Baldo, editor, *The Deal* (2010).
2. John Rapisardi, co-chair, Financial Restructuring Department, Cadwalader, Wickersham & Taft, LLP.
3. For 2009 trends, see "Mergers and Acquisitions Review: Legal Advisors," Thomson-Reuters League 3. Tables for M&A, First Quarter 2010; available at http://online.thomsonreuters.com/DealsIntelligence/Content/Files/1Q10_MA_Legal_Advisory_Review_Final.pdf, last accessed November 2, 2010. For the new 2010 League Tables see *Distressed Debt and Bankruptcy Restructuring Review*, which includes all bankruptcy sales.http://online.thomsonreuters.com/DealsIntelligence/Content/Files/3Q10_Distressed_Debt_Bankruptcy_Restructuring_Review.pdf. In announcing the new League Table, Thomson_Reuters stated "In the face of an *uptick in distressed company transactions in recent years*, we have worked with leading restructuring advisory firms to create a standardized set of restructuring league tables, which cover all global regions and generate rankings of financial and legal advisors to distressed companies in connection with debt exchange offers, debt tender offers, bankruptcy sales, loan modifications, and debt retirement funded by equity offerings."http://online.thomsonreuters.com/DealsIntelligence/Content/Files/3Q10_MA_Legal_Advisory_Review.pdf
4. Mike Specter, "Bankruptcy Beauties: Once-Shunned Companies Look More Attractive—Once-Forsaken Firms under Bankruptcy Protection Are Looking More Attractive, and Generating Recoveries for Stakeholders Unheard of a Year Ago," *Wall Street Journal*, May 13, 2010.

SECTION ONE

The Big Picture

Before buying or selling a business with financial woes, it is helpful to start with some perspective regarding corporate bankruptcy.

Why do businesses fail? Chapter 1 of this book provides some basic statistics on how many have gone sadly south, and explains some of the fundamental differences between buying a healthy company and buying one that is distressed.

Chapter 2 of *The Art of Distressed M&A* explores restructuring alternatives for distressed businesses, including (1) workouts outside of bankruptcy court, (2) Chapter 7 liquidation for the orderly sale of a debtor's assets by a trustee, and (3) the better-known Chapter 11, which allows the debtor to continue operating while the company's capital structure is revamped in court.

In Chapter 3 of this book, we discuss some of the largest corporate bankruptcy filings to date, highlighting lessons that can be learned from those filings. We conclude with an overview of ways of investing in distressed debt and equity.

CHAPTER 1

Business Failures

Failure is simply the opportunity to begin again, this time more intelligently.

—Henry Ford, Founder, Ford Motor Company

OVERVIEW OF BUSINESS FAILURES

Why do businesses fail?

Businesses fail for the same reasons that they can succeed; failure and success are the two sides of the coin called risk. Just as the risks that businesses take are many and varied, so too are the reasons for business failure. However, the issues driving such failures fall into three general categories: industry, company, and management issues.

- *Industry*. Many businesses fail because of issues affecting their entire industry, such as macroeconomic factors, overcapacity, technological innovation, commodity cost spikes, foreign competition, turmoil in the capital markets, and regulatory change.
- *Company*. In other cases, the industry may be performing well, but a particular company experiences one or more problems, such as an overleveraged balance sheet, a product recall, an environmental disaster, a botched IT upgrade, the loss of a key employee, a union strike, uncollectable receivables, or unfavorable litigation.
- *Management*. Finally, even though the industry and the company are experiencing strong performance, financial distress may nevertheless be caused by issues related to mismanagement. These issues might involve fraud, generational transition, petty politics, and various instances of poor judgment, lackluster decision making, or misguided strategies.

Often the root causes involve more than one of the three categories, such as the failure to integrate a prior acquisition, which includes both the company's worsening performance and management's inability to execute its plan. This three-part framework is typically a good place to start when evaluating a distressed business for acquisition:

1. If problems within the industry are the main cause of the company's distress, the potential buyer will need to develop a view of how the trends affecting the industry will progress in the future. If the industry is cyclical, investing at the bottom of the cycle can yield solid returns. On the other hand, if the industry is plagued by chronic problems, then it may be difficult for an investor in a particular company to change the company, let alone the industry.
2. If issues within the company are the main cause of its distress, the potential buyer will need to assess whether an ownership change can fix these issues sufficiently to generate an attractive return on the overall investment (the current valuation plus any additional capital investment needed).
3. Financial distress that is primarily caused by management's ineptitude can often be the most attractive investment opportunity. If the new owner inherits a strong industry and company, then its key strategy may be to simply discontinue discredited decisions and encourage sound business judgment going forward.

Isn't bad management really the underlying cause of all these explanations?

There are certainly many investors who believe that good management can solve every business problem, but no human being can realistically be expected to work miracles. It seems unreasonable to expect management to be able to pinpoint the rise and fall of an industry cycle with complete accuracy. Similarly, it seems unfair to expect management to predict the precise outcome of every lawsuit, the customer reaction to every product launch, the impact of every competitive threat, and the severity of every product recall. While management may strive relentlessly to navigate perfectly through both calm and troubled waters, even the *Titanic* hit an iceberg. On the other hand, management teams will too often blame "a perfect storm"

for their misfortune and go too far in excusing their reckless behavior, inattention to detail, and flawed strategies.

Rather than simply blaming management for a company's downfall, it seems more reasonable to acknowledge that businesses need different types of talent to manage different challenges in different periods of their development. More entrepreneurial executives have strong talents for growing businesses, developing products and services, building new facilities, strengthening relationships, recruiting new employees, mentoring existing employees, and expanding profitability through top-line growth. Other business leaders excel at fixing broken processes, improving operational efficiencies, rationalizing products and services, managing change, shutting down facilities, downsizing headcount, overhauling business strategy and positioning, and expanding profitability through cost reduction. Rarely is the same individual able to exhibit strength in both sets of skills. In fact, the person who created some aspect of a business—designed a new product, built a new facility, hired a new employee, or negotiated a new contract—is often the worst person to fix that area when things go wrong. Since no one likes to admit that he made a mistake, achieving real change often requires a fresh perspective.

Many of the practices taught in business schools and management training programs implicitly assume that a company has ample liquidity to pursue the various initiatives that are being described. Day-to-day operations also proceed on the assumption that the company has ample liquidity. Therefore, the vast majority of talented managers may never have experienced or even thought about a financial crisis, where everyday decisions need to be made in the context of extremely tight liquidity. Indeed, they may simply lack the training to analyze the underlying causes of the company's financial distress, derive alternatives for fixing the company's problems, and lead the investigation into and implementation of the best solutions. With the right turnaround advice, however, the managers who are most familiar with their business may be the best choice for leading the company through a financial crisis. If the existing management team stubbornly resists change and remains fixated on the same vision, however, then that team may be unable to fix the business no matter what advice it receives.

As Steve Jobs, cofounder of Apple Computer, explained, "Sometimes when you innovate, you make mistakes. It is best to admit them quickly,

and get on with improving your other innovations." Despite such advice, many leaders of companies that are facing financial distress remain in denial about the severity of the situation. They may whine that all they need to fix the company's woes is another day and another dollar, they may resist any suggestion that their strategy is flawed or that they need to change direction, or they may dismiss any downside scenarios as being overly pessimistic and based upon unrealistic assumptions. Any mention of bankruptcy may get someone fired on the spot. After all, throughout the executive's career and the company's history, there have been ups and downs, but the company's fundamental survival has never been a concern. Under most dire circumstances, some fortunate turn of events—a last-minute big order by a customer, for example—has saved the day. This state of denial among executives and boards of directors may cause a company to defer action, hoping that the situation will improve. However, as the saying goes, hope is not a strategy. The reality is that, in most cases, the options available to businesses to deal with their predicaments become more limited over time rather than more plentiful. For these reasons, many observers use the analogy of a melting ice cube to illustrate a company's financial distress. For both, time is of the essence.

Therefore, some of the most compelling opportunities for distressed M&A arise when business leaders fail to act in time. In these circumstances, a potential buyer's turnaround strategy may be simply to replace the existing growth-oriented management team with a fix-oriented turnaround team.

Aren't business failures caused by companies' taking on too much debt?

While many business failures are directly related to companies becoming overleveraged, with the result that too much debt is burdening their operations, debt is neither a requirement for nor a cause of business failure. Solvency and liquidity are better ways to measure the health of a business. Simply speaking, businesses fail because they run out of cash, meaning that they can no longer conduct their daily operations because they can no longer pay their employees and vendors. These companies are illiquid. Illiquidity can arise whether a company is financed with a combination of debt and equity, such as a leveraged buyout, or with equity only, like a venture

capital start-up. The issue is whether a company can tap additional capital resources—whether debt, equity, trade credit, or government grants—to increase its liquidity when necessary. In fact, financial distress can sometimes arise if a company takes on too little debt during good times and is unable to pass lenders' underwriting examinations in bad times. Indeed, the primary reason why many small businesses fail is a lack of financing, not too much.

Saying that an overleveraged balance sheet causes a company's financial distress is really mistaking cause and effect. By "overleveraged," finance professionals are usually referring to the level of a company's debt relative to its earnings strength, such as its debt/EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio or its interest coverage ratio (EBIT/interest expense). While a company's leverage ratio (debt/equity) can also be helpful for monitoring its balance sheet over time or comparing it to competitors' balance sheets, it is not as useful for detecting financial distress because earnings are excluded from this measure. When a company completes its debt financing, both lender and borrower usually expect the company's leverage ratios to remain within healthy limits until the maturity of the debt. When unexpected issues arise with the company's operations, declining profitability and cash flow result in the balance sheet appearing overleveraged. The denominator in the applicable ratios decreases, while the numerator may increase as a result of missed amortization payments, accrued interest expenses, and additional advances to cover losses. When these ratios become too stretched, the company may be nearing insolvency.

In 1968, Edward Altman, now a professor at New York University Stern School of Business, published his Altman Z-Score formula for predicting the probability that a firm will go into bankruptcy within two years. The Altman Z-Score uses multiple corporate income and balance sheet values to measure the financial health of companies in most industries except financial institutions. To calculate a particular company's Altman Z-Score, enter the required variables at http://www.creditguru.com/CalcAltZ.shtml.[1] The Z-Score is another indication of solvency and liquidity.

Finally, even companies with no debt still have creditors. Whenever a company does business with a vendor on payment terms, that vendor becomes a creditor between the time when the goods are shipped or the services are provided and the time when payment is received. If a company

pays its workers periodically, the employees become creditors between the time when they work the hours and the time when they receive a paycheck. If a company loses a lawsuit, the plaintiff becomes a creditor. If the amounts due to these creditors overwhelm a company's resources, it can become insolvent, illiquidity, or both.

Overall, rather than focusing on whether a company is overleveraged, it is more constructive to determine if it is insolvent or illiquid.

What is insolvency?

Insolvency, which is discussed at length in Chapter 10 of this book, is another way of saying that a company is overleveraged. Different authorities define insolvency in different ways. The *Bankruptcy Code*, found under Title 11 of the United States Code (11 U.S.C.), defines the term *insolvent*, as it applies to a corporation, as a "financial condition such that the sum of [the] entity's debts is greater than all of such entity's property, at a fair valuation."[2] In this definition, debts include contingent liabilities. A *fair valuation* of an entity's property refers to the amount of cash that could be realized from a sale of the property "during a reasonable period of time."[3] A *reasonable period of time* is an amount of time that "a typical creditor would find optimal: not so short a period that the value of goods is substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price."[4]

The Uniform Fraudulent Transfer Act (UFTA) also defines *insolvency* as having more liabilities than salable assets, but also deems insolvent any debtor "who is generally not paying his debts when they become due."[5] This is sometimes referred to as the *equity definition* of insolvency.[6] Most state laws have a definition that resembles that of the Bankruptcy Code, but some states (e.g., New York) follow the equity definition for certain situations other than fraudulent transfers.[7] Fraudulent transfers are discussed in depth in Chapter 10.

Under generally accepted accounting principles (GAAP), a company can be considered solvent if it has sufficient assets to pay its debts as they come due or if it has book assets that are greater than book liabilities. This GAAP definition is more lenient than other definitions because it does not count contingent liabilities. It may be significantly misleading if the market

value of the assets declines in a manner that was not predicted by the applicable accounting principles. Therefore, merely examining whether book equity (i.e., the difference between book assets and book liabilities) is positive is usually insufficient to determine whether a company is solvent.

When does a pattern of late payments cross the line into insolvency?

Generally, insolvency begins when creditors stop trusting the entity to pay within an acceptable time frame. One or even two or three missed or late payments may not trigger an extreme response from creditors if the company has no history of financial difficulty or misdeeds. Companies stretch their accounts payable all the time, and a late fee or other minor penalty will frequently be sufficient to maintain the relationship. However, a recurring pattern of missed or late payments will usually trigger some kind of action. The action will vary, depending on the type of debt involved.

- If the debt is a bank loan, a loan officer will call, point out that the borrower is in violation of a loan agreement, and ask for an immediate meeting, which usually includes someone from the bank's workout department.
- If the debt is a commercial bill for merchandise or services, usually someone from the vendor's accounts receivable department will telephone and follow up by letter to inquire about the missed or late payments.

What are some warning signs that a company is in financial distress?

When a company is in financial distress, there are no obvious solutions to its problems. If the answers were obvious, then the crisis could have been averted. Perhaps the board of directors would have solved the company's problems by refinancing to lengthen debt maturities, changing management, discontinuing certain operations, pursuing strategic acquisitions, approving capital expenditures, revamping marketing strategies, or hiring a turnaround manager or management consultant. When the traditional

defenses and normal course corrections prove to be inadequate, a company can enter the dreaded "death spiral," where one issue spawns another and another until there is a full-blown crisis. The common theme as a company sinks through the depths of the death spiral is shrinking liquidity leading to tougher choices and fewer alternatives.

Warren Buffett has a point when he notes, "It's only when the tide goes out that you learn who's been swimming naked." During periods of strong revenue growth, executives, directors, investors, and lenders may miss the warning signs that a company is approaching financial distress, especially if its lenders agreed to weak financial covenants or, worse, if the debt is *covenant-lite* (issued with no or few covenants). Strong revenue growth can mask a lot of issues inside a company. When the drivers of strong pricing and rising volume begin to change direction, however, mismanagement often becomes evident. As revenue growth flattens and then declines—often sharply in an industry downturn or economic recession—companies are frequently unable to contain their costs sufficiently to maintain profitability. Executives may have approved rapid expansion of new facilities, new equipment, long-term supply contracts, and bold marketing programs that sounded ideal when revenue growth was strong, but that burden the company with high fixed costs when revenue is declining. Management may have tolerated lax accounting practices, making it difficult to identify the profitability of each product or service, and therefore impossible to decide quickly which operations to discontinue. In other cases, management may have been in a rush to recruit new hires as soon as talented candidates became available, and determining which employees should be retained and which laid off may not be straightforward. Naturally, hindsight is 20/20, but companies that are going through these transitions lack a crystal ball to predict the future—even the near future—and may misread the warning signs.

Even when revenue growth appears to be healthy, there are many potential warning signs that a company may be in real trouble. These warning signs may include

- *Deterioration of cash flow.* Always, always, always keep an eye on cash flow. Things to watch for are free cash flow beginning to diverge from net income as measured under GAAP, accounts payable being increasingly stretched to abnormally high levels

compared to the industry norm, and/or capital expenditures trending toward, or going below, replacement levels. An unexpected dividend cut can also be a harbinger of growing cash flow problems. It's prudent to track common financial ratios such as the company's fixed charge coverage (EBITDA as a multiple of fixed charges, such as debt repayments, interest expense, lease payments, and so on) and its current ratio (current assets divided by current liabilities).

- *Change of auditors.* It's generally uncommon for a company to switch auditors, except perhaps in cases in which there are consulting conflicts or when the company has outgrown its auditor and is upsizing to a larger outfit. As a general rule, scrutinize the reasoning behind an auditor change; you may discover that the auditor has raised a going-concern issue, internal control problems, or aggressive accounting interpretations.[8]
- *Unexplained departures of executives.* Like rats fleeing a sinking ship, it's not uncommon to see senior managers leaving in droves when a business starts to falter. This dynamic plays out quickly in publicly traded companies, particularly in this post-Sarbanes-Oxley era, when management must personally sign off on the financial statements. Often, if a CEO or CFO suddenly resigns with little or no credible explanation from the remaining management, many public shareholders assume the worst (e.g., malfeasance) by selling first and asking questions later.
- *Sale of crown jewels.* Be wary of a company that begins to pare off high-return product lines, facilities, or business units. This is particularly concerning if the assets divested were part of the core focus of the enterprise.
- *Constant restructuring charges.* It's reasonable to be concerned about companies that constantly post restructuring charges related to severance, material changes in plan benefits, plant closures, and so forth. This suggests that there is a risk of substantially underutilized capacity, and, consequently, begs the question, *Why?* Is management in the process of legitimately trying to turn the business around, or is it merely "kicking the can down the road" with only incremental changes?

- *Unusual credit-related developments.* There are a handful of items to watch for along these lines. For instance, if a company draws down a substantial amount of its revolving credit facility (not in the ordinary course of business), this may indicate that management is preparing to file for bankruptcy and is seeking to maximize its cash just prior to entering the process. Other warning signs might be if the company violates a financial covenant or seems precariously close to doing so in the near future. Finally, it's worth considering the company's future debt maturity schedule. Are there any sizable repayments coming due in the next few years that cannot be made out of internal free cash flow? If so, it's advisable to consider the potential terms of this debt rollover; after all, many companies that levered up in recent years were able to do so at unusually tight spreads and with limited covenants. It's highly unlikely that many such capital structures could be replicated today. For these reasons, looming repayment obligations could portend future financial distress.
- *Competitors experiencing financial distress*. If a company's competitors are experiencing any of these issues, then the company itself may be next. Understanding the root causes of the competitors' distress will help determine whether the overall industry is experiencing negative developments or whether the issues are isolated.
- *Ratings downgrade.* If a company's securities receive a negative report or negative ratings from a credit rating agency like Standard & Poor's, Moody's, or Fitch,[9] this is a clear warning sign that the company is heading into trouble. For example, if the company's debt securities have a low rating, beware, especially if they are *high-yield bonds*. In an extreme case, the credit rating agencies may lower a company's rating by multiple notches at once, demonstrating serious concern about impending distress. For example, in June 2010 Fitch downgraded BP from AA- to BBB once the extent of the company's liability became clearer weeks after the explosion of an oil rig in the Gulf of Mexico, which commentators have labeled the largest manmade disaster in history.

A PRIMER ON HIGH-YIELD BONDS

What are high-yield bonds?

Before they became distressed, many troubled companies were financed with high-yield bonds, which are medium- to long-term obligations that (1) are subordinated to senior debt, (2) are normally unsecured, and (3) bear high interest rates. Historically, such bonds were also referred to as *junk bonds*, a term that was reportedly coined by famed financier Michael Milken. High-yield bonds are normally not prepayable for an initial period (usually three to five years, but some are not callable until maturity), and thereafter are prepayable only at a premium, which is called *call protection* (see Chapter 14 of this book for further discussion on call protection and *make-whole* provisions).

The main purpose of high-yield bonds is to provide mezzanine financing, filling in the gap between senior secured debt, which pays a lower interest rate, and the seller's takeback financing or the buyer's equity financing, which is the last to be paid back. There is sometimes more than one layer of high-yield debt, with one being senior subordinated and the other junior subordinated debt.

In the high-risk, high-reward gambles enabled by issuing high-yield bonds—such as leveraged buyouts (LBOs)—there will inevitably be some winners and many losers. The losing bets will produce distressed companies rather than investment gains.

To whom and how are high-yield bonds sold?

High-yield bonds are commonly sold to large financial institutions—insurance companies, pension funds, and mutual funds, including overseas investors—usually in blocks of $500,000 or more; they are primarily for sophisticated investors. Funds that invest in high-yield bonds often attract super-sophisticated portfolio managers who are known to go into and out of the high-yield bond market rapidly, causing volatility in prices. Often, but not necessarily, the offerings are registered under the federal securities laws to increase their marketability and are sold in a package with warrants to acquire common stock in the target. If they are privately placed, they often carry registration rights that will enable the holders to require the borrower to register the debt for sale in a public offering.

When issuers of high-yield bonds experience signs of distress, the bonds will typically trade downward, perhaps sharply, as risk-averse portfolio managers exit before the situation worsens. Indeed, certain mutual funds and other bond funds may be prohibited from holding the bonds of companies that have defaulted or entered bankruptcy, motivating the portfolio managers to sell the high-yield bonds indiscriminately at the first signs of trouble. For buyers of distressed companies, seeing bonds trade down can be one of the best indicators that a company may become an acquisition target.

What is a bond indenture?

The *indenture* is the basic agreement setting forth the terms of the high-yield bonds. It is entered into between the borrower and a bank, which acts as trustee for the bondholders. It serves the same function as the credit or loan agreement executed with the senior secured lender and the note purchase agreement executed with an institutional mezzanine lender. The indenture contains the covenants, events of default, and other material terms of the transaction, including the various responsibilities and rights of the issuer, the trustee, and the bondholders. If the bonds are issued or subsequently sold pursuant to a public offering, the indenture must qualify under the Trust Indenture Act of 1939. Much of the boilerplate in the indenture is derived from requirements under that law.

The principal objectives of the covenants are to prevent the borrower from disposing of its assets (unless the borrower reinvests the sale proceeds in assets that are used in the same business or uses them to pay down its debt); to ensure that if any merger, consolidation, or change affecting the borrower occurs, the successor entity is obligated to repay the bonds on the same terms and is in as strong a financial position after the transaction as before; to limit the creation of additional debt and liens (particularly secured debt that is senior to the bonds); to limit payments of dividends and distributions to stockholders; and to restrict transactions with affiliates.

What covenants do high-yield bonds normally contain?

Compared with senior debt agreements, unsecured high-yield bond indentures are simpler, fitting the classic bond indenture mold. Unlike senior debt

instruments, which provide for total information flow to lenders, hair-trigger default provisions, and, in theory, extensive second-guessing and approval of management decisions, high-yield bond indentures tend to rely more on the borrower's good judgment and the value of the company as a going concern. As such, these indentures limit themselves to protecting the bondholders against major restructurings, asset transfers, or increases in the amounts of senior or secured debt. Typical financial covenants for this purpose include fixed charge coverage ratio, minimum EBITDA, maximum capital expenditures, debt/EBITDA ratio, interest coverage ratio, leverage ratio, and other measurements of financial performance. This relatively simple approach reflects the longer-term nature of such debt and the impracticality of obtaining consents from a large, diverse group of public bondholders.

In the rare case that the high-yield bonds are *secured,* however, a more elaborate set of covenants relating to the protection of collateral will be included.

Generally, borrowers should try to limit the financial covenants in high-yield bond issues to "incurrence" tests rather than "maintenance" tests. In other words, the covenants should not require that any specified level of financial health be maintained and should be breached only by a voluntary act by the company, such as paying a prohibited dividend, incurring prohibited debt, merging or combining with another company or selling assets unless certain tests are met, or dealing with affiliates other than at arm's length. These covenants will often closely restrict operating subsidiaries of the borrower to ensure that all debt is incurred on the same corporate level.

Depending on the conditions of the credit markets at the time the high-yield bonds are issued, the covenants may go much further. These tighter covenants may include detailed financial maintenance covenants relating to net worth, current ratios, interest coverage, and the like; limitations on investments; and application of proceeds from asset sales outside the ordinary course of business.

But won't it be possible to just waive these covenants if they prove to be too restrictive?

No. Prepaying the high-yield bonds is very likely to be either impossible or very expensive because of prepayment restrictions and penalties. In addition, unlike the case with senior lenders, it is often impossible, or at the

least very difficult, to obtain waivers of covenants from a multitude of public bondholders. Therefore, the restrictions contained in the high-yield bond indenture should be something that the borrower can live with for a long time. Special care must be taken to ensure that the covenants fit the company's long-term plans with respect to acquisitions, dispositions of assets, expansions, and so on. Once the covenants are in place, the borrower will have to live with them pretty much unmodified. If the borrower violates the covenants, it may default.

DEFAULTS

What does it mean to default?

Legal documents related to debt issuance, such as credit agreements and bond indentures, typically define *events of default* that, if not cured, result in a default on the borrower's obligations. Defaults may relate to any kind of fixed income security, including high-yield bonds, leveraged loans, and other types of debt. A default usually provides the company's creditors with enhanced access to information, higher interest rates called *default interest*, and opportunities to renegotiate the terms of the debt going forward. In dire situations, a default may trigger an acceleration of the maturity of the debt such that the principal amount is immediately due and payable. Default interest, which may begin upon the event of default or at the time of acceleration of the debt, may involve a premium of 2 or 3 percentage points above the rate normally in effect. See Chapter 14 for a discussion on "amend and extend" agreements regarding defaults. There are three types of default that are relevant to distressed M&A: *payment default*, *technical default*, and *cross default*.

A *payment default* arises when a company fails to make a scheduled payment to one or more of its creditors. Usually, creditors give companies a *grace period* within which to make a late payment after the scheduled due date. If a company still has not made the payment by the end of the grace period, then a payment default occurs.

Technical defaults occur when a company's declining performance triggers one or more defaults with respect to its covenants (often called "tripping covenants"). When a company takes out a revolving line of credit or a term loan with its senior lenders or issues debt, such as bonds, with its unsecured creditors, the legal agreements between the company and its creditors specify certain covenants relating to financial, legal,

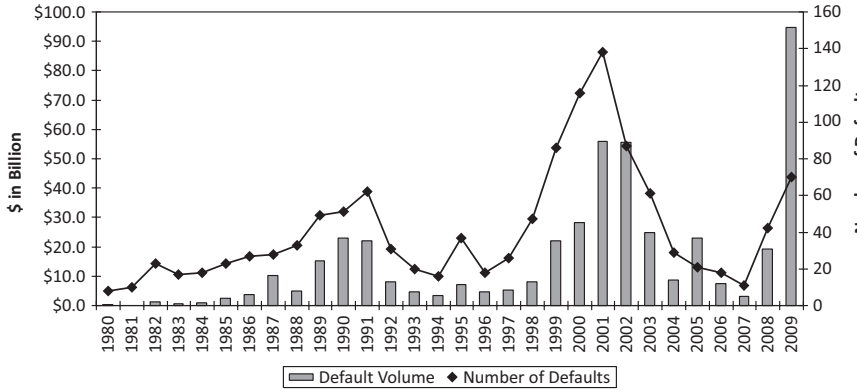
administrative, and other issues. By defining minimum expectations, these covenants are a primary means for a creditor to remain a passive investor and allow the borrower to exercise its *business judgment* for managing day-to-day operations. When a borrower's performance falls below these minimum expectations, however, creditors understandably become concerned about the company's future performance. Therefore, when a company breaches one or more of these covenants, there is a technical default. A technical default can arise even if the company makes all of its payments on time.

A *cross default* occurs when a default with one group of creditors triggers defaults with other creditors. Companies with more complicated capital structures have multiple *tranches* of debt, with different legal agreements for each tranche. In such situations, it is typical for each tranche of debt to have as a covenant that the company is not in default with any other tranche of debt. If one group of creditors gains rights as a result of a default, the other creditors want to level the playing field by gaining those rights as well. Also, if one group of creditors is on notice that a company's performance is declining below minimum expectations, then other groups of creditors want that same notice. When a cross default occurs, a company's distress may accelerate if it finds itself simultaneously negotiating with multiple groups of creditors, causing a major distraction for management as it tries to run the day-to-day operations of the business.

How common are defaults?

As discussed previously, companies fail for a variety of reasons, meaning that defaults occur in every economic period. To illustrate this point, Exhibit 1-1 shows the volume and number of high-yield bonds that defaulted over three decades. Not surprisingly, though, default rates tend to spike in recessionary periods, as illustrated by Exhibit 1-2.

Default rates differ across industries, reflecting the wide variety of risk factors involved. Exhibit 1-3 summarizes default rates by industry from 2000-2009. During this decade, the financial, diversified media, and transportation sectors experienced the highest rates of default, while the energy, broadcasting, and healthcare sectors experienced the lowest rates of default. Overall, high-yield bonds experienced an average default rate of 4.17 percent across all industries during this period. Any particular year or decade, however, may generate vastly different results.

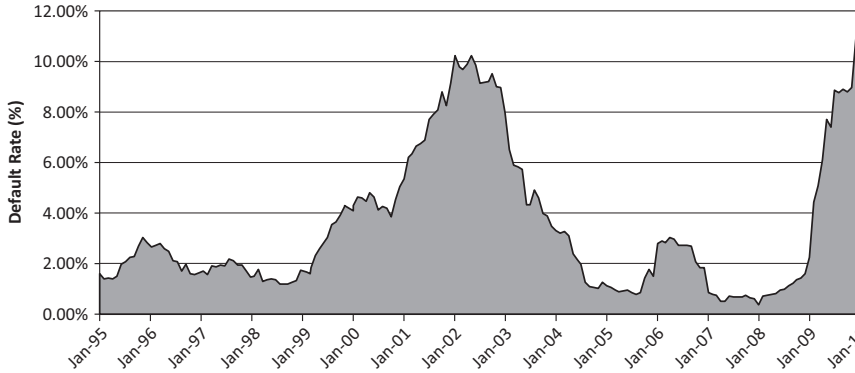


Note: Includes grace-period defaults.

Source: J.P. Morgan.

Exhibit 1-1 High-Yield Bond Defaults 1980-2009

Another way to analyze default rates of high-yield bonds is to consider the year of issuance. Trends in interest rates, debt levels, leveraged buyouts, and covenants often impact the credit quality of bonds issued in the same period. Depending on the appetite for risk, investors may follow more rigid standards in some periods while permitting looser terms in others. Exhibit 1-4 highlights the average number of years to default for



Note: Includes grace-period defaults.

Source: J.P. Morgan.

Exhibit 1-2 High-Yield Bond Default Rates

Industry	2000–2009 Average
Diversified Media	9.15%
Financial	8.76%
Transportation	7.05%
Cable/Wireless Video	5.90%
Wireline Telecom	5.65%
Metals/Minerals	5.20%
Consumer Products	4.64%
Food/Tobacco	4.33%

Industry	2000–2009 Average
Aerospace	4.01%
Food and Drug	3.81%
Wireless Telecom	3.37%
Manufacturing	3.29%
Retail	3.11%
Forest Products	3.05%
Gaming/Leisure	3.04%
Housing	2.91%

Industry	2000–2009 Average
Chemicals	2.83%
Information Technology	2.75%
Service	2.31%
Utility	1.96%
Healthcare	1.87%
Broadcasting	1.51%
Energy	0.71%
All Industries	4.17%

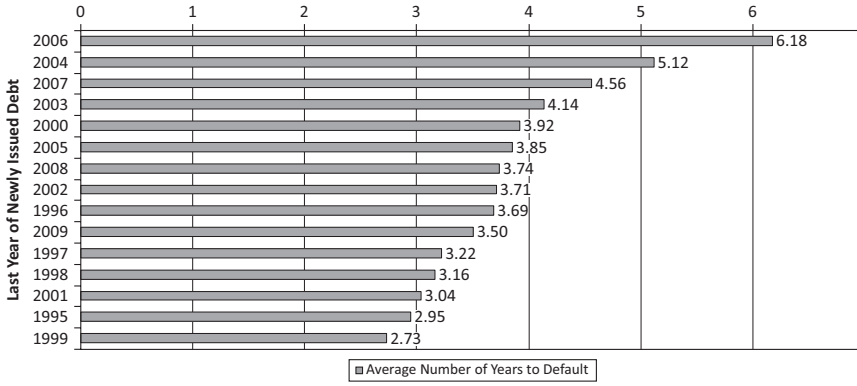
Source: J. P. Morgan.

Exhibit 1-3 Average High-Yield Bond Default Rates by Industry, 2000-2009

high-yield bonds to show the number of years since the defaulted issuer last issued new debt in the capital markets. During this 15-year period, the average time to default was 3.8 years.

How are defaults related to bond ratings?

Most bonds are rated by credit rating agencies, such as Standard & Poor's (S&P), Moody's, and Fitch. In general, investors expect these ratings to indicate a bond's credit quality, likelihood of default, and expected recovery in a distressed situation. Also, credit ratings enable investors to compare bonds across different industries and in different parts of the capital structure.



Source: J.P. Morgan.

Exhibit 1-4 Average Number of Years to Default for High-Yield Bonds

This discussion will focus on S&P's ratings symbols, which label investment grade bonds AAA, AA, A, and BBB and speculative grade (i.e., high yield) bonds BB, B, CCC, CC, C, and D.[10] Just because debt may be rated investment grade does not mean that it cannot default. When a security's rating has a "+" or "–" after the symbol, this shows the relative standing of the security within the major rating category. The other credit rating agencies use symbols that are comparable to S&P's. Rating agencies are constantly monitoring the debt that they rate and periodically change their ratings. When credit rating agencies arrive at different conclusions for the same bond, the bond becomes known as *split rated*.

Exhibit 1-5 examines the default rates by credit rating from 1981–2009 by showing the likelihood of default during the time horizon since the bonds were issued. In general, the lower the credit rating and the longer a bond remains outstanding, the more likely a default will occur.

Exhibit 1-6 shows the default rates for speculative grade bonds by year of issuance regardless of when such debt ultimately defaulted. These calculations use par amounts.

How can a bond default if it is covenant-lite?

Investors use the term *covenant-lite* to describe bonds with minimal covenants in the bond indenture. In a situation in which debt is covenant-lite, a company can spiral out of control without triggering a technical default on its bonds or a cross default. However, it must still generate sufficient cash flow to make the scheduled interest and principal payments.

	Time Horizon (Years)						
Rating	**1**	**2**	**3**	**4**	**5**	**10**	**15**
AAA	0.00%	0.03%	0.14%	0.26%	0.39%	0.82%	1.14%
AA	0.02%	0.07%	0.14%	0.24%	0.33%	0.74%	1.02%
A	0.08%	0.21%	0.35%	0.53%	0.72%	1.97%	2.99%
BBB	0.26%	0.72%	1.23%	1.86%	2.53%	5.60%	8.36%
BB	0.97%	2.94%	5.27%	7.49%	9.51%	17.45%	21.57%
B	4.93%	10.76%	15.65%	19.46%	22.30%	30.82%	35.74%
CCC/C	27.98%	36.95%	42.40%	45.57%	48.05%	53.41%	57.28%

Source: Standard & Poor's Leveraged Commentary & Data.

Exhibit 1-5 Cumulative Average Default Rates by Credit Rating, 1981-2009

Rating	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Split BBB	0.00%	12.20%	34.70%	2.20%	32.20%	22.20%	16.80%	0.00%	0.00%	4.60%	4.50%	0.00%	0.00%	0.00%
B B	7.40%	14.30%	25.50%	13.60%	28.40%	11.10%	17.60%	4.80%	3.20%	3.30%	2.00%	4.90%	0.00%	0.00%
Split BB	26.00%	33.80%	11.00%	22.00%	45.50%	19.20%	20.40%	2.10%	2.90%	5.90%	0.50%	3.90%	0.00%	0.00%
B	26.60%	28.80%	39.10%	45.10%	35.00%	56.50%	17.70%	13.40%	12.20%	12.50%	5.40%	15.10%	7.50%	17.00%
Split B	26.00%	17.60%	37.00%	39.80%	31.50%	87.10%	0.00%	15.30%	19.90%	5.00%	7.60%	16.40%	4.90%	5.20%
CCC	27.80%	0.00%	40.70%	60.40%	46.30%	81.00%	35.80%	0.00%	4.30%	5.80%	6.00%	13.50%	7.60%	0.00%
Not Rated	78.50%	42.30%	61.30%	74.80%	44.10%	57.60%	0.00%	0.00%	5.00%	75.20%	21.50%	4.70%	0.00%	0.00%

Source: J. P. Morgan.

Exhibit 1-6 Default Rates for High-Yield Bonds by Credit Rating

Therefore, while it may be unlikely—or even impossible—for a covenant-lite bond to experience a technical default, the borrower may still trigger a payment default when it eventually runs out of cash.

In most periods, investors require meaningful covenants in bond indentures, but capital markets sometimes become so competitive that borrowers convince investors to accept covenant-lite bonds. For example, in 2006 to 2007, borrowers issued nearly $125 billion of covenant-lite bonds.[11] As noted previously, these frothy capital markets led to record high defaults in 2009.

NEVER LET A CRISIS GO TO WASTE

Why would anyone want to voluntarily get involved with all of these messy issues by buying a distressed company?

In a nutshell, price. The most compelling advantage of buying a troubled business is that the company should be trading at a relatively cheap price. If the current owners are in a panic and feel that their options are limited, a buyer can have significant leverage when negotiating a transaction. In a properly functioning market, a fair price is determined by a willing seller and a willing buyer. In a distressed situation, however, the seller is under duress, and the M&A market is almost always not working well. Indeed, the distressed M&A markets can be some of the most inefficient markets for conducting transactions because of confusing information, intense time pressure, uncertain issues, and unfamiliar procedures. Most potential buyers simply avoid the hassle of figuring it all out and prefer cleaner M&A targets with more orderly sale processes. Other potential buyers simply cannot move quickly enough to deal with the fast sale process that distressed M&A markets may demand. These buyers may need to have multiple levels of executives and directors involved in the decisions or may need more time to raise financing. As a result, demand among potential buyers is sufficiently suppressed to make distressed M&A markets inefficient, causing the prices of these companies to appear cheap relative to traditional M&A valuations.

Those few brave investors who are willing to participate in distressed M&A transactions are betting that inefficient markets and relatively cheap prices at the beginning of their investment will lead to above-average

returns when they exit their investment. What other investors perceive as extraordinarily high risks, investors in distressed companies see as particularly attractive opportunities. At the most basic level, these investors believe that turning a bad company back into a good company offers a superior risk/reward profile to transforming a good company into a great company. Investors in distressed companies believe that refocusing management on "basic blocking and tackling" is actually less risky than creating and implementing ingenious growth strategies. We provide additional perspective on investing in distressed companies in Chapter 3 of this book.

What are the key differences between traditional M&A and distressed M&A?

The most obvious difference between traditional and distressed M&A is that a distressed company is experiencing a liquidity and solvency crisis, so the interaction between debtors and creditors is different. Another clear difference between traditional and distressed M&A is the role of the judiciary, such as bankruptcy courts, in addressing these tensions between debtors and creditors. Distressed M&A probably requires more creative, out-of-the-box thinking regarding both the company and the transaction. Like traditional M&A, successfully completing a distressed M&A transaction involves complicated game theory and savvy negotiations.

The key differences between traditional M&A and distressed M&A are summarized in Exhibit 1-7.

	Traditional M&A	Distressed M&A
Diligence	Available and organized data	Opaque and confusing data
Timing	Quick	Urgent
Valuation	At or above market	Below market
Competition	Relatively high number of bidders	Relatively low number of bidders
Liabilities	Probably need to assume	Probably able to avoid
Legal	Out of court	In court or out of court
Management	Probably retain	Probably replace
Strategy	Grow	Fix

Exhibit 1-7 Key Differences between Traditional and Distressed M&A

Doesn't distressed M&A simply involve buying good companies with bad balance sheets?

While this makes sense intuitively, these opportunities are fairly rare in practice. Years ago, distressed M&A may have involved buying good companies with bad balance sheets, but M&A and credit markets today are too sophisticated. There are many investors and acquirers who are seeking such opportunities, so good companies with bad balance sheets can be adequately addressed with traditional M&A transactions. In addition, lenders in today's markets will typically work with a fundamentally good company to refinance its balance sheet rather than force a distressed sale. Both the borrower and the lender should prefer avoiding the uncertainties and costs of bankruptcy or some other type of distressed sale. The credit-friendly environment of the past decade has given failing businesses staying power, enabling even weak businesses to work out their balance sheets. Every once in a while, circumstances may indeed produce a good company with a bad balance sheet, so investors should pay careful attention and watch for these situations, but they should probably not form their entire investment thesis around them.

Therefore, in the current environment, distressed M&A very often involves a company with both troubled operations and an overleveraged balance sheet. As a result, an important aspect of distressed M&A is determining whether a company's troubled operations can be saved and, if so, the amount of time, effort, and capital that will be required. If a business is worth saving, the distressed M&A process offers a key advantage over and above deleveraging the balance sheet. If the burdens of certain legacy costs are handicapping the company's competitiveness and hindering its ability to change, the company may be salvageable if it can use the distressed M&A process to fix its cost structure. Costs that are adjusted might include unfavorable customer agreements, vendor commitments, leases, product liability, union contracts, pension plans, or other claims. Shedding these sorts of liabilities—as well as debt—can transform an unattractive business into a highly desirable acquisition for prudent investors who recognize a fundamentally good franchise underneath.

How does a potential buyer know if a target company is worth saving?

Whether a business is worth saving is highly subjective. Financial buyers (such as private equity firms) and strategic buyers (such as competitors)

may view a company's operations very differently. To begin, interested buyers should identify the company's core franchise and evaluate its strength relative to its competition. Key questions to ask are

- Who will care if this company ceases to exist?
- Where would customers go if this company were no longer around?
- Why have customers chosen this company in the past?
- Where does this company's market share rank today as compared to five years ago?
- Is the company's industry highly fragmented?
- What are the barriers to entry to compete with the company?
- Does the company have any unique intellectual property, such as patents?
- Does the company have any long-term contracts with its customers?
- What does the company's brand mean to customers?

Many companies become financially distressed because they have allowed themselves to become undifferentiated in the middle of their markets. Over time, the company's value proposition to its customers, which may have been very strong for a long time, has been eroded by more formidable competition and a changing marketplace. Rather than proactively refreshing its value propositions, the company has allowed its competitors to outflank it in both (1) the low-price, high-volume, commoditized portions of the market and (2) the premium-price, low-volume, value-added portion of the market (see Exhibit 1-8). Midpriced, mediocre volume is often a road to financial distress as customers decide that they would rather either pay less for more basic products and services or trade up to gain the compelling benefits of the higher end of the market. In these situations, a company that is stuck in the middle may be worth saving if it can be reorganized by fixing its cost structure so that it can compete in the low-price market segments or improving its products and services so that it can compete in the premium market segments. If the company cannot pursue either path, then liquidation may be preferable to reorganization.

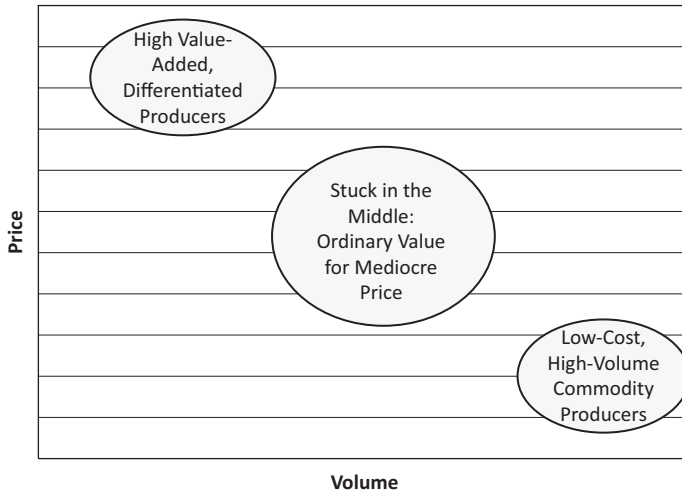


Exhibit 1-8

There are many examples of companies that have been stuck in the middle. In retail, concepts like Montgomery Ward, Ames, Caldor, Bradlees, Hechinger, Circuit City, Tower Records, and Lechmere enjoyed customer loyalty for decades, but then mass merchants attacked on one side and niche retailers struck on the other. All of these companies ultimately were liquidated, but others, like Kmart and Filene's Basement, reorganized. Among restaurants, Bennigan's and Steak & Ale succumbed to competition, but Schlotzsky's, Planet Hollywood, Mrs. Fields, and Sizzler lived to fight another day.

Even if a company avoids being stuck in the middle, it may still experience financial distress if its business model is fundamentally flawed or if it loses its competitive edge. Some recent examples of niche businesses that were unable to reorganize and were liquidated include, among retailers, Linens 'n Things, The Custom Shop, The Museum Store, Ritz Camera, The Sharper Image, and Today's Man.

So as you look for bargains, ask yourself:

- Are there structural fault lines within the industry?
- Has the company's primary offering reached the end of its life cycle?

- Is volume below critical mass to support the company's fixed costs, and, if so, what are likely scenarios as to how it will rebound?
- Has regulatory change forever dimmed the company's prospects?
- Are there successful competitors with business models that the company can emulate?
- Are the company's assets being put to their highest and best use?
- Is there an upcoming wave or a new trend that can benefit the company?
- Has the brand, trademark, and other intangible franchise value been irreparably damaged?
- Have the best employees already left the company, with the result that key customer relationships, operational wisdom, and competitive intelligence have been drained from the business (and have prior employees already taken this "tribal knowledge" to the company's competitors)?
- Overall, is the company past the point of no return, or is there still a realistic chance for recovery?

What are the differences between the terms used to describe troubled companies?

There are many terms of art that professionals use to describe troubled companies, including

- *Special situations.* This is usually the broadest term; it encompasses any and all of the ones below, and it is often chosen by professionals to remain opportunistic in selecting target investments and nonthreatening when soliciting clients.
- *Workouts.* This typically refers to out-of-court processes where a bank's workout group gets involved following a default by the company (see Chapter 2 of this book).
- *Underperformers.* While this term may refer to the company's current state as compared to its prior financial results or the company's performance vis-à-vis its competitors, it usually means that the company is on a negative trajectory, but is not yet in distress or bankruptcy and has not yet defaulted on its credit agreements.

- *Restructurings.* This term typically refers to a balance sheet restructuring, such as a debt-for-equity exchange, whether out of court or in bankruptcy, but it may also be used more generically, like special situations.
- *Turnarounds.* This optimistic term usually refers more to the operational aspects of a distressed company than to the balance sheet, but it may also be used more generically, like special situations.
- *Stressed companies.* Like underperformers, companies with this description have certain warning signs that indicate that there are potentially serious problems on the horizon that management and owners should proactively address, but that the company is not yet in crisis mode or in default with its creditors.
- *Distressed companies.* This is usually a broad, pessimistic term that is meant to include deeply troubled companies in a variety of situations where the company has defaulted on its commitments to its creditors, including out-of-court workouts, bankruptcies, and liquidations.

What are some of the key pitfalls of acquiring a troubled business?

Far and away, the key pitfall to overcome is uncertainty. Why is the business troubled in the first place? If you don't know, you could be taking on more than you can handle. The worst-case scenario is often referred to as "catching a falling knife," where the company continues through the death spiral even after the closing of a distressed M&A transaction. Buyers may be unpleasantly surprised to find that the seller's temporary fixes to the cost structure masked chronic problems that will be costly and time-consuming for the buyer to repair permanently. In other cases, buyers may unfortunately realize that an industry's cycle still has further to fall when they thought it had already hit bottom. Sometimes a buyer may have misjudged the valuable roles played by key employees and mistakenly cut muscle and not just fat during headcount reductions. Buyer's remorse can be just as painful when overpaying for a distressed company as when overbidding for a healthy one.

Such fundamental analysis aside, the distressed M&A process itself has its own set of potential pitfalls. While all potential acquirers will have

to expend significant amounts of time, effort, and cost, only one bidder can ultimately be successful. Many bidders may chase a potential troubled company and wind up with nothing to show for their perseverance. Other bidders may decide to drop out of the distressed M&A process when they learn that the target company is worse than they expected, leaving them with similar sorts of "dead deal" costs.

In other cases, a company may begin down the distressed M&A path and then reconsider restructuring on its own if its operations or the capital markets improve and a distressed valuation is no longer the best option. Sometimes potential buyers may inadvertently reveal their turnaround strategies for a particular business to the existing owner, causing the seller to change its mind and try to fix the business itself.

Finally, another pitfall is that a buyer may attempt to drive down the valuation too far, leading the seller to investigate liquidation alternatives further. If a seller's initial estimates of the attainable value, professional costs, and time commitment involved in liquidation prove to be overly pessimistic, the seller may decide that it prefers liquidation to selling the troubled company as a going concern.

Sellers need not rush this decision. Instead, they should weigh their alternatives. The next chapter shows how.

Endnotes

1. See Edward I. Altman, "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy," *Journal of Finance*, September 1968, pp. 189–209; and Edward I. Altman, "Predicting Financial Distress of Companies," July 2000; http://pages.stern.nyu.edu/~ealtman/Zscores.pdf, last accessed May 16, 2010.
2. 11 U.S.C. §101(32)(A).
3. *Travellers International AG v. Trans World Airlines, Inc.* (*In re Trans World Airlines*), 134 F.3d 188, 194 (3d Cir. 1998), *cert. denied*, 523 U.S. 1138 (1998).
4. Ibid. at 195.
5. Uniform Fraudulent Transfer Act §§2(a) and (b).
6. *Brandt v. Hicks, Muse & Co.* (*In re Healthco Int'l, Inc.*), 208 B.R. 288, 300 (Bankr. D. Mass. 1997), noted that "insolvency in the bankruptcy sense [is] an excess of liabilities over the value of assets," but in the context of fiduciary obligations of directors to creditors, "another form of insolvency is equally relevant—insolvency in the equity sense," that is, "an inability to pay debts as they mature. Even though not insolvent in a bankruptcy sense, a business is insolvent in the equity sense if its assets lack liquidity."

7. New York Business Corporation Law (§102(a)(8)) defines *insolvent*, in part, as "being unable to pay debts as they become due in the usual course of the debtor's business."
8. Public companies are required to disclose a change in auditors on Form 8-K as soon as it occurs, along with the reasons for the change. See Sections 13 and 15D of the Securities Exchange Act of 1934. For Form 8-K, see http://www.sec.gov/about/forms/form8-k.pdf, last accessed March 13, 2010. For disclosure details, see U.S. Code, Title 17, §229.304 (Item 304), "Changes In and Disagreements with Accountants on Accounting and Financial Disclosure"; available at http://law.justia.com/us/cfr/title17/17-2.0.1.1.11.4.30.4.html, last accessed March 13, 2010.
9. The major bond rating services—Standard & Poor's (S&P), Moody's Investor Services, and Fitch—use different symbols and sometimes arrive at different conclusions, known as a split rating. The best-known rating system is S&P's, which is, from the top, as follows: AAA, AA, A, and BBB for investment grade; BB, B, CCC, and lower for non–investment grade. S&P uses an "r" rating for bonds of any grade that carry a relatively high risk factor.
10. See http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us (last accessed October 6, 2010) for more details.
11. As reported by J. P. Morgan and Standard & Poor's Leveraged Commentary & Data.