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Corporate bankruptcy

Burning down the house

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Why credit-default swaps make restructuring harder to pull off

LYONDELLBASELL, the world's third-largest petrochemicals producer, should have "Danger, inflammable substance" signs posted on its debt. Its struggle against insolvency is a cautionary tale in the era of credit derivatives. As defaults soar, it is one of the first big firms to have its restructuring complicated by holders of credit-default swaps (CDSs). It is unlikely to be the last.

Last month the company's European arm missed an interest payment. Its woes, however, began much earlier. In the heady days of 2007 Basell, headquartered in the Netherlands, bought its American rival Lyondell in a \$19 billion deal, all financed with debt. Leveraged buy-outs usually take place in stable industries. The petrochemicals industry is cyclical, but caution was in short supply as the buy-out cycle neared its end. Then came the commodities boom, which made LyondellBasell's feedstock more expensive. After the bust it had \$26 billion of debt. In early January its American unit filed for Chapter 11 protection.

Now, ominously, some creditors would like to see the European parent default as well. The firm has obtained a temporary restraining order to prevent them from making claims against the European parent. It secured a grace period, and now has less than a month to make the missed interest payment.

The cause of this turn of events is the proliferation of CDSs on the company's debt. A CDS works like a fire-insurance policy: the holder pays a regular premium, but if the house burns down there is a big payoff. With CDSs, the payoff is triggered by a default—and filing for Chapter 11 did indeed trigger some CDSs. Now other CDS holders would like to see a default in Europe, to provoke a payout. Unsecured creditors who hold CDSs might prefer default to a lengthy restructuring: to them, the insurance policy is worth more than the house.

But there are good reasons to keep the European operations out of insolvency while the company restructures in America, says Mark Hyde, a specialist in cross-border restructuring at Clifford Chance, a law firm. Bankruptcy proceedings in Europe are messy, and merely to avoid the tangle of multiple jurisdictions is appealing. By contrast, America's Chapter 11 has the advantage of enabling the firm to obtain "debtor-in-possession" financing, which is senior to all other types of capital. New creditors are therefore willing to step in and fund operations while restructuring takes place. The firm has received a DIP loan of \$8 billion, the largest on record. That is a red, gasoline-soaked, rag to CDS holders.

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