

Auctions Point To A Changing Bankruptcy Market

Wednesday, September 20, 2006 --- With bankruptcy auctions hotter than ever, the sale of distressed companies is serving to highlight the many changes currently taking place in the shifting bankruptcy arena.

Assets are rapidly changing hands, as hopeful bidders fiercely compete for the beleaguered businesses, says Peter Gilhuly, a bankruptcy partner at Latham & Watkins.

“Judges used to be reluctant to sell without a reorganization plan,” he says. “What has happened is that the court now looks and says we don’t have time, we need to sell the assets. There are compelling reasons to get it done soon.”

Since late July, Gilhuly has handled four separate “363” auctions, “a lot of activity” for the transactional insolvency lawyer.

“In the old days, you would have a traditional secured lender who said pay me back and did not want to own the company,” he said. “Now there is a lot more money and things move quickly.”

Gilhuly recently handled an auction for bidder Kendall-Jackson Wine Estates, which snapped up the assets of beleaguered California wine group Legacy Estate.

The case helped to underscore the enormous amount of influence that hedge funds are currently wielding in the bankruptcy market, says Gilhuly.

Like the junk bond market in the 1980s, hedge funds have exploded over the past decade, ballooning to an estimated 8,661 worldwide and controlling approximately \$1 trillion.

As companies limp into Chapter 11, hedge funds have been ready and willing to provide liquidity to the struggling companies in exchange for a large stake in the business.

“There are 9,000 hedge funds and a lot of them are not risk-averse,” says Gilhuly. “In the Kendall Jackson case, it’s the hedge fund that has made the loan and owns the company. You can’t pay them back and they are happy to put in new money.”

As a result, the market has become flooded with liquidity, which has provided a short-term fix for the numerous companies that are willing to change ownership hands.

“There is a lot of deferral going on,” says Gilhuly. “It’s pretty easy to put a band-aid on and refinance the problem.”

Due to the glut of available capital, companies often put off addressing the structural problems and instead opt for a temporary solution.

“Having massive liquidity changed the dynamics,” he says. “Second-liens have exploded, with seconds trying to buy out the first-lien holders.”

The hedge funds are clamoring to grab anything with residual value, since their duty is to drive the value of the distressed holdings up in order to maximize recovery, according to Gilhuly.

“So many hedge funds have been delivering and promising high returns,” says Gilhuly. “But what goes up tends to come down.”

Earlier this week, Greenwich-based hedge fund Amaranth Advisors LLP revealed that it lost more than \$3 billion since August, prompting fears that fund tactics might prove too aggressive.

But Gilhuly maintains that it is not hedge funds alone but also an influx of private equity money that have created a situation where there is money on all sides.

“What’s happening is there is a lot of money coming into insolvency situations and solving them before they become problems with a sale or a deal,” says Gilhuly.

While the enormous amount of liquidity can certainly lead to the delay of deeper problems in some situations, he contends that it may have helped to hone the bankruptcy system.

“Within the first month or two now, the asset side is over,” he says. “It’s an efficient way to deal with a lot of situations. The assets are sold, you get everyone a higher recovery and you move on.”

Though Gilhuly believes that the hedge fund phenomenon in bankruptcies is here to stay, he does predict that there will be a downturn in the near future.

“We have been in a relatively healthy economy,” he says. “At some point, when the interest rates go up and there are a few other dynamics that lead to lower consumer confidence, somebody is going to be left holding the bag.”

--By Anne Urda, anne.urda@portfoliomedia.com