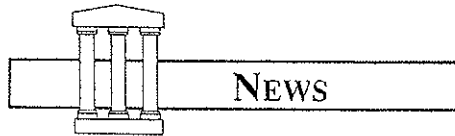


# Weekly News & Comment

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**NEWS**

## One in three people aware of bankruptcy reform efforts

Bankruptcy reform may not be the sleeper issue we all thought it was. According to a national telephone survey conducted by **Rasmussen Research**, 34 percent of likely voters said they knew **Congress** was considering a law that would make it more difficult to file for bankruptcy. Forty percent of the respondents said they thought this was a good idea, while 34 percent said they thought it was a bad idea. The remaining 26 percent were not sure.

It's interesting to note that 63 percent of the people called believe individuals should have the ability to file for bankruptcy, but only 47 percent believe corporations should have that same option.

## Allan Brilliant joins Milbank Tweed

**Allan S. Brilliant**, former chair of the Bankruptcy and Reorganization Department of the now defunct **Holleb & Coff** in Chicago, has joined the New York office of **Milbank, Tweed, Hadley & McCloy LLP** as a partner.

"Allan's successful track record in bankruptcy litigation will be of particular significance to our practice area," said **Luc A. Despina**, co-chair of Milbank's Financial Restructuring Group.

(See **BRILLIANT** on page A5)

## Sub-prime lender as prime time debtor

First, there was **CRIIMI MAE Inc.**, a sub-prime lender of commercial mortgage securities that filed Chapter 11 Oct. 5, 1998. It was quickly followed into bankruptcy by sub-prime residential mortgage lenders **Southern Pacific Funding Corp.** and **Cityscape**. A few months later, on March 1, 1999, **United Companies Financial Corp.**, also filed.

UCFC, whose plan of reorganization was confirmed Oct. 27 by **Judge Mary Walrath** (Bankr. D. Del.), provides an enlightening case study and is illustrative of what can happen in a volatile market that counts anticipated earnings as assets despite delinquency rates as high as 30 percent.

UCFC, founded in 1946, was one of the oldest of the sub-prime lenders and was perceived by the marketplace to have one of the strongest loan origination franchises in the industry. With 38 securitizations involving servicing responsibilities for over \$6 billion at the end of 1998, and origination through its own approximately 200 retail branches of

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over \$2 billion in loans during 1998, it was also one of the industry's largest players.

"As one of the stronger credits in the industry, United, unlike its competitors, had been able to get unsecured financing. This, combined with its apparently vital retail franchise, gave United a relatively strong position from which to try to weather the storm."

So says **Deborah Midanek**, then a principal of **Jay Alix and Associates** and now head of the New York office of **Glass & Associates**. Midanek should know. She served as advisor to Cityscape in its pre-negotiated plan of reorganization before she accepted the challenge of working with United Companies in Baton Rouge, La. Midanek became chief restructuring officer in December 1998 and assumed the role of CEO at the March 1999 filing date.

Unfortunately, this was one storm United would not be able to weather thanks to the problems with **Long Term Capital Management, LLP**, the \$3.5 billion hedge fund that collapsed in Sept. 1998 and had to be bailed out by a group of 15 commercial and investment bankers, and the Russians, who defaulted in April 1999 on \$1.3 billion in bonds.

"Suddenly, securitizing pools of loans made to borrowers with less than impeccable credit ratings seemed too risky, and the markets lost confidence in the product overnight," Midanek said.

Overnight, finding financing became a nightmare.

"Three Fridays in a row, we were down to \$2 million in the bank," said Midanek, who was responsible for 2,500 employees who were originating \$150 million in loans a month. "It was a bit hairy. Though the bank debt (\$850 million) and the bonds (\$225 million — check) were unsecured, and it appeared that we had plenty of collateral to pledge as a result, the terms of the debt precluded that — absent a waiver."

In one month, bankruptcy counsel **Marcia Goldstein** of **Weil, Gotshal & Manges** in New York and Midanek negotiated six different financing deals with the banks, who were represented by **Chaim Fortgang** of **Wachtell Lipton**. They also attempted to sell loans as soon as they originated them rather than waiting to pool and securitize them.

"Unfortunately, we discovered that the quality of what we had to sell was not great, and the prices we achieved were disappointing," Midanek said. "We immediately changed the underwriting standards and the

[employees'] commission schedule and centralized the appraisal process. At the same time, we came to the conclusion that the only way to secure enough financing ... was to file. The filing was liquidity driven. In bankruptcy, we were able to arrange a combined DIP loan and loan purchase facility of \$500 million from **Greenwich Capital** and **CIT**."

Obviously, at the time of filing, the market for the selling of mortgage-backed securities couldn't have been worse. Yet the Jay Alix team achieved spectacular results. On Nov. 10, 2000, the debtor sold its mortgage loan servicing operations and its interest-only and residual-interests to **EMC Mortgage Corp.** and **EMC Mortgage Acquisition Corp.** for \$850 million, includ-

ing assumed liabilities. The two buyers are subsidiaries of **The Bear Stearns Companies, Inc.** Coupled with United Companies' earlier sale of its whole-loan portfolio, creditors' recoveries ranged from 40 percent to 83.7 percent. More is expected to come from a litigation trust.

*"Three Fridays in a row, we were down to \$2 million in the bank. It was a bit hairy."*

— **Deborah Midanek**  
**Glass & Associates**

How was this result possible in such a climate?

**Background**

To understand how the Jay Alix team managed this achievement, you first have to understand how United Companies — and other sub-prime lenders — make a profit (for a complete discussion of this topic, please see BCD, Vol. 33, Iss. 6, p. 1). It starts with thousands of individual loans, which are originated across the country by United's retail branches. The loans are then grouped together, or "pooled". The pools can be sold "whole" to other buyers (i.e., financial institutions), or they can be sold in securitized pools in the bond market, which is the preferred method. In the latter case, the pools are analyzed by surety companies and ratings agencies to determine the amount of extra collateral required to get the bond a triple A rating.

In the case of United, homeowners paid approximately 11 percent to 12 percent interest on their mortgage loans. Of this, investors in the securitized product got 7 percent and the servicer of the loan (which, in this case, was also United) got 50 basis points or half a percent. United recognized the difference between the homeowners rate and the amount paid to the bondholders as a "gain on sale" at the time the sale was closed by discounting the expected future stream of payments to today's value.

Was this profitable? Well, it certainly had the potential to be. Let's say a borrower made his or her pay-

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## Web site made a difference

So who is happiest about the spectacular result in the bankruptcy of **United Companies Financial Corp.**? The banks?

Not exactly.

During the turnaround, the 22 original banks involved in the deal were replaced by 22 distressed securities investors and special situation opportunity funds in very active trading. How did Wall Street know what was going on?

"We found early on that doing a good job isn't enough," said **Deborah Midanek**, then of **Jay Alix & Associates**, who took over as CEO at the company's March 1999 filing. "Communicating that fact is important."

In addition to maintaining close contact with the creditors' committee and the equity committee, the team had a Web site that was updated daily. "The network was provided by **Intralinks**, a company founded by a former colleague of mine from **Drexel**," Midanek said. "Coincidentally, **Ernst & Young**, financial advisors to the debtor, had invested in **Intralinks** and supervised the network."

However, this wasn't a public Web site. You had to have a password to get in. "The people who could get in were the professionals for the creditors' committee and the equity committee and all the potential buyers, who at one time [ totaled ] 37," said **Larry**

**Ramaekers**, also of **Jay Alix**, who stepped up as CEO in October 1999.

"That included two sets of professionals, the trustee of each of the securitization trusts, **Bank One** and **Bankers Trust**, who were monitoring what we were doing. **CSF Boston** bought some subordinated debt and eventually got access too."

The Web site was changed almost daily. United's cash positions, corporate minutes and bank statements were posted. So were bank and loan documents as well as PSA agreements, which are the documents that control the securitization. The turnaround team also had to do almost continuous tax research. Every time they answered someone's question, they put the answer on the Web site, figuring others would want the same information.

"It saved a lot of time because, in evaluating our performance, you really had to look at the performance of 100,000 loans," Ramaekers said. "You didn't just want to look at the top line performance. You had to get into the loan level detail."

Ramaekers believe all the investors did well.

"My understanding is that vultures want a quick return," he said. "If they bought at 80 and sold at 83, they probably did better than [ those who ] bought at 45 and sold at 83. The return rate changes based on how long they hold it. But [ at these rates ], they all did well, I assume."

ment at 11.5 percent interest. After subtracting the bondholders' 7 percent and the servicers' ½ percent, United Companies would keep the 4 percent difference plus the ½ percent it got as servicer of the loan. Averaged over \$6 billion worth of securitized loans, that's quite a chunk of change.

### The problems

Unfortunately for the sub-prime lenders, making a profit is not as easy as the math above might make it appear. As soon as the sub-prime lender sells its aggregated loans, it gets a "residual certificate." In the example above the certificate would be for 4 percent over, say, 30 years. Spread over a portfolio of 15,000 loans, that certificate could easily be valued at \$100 million. Typically, a sub-prime lender posts this \$100 million on its books as an immediate profit using what is known as "gain on sale accounting."

"The actual value is only known over time as the loans are collected, but the apparent earnings momentum created by ever larger securitizations and ever more aggressive gain on sale assumptions confused a large number of investors and company managements,

who behaved as if the gains on sale were already money in the bank," Midanek said.

That's not the only problem. This is the sub-prime market. At least 30 percent of these borrowers aren't going to pay off their mortgages — ever.

The entire sub-prime industry is also under scrutiny by regulators for various **Truth in Lending Act** (TILA) violations and most have various lawsuits pending, which is why any buyer had to purchase the company's potential liabilities. In discussing the industry's TILA problems, one of the large bank debt investors gave this example, which is not from United Companies. "[ One company ] was accused of lending to a woman who needed to do a \$5,000 porch rebuilding. She suddenly had fees up to \$40,000 on a house worth \$50,000. She couldn't pay it. They took her house."

United's loans averaged \$50,000. The company generally pooled 10,000 to 15,000 loans at a time, which would be worth between \$500,000 to \$700,000, and relied on its ability to sell the loans in its "inventory" in

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securitized pools to Wall Street each quarter. Further, the market started to realize, with the large write-downs taken industry wide, that the carrying values of the residual interests were unrealistic. Gain on sale accounting started to come under scrutiny. People asked, 'Are your assumptions realistic? Did you really book a \$100 million profit? Should you have put that on the books when you sold those loans?'

"Deborah [Midanek] came in early on and realized there was no benefit to running the company as a going concern, which is a very difficult thing to decide," said one of the large bank debt investors. "It's difficult to make that decision and it's difficult to convince the board to sell the operations. The origination platform was bleeding \$8 million a month. She got someone [**Aegis Mortgage Corp.**] to buy it for \$3 million plus operating expenses — to take on that liability, the costs of carrying new loans, and all the people and that negative cash flow. That allowed the company to shore up its servicing ability and to take the assets it did have and get the value out of those."

This investor said that it had become clear to Midanek that the business model for these sub-prime lenders didn't work. "They all had a negative cash flow, but they were booking earnings based on net values of receivables booked based on discount rates. It was all perfectly legal, but they took it to the limit. Some investors questioned the enormous negative cash flow of these companies. It was like the shields were taken off people's eyes. Financial companies are always built on confidence. Once the confidence goes away, they have no access to capital. They can't keep burning cash."

With the branch system sold and the workforce reduced from 2,500 to 500, the money being collected from the existing portfolio instantly made the company cash positive. That gave the Jay Alix team time to focus on improving the loan servicing operation in order to protect the value of the company's residual certificates. Midanek brought on **Larry Ramaekers**, another Jay Alix principal, to serve as chief operating officer and lead the team's efforts to improve operations. When Midanek left in October 1999, Ramaekers stepped up as CEO and completed the Nov. 10, 2000 sale to EMC.

#### **Prepayment speed**

So how did the team increase the value of the residual certificates?

*'EMC Mortgage Company said, "We'll service your loans, but we think you'd be better off if you sold them to us."'*

— **Larry Ramaekers**  
**Jay Alix & Associates**

"Three elements determine the value of your residual certificate," Ramaekers said. "One is called prepayment speed, the rate at which customers pay off their loans. Customers pay off their house or refinance it, or they stop making payments and we foreclose and sell the house."

At least 25 percent to 30 percent of borrowers pay off their loans in any given year, which means the value of the portfolio is reduced rather quickly. While prepayment speed is an important variable, it's the economy and the status of the buyer who control this variable — not the sub-prime lender.

The two elements over which the lender has at least some control are the delinquency rate and the amount of losses it sustains on foreclosure.

#### **Delinquency rate**

As a homeowner with normal credit, you probably received a coupon book from which you detach a coupon each month to mail in with your mortgage check. It doesn't work this way in the sub-prime market. "Several days before payment is due, we mail a statement to the borrower," Ramaekers said. "Then we call and remind them. On the 10th of the month, after the payment

is due, something like 70 percent still have not paid. So it's a matter of having good people who are able to work with the borrowers to get the money in. These borrowers generally don't have a bank account. Their decision is which bill to pay. If they like you, or are worried you will take their house, they will make a payment to you. It's like in any other business. If one company will let you get away with 60 days, but another calls you and says your bill is 30 days overdue, you'll pay the one who keeps reminding you. So you can very definitely influence the delinquency rate."

Ramaekers, who has spent his career in the turnaround industry and who was recently awarded the **Turnaround Management Association's** first Lifetime Achievement Award, said every business has a glamorous side and a dirty side.

"Good people and the attention of management almost always go to the glamorous side of the business. At **Cardinal Industries** [another Jay Alix turnaround], we were manufacturing and selling limited partnerships in motels and apartment buildings. Once you built it, you had to manage it. That wasn't glamorous. You did it only because you

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## Halting employee turnover

In the spring of 1999, immediately post filing, employee turnover at the failing **United Companies Financial Corp.** was 11 percent a month.

"That can't continue very long," said **Deborah Midanek**, then of **Jay Alix & Associates**, who took over as CEO of the company in March 1999. "We had to stop the bleed and keep the people in place."

Within two months, the company had turnover down to 1.4 percent a month, which continued through the end of September 2000. How?

"We had a retention program [in which] we said that anyone who was here or who had not been terminated for cause would receive eight weeks of pay on Sept. 30, 2000," said **Larry Ramaekers** of Jay Alix, who stepped up as CEO in October 1999.

"In addition, we had a severance program that gave everybody, even brand new employees, a minimum of four weeks severance — more for key or

long service employees — up to 26 weeks of severance pay."

At the time, it seemed Sept. 30 was more than enough time to accomplish the turnaround. It was actually four to six weeks short of the deadline.

"We made the payments as scheduled on Sept. 30 — and we began losing about 10 employees a week after that," Ramaekers said.

Still, enough employees remained to make the transition work — probably because they felt they had been treated fairly. Ramaekers said employees always knew the probable outcome. The team never lied to them. The turnaround team also set up job fairs that included neighborhood employers and paid for training sessions on resume writing. In addition, they invited in "change" consultants to help employees deal with the transition since United Companies was viewed for years as THE place to work in Baton Rouge, La.

had to do it in order to sell apartment buildings. It was the same thing at United. You collected because you had to collect in order to sell the next loan, but you didn't put your attention there. What we've found is that anything you watch gets better. When we started putting our attention there, things got better."

Employees knew that the company wanted a 30 percent delinquency rate or less by the end of the month, but they had no daily targets so they didn't know if they had achieved that target until the end of the month. The turnaround team set targets so employees would know where they should be on Nov. 2, Nov. 3, etc.

The company's automated system also called borrowers alphabetically, which meant that those whose last name began with the letter A got a lot more calls than those whose last name ended with the letter Z. The turnaround team decided to reprioritize calls so they would be more productive. For example, big loans were called first. Employees also began focusing on loans that were 30 days past due versus 120 days past due, when it was virtually impossible to collect.

### Foreclosures

Now, we move to the third element that influences the value of the residual certificates: the amount of losses sustained on foreclosures. When Midanek arrived, the time between a defaulting borrower's last payment and the sale of the house was 28 months. The Jay Alix team was able to take roughly 10

months out of that process. Since it costs the company about 1.3 percent of the loan balance to "hold" a mortgage loan, cutting 10 months or 13 percent off the costs of its \$6 billion portfolio saved the company millions.

To reduce the time between default and sale, the Jay Alix team set up a whole new de-

partment to monitor real estate agents and lawyers. With 250 to 300 new houses a month and an inventory of 3,700 houses, the team really had to monitor the sales process to make sure they got the most from each house.

"Every one of the foreclosures was run by some lawyer out in the boonies," Ramaekers said. "In the past, we didn't watch how long they took. When we started saying, 'I sent you the paperwork last Fri-

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*'Deborah [Midanek] came in early on and realized there was no benefit to running the company as a going concern, which is a very difficult thing to decide.'*

— Large bank debt investor

day a week ago and you haven't filed yet,' they started cutting off a few days. Decisions are made in every lawsuit that speed up or slow down a case. We made them report to us as to what steps were going on."

United also began letting third parties outbid it at foreclosure sales.

"We used to buy every house," Ramaekers said. "We would bid in the debt. But many aren't worth the debt. When somebody buys the house, it's off your books. It's not around the average eight months it takes to sell. Eight months times 1.3 percent — you can reduce your price somewhat and move them quicker."

Ramaekers says the key reason sub-prime lenders are in trouble is because 11.5 percent interest, far from being usurious, isn't enough. "It's not like you sit back and collect 4 percent for nothing. It's not that easy. The average recovery on a loan, after carrying costs of 18 to 28 months, is something like 70 percent by the time you add in foreclosure costs. That's not to mention the guy who gets mad and puts a hose in the attic and turns it on when he leaves. He's not worried about his credit rating — it's already messed up. If he's nice enough to burn it down, at least you've got insurance."

#### Management

To exit bankruptcy, the Jay Alix management team knew they had to replace themselves. But with such a high-risk company, they didn't believe this was possible. So they went to competitors and asked them to make a proposal for collecting United's loans.

"Remember: the better the job they do with collecting the more our residual certificates are worth," Ramaekers said. "EMC Mortgage Company said, 'We'll service your loans, but we think you'd be better off if you sold them to us.'"

Because United was a distressed company, the team thought it possible that they would not get a full value bid. "We spoke with more than 30 possible players about their interest and the structure they would propose to use to service the loans," Midanek said.

In the end, the company had two bidders: EMC and a group affiliated with **Goldman Sachs** and **Greenwich Capital**. The result was that the bid was raised

another \$65 million to more than \$850 million, including the value of assumed liabilities.

"The company had two assets: the residual certificates and \$300+ million in loans it had made that were not yet securitized," Ramaekers said. "The owned loans were sold on Sept. 18. The residual certificates and servicing business was sold Nov. 9."

"[The Jay Alix team] did a terrific job signing up Bear Stearns, giving them a breakup fee, and then bringing in Goldman to create some competition," said one of the large bank debt investors. "There was

a huge amount of competitive fury. It was a very complex transaction all around. The Weil Gotshal people [who represented the debtor] also did a fantastic job."

#### Trading

United traded as low as 40 cents early in the case [At confirmation, what was it trading at] — but at confirmation it was projected that bank loan claims totaling \$857.9 million would

receive an 83.7 percent recovery. Senior note claims totaling \$238.9 million would receive a recovery estimated at 48.4 percent, while general unsecured claims totaling \$30 million would receive a recovery estimated at 40 percent. Even holders of subordinated debenture claims totaling \$158 million will receive a cash payment of \$2.5 million.

That's not all. The plan also provides for the establishment of a litigation trust. Proceeds above an initial \$10 million will be allocated 30 percent to equity holders, 30 percent to subordinated debenture holders, and 40 percent to bank claim holders, senior note holders, and general unsecured claim holders.

United's plan went effective Nov. 13.

"Given the number of players involved, we had extraordinary cooperation from our lenders, from the banks and the bondholders, and from the securitization trustees and insurance companies, who were all confronted with an absolute mess," said Midanek, who now moves on to head the New York office of Glass & Associates.

"We had a lot of fun [on this engagement]," said Ramaekers, who is retiring. "I got a real sense of accomplishment. But I'm sitting here today in Boca Raton [Fla.], looking at my pool. It's 82 degrees and sunny. I think there are other things for me to do."

*'Good people and the attention of management almost always go to the glamorous side of the business. . . . What we've found is that anything you watch gets better.'*

— Larry Ramaekers