It was a warm Monday afternoon. Men and women in suits mingled around a conference room, carefully examining the selection of cookies, drinks and popcorn on the side tables. At about 10 minutes after the hour, the bankers from National Bank entered the room, followed by two partners from Aron, Murphy, Dorans & Hansen LLC. Four consultants from Cashburn Consulting slipped in and took seats in the back of the room. Brian Stern of National Bank made some brief introductions and turned to meeting over to his colleague, Roger Blunt, from a group called Special Assets Division (SAD). Roger wore a slightly rumpled tweed suit, and a dark green tie with a serving of today’s soup splattered in the middle – beef barley. He had dark circles under his steely grey eyes and a deep gruff voice. As he explained the events of the past 72 hours, small gasps came from the audience. Some bankers exchanged wide eyed stares. Others started pacing behind their chairs. A pencil snapped. Roger kept on with his story. The Treasurer of Amalgamated Party Supplies (APS) had called Brian Stern on Friday morning. Inventory returns from the end of school year birthday party season were running unusually high – he cited too many single sex birthday parties. Also, the big licensing contract APS had signed for Margaret Thatcher themed party favors has proven unpopular with the primary school set. APS would be unable to meet payroll in three weeks. The bank facilities were now fully drawn and the company needed an additional $100m loan to continue operating. Roger turned the meeting over to the lead partner from Aron, Murphy who explained the basic steps of the impending Chapter 11 bankruptcy and the concept of a Debtor-in-Possession loan. Finally, Roger wrapped up saying that no bank could get out – the exit doors were barred.

As Brian got to work the next day, there were 3 urgent messages from the banker at Community Bank. He had spoken with the Credit Committee at their home office overnight and they wanted out! He needed to know how much National would pay to buy Community’s share of the APS loans. After asking the banker to repeat himself more slowly, Brian said he would discuss the matter internally and get back to him. Brian went down to Roger’s office in the basement. He explained Community’s request. Community was in many National Bank syndicates and had been very supportive, taking large stakes. More recently, Community was under pressure from regulators to reduce its growing NPLs. Brian and Roger consulted with their Chief Credit Officer and decided they could offer to buy Community’s loans at 30 cents on the dollar, if they really needed to get out. Brian called the Community banker, who accepted the offer 5 minutes later. They agreed to keep news of the transaction to themselves for the next few weeks so as not to cause a stir among the other banks. Later that afternoon, Brian received a bottle of champagne from the banker at Community, thanking him for helping them with their problem.

Wait a minute! What kind of ridiculous behavior is going on here? No one gets out? A lender sells at 30 after one bank meeting? And then sends over a thank you gift? What about that bank meeting? Why wasn’t everyone just on the phone? Surely, this is a fantasy.

Well, it is. But it serves to highlight some of the many changes to the practice of managing bad loans over the past few decades. First of all, we never called them distressed loans. Even this small distinction can be seen in the context of the dramatic changes in our marketplace, which include: higher quality financial disclosure and analysis; vast increases in liquidity; lower and less volatile interest rates; better financial management; greater experience with Chapter 11 reorganizations; expansion of court supervised reorganizations (a la U.S. Chapter 11) across the world; new investors – unregulated, short-term players and long-term investors; greater regulatory oversight at banks and borrowers.
So why not distressed? Distressed implies some possibility that the severity of the situation might be exaggerated. We were never exaggerating. When something was identified as a bad loan, the company was quite often out of cash. Over the past 25 years of INSOL's existence, the number of people looking at troubled credits has grown dramatically. One benefit of this has been a growing sophistication in the level of analysis. The many professional analysts, traders, lenders and investors that are active in the field are all acutely focused on liquidity and cash flow. In today's market the analysts might be the first to be telling APS management about the problems with their Thatcher party supplies.

Many of the changes to the distressed loan market have complemented each other to create today's (January 2007) frothy environment. The most notable change is liquidity. The fairy tale above where Community Bank's only way out of the credit was to go to the agent asking to sell at any price would never happen today. Equally, the idea of a lender holding an auction to sell its piece of a loan would have seemed ridiculous in the 1980s and early 1990s. Not only has liquidity arrived in the form of multiple bidders for loans, but the market now offers credit default swaps in a variety of flavors to allow non-traditional investors to create credit portfolios without ever having to call on a company treasurer.

Many of these new investors have come to troubled credits seeking yield. Low interest rates and modest equity returns since the hi tech crash in 2001, have led investors to seek new types of investments. Low rates have also made it very attractive to lever up investments in distressed assets, vastly improving yields and bringing a flood of interest from hedge funds (often financed by the more traditional bank lenders) to the market.

The past few decades have also brought a general improvement in the financial management of corporations. The prevalent use of the Chief Financial Officer title today is an accurate reflection of the increase in the sophistication that the job requires. Many CFOs have seamless access to a variety of funding sources and hedging options in addition to accounting and M&A responsibilities. They are constantly evaluating options to most efficiently finance businesses that are often growing rapidly or experience volatility. In distress, these professionals are more likely to act early to stabilize a capital structure or shore up liquidity. They are more proactive and less reactive. At least the good ones are.

Our entire industry has more experience with reorganizations and restructurings now and less with bankruptcies, insolvencies and liquidations. Companies get faster and better advice about how to avoid or use a court supervised reorganization to their advantage. At the same time, the concept of reorganization (vs. liquidation) has spread across the world. More and more political and financial communities, from Brazil to China, see having a fair and transparent forum for managing financial distress as critical to their successful growth and economic development.

Finally, the recent era of heightened regulatory oversight and enforcement has improved the quality of the universe of distressed assets. While there have been some notable and tremendous frauds uncovered recently – several of which caused this increased scrutiny – overall, the result has been greater and earlier disclosure of potential problems and issues. In the U.S., the recent episodes of financial restatements due to back dating employee option grants have scarred a few reputations, but caused very little financial distress. Today, the senior executive in favor of creative accounting or an overly generous expense account or pension plan is more likely to have more issues with prosecutors and plea bargains than with irate creditors. In the past, lenders were more often left with the distasteful task of negotiating a generous severance with the aforementioned CEO just to get him out of the way so others could focus on fixing the business, saving jobs and preserving creditor and shareholder value.

No doubt, the past 25 years have presented tremendous change in the insolvency and restructuring community. This change has brought a steady amount of fear and hand wringing – then: how will all those foreign lenders behave; now: how will all those hedge funds behave? But the choices and options available to borrowers, lenders and investors today would have been unimaginable 25 years ago. In some part, this progress is due to the contributions toward learning and best practices promoted by INSOL – Happy Birthday!

If only Community Bank had survived to see how much easier it would be to manage a troubled loan portfolio. As a member of an institution akin to National Bank, I guess I should feel some remorse about National's behavior, taking advantage of a desperate comrade with a 30 cent bid.

...Nah, I just miss the good old days.