

## Testimony Before the ABI Chapter 11 Reform Commission

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My name is Lee Shaiman. I am a Managing Director with GSO Capital Partners, a division of Blackstone in the Debt Funds Group. I oversee the management of portfolios of senior secured bank loans and mezzanine debt securities that are held by CLOs, mutual funds, and separately managed accounts, including foreign banks, pension funds, sovereign wealth funds, and fiduciaries. GSO currently has approximately \$55 billion under management. Before joining GSO Capital, I was a Managing Director in the Debt Funds Group at the Royal Bank of Canada and the IndoSuez Capital Division of Credit Agricole, where I managed various structured investment vehicles. Prior to that I was a Managing Director at UBS Warburg, where I was global head of high yield capital markets, assisting corporate finance clients of the firm.

I am grateful to the ABI Commission for the opportunity to testify today regarding these important issues. I understand that the Commission is considering reforms to chapter 11 that would significantly curtail the rights of secured lenders and holders of debt purchased in the secondary markets. While I applaud the Commission's goal of preserving businesses, I share the concern voiced by Ms. Murphy that such reforms would seriously impair the functioning of the capital markets—and thus harm businesses both in and out of bankruptcy. I would like to underscore how such “reforms” will profoundly affect decisions to purchase debt and could ultimately drive certain investors and borrowers out of the market, dramatically reducing the availability of capital to non-investment-grade companies.

*1. Diluting the protection of secured creditors' rights in bankruptcy would result in the contraction of credit markets and increase the cost of credit.* Capital markets, as Ms. Murphy explained, operate on a risk continuum that runs from the most highly secured debt at one end to the most speculative equity investments at the other. The price of capital turns in large part on where an investment lies along that continuum.

My clients' strategies are centered on secured lending. When purchasing secured debt on behalf of clients, we first assess the borrower's financial health. This includes the sustainability of the company's earnings, its ability to pay its debts when they are due, and its probability of receiving future credit if it will rely on credit (such as a refinancing) to cover its debts. The main goal, of course, is for the borrower not to be in trouble in the first place, but to be able to repay its indebtedness out of revenues generated by its business operations.

We understand, however, that no matter how robust our underwriting process, a certain number of firms, for whatever reason, will not be able to pay their debts as they come due. These firms will either dissolve or seek to restructure their debts, with or without judicial

oversight. Enforceable security interests in that event are critical to the decision to invest in the first instance.

A borrower's risks are priced at the front end. When a lender determines the price of credit, it assesses the credit spread or the compensation for the risk that it is taking. When a borrower can pledge security, a lender is willing to take on additional credit risk because the lender knows it can recover its collateral if the borrower proves unable to repay. Indeed, through the past four credit downturns, recoveries on defaulted secured bank loans have averaged about 80%, and median recoveries are significantly higher than that. Borrowers are thus able to draw more credit. Without reliably enforceable security interests, lenders will charge more to compensate for the enhanced credit risk, and some lenders may not participate in the lending market at all.

I invest in debt on behalf of my clients on terms providing that investors will be paid in full or receive the value of their collateral. Reforms that eliminate or introduce uncertainty regarding the benefit of that bargain have the potential to harm capital markets in several ways.

*First*, such changes to the law would affect the ability to price a loan and find investors on the front end. For example, it would be difficult to price senior secured debt that can be subrogated if the borrower reorganizes. Uncertainty as to whether a security interest will be enforceable in bankruptcy will itself contract the lending market as lenders struggle to price that additional legal risk.

*Second*, lessening the protections accorded secured creditors would affect loan sizes going forward. Lenders would not be willing to lend as much if they cannot be sure that they will be able to collect as much as they are owed or the value of their collateral in the event of default.

*Third*, such changes would increase the cost of credit in light of the additional risk flowing from the possibility that a security interest would not be enforced in bankruptcy.

*Fourth*, such changes would alienate more risk-averse lenders, potentially causing them to exit the market altogether.

*Fifth*, such changes would dramatically diminish the flow of capital to non-investment-grade companies. The greatest selling point for investors in non-investment-grade companies is that those companies pledge their assets to secure their debt. Without those enforceable security interests, many investors would not invest in non-investment-grade companies, which could reduce the market by billions of dollars, leaving only a fraction of the capital currently available to those companies.

2. *The soundness of the secondary markets in distressed debt creates liquidity in the market and makes credit more broadly available to borrowers.* Lenders also take the secondary market into consideration when making loans in the first instance, and they rely on a liquid secondary market. Debt is purchased with the understanding that it may be sold later, and most primary market lenders are not interested in, or are unable to hold, distressed debt. Reforms restricting primary investors' ability to sell in the event of the borrower's financial distress, or making it less desirable for investors in the secondary market to buy such debt, will increase the

overall risk of primary lending. It will thereby decrease the number of investors in capital markets and drive up the cost of credit.

In short, bankruptcy reforms will not affect bankruptcy alone. Weakening the protections available to secured creditors, or reducing the recovery of holders of debt bought on the secondary market, will have a profound, and negative, effect on the availability and price of credit—particularly credit extended to non-investment-grade companies. Such companies could see their access to capital markets vanish, and see their ability to continue to run and grow their businesses vanish with it. That means fewer businesses and fewer jobs, something we can ill afford, especially in these difficult times.