New workout 'paradigm' promises to preserve value in financially troubled companies

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With the recent wave of highly leveraged private equity deals and the current problems in credit markets, market observers are now predicting a sharp increase in corporate defaults, with possibly serious spillover effects. But thanks to changes in workout and bankruptcy practices in the U.S. and abroad during the last two decades, the prospects for preserving the values of financially distressed companies are greatly improved.

In the "Morgan Stanley Roundtable on Managing Financial Trouble" that appears in the Fall 2007 issue of the *Journal of Applied Corporate Finance*, a distinguished group of bankruptcy academics and practitioners discuss the promise of these developments, along with a number of potential obstacles.

The discussion begins with University of Chicago legal scholar Douglas Baird and bankruptcy lawyer Donald Bernstein describing a "new corporate reorganization paradigm"--one in which vigorous trading of distressed corporate debt by active investors such as hedge funds and private equity firms ends up transferring corporate assets quickly to their most efficient users.

However, this new, market-driven reorganization process does face some relatively new challenges. In many cases, accomplishing this task will require investors to find ways to manage relatively new “inter-creditor” conflicts stemming from the use of junior secured ("second-lien") debt and the dispersion of claims in collateralized debt obligations (CDOs) and colleralized loan obligations (CLOs).

The good news--and the dominant theme of the discussion--is the ingenuity of today's distressed investors in finding ways to keep viable, but financially distressed companies out of bankruptcy when possible—while making the most of the advantages of the new streamlined Chapter 11 when not.

"It's the great paradox of capitalism that all this self-interest, this so-called 'vulture' investing, is likely to end up benefitting all of us," Douglas Baird tells his fellow panelist in closing. "If we do go into recession and companies begin to struggle with their debt loads, then it may be the activity of people like you around this that is the best hope for ensuring that the businesses that should survive, do survive."

Source: Blackwell Publishing Ltd.