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Private equity returns

GALL

Reluctant proprietors

Banks aren't thrilled to pick up equity in bankruptcy reorganizations, but out of necessity they're getting more accustomed to acting as owners

By Jamie Mason

ILLUSTRATION
by
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A BANKER WOULD undoubtedly blanch if you suggested that he go into the gaming business, though the charge that banking has become a casino is heard often enough. But that's exactly what first-lien lenders led by Bank of America Merrill Lynch have done.

UTGR Inc. operates the Twin River Casino in Lincoln, R.I. When the bankrupt company failed to find a buyer, BofA and other first-lien lenders reluctantly filled that role. UTGR on June 24 won court confirmation of a plan enabling it to give all its reorganized equity to those lenders in exchange for forgiveness of $442.4 million in debt and a new $300 million senior secured first-lien credit facility. When UTGR leaves Chapter 11, BofA and the rest will effectively own it.

Does BofA really want to be the proprietor of a gaming company? Not particularly. But more and more lenders, in the wake of the worst bankruptcy cycle in history, find themselves swapping debt in distressed companies for reorganized post-Chapter 11 equity. Some have amassed so much equity in so many companies that their portfolios make them resemble private equity firms.

Among these new owners are BofA, Credit Suisse Group and J.P. Morgan Chase & Co., which have all been involved in seven debt-for-equity swaps as either lenders or agents from Jan. 1, 2009, through Sept. 30 of 2010. Wells Fargo & Co. has been involved in six, and GE Capital Corp., four (see page 43).

"The banks are entering the realm of private equity," says David Heller, a Latham & Watkins LLP partner who mostly represents secured lenders in bankruptcies. "You can no longer say with certainty that banks don't like to take equity. Their restructuring departments are getting better at owning equity."

Heller expects that trend to continue, believing there will be more debt-for-equity swaps involving bankrupt companies in the next six to 24 months, especially as interest rates rise and corporate managers continue to chant a deleveraging mantra. "Banks are not making a decision to become more like PE firms," he says. "Whether they like it or not, much of the value in restructurings is in new equity, so they have to be willing to accept it or they'll be left behind with a less desir-

able outcome."

GE Capital and Credit Suisse declined to comment for this story. BofA, J.P Morgan Chase and Wells Fargo didn't return calls. All these institutions find themselves in a peculiar spot. They aren't loan-to-owners like many hedge funds and buyout firms, and yet they aren't accidental tourists in bankruptcies, either—the exigencies of being secured creditors has become common for them. "I don't think a bank ever wants to take equity, but I certainly don't think that banks are afraid to take it," says Zolfo Cooper senior managing director Joff Mitchell. "Banks examine the enterprise value and understand the value of the enterprise. The banks focus on maximizing their position in a restructuring."

Portfolio building *Jan. 1, 2009–Sept. 30, 2010*

*While scores of banks got equity in return for debt forgiveness in the aftermath of a historic bankruptcy up cycle, the five below compiled the most. Here's a sampling of their debt-for-equity participation.**

Bank of America Corp.

BANK ROLE	PORTFOLIO	CONFIRMATION DATE	TOTAL DEBT SWAP BY LENDER GROUP ($MILL.)	TOTAL EQUITY RECEIVED BY LENDER GROUP
Lender	Affiliated Media Inc.	3/4/10	$590.0	88.0%
Lender	CCS Medical Inc.	3/11/10	348.8	100.0
Agent	Neff Corp.	9/21/10	90.0	100.0
Agent	Regent Communications Inc.	4/12/10	87.0	100.0
Agent	SemGroup LP	10/26/09	2,930.0	95.0
Agent	UTGR Inc.	6/25/10	442.4	100.0
Agent	WCI Communities Inc.	8/26/09	735.6	95.0

J.P. Morgan Chase & Co.

BANK ROLE	PORTFOLIO	CONFIRMATION DATE	TOTAL DEBT SWAP BY LENDER GROUP ($MILL.)	TOTAL EQUITY RECEIVED BY LENDER GROUP
Lender	CCS Medical Inc.	3/11/10	$348.8	100.0%
Lender	Eurofresh Inc.	10/28/09	170.1	10.0
Agent	Freedom Communications Holdings Inc.	3/9/10	772.0	100.0
Agent	Idearc Inc.	12/22/09	1,000.0	95.0
Agent	Journal Register Co.	7/7/09	470.0	100.0
Agent	Lear Corp.	11/5/09	1,600.0	35.5
Agent	Mark IV Industries Inc.	9/24/09	350.0	88.0

Confirmed reorganization plans Jan. 1, 2009–Sept. 30, 2010
*Includes debt-for-equity transactions by bank affiliates or units

Source: The Deal Pipeline

Setting aside the larger deleveraging trend in still-tenuous economic times, bankrupt companies try to swap debt for equity for two big reasons. First, it's easier once a company is in Chapter 11 to get creditor approval for such an exchange. Second, such swaps preserve a once-bankrupt company's ability to use net operating loss, or NOL, carryforwards.

Banks have become further enmeshed in this process because of their preference for holding a company's debt when it goes into bankruptcy. Doing so gives them voting power in reorganization planning. It also enables them to retain corporate relationships. Banks fear that unloading bad loans to hedge funds and other opportunistic players will tarnish their reputations in boardrooms.

While banks try to sell the resulting equity as fast as they can, sometimes things don't work out. J.P. Morgan Chase, for example, got 14.3% of the reorganized shares of Constar International Inc. when it exited from Chapter 11 on May 29, 2009, and didn't peddle the equity until Sept. 20—a span of almost 16 months. By the time J.P. Morgan sold the shares, Constar's stock price had plunged to below $3 per share after having priced at $20 when the company relisted on April 9 of this year.

According to a yet-to-be-released study entitled "Debt Ownership in Ch. 11 Restructurings" by Victoria Ivashina (Harvard Business School), Ben Iverson (Harvard Business School), Per Strömberg (Stockholm Institute for Financial Research and Stockholm School of Economics) and David C. Smith (University of Virginia), banks in 20 of 62 bankrupt companies that reorganized via a debt-for-equity swap between 2001 and 2009 ended up as controlling shareholders. In the other 42 cases, junior claimholders, such as bondholders, unsecured creditors or their prepetition shareholders, won the dominant equity position. These other players often get more equity than banks in restructurings, but, as hedge and private equity funds, holders of collateralized loan obligations and other investment specialists, they're more accustomed to those ownership roles.

That may be changing. Five to 10 years ago, major banks were equity-averse. They didn't know how to value it, and it was not part of their worldview. In the past two years, however, more and more banks have come to understand that equity can be a good investment, says Latham & Watkins' Heller. "The standard bank phrase became: It's not our preference to take equity, but we will if we have to. I think banks became increasingly concerned that if they signaled any hesitation to take equity, the hedge funds would cash them out on the cheap."

It's no secret that buyout shops and hedge funds often engage in loan-to-own strategies. They will lend to companies

with the intent of eventually owning them or buy debt with the hope that it gets converted into equity. In addition, there's an active debt-trading market, and many hedge funds and other investment vehicles are interested in buying distressed loans in the hope that the debt will be traded for equity.

Banks are different. Whether or not a bank wants to take equity often depends on its loan accounting. Under current accounting rules, banks have a choice in accounting for loans based on whether they are held for sale or for investment purposes.

One Wall Street workout specialist says some banks mark everything to market so they don't keep assets on their books at par when they are worth half that. Other institutions, he adds, never write anything down because they don't want to show losses.

When banks don't mark assets to market, they may prefer to reinstate the loans and push out maturities rather than take equity. Quite often, the workout specialist says, banks want the interest to be payment in kind, which means that the interest is payable in additional debt.

Reinstating the loan also saves the bank from having to write down the shares if their value falls, he says.

But there can be an upside to taking a company's reorganized equity. If a bank thinks it will only get, say, 50 cents on the dollar for the debt, it may want to risk taking equity and its potential upside.

Nor can banks truly remake themselves into holding companies for past bankruptcies. Brett Barragate, a financial institution litigation lawyer at Jones Day, explains that regulations limit just how much equity they can hold on balance sheets. Under Title 12 of the U.S. Code, banks can't hold more than 5% of the voting securities in a company that is not a bank. In addition, banks can't have more than 5% of their total assets on their balance sheet tied up in equity.

An even bigger deterrent for banks' taking equity is that it hurts their core business—making more loans. After all, you can't use the equity to make loans. "It's inconvenient for banks to become an investor in a company, and it impairs their ability to make a new loan," says Robert Willens, president of Robert Willens LLC, a tax and accounting consulting firm.

Some lenders sell stakes in a loan so they can move on and reallocate their capital, one loan syndication source says. "Frequently, banks make a decision to sell their position. What they want to do is maximize value," Zolfo Cooper's Mitchell says. "Banks develop a view of the value of their debt. If they can sell it for something close to their valuation, it may be preferable to do that than to invest the time and effort in a long and complicated restructuring."

Other considerations also come into play when banks sell off the debt. The University of Virginia's Smith says one reason administrative agents hold on to a piece of a loan they've syndicated is so they can maintain a relationship with the borrower, who gets nervous if the bank syndicates the entire loan, then walks away. Administrative agents may also want to retain voting power. In a syndicated loan, the lenders get a vote on how the debt will be restructured, Smith says.

He notes that banks do not want to

GE Capital Corp.

BANK ROLE	PORTFOLIO	CONFIRMATION DATE	TOTAL DEBT SWAP BY LENDER GROUP ($MILL.)	TOTAL EQUITY RECEIVED BY LENDER GROUP
Lender	Freedom Communications Holdings Inc.	3/9/10	$772.0	100.0%
Lender	Global Safety Textiles Holdings LLC	11/30/09	111.2	86.5
Lender	Hayes Lemmerz International Inc.	11/3/09	100.0	84.5
Lender	Regent Communications Inc.	4/12/10	87.0	100.0

Credit Suisse Group

BANK ROLE	PORTFOLIO	CONFIRMATION DATE	TOTAL DEBT SWAP BY LENDER GROUP ($MILL.)	TOTAL EQUITY RECEIVED BY LENDER GROUP
Agent	Buffets Inc.	4/17/09	$10.0	93.0%
Lender	CDX Gas LLC	9/22/09	400.0	100.0
Lender	Eurofresh Inc.	10/28/09	170.1	10.0
Agent	Express Energy Services Operating LP	12/7/09	326.2	98.0
Agent	Hawkeye Renewables LLC	6/2/10	593.4	99.0
Lender	Isolagen Inc.	8/27/09	73.2	33.0
Agent	Lake at Las Vegas Joint Venture LLC	7/1/10	127.0	94.0

Wells Fargo & Co.

BANK ROLE	PORTFOLIO	CONFIRMATION DATE	TOTAL DEBT SWAP BY LENDER GROUP ($MILL.)	TOTAL EQUITY RECEIVED BY LENDER GROUP
Lender	Affiliated Media Inc.	3/4/10	$590.0	88.0%
Agent	Building Materials Holding Corp.	12/17/09	302.0	100.0
Agent	CCS Medical Inc.	3/11/10	348.8	100.0
Lender	Freedom Communications Holdings Inc.	3/9/10	772.0	100.0
Agent	Penton Business Media Holdings Inc.	3/5/10	266.0	46.3
Lender	WCI Communities Inc.	8/26/09	735.6	95.0

be seen hanging their borrowers out to dry, since that may persuade other borrowers not to do business with them. Many banks are thinking long and hard about selling debt to hedge funds for fear they'll rough up borrowers, thus besmirching the banks' reputation, says William Welnhofer, a banker at Robert W. Baird & Co.

OF COURSE, banks may act differently when it comes to the disposition of their debt in a bankruptcy. "Different banks have different views on things," says Zolfo Cooper's Mitchell. "Some banks are more prepared to take equity than others. One of the difficulties is that members in large, internationally diverse bank groups have very different views. For example, some banks will be focused on the term of the restructured debt, some on the interest rate, some on the amortization."

Who gets the equity in a debtor's reorganization also depends on who holds the fulcrum security, the most senior position that is not going to get paid in full and will instead receive equity. "Presumably, the obvious situation where the banks may take equity is when they are undersecured and the equity holders and other creditors are out of the money," Mitchell says. "In this example, the secured debt is the fulcrum security."

"Some banks are more prepared to take equity than others. One of the difficulties is that members in large, internationally diverse bank groups have very different views. For example, some banks will be focused on the term of the restructured debt, some on the interest rate, some on the amortization." —Mitchell

When this occurs, it doesn't necessarily mean the bankrupt company's other creditors will receive nothing. Junior creditors frequently receive a small piece of the equity, out-of-the-money warrants or a token cash payment to go along with the restructuring. The existing management team may also get some type of equity, says the Wall Street workout source.

In the bankruptcy case of Affiliated Media Inc., the newspaper company's secured lenders, including BofA and Wells Fargo, received 88% of its reorganized stock, but subordinated noteholders got warrants to buy up to 8.25% of the company's new Class B common stock. In the reorganization of CCS Medical Inc., secured lenders such as BofA, J.P. Morgan and Wells Fargo swapped $348.8 million in debt for $200 million in new debt and all of the medical devices distributor's new shares. Unsecured creditors shared a $250,000 cash payment. And senior secured creditors including Credit Suisse handed over 2% of the reorganized equity in Express Energy Services Operating LP to Macquarie Energy Holdings LLC, the drilling services company's prepetition owner.

Wrangling between creditors often necessitates such deals for reorganizations to work, and bankruptcy has proved to be a good forum to execute debt-for-equity swaps. After all, outside of bankruptcy, a company needs 100% approval from its shareholders to do such a swap. Inside bankruptcy, a debtor needs holders of only two-thirds of its total debt and half of them in number to get such an exchange through.

Then there's the NOL benefits. Outside bankruptcy, NOLs, which can be used to offset taxable income, can significantly lose their economic value. But if a company reorganizes in bankruptcy, it can preserve the value of that asset, Welnhofer says. Banks that get equity in such companies can't use those NOLs themselves, but the equity they're holding rises in value as the company's bottom line grows, helped by a lower tax bill, Willens says.

In some restructurings, the equity that banks receive is even being designed to be more palatable to them. "There are now structures that allow banks to take nonvoting stock, which makes them more comfortable taking equity," says Heller.

He cites the reorganization of Station Casinos Inc., in which the Nevada gaming company swapped the $1.8 billion owed to its lenders led by J.P. Morgan and German American Capital Corp. for half its nonvoting common stock. The other half was bought by Fertitta Gaming LLC for $85 million in cash.

One result of all this re-engineering is that debt itself is increasingly viewed as if it's equity to begin with. In the past, Welnhofer says, a borrower's default on a loan would have triggered the bank to drive the company into bankruptcy, a refinancing or a sale. Banks aren't taking such severe measures as often anymore. "More times than not, regulated financial institutions are not forcing the company into a liquidity event," he says. "Instead, they're accommodating the borrower so that the debt is treated more like equity than real live debt."

Not moving briskly to force a company's hand also delays the accounting effect of a bad loan that's swapped for equity. When a bank engages in a loan-for-equity swap, it has to account for that by writing down the difference between the loan and the value of the equity. So if a $100 million loan isn't going to be repaid in cash and the bank instead receives $20 million worth of stock, the bank will have to write off $80 million—something, Willens says, it will do immediately. That write-off will result in a hit to earnings and capital.

But accounting for equity doesn't end there. If the bank later sells the equity for more than the debtor valued it in its reorganization plan, it will usually be considered a one-time gain, Willens says. However, Welnhofer notes that the bank might avoid that if it sells equity stakes frequently, making

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it a gain from the sale of investments. The bank will also periodically write up or down equity, depending on the fluctuating value of the business.

UNLIKE BUYOUT firms, banks aren't interested in the reorganized equity for the operating leverage it can provide. Also, while banks often receive all of a reorganized company's equity, individually they may pick up only 1% to 15% of it, the Wall Street workout source says. In that regard, he notes, banks operate more like mutual fund companies than private equity firms. It's only when a bank receives a significant amount of equity, say 25%, that it can appoint directors.

"Banks typically don't want to take an active management or governance role," says Zolfo Cooper's Mitchell. "They appoint an independent board of directors to manage the equity interests. The banks make decisions along the way as to how to best realize their investment."

One company, Halsey Lane Holdings LLC, was founded a year ago to help so-called unnatural owners such as banks, hedge funds, holders of collateralized debt obligations and CLOs, mutual funds, insurance companies and others. Mark Dalton, a founder who serves as its managing principal, says Halsey Lane is often put on the board of a reorganized company and acts for the owners as if it were a private equity sponsor. Halsey Lane doesn't run day-to-day operations, but like a PE firm, it helps analyze acquisitions, raise money, find new management and cut costs. The idea, Dalton says, is to get the reorganized company back on its feet so that the unnatural owner can sell its stake.

While Dalton declines to divulge Halsey Lane's mandates, he does note that the firm gets involved when it becomes clear to a lender that they are going to become an owner. He says banks aren't quick to sell stakes and that they commonly hold on to equity for a year or two because bailing out often means taking a loss on the sale. Banks aren't trying to maximize their investment, like a PE firm, but to make the money back they lost on the loan, Dalton says.

"Banks exit the moment they think they can get a fair price," Heller says. "The bank's ability to exit may very well depend on the liquidity of the equity they are getting."

Mitchell points to one example where a large reorganized company that owned multiple power plants restructured more than $1 billion in debt. The banks held the fulcrum security and received equity. Some banks held on to that equity for 12 months and recovered more than the par value of their debt; others chose to sell positions to distressed investors. Other banks stayed with the equity for more than a year and suffered when it lost value.

Of course, sometimes the equity isn't very liquid. "In a private deal, where the stock is not publicly traded, there may be restrictions on who the bank can sell the equity to," Heller says. "Often they are only able to sell to other holders who are already in place. They wouldn't be able to sell to outside parties."

When banks hold on to reorganized equity for some time, they may begin to resemble PE firms, says Clifford Chance LLP partner Rick Antonoff, who usually represents banks and other secured lenders, adding that they're more likely to sit on the equity if values are depressed in the hopes that they'll bounce back.

Meanwhile, more debt-for-equity swaps involving bankrupt companies may be in the offing. As the Wall Street workout pro says, many companies have "amended and pretended" their leverage, basically kicking the reorganization can forward by reinstating debt and pushing out its maturities. He expects more debt-for-equity swaps in 2012, not fewer.

Heller agrees. "The day of reckoning is coming," he says.

Reluctantly, banks will be ready. ■