

CREDIT TERMINOLOGY

There are three sources of credit risk: leverage, priority and time.

Fraudulent Conveyance

When a debtor transfers an asset to another party without adequate consideration, or with intent to hinder the other creditors, then (if the other conditions for fraudulent conveyance liability are met), the bankrupt can recover this "fraudulent" transfer for itself and for the benefit of all of the bankrupt's creditors.

Preference Law

Preference law allows the bankrupt company to recover payments made to creditors (or assets taken by secured creditors) within 90 days *before* the bankruptcy, to allow all creditors to share the payment (and to discourage races to seize the debtors' assets).

Equitable Subordination

Equitable subordination sends misbehaving, over-reaching creditors to the end of the bankruptcy priority line.

Cramdown

If the creditors cannot settle their inter-creditor disputes within a reasonable period of time, the court can cramdown a plan of reorganization. A "cramdown" typically requires a valuation of the firm - to see how much value there is in the firm to distribute. Because the cramdown is the ultimate judicial weapon in chapter 11 and affects renegotiations even in the many reorganizations in which the debtor and its creditors settle, the players' fears and hopes of how a judicial cramdown would be employed will influence what they will accept, or what they will insist on, when making a deal.

If there is at least one impaired class that votes in favor of the plan (consents to the plan, that is), then satisfaction of the cramdown requirements of section 1129(b) can override section 1129(a)(8)'s requirements of consent of all impaired classes.

By the absolute priority rule, the court can cramdown a plan if those classes junior to the impaired class receive nothing.

Section 1129(b) requires that:

- At least one impaired class of claims has accepted the plan
- The plan does not discriminate unfairly
- The plan is fair and equitable

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Cramdown (cont'd)

3 different tests for determining whether a plan is 'fair and equitable', depending on whether the class is a secured claim, unsecured claim or ownership interest

Secured

Determine the amount of the secured claim

Determine a cram down interest rate

Determine the FV for the replacement value so that its discounted PV is equal to the value of the collateral

That is, the PV of the crammed down secured claim must be a stream with a PV = replacement value

Unsecured

Satisfied if the "holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property"

A Chapter 11 plan cannot be crammed down on unsecured creditors unless SH/H get nothing

New Value

There is a "new value" exception to the absolute priority rule, recognized in Case v. Los Angeles Lumber Products Co. (1939). Shareholders of an insolvent debtor could retain an interest in a reorganized entity if their 'participation is based on a contribution in money or money's worth, reasonably equivalent in view of all of the circumstances to the participation of the shareholder."

However, the Court subsequently held that a debtor could not simultaneously retain the exclusive right to file and plan and then propose in its plan that its owners (and only its owners) could contribute new capital to obtain the ownership of the reorganized debtor. The Court reasoned that the exclusive opportunity to buy the ownership must be considered property received "on account of" old equity interests in the entity and so prohibited by 1129(a)(2)(B)

Security

One can think of the corporation as a collection of cash flows. A secured creditor gets a promise from the corporation that it, the secured creditor, can collect its payments by seizing specific assets of the corporation if the corporation cannot get the cash together to pay the secured creditor. *In this sense, the value of the asset is a guarantee of the future cashflows the debtor will have to pay the creditor. Seizing the asset and selling it is a way of bringing forward the expected cash flows from the asset since the value of the asset is theoretically equal to the present value of its future cash flows.*

Automatic Stay (Section 362)

Automatic, broad and effective, the automatic stay prohibits any person from the liability side of the balance sheet from insisting upon payment of interest or repayment of loans until such forbearance is lifted.

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Valuation and Recovery

The more value there is in the firm, the further down the capital structure pecking order the court can move.

US Trustee

A trustee appointed by the government to perform certain administrative functions that the court does not perform in bankruptcy cases.

Trustee

Section 1104 sets out the grounds for the appointment of a trustee. A trustee is appointed if there is cause (fraud, dishonesty, mismanagement, or incompetence) or if the appointment of a trustee is "in the interest of creditors, any equity security holders, and other interests of the estate."

Essentially, the trustee (once appointed) has responsibility for the operation of the business and the formulation of the Chapter 11 plan.

Examiner

If a trustee is not appointed, the court can order the appointment of an "examiner". The requirements for the appointment of an examiner are: 1) a trustee was not appointed; *and* 2) the appointment of an examiner was requested by a party of interest; *and* 3) the debtor's nontrade, nontax, unsecured debts exceed \$5 million, *or* "such appointment is in the interests of creditors, any equity security holders, and other interests of the estate".

An examiner does not run the debtor's business or run the debtor's Chapter 11 case. An examiner merely examines: she investigates the competency and honesty of the debtor and files a report of the investigation.

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Section 363

Section 363 empowers the debtor-in-possession or trustee to continue using, selling and leasing encumbered property. The interest of the lien creditor is safeguarded by section 363's requirement of "adequate protection", section 363(e).

Section 361 provides for "adequate protection" of "an interest of an entity in property," not adequate protection of an entity in having its debt repaid. Adequate protection is not defined, but examples are given.

The purpose of adequate protection is to assure that at the end of the bankruptcy case, secured creditor *S* has an interest in property that is worth as much as the value of the collateral securing the debt at the time of the filing.

Example: Assume that debtor *D* files for bankruptcy owing secured creditor *S* \$1 million, secured by equipment worth \$800,000. *S* has an interest in property that is worth \$800,000. The purpose of adequate protection is to secure that at the end of the bankruptcy case *S* has (i) collateral worth \$800,000; or (ii) payments of \$800,000; or (iii) a combination of collateral and payments that total \$800,000.00

Example: Assume that the property is declining in value by \$10,000 a month. The court could require the debtor to make monthly payments of \$10,000 a month to *S*, so that if the case lasts 14 months (and the court was correct about the rate of decline in value), then *S* would have received \$140,000 in cash adequate protection payments and a lien on property worth \$660,000, for a total of \$800,000.00

Example: Assume that debtor *D* files owing *M* \$500,000, secured by a first mortgage on a property called Greenacre worth \$300,000. If the court concludes that Greenacre will not decline in value, then the court could rule that no adequate protection payments are warranted.

Under section 507(b), a creditor may seek an administrative expense claim for the amount by which the adequate protection ordered proves to be inadequate. If, however, the case is converted from Chapter 11 to Chapter 7, then the administrative expenses from the 11 are not paid until the administrative expenses from the 7 case are paid in full.

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Cash Collateral

Defined in Section 363(a). Cash collateral must be collateral, i.e. property that a creditor has an interest because its lien extends to the property. Cash collateral must be cash or cash equivalent. Cash collateral can be derived from other collateral, i.e. proceeds, rents, etc. from other collateral.

Example: Cash received by debtor *D* from the postpetition sale of prepetition inventory that was encumbered would be the creditor *C*'s cash collateral.

Cash collateral may be used only if the lienholder *C* consents, or if the court, after notice and hearing, finds that *C*'s collateral position is adequately protected and authorizes such use under section 363(c)(2).

Creditors, understanding the court's sympathy to the debtor's argument that it needs to use its cash collateral in order to operate its business, generally agree to the debtor's use of cash collateral in exchange for some sort of replacement lien on postpetition assets (say, inventory and receivables) and some sort of administrative expense priority. Most court orders approving the use of cash collateral are consent orders.

363 Sale

A debtor-in-possession or bankruptcy trustee may sell assets of the estate after notice and a hearing (a so-called 363 sale, referring to the Bankruptcy Code's Section 363). Assets may also be sold through a confirmed Chapter 11 plan. Advantages to a 363 sale, from the perspective of the buyer include the following:

Reduces the risk of later challenges, including fraudulent transfer

Sale may be free and clear of third party liens and interests

Sale can be accomplished over the objections of unsecured creditors and shareholders

Once the court order for the sale becomes final, the debtor or the trustee can only undo it if there is collusion among the bidders

Debtor has the right to reject executory contracts that the buyer does not wish to acquire

Debtor may cure and reinstate defaulted executory contracts and leases and assign them to the buyer

Executory Contract (in bankruptcy law)

A contract in which continuing obligations exist on both sides of the contract. (Section 365).

Priming Liens

Under Section 364(d), the court, after notice and hearing, may authorize the obtaining of postpetition credit secured by a senior lien on property of the estate that is already subject to a lien. There are two requirements: 1) the trustee is unable to obtain such credit otherwise and 2) the interest of prepetition lienholders on the property whose liens are displaced by the borrowing are adequately protected.

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Impairment

Under Section 1124, a class of claims or interests is impaired unless:

- 1) the legal, equitable and contractual rights of the holder are left 'unaltered'; *or*
- 2) the only alteration of legal, equitable or contractual rights is reversal of an acceleration on default by curing the default and reinstating the debt

Plan Approval

A class of claims has accepted a plan when more than one half in number and at least two thirds in amount of the allowed claims **actually voting** on the plan approve the plan, per section 1126(c)

Confirmation Requirements

Key requirements spelled out in Section 1129(a) for confirmation of a plan include:

Best interests of creditors test: each dissenting member of a class - even dissenting members of a class that approve a plan - receive at least as much under the plan as it would have received in a Chapter 7 liquidation.

Priority claims: A holder of an administrative expense claim or a claim for certain postpetition expenses in an involuntary case must be paid in cash on the effective date of the plan unless the **claimholder** otherwise agrees. Each priority tax claim must receive deferred cash payments that a present value equal to the amount of the claim, section 1129(a)(9)©

Feasibility: the court determines that the debtor can meet its plan commitments, i.e. that confirmation is not likely to be followed by liquidation or further financial reorganization.

At least one consenting impaired class

Liquidated Damages

Damages whose amount the parties designate during the formation of a contract for the injured party to collect as compensation upon a specific breach (e.g. late performance).

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Priority

There are four primary techniques for distinguishing priority: grants of collateral, term structure, contractual provisions and corporate structure.

Grants of collateral: the primary purpose of the security agreement is for the borrower to grant a security interest, within the meaning of the Uniform Commercial Code, in collateral for the benefit of the lender. The secured lender is first in line to collect the proceeds of the collateral, regardless of what other claims are against the debtor. When a lender has a broad lien on all of the debtor's assets, the lender has pretty much assured itself that no other claim will be honored before the secured lender is fully repaid.

Contractual provisions may be the most straightforward way to assign priority. For example, subordination is a legal provision contained in a loan document of the instrument in question expressly providing that the instrument is subordinated.

The maturity structure is generally more important in analyzing the investment characteristics of bonds, rather than bank loans. Bank loans typically have floating interest rates which minimize the duration risk, unlike investment grade bonds with their fixed coupons. For below-investment grade bonds, credit risk is much more important than duration risk. Since uncertainty increases with time, bond buyers typically want a shorter maturity to reduce the length of time they are exposed to potentially adverse credit developments. There may be opportunities to buy shorter-dated maturities likely to be paid off, and at a discounted price, before real credit problems hit a borrower.

Corporate structure: most firms conduct their operations through multientity structures in which a nonoperating holding corporation owns, directly or indirectly, a variety of nonoperating and operating subsidiary corporations. Operating in this manner creates (or reinforces) capital structure priority differences. The further down the tier (ie the more removed from the holding corp), the more structurally senior the borrower.

Guarantees

A guarantee is a contractual promise to pay the obligation of another. It essentially has the legal effect, depending on the terms, of making the guaranteeing party a co-obligor.

Non-Recourse Borrowing

The opposite of a guarantee is the non-recourse provision. A non-recourse provision (typically only found in secured loans) states that in the event of a default on the loan, the lender has no right to attempt to recover from certain persons. The most common context for a nonrecourse loan is a mortgage on income-producing real estate. The non-recourse loan terms state that in the event of default, the lender can foreclose on the property, but has no right to pursue the owner for any deficiency. It is an explicit "nonguaranty" of an obligation.

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Covenants

The basic tools of credit risk management are restrictive contractual provisions, generally called covenants, detailed contractual provisions contained in lending documents or bond indentures.

Restrictive covenants restrict the borrower from doing something should the covenant be breached. Performance covenants when breached constitute an event of default.

Leverage covenants restrict leverage, as defined, to a specified multiple of EBITDA, typically. The leverage covenant may also condition new borrowing on the maintenance of specified pro forma interest coverage. Violation of a leverage covenant is typically not an event of default. The usual 'penalty' for violating the provision, which most often occurs because of a decline in operating performance, is to prohibit the issuer from incurring additional debt. The inability to borrow to obtain liquidity can be effectively a death sentence if the borrower is experiencing sufficiently negative free cash flow.

Priority covenants seek to limit or prohibit the erosion of credit support before the loan in question is repaid. These can be complicated and typically involve a variety of covenants or restrictions. The objective is to prevent the borrower from doing anything that tends to increase the risk that the existing assets of the firm will not be available to repay the current loan.

Restricted Payments tests are designed to limit the firm from distributing its assets to third parties to the detriment of the creditor. RP provisions are usually structured to a) identify the parties to whom distributions, in the lender's view, will be likely to erode credit support as opposed to parties that further the legitimate value and credit-support-enhancing functions of the business and b) define what assets or activities of the borrower should be restricted. These would include any payment to shareholders and junior creditors, as well as extraordinary payments to managers, securities repurchases and loans to affiliated companies. And more.

Restricted and Unrestricted Subsidiaries. Unrestricted subsidiaries are generally not bound by the terms of the loan agreement in question and, analytically, are not part of the credit support for the loan. (They are potential leeches.) Restricted subsidiaries are bound by the loan agreement.

Restricted payments in bond indentures typically allow interest payments to junior debt, but there will often be restrictions on the repayment of principal. The more common approach is to prohibit any principal payments prior to maturity (unless from the "basket") and then require that at maturity the principal be financed from the offerings of new junior debt or equity securities.

The general mechanism for tracking what amounts are available for restricted payments is a lengthy formula that sums up to the "basket".

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Covenants (cont'd)

Blocking: a secured bank loan will often have fairly restrictive performance covenants that are breached when the borrower begins to experience financial distress. This usually gives the bank the right to prevent interest payments due on unsecured (even senior unsecured) debt, even when the borrower has the cash to make the payment. However, this will usually trigger the grace period on the bondholders' debt, giving the bondholders the right to accelerate. A bank that blocks is signaling that it is happy to trigger a filing, so that the borrower and the bondholders need to concede something to the bank if they want to avoid a filing

Typical RP basket

Carve - Out

Plus:

% of all Net Income earned
100% of proceeds from sale of common or preferred stock
100% of proceeds from issuance of any junior debt securities

Less:

100% of all Net Losses
100% of all amounts distributed as dividends
100% of all amounts used to buy back common or preferred stock
100% of all amounts contributed or loaned to (or amounts guaranteed on behalf of) unrestricted subs
100% of all amounts defined as restricted payments not otherwise covered above

Negative Pledge. A second manner in which a senior lender's priority can be compromised, particularly if unsecured, is by giving other creditor's liens or security interests in certain assets. When a lender provides unsecured credit to a firm that has not previously given collateral pledges, it essentially does so on the assumption that, in addition to the firm's cash flow, its existing assets are generally available to all unsecured creditors as credit support. Unsecured lenders will request a **negative pledge** provision, which essentially states that if the borrower gives a security interest in any of its assets to any other lender, it must include the existing unsecured debt as beneficiaries of that pledge.

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Time

Over time, four provisions have become increasingly common techniques used by lenders to manage future risk.

Performance Covenants. Lenders - and this is almost exclusively limited to bank lending situations - may require affirmative performance milestones to be achieved. Where performance covenants are included, failure to comply with the requirement is an event of default, unlike restrictive covenants where failure to comply may prevent the borrower from taking some specific action. The basic purpose of performance covenants is to control the lender's risk and to give it more say in the management of the business when things are not proceeding as planned. Lenders seldom trigger a default with violation of a performance covenant, but they do use it as an opportunity to extract more fees and/or increase pricing.

Put Rights. The provision of interim milestones when lenders can decide whether or not they want to remain in the deal. If they do not, the borrower must repay the loan.

Forced Call In The Event of a Downgrade. Borrower must repay the obligation should the ratings agencies downgrade the loan or bond below investment grade.

Performance-Linked pricing Provisions. Provisions that automatically adjust interest rates in the event of a credit deterioration. There is no default, just an adjustment of the interest rate payable.

Absolute priority - order of payment

Administrative claims
Statutory priority claims (tax claims, rent claims, consumer deposits, unpaid wages and benefits pre-filing)
Secured creditors' claims
Unsecured creditors' claims
Equity claims

Administrative Claim

Debt incurred by the debtor, with court approval, post-petition including necessary costs of preserving the estate, wages, salaries, court costs, lawyers' fees, accountants' fees, trustees' expenses, etc.

Avoidance Power

Power of the court to invalidate certain obligations or transactions undertaken by a debtor prior to filing bankruptcy

Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005

Primarily affecting consumer filings, legislation that makes it more difficult for a person or estate to file for Chapter 7. BAPCPA impacts business filers as well, with the heaviest impact on smaller (< \$2m debt) businesses.

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Bankruptcy Act of 1898

Basis of the federal bankruptcy statutes until Bankruptcy Reform Act of 1978

Bankruptcy Act of 1933

Statutory expansion of reorganization for companies. The Bankruptcy Act of 1933 and the Bankruptcy Act of 1934 were superseded by the Chandler Act of 1938.

Bankruptcy Act of 1934

A further statutory expansion of reorganization for companies. Superseded by the Chandler Act of 1938.

Bankruptcy Amendments of 1984

Set of amendments to the '78 Act, containing a number of provisions including limiting the jurisdiction of the bankruptcy court, limiting the right of companies to invalidate labor contracts while in bankruptcy and providing for the prevention of 'substantial abuse'

Bankruptcy Reform Act of 1994

Most comprehensive legislation since the '78 Act, including provisions to expedite bankruptcy proceedings, provisions to standardize fees, provisions to encourage individual debtors to use Chapter 13 to reschedule their debts rather than use Chapter 7 to liquidate, provisions to aid creditors in recovering claims against bankrupt estates, creation of a National Bankruptcy Commission to investigate further changes in bankruptcy law

Bankruptcy Reform Act of 1978

First substantive code revision since the Chandler Act of 1938. Upgrading the jurisdiction of the US bankruptcy courts to deal with cases handled by other courts, allowing the filing of a single joint petition by husband and wife, reorganizing the Chapters of bankruptcy, in particular concerning business reorganizations.

Bankruptcy Rule 2004

A provision of the Code that allows one party in a bankruptcy proceeding to compel discovery or other examination against another party

Bankruptcy Tax Act of 1980

Specifies the tax treatment of tax loss carry-forwards and exchanges of equity for debt

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Cash Collateral

Cash and cash equivalents held by the debtor in a Chapter 11 case subject to liens of other parties

Chapter

Code is organized into Chapters, all odd-numbered and enumerated with Arabic numerals

Cramdown

Confirmation of a POR over the objections of one or more classes of creditors

Default

Failure by an entity to abide by the covenants in a debt obligation or other agreement to which it is a party.

Equitable Subordination

The lowering of a claim's priority because the holder of the claim is found to be guilty of some kind of improper conduct

Examiner

A professional appointed by the bankruptcy court to investigate and oversee certain aspects of the debtor or the proceedings. Investigates and reports to the court

Exchange Offer

An offer by an issuer of debt securities to exchange new securities with less onerous provisions for currently outstanding securities. Often made in an attempt to avoid bankruptcy.

Exclusivity

A debtor in Chapter 11 has the exclusive right to file a POR for the first 120 days of its bankruptcy. Unless the period of exclusivity is extended by the court, other parties may file subsequently their own POR proposals

Executory Contract

A contract in which some or all of the obligations of each party have not yet been completed. The debtor-in-possession is allowed to reject unilaterally certain executory contracts

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First Meeting (341 Meeting) of Creditors

A mandatory meeting between creditors and the debtor, usually held within a month of the filing but often occurs later when the debtor has filed its schedules of financial information

Fraudulent Conveyance

The transfer of valuable assets from a company which i) occurs when the company is technically insolvent, ii) renders the company insolvent, or iii) is made for less than adequate consideration. The spate of LBOs has spurred a number of fraudulent conveyance allegations in recent years.

Fresh Start

New accounting rules applicable to bankrupt companies exist. Assets are valued at market value rather than at historical cost.

Impairment

When a POR alters the contractual rights of a class of holders of claims, that class is deemed to be impaired. A class that is unimpaired is deemed to automatically accept a POR.

Interests

The equity interests of stockholders are often referred to in bankruptcy documents merely as "interests"

Lien

A charge upon a specific property designed to secure payment of a debt or performance of an obligation

Liquidated Claim

A creditor's claim for a fixed amount of money

An **unliquidated** claim is a claim for which a specific value has not been determined.

Omnibus Hearing

Court hearing at which the court may hear of variety of different matters relating to one particular case

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Preference

A payment made by a debtor during a specified period (90 days, or 1 year if insider) prior to the filing that favors one creditor over others. Preference payments can usually be recovered and returned to the debtor's estate

Prepackaged Bankruptcy

Where the company and its creditors agree to a POR before the company files its petition. In a true prepack, a POR is circulated and approved by creditors before the petition is filed. The court then confirms the POR and the company emerges quickly

Reinstatement

Through reinstatement, a debtor cures default and resumes payment under original terms negotiated. In contrast, a debtor redeems when it purchases the release of collateral from a lien for a price equal to the total amount of debt owed. Reinstatement will be generally more favorable to the debtor, or to a subordinate lienholder, because it typically requires a much smaller immediate cash outlay than redemption. Reinstatement de-accelerates any obligation that may have become due under the terms of an acceleration clause and returns the debtor to the original contractual payment schedule.

Restructuring or Workout

An out-of-court attempt to reorganize and satisfy debts

Set-off

Ability to discharge or reduce a debt by applying a counter-claim between the same parties. Akin to netting. Example: a bank which has lent money to a debtor may attempt to satisfy some or all of the loan by seizing the debtor's deposits at the bank

Substantive Consolidation

Combination of the estate of one debtor with the estate of one or more other debtors and the application of the combined estate to satisfy their combined liabilities. Often considered in the case of parent/subsidiary debtors and other affiliated entities.

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Distressed Exchange

During a time of credit distress, debt holders may be effectively forced to accept securities in exchange for their debt claim - such securities being of a lower value than the nominal present value of their original claim. They may have a lower coupon, delayed sinking funds, and/or lengthened maturity. For historical estimation of default probabilities, this would count as a default event since it can significantly impair value.

Kurtosis

Characterizes relative peakedness or flatness of a given distribution compared to a normal distribution. It is the fourth moment of a distribution. Since the unconditional normal distribution has a kurtosis of 3, excess kurtosis is defined as $K_x - 3$.

This is akin to speaking about the fatness of the tails.

Leptokurtosis

The property of a statistical distribution in which one would expect more occurrences away from the mean than would be predicted by the normal distribution. Excess kurtosis > 0 .

Moment

In general, the shape of any distribution can be described by an infinite number of its moments.

1. The first moment is the mean which indicates the central tendency of a distribution
2. The second moment is the variance which indicates the width or deviation
3. The third moment is the skewness which indicates any asymmetric "leaning" left or right
4. The fourth moment is the kurtosis which indicates the degree of central peakedness

Upstream Guarantee

The guarantee by a subsidiary of its corporate parent's debt

Cross-stream Guarantee

The guarantee of a "sister" corporation's debt

Downstream Guarantee

The guarantee by a parent of a subsidiary's debt or a shareholder of the corporation's debt

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OID

Purchasers of secured debt that is issued at a discount are not entitled to a claim for the face amount of the debt.

In re: Solutia

