Financial Week
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Crunch makes Chapter 11 book harder to close

Exit problems for Delphi, Citi suing Solutia show new hurdles in post-bankruptcy loans
February 15, 2008

While the credit crunch is expected to push more and more companies into bankruptcy, it's also making it increasingly difficult to emerge.

In recent weeks, both auto parts maker Delphi and chemical manufacturer Solutia have tried to go to market with loans needed to exit Chapter 11, but they have encountered investors unwilling to meet their conditions. Making matters worse, the banks can even walk away based on the terms of the deal. In the case of Solutia, they already have.

Such resistance is likely to have the effect of longer stays in bankruptcy and the increasing prevalence of certain financing terms—among them "material adverse change" clauses tied to market prices, Libor floors that prevent interest rates from falling below specified levels, and broad bands in pricing that give flexibility in market prices.

Yet even that won't solve the problem in the near term. The credit markets are so tight now that even deals already in the market are not selling despite broader bands of pricing and Libor floors, in which a loan always maintains a minimum yield no matter how low the London interbank offered rate goes.

Banks, accustomed to syndicating and securitizing loans, have much less skin in the game when it comes to issuances where they have committed funding. Much depends on borrowers' relationships with banks, which have eroded in recent years as lenders have syndicated or securitized loans.

"In many cases, the lead banks haven't underwritten the deals, so the market risk remains with the debtor," said Penny Friedman, senior managing director and group head in CIT's national restructuring group. "Lining up new exit financing for a large-cap business is extremely difficult. There is still a market for midcap deals, and there is still a market for well-structured [debtor-in-possession] loans."

Instead of lining up committed capital, which is expensive at the moment, companies are engaging banks to sell their loans under "best efforts" agreements, where the bank agrees to use all efforts to sell as much of an issue as possible to the public. But if it's unable to sell all securities, it is not responsible for any unsold inventory. As an underwriter, it would have such an obligation.

A good example is Delphi and the $6.1 billion in loans it is seeking as it attempts to emerge from more than two years of bankruptcy protection. Reports said last week that J.P. Morgan Chase and Citigroup are having trouble syndicating the loans as investors balk at the pricing. The banks are only bound by a "best efforts" arrangement, threatening the deal altogether. Conditions are so bad for Delphi that it may seek financing from its former parent General Motors, which last week announced it lost a record $38.7 billion in 2007.

"Delphi is seeking exit financing to support its planned consummation, but the market conditions are very difficult and it's proven difficult to obtain the planned financing levels," said Fritz Henderson, GM's CFO, on a conference call announcing GM's earnings last week. "At this point, GM is exploring alternatives with Delphi in the event that the planned financing levels can't be achieved."

As for the banks, Citi is already tied up in a nasty battle with Solutia, which is suing the bank, along with Goldman Sachs and Deutsche Bank, for failing to fund a $2 billion loan needed to help it exit bankruptcy. Last week, Solutia went so far as to seek a court order to force Citi CEO Vikram Pandit to explain the decision to back out on the loan. In pulling the loan, Citi and the other banks invoked a market material adverse change (MAC) clause.

Solutia said it was caught off guard by the clause, saying it was given "the impression" that the market MAC clause was boilerplate. Of course, it is likely to be a standard term in at least the near future. Indeed, the lenders responded in court papers, "Citi explicitly advised Solutia that the inclusion of an adverse market change provision was a condition for approval of the financing by its credit committee."

Exit financing, by its nature, is the final piece of the Chapter 11 restructuring process, but given market conditions it is currently no less complicated than a full operational overhaul.

The last successful large-cap exit financing to come through was that of auto parts maker Dana, a $2 billion loan offering led by Citi, Lehman Brothers and Barclays at the start of this month, accounting for nearly two-thirds of the $3.2 billion in leveraged loans that have come to market so far in February.

Unlike Solutia and Delphi, Dana locked down its funding commitments, averting the market MAC clause and opting for more than "best efforts."

"You can't be an arrogant company that thinks they're not going to have to pay for that commitment and just take your chances," said Corinne Ball, head of restructuring at law firm Jones Day and lead lawyer for Dana during its reorganization. "We always erred on the side of margin of error for the company and had very little conditionality [in the financing]."

Going forward, companies teetering on the verge of bankruptcy or heading for it will have to change their plans and have a clearer view of their ultimate exit.

"During the past few years of robust liquidity, severely distressed companies raised financing out of court, whereas in prior cycles, the companies in similar situations would have had a bankruptcy as the only option rather than the ability to find new financing," said Ms. Friedman. "Today in the credit crunch, severely distressed companies have fewer options, the best of which is to pursue prepackaged arrangements either in court or out of court in terms of financing." FW