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Hitting the wall

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As high-yield lenders stand ready to hit "That worrying wall of debt" maturing between 2012 and 2014 and amounting to $430 billion in leveraged loans alone (The Deal magazine, June 5), they might need to revisit their recovery expectations, due to the increasingly apparent effects of a law meant to avoid defaults.

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act. The measure contains an amendment to section 503(b)(9), which grants an administrative priority claim for goods sold to and received by a debtor in the ordinary course of the debtor's business within 20 days prior to its bankruptcy filing.

In making full payment of such claims a prerequisite to reorganization, Congress clearly intended to prevent concern regarding a debtor causing its suppliers to withhold credit and inducing a liquidity crisis. Unfortunately, two features of the 503(b)(9) Amendment as interpreted by the courts blunt its power to reduce defaults. A third one could make many future reorganizations extremely difficult to pull off.

First, the 503(b)(9) Amendment provides administrative expense cover to suppliers of goods, but not services. Service suppliers' attempts to expand the reach of "goods" to a broader "supply" sense have stumbled on an absence of definition in the Bankruptcy Code, and on a meaning restricted to "movable" items in the Uniform Commercial Code. Practically, the 503(b)(9) Amendment will not bring down the risk of trade-induced defaults of companies relying mostly on service suppliers for their activity, i.e., a substantial portion of the economy.

Second, courts have ruled that the 503(b)(9) Amendment does not mandate payment to 20-day creditors during the stay period, but that payment may be made at the conclusion of bankruptcy. Waiting for a possibly protracted emergence will be detrimental to the liquidity of movable goods suppliers. They might decide to hold off shipment or tighten terms to their weaker clients in much the way they would have before passage of the 503(b)(9) Amendment.

Third, while the 503(b)(9) Amendment provides that 20-day creditors can accept payments below their claims at their discretion, the 503(b)(9) Amendment does not regroup them into a separate class. They are bundled with other parties with administrative claims of divergent interests. In cases when secured lenders would forego their liquidation option only if 20-day creditors accepted a claims reduction, the only way to seek the latter's approval is an unwieldy array of individual offers. Odds of acceptance will be low. Some 20-day creditors will balk at a cut, not knowing if others have not obtained higher, possibly full payments. Some may engage in gamesmanship, and insist on full satisfaction, in the hope that enough other 20-day creditors will have agreed to a discount to make reorganization workable. Inability to reach consensus will be self-destructive for this group: In liquidation, 503(b)(9) creditors will rank behind secured lenders. Yet, liquidation will be the outcome of many of the looming high-yield defaults.

In assessing the effect of the amendment on high-yield recoveries, rating agencies take contrasting approaches. **Moody's Investors Service** correctly places 20-day creditors at the top of the reorganization claims waterfall, but it does so as if all claims were for movable goods. Also, Moody's

ignores the dynamics that will often push secured creditors to opt for liquidation to bump 503(b)(9) creditors behind them in the priority waterfall. This exaggerates the dampening effect of the amendment on high-yield secured investors' recoveries. By contrast, **Standard & Poor's** does not give 20-day creditors' claims specific recognition and low-balls their impact on all investors, secured and unsecured. Bank lenders and bondholders should be mindful of these biases when assessing their prospective recoveries.

The 503(b)(9) Amendment will dampen recovery for secured lenders, who will fall back on their liquidation floor more often than they expected. General unsecured lenders will take it on the chin in all cases, as they will be primed by much larger than anticipated administrative expenses, in both reorganizations and liquidations. As for the general interest, the rule illustrates the law of unintended consequences. It should not noticeably reduce instances where suppliers withhold credit; it should not measurably protect trade creditors as more bankruptcies should result in liquidation; and more jobs will be lost due to fewer reorganization outcomes.

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