

Bankruptcies Rise for Firms 'That Should Have Failed' (Update1)

By Tiffany Kary and Caroline Salas



April 15 (Bloomberg) -- U.S. corporate bankruptcies are accelerating as the economic slowdown compounds the end of easy credit.

The filing by Frontier Airlines Holdings Inc. April 11 followed those of three other airlines and companies in restaurants and retailing this year. Increased levels of distressed corporate debt signal that failures will accelerate, says **Lynn LoPucki**, a professor at the University of California, Los Angeles law school who studies bankruptcies.

The amount of distressed corporate bonds jumped to \$206 billion April 11 from \$4.4 billion in March 2007, according to a **Merrill Lynch & Co.** index of bonds yielding at least 10 percentage points more than Treasuries. The share of leveraged loans considered distressed was 16 percent at the end of March, the highest since 1997, says Standard & Poor's, based on loans trading below 80 percent of their face value.

"Money was so easy, companies that should have failed were kept alive," said **Rick Cieri**, a bankruptcy lawyer at Kirkland & Ellis in New York. He said bankruptcies will include businesses "with severe operational problems" and too much debt. "Companies may well be sicker when they enter Chapter 11."

A company bankruptcy isn't just a sign of a weakening economy, LoPucki says. There is an economic effect.

"It is a disruption of the use of resources, and the costs of redeploying them are huge," said LoPucki, who keeps a **Web site** and wrote the 2005 book, "Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts." "People need to look for new jobs. Someone needs to take physical assets and recycle them. All the organizational work that went into the construction of the enterprise is lost."

Subprime Fallout

The wave of defaults on subprime mortgages, loans made to the least creditworthy home buyers, is spilling into the lower tiers of corporate credit, said **Anders Maxwell**, managing director of New York-based investment bank **Peter J. Solomon Co.**, speaking at a Feb. 28 conference on distressed investing in New York.

"Subprime was just a paradigm for the credit markets overall," Maxwell said. "Now in the corporate market, the shoe is just beginning to fall, and we're poised for a major correction that has been coming for at least a decade."

Bankruptcy filings have just begun to increase. According to court records compiled by Jupiter eSources LLC, Chapter 11 business bankruptcies, including small, nonpublic companies, increased 16 percent in the first quarter of 2008. Under Chapter 11 of U.S. bankruptcy law, a company seeks court protection from creditor lawsuits while working out a reorganization.

``I think this is the beginning," said Brett Barragate, a bankruptcy lawyer at Jones Day in New York. ``You have rising defaults into a market where it's virtually impossible to get refinanced."

Housing and Airlines

Some of the early bankruptcy filers this year reflect the decline in the housing industry, including homebuilder Touse Inc. of Hollywood, Florida, and moving company Sirva Inc., of Westmont, Illinois. Now following them are small airlines fighting rising fuel costs and competition from bigger carriers.

``They have no way to avoid default," said **George Godlin**, an analyst at Moody's Investors Service in New York, speaking of Frontier. ``They will continue to lose money in this environment, and the only way they can cease to lose money is by stopping operating."

Virgin America Inc., the startup airline partly owned by U.K. billionaire **Richard Branson**, may be among the next airlines to fail, analysts at JPMorgan Chase & Co. and Avondale Partners LLC wrote in April 7 reports. The private airline lost \$34.8 million in its first quarter of operation, which ended Sept. 30.

Las Vegas Casinos

Some issuers of bonds that are currently distressed, or considered at risk of default, are affected by cutbacks in spending by consumers. They include Claire's Stores Inc. of Pembroke Pines, Florida; Michael's Stores Inc. of Irving, Texas; and Herbst Gaming Inc., Tropicana Entertainment LLC and Station Casinos Inc., all of Las Vegas.

Linens 'n Things Inc., the Clifton, New Jersey-based housewares retailer, hired a restructuring company to explore options including a bankruptcy filing and said it postponed a \$16.1 million interest payment due today. Buyout firm Apollo Management Group led investors who bought Linens 'n Things in 2006 for \$1.3 billion.

Another company with a restructuring specialist is Hawaiian Telcom Communications Inc. of Honolulu, which hired **Stephen Cooper** of Kroll Zolfo Cooper LLC in Roseland, New Jersey.

Hawaiian Telcom is the biggest loser in the high-yield bond market this year, according to an April 10 report by JPMorgan. The company was formed in 2005 when Carlyle Group of Washington, another buyout firm, bought Verizon Communications Inc.'s Hawaiian operations.

20 Cents on Dollar

Its \$150 million of 12.5 percent notes due 2015 have fallen more than 83 cents to 20 cents on the dollar. The debt yields about 63 percent, 60 percentage points more than similar-maturity Treasuries, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority, the main brokerage watchdog.

More than 170 companies have bonds that are now considered distressed, according to data compiled by Bloomberg.

Martin Fridson, chief executive officer of FridsonVision LLC in New York, a high-yield research firm, predicted that a recession as deep as the eight-month contraction that started in 1990 could push defaults to 16 percent.

Last Recession

The highest default rate for speculative bonds and loans since 1983 was 9.98 percent in 2001, during the last U.S. recession. The average annual default rate over the same period was 4.48 percent, Moody's says.

Default rates may not rise along with a company's financial distress this time as they have in the past because some companies got so-called ``covenant lite" loans, without restrictions that can trigger defaults, said **Kenneth Emery**, Moody's director of corporate default research, in an interview. The covenants are usually financial ratios that measure ability to service debts, such as a quarterly limit on

total debt related to cash flow.

`` Even if a company's operating performance is sub-par, the bank issuers can't force them into bankruptcy because there are no covenants," Emery said. As a result, if a company does eventually file for bankruptcy, it will have even more debt, and less value.

The growth of leveraged loans, which include packages of high-risk bank loans called collateralized loan obligations, has grown to \$558 billion from \$14 billion in 1996, according to S&P. A secondary market that lets investors trade in and out of the loans may change their behavior.

` Out of My Hands'

`` Will this loan last long enough to get it out of my hands and into those of another individual," said **Timothy Coleman**, senior managing director of the Blackstone Group, the New York- based hedge fund, describing traders' attitude during a recent conference at Cardozo Law School in New York on `` challenges and opportunities created by the credit market crisis."

The new wave of filings may be affected by debt from the era of easy credit. Some lenders have second and even third liens on a company's assets. That puts them behind the creditor first in line to recover.

The tightening of loan standards means some companies may have difficulty obtaining so-called `` debtor-in-possession loans" that fund operations as a company restructures. Others have had trouble getting financing needed to exit bankruptcy.

Exit Financing

Solutia Inc., the bankrupt nylon and plastics maker based in St. Louis, sued its lenders to force them to fund a \$2 billion exit loan. The emergence from bankruptcy by Delphi Corp., the Troy, Michigan-based auto parts maker, was delayed April 4 when hedge fund Appaloosa Management LP pulled out of a \$2.55 billion loan agreement, citing a failure to meet conditions.

`` It is apparent now that some companies may be postponing Chapter 11 filings because it's not even clear they can fund themselves in bankruptcy," Kirkland & Ellis's Cieri said.

For some investors looking to buy distressed assets, the boom has already begun.

`` My philosophy is there are a lot of bargains now," said **Gary Hinder**, manager of a \$100 million distressed portfolio at Deltec Asset Management in New York, in an interview. `` But that doesn't mean I won't be guilty of premature accumulation -- or trying to catch a falling knife."

To contact the reporters on this story: **Tiffany Kary** in New York at tkary@bloomberg.net; **Caroline Salas** in New York at csalas1@bloomberg.net.

Last Updated: April 15, 2008 10:39 EDT