

The Secured Debt Report

News, Information, and Analysis of Asset-Backed Finance for Middle Market Companies

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NEW SIGN OF DISTRESS

Pangaea Pays Wide Spreads to Complete CLO Offer

by Don Dzikowski

Last week saw a significant sign that the turbulence in the bond market over the last few weeks has leaked into the middle market.

Pangaea Asset Management's first collateralized loan obligation priced on July 19 at spreads that blew out to a whopping 16.5 basis points wider than where they were marketed, on average for all of the security classes.

"We got whacked on account of the tough market," said Barry Shear, president of Pangaea.

Investors demanded among the widest yields seen in recent months for such deals for the lower-rated tranches of Pangaea CLO 2007-1, significantly raising funding costs for the issuer. Sources said

that, in general, spreads paid by CLOs containing significant quantities of middle market debt have widened since late June between eight and 11 basis points overall. The double-B class of Pangaea's deal widened out about 50 basis points, compared with similar classes of securities of CLOs issued earlier in June.

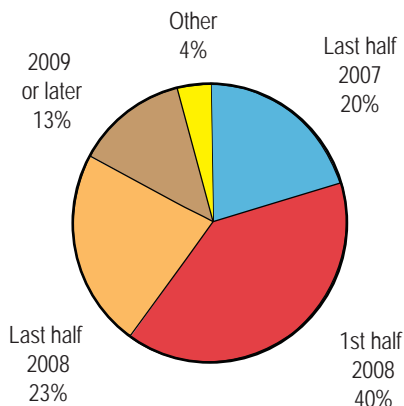
The large yields were necessary for Pangaea to compete its deal, even after it had already reduced the size of its offering a few weeks ago from \$400 million to \$300 million. Shear said he was grateful to have gotten the sale completed at all, given the risk that conditions might worsen.

Pangaea CLO 2007-1's \$217 million triple-A rated tranche will pay 25 basis

See Distress Sign page 11

TMA SURVEY OF TURNAROUND CONSULTANTS

Projected Increase in Debt Defaults



Source: Turnaround Management Association

TURNAROUND CONSULTANTS GET READY FOR A DOWNTURN

'It All Starts With Denial'

by Reg Crowder

S. Douglas Hopkins, president of the Parsippany, N.J., turnaround specialist **Kestrel Consulting**, has seen a lot of changes in his more than 25 years helping distressed companies get out of trouble.

But one thing never changes.

"It all starts with denial," Hopkins said. "The turnaround consultant has to find a way to overcome that denial. I have never seen a consultant come in to the board of a company with new numbers and new facts. They're always the same numbers and the same facts that the board had before them all along."

He said it is human nature for people to interpret facts the way they want to see them. Board members are no different. "The first and most urgent task is to give the board a careful diagnosis of the facts they already have," Hopkins said. "You have to tell them what you got wrong and what your problems are."

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MIDDLE MARKET LENDERS START TO SEE CRACKS IN THE MARKET

While the problems in the subprime mortgage and high-yield debt markets have so far been kept largely contained to those areas, sources report anecdotal evidence of the cracks extending into the middle markets.

Colin Cross, managing director of Chicago middle market debt fund **Crystal Capital**, said he is “starting to see some investor pushback on structure and pricing” for loans to medium-sized companies with annual EBITDA of \$30 million to \$50 million.

Investors in second lien loans to such companies are currently asking for yields around LIBOR plus 550 to 575 basis points, Cross said. That’s about 50 to 75 points more than they were seeking a short time ago, he added. The investors have also been refusing loans they consider to lack adequate covenants and other protections, and demanding premiums of 100 basis points to accept loans with PIK toggle notes.

Mark duFour, a managing director in the middle market lending unit at **NewStar Financial** in Boston, agreed that the turbulence in the high-yield and subprime markets has awakened middle market investors to the possible catastrophe that can result when lenders in a highly liquid market slacken off on credit standards. They are therefore taking corrective steps to avert problems. These include a retreat from the high-yield conventions that have filtered down to companies with \$20 million to \$50 million in annual EBITDA and a demand once again for the historical norms of tight covenants, flexible pricing and shortened amortization periods, according to duFour.

Cross, who is also chairman of the Turnaround Management Association, said deals that would have been oversubscribed a short time ago, may now be

difficult to complete. Investors no longer will accept “take it or leave it,” because the ones who had been lined up behind them are no longer there.

Despite investors’ skittishness, Cross said he still has seen no sign of a slowdown in the overall middle market pipeline in recent weeks. Demand for buyout financing remains strong, although loan refinancings have begun to slacken off a bit, he said.

Steve Ellis, head of the junior capital group of the **Proskauer Rose** law firm in Boston, related his own example of what he said could be indicative of a crack. A client recently decided not to buy into a significant debt position in a larger deal to a company with roughly \$100 million in annual EBITDA. The investor believed if he waited until shortly after closing he would be able to make the same purchase for under par, Ellis said.

In addition, Ellis said his firm handled about 75 junior debt transactions for middle market companies in 2005. This year the firm has completed about 100 so far. Out of the 75 loans two years ago, not a single one has gone into default or needed work. But 10 deals out of this year’s 100 have already needed fine-tuning in the form of a minor restructuring or a small amendment.

“As far as cracks in the marketplace, we are not seeing a slippery slope. However 10% indicates a little reason to be concerned,” Ellis said.

One middle market debt fund manager in New York, who asked to remain anonymous, said he has just recently started seeing cases where investors place a dozen or so second liens and mezzanine loan investments in portfolios and sell them off to the secondary market at a discount.

— DD

Market Players Say They're Seeing More Fraud

Some debt market players say they are seeing more instances of fraud. They view it as evidence of a fast and loose credit environment and a possible sign of worse things to come.

"Lenders are facing increasing incidents of fraud," said Maggie Good, president of middle market turnaround firm **The Meridian Group** in Pittsburgh. Good said she was personally aware of six different cases in recent months where borrowers falsified financial information or collateral levels to obtain new financing. The victimized institutions included funds, specialty lenders, and banks.

One high-profile fraud case has been that of **Le-Nature's**, a Latrobe, Pa., maker of bottled juice drinks that lost more than \$500 million in secured debt, some of which was allegedly funneled to an illegal clandestine resale business. At a recent distressed debt conference in New York, panelists highlighted Le-Nature's case as the type of massive lender fraud that, should it become more common, could erode investor confidence, like the **Enron** and **WorldCom** scandals did in the last market downturn.

Good described the fraud she has seen as "evidence foreshadowing of events to come."

A New York bankruptcy attorney, who requested anonymity, attributed increasing fraud to the sloppiness that comes with the loosening of underwriting standards in a highly liquid and competitive market. Lenders are not performing adequate due diligence on clients, knowing that the time required to do so could cause them to lose deals to competitors.

Sheila Smith, a principal at **Deloitte Financial Advisory Services** in Boston, agreed that the frothy lending market has been facilitating more fraud. Just as loans with loosened covenants have become routine, borrowers have been able to forego the usual quarterly external field

audits. Lenders are trying to compete by telling borrowers, "we will give you the same low interest rate but we will not be a burden to you," Smith said.

An Association of Certified Fraud Examiners survey of 1,134 organizations that were victims of fraud from January 2004 through January 2006 found that external audits were the most common anti-fraud measure they used. About 75% of these victims of occupational fraud, which included borrowers whose management had falsified financial information to obtain financing, used external audits.

Audits ranked only fifth, however, among the most common ways that fraud had been successfully detected. Tips, accidental detection, internal audits and internal controls proved more effective in the cases surveyed, according to the Austin, Texas, trade group.

Smith said it's gotten easier for borrowers to conceal collateral and cook the books. She attributed that to the speed of e-commerce in completing transactions and increasing globalization, which allows borrowers to use overseas operations and currency exchanges to obscure finances.

Chapter 11 for Oasys Mobile

Oasys Mobile, a Raleigh, N.C.-based provider of mobile media applications, filed for Chapter 11 protection, saying it can't repay \$8 million owed on senior secured debentures held by **LAP Summus Holdings** and **RHP Master Fund**.

The filing was made on July 18 in the U.S. Bankruptcy Court in Delaware.

LAP and RHP invested in Oasys in November 2005, when the company was doing business under the name **Summus**. The two funds split an \$8 million PIPE offering of 19-month senior secured convertible debentures and warrants.

LAP and RHP, as senior secured creditors, will exchange their secured claims for substantially all of the equity in the post-bankruptcy company, Oasys said in a filing with the Securities and Exchange

Commission.

Summus, which provided screensavers and computer wallpaper bearing images from the 2005 Hooters Calendar Girls Collection, changed its name to Oasys Mobile last year and began focusing on a mobile lifestyles portal business. In recent months, the company again refocused, moving away from the portal business to game and application publishing.

While Oasys achieved incremental gains in gross revenues in 2006, the firm's net losses more than doubled from \$6.1 million in 2005 to \$14.8 million last year. On the balance sheet, the company had about \$4 million in assets and \$9 million in liabilities at the end of last year. Matters worsened somewhat in 2007, and the bankruptcy filing reflects assets of \$2.1 million and liabilities of \$11.5 million.

Aside from the noteholders, the biggest creditors are **Mattel**, **Provident Advertising and Marketing**, and **Sony BMG Music Entertainment**, according to the bankruptcy filing. The three are owed a total of about \$750,000.

After the filing was announced July 19, Oasys stock fell about 60% to 27 cents.

U.N., Trade Group to Promote International Lending Standards

The United Nations is expected soon to approve an initiative that could help U.S. lenders doing business overseas.

In cooperation with the Commercial Finance Association, the U.N. Commission on International Trade Law plans around year-end to release a comprehensive guide for nations to streamline their laws governing all types of secured lending.

"We are hoping the World Bank and the International Monetary Fund will play a role in promoting the guide," CFA co-counsel Richard Kohn said.

Kohn, who is also head of the finance practice of Chicago law firm **Goldberg Kohn**, said a group of delegates from 38 industrialized and developing countries

have been working on the guidelines with representatives of the CFA for the last six years

Kohn said the guide may be most useful for developing countries in Asia, the Middle East, and Eastern Europe to adapt their laws to attract U.S. investors. (The guide will also address lending under Islamic law.) Many American lenders will not entertain deals in nations where they feel the commercial trade laws lack credibility, and do not afford protections such as title to secured assets, Kohn said.

The guidelines could also benefit lawmakers in some developed nations, such as Germany, that lack statewide filing systems like the Uniform Commercial Code system in the U.S.

“Filing systems in many countries are cumbersome or they have no filing system at all,” Kohn said. That can make it difficult for a lender to put a lien on collateral, as it creates uncertainty about whether the lender is in the senior position.

The guide is also expected to update a framework for insolvency laws passed by the U.N. in 2004 and for court systems to enforce them, said Kohn.

Topics that the guide will cover include asset-based and enterprise lending, liens on intellectual property, factoring, and equipment leasing and securitization.

Appellate Court Limits Equitable Subordination Claims

A federal appellate court has affirmed the limited circumstances where a creditor committee can seek to knock down the priority of a secured lender’s claim under the legal principal of equitable subordination.

The decision could be significant in that it limits options for entities that pursue litigation strategies to generate returns on investments in bankruptcy companies.

The Second Circuit Court of Appeals, whose territory includes New York, ruled July 9 against the unsecured credi-

tors committee in the Chapter 11 reorganization of defunct Internet company **AppliedTheory**. The committee had sought to have a secured loan held by a group of five hedge funds recharacterized as equity or subordinated to other creditors’ claims. The lenders included **Hali-fax Fund, Palladin Partners, Hatteras Partners, Spectrum Investment Partners, and Elliott Associates**.

Under the legal principal of equitable subordination, debt can be recharacterized as equity or subordinated to other claims because of wrongdoing by the lender.

In AppliedTheory’s case, the unsecured creditors committee argued that the hedge funds that provided a \$30 million loan were insiders at the company and abused their insider status to convert their unsecured debt to secured. At the time, AppliedTheory was allegedly insolvent, undercapitalized, and generating huge losses. The conversion from unsecured debt to secured debt was in return for an additional advance of \$4 million.

In upholding a lower court’s decision, the appellate court cited a long-established rule holding that the right to pursue equitable subordination claims on behalf of a bankruptcy estate is vested primarily with the debtor-in-possession, the bankrupt company or the bankruptcy trustee. Therefore, the unsecured creditors’ committee can’t pursue an equitable subordination claim without authorization from the trustee or debtor-in-possession. The appellate court found that the only exceptions could be if the bankruptcy court granted the committee permission to pursue the claim, after the trustee and debtor-in-possession had unreasonably failed to pursue the claim themselves.

“Reorganizations would routinely spin out of control if decisions that would commit the time and limited resources of the estate could be taken without the consent of the bankruptcy court,” the appellate court stated in its opinion.

In this case, the trustee Yann Geron with the law firm of **Fox Rothschild** in New

York, refused to intervene on the creditor committee’s behalf, after finding the equitable subordination claim lacked merit and was unlikely to succeed.

Martin Zohn, head of the Los Angeles bankruptcy practice of law firm **Proskauer Rose**, said the decision doesn’t completely eliminate the claim of equitable subordination as an option for distressed debt investors. Any individual creditor could independently assert such claims on their own behalf, but generally not as part of a creditor committee acting on behalf of the estate and at the estate’s expense.

One exception may be when the creditors can argue that the debtor-in-possession is under the control of insiders against whom an equitable subordination claim would be asserted. “This is common in fraudulent transfer actions,” Zohn said.

The bankruptcy trustee Geron had, in fact, argued for a fraudulent conveyance claim on behalf of the unsecured creditors’ committee. Geron agreed with the committee that lenders to AppliedTheory should have all or a substantial portion of their \$37 million lien against the bankruptcy estate eliminated as a fraudulent conveyance. As insiders, they had improperly converted their debt from unsecured to secured, he argued. But both the bankruptcy court and the district court disagreed with the fraudulent conveyance claim in separate rulings. Geron has an appeal pending before the Second Circuit.

Under a settlement agreement reached in November between the trustee and the lenders, Geron would drop his appeal of the fraudulent conveyance claim, AppliedTheory’s bankruptcy case would be dismissed and lenders would only also receive about half of their claim, after administrative expenses are paid. The unsecured creditors, who have filed papers opposing the settlement, would receive nothing on their roughly \$17 million claim.

Dura Rights Offering Opposed by Sub Debtholders

Dura Automotive may face stiff opposition from subordinated bondholders to a proposed equity rights offering designed to finance the auto parts maker's exit from bankruptcy.

Market players have been watching Dura's case for indications of how second lien debt is likely to be treated in future bankruptcies. The intercreditor agreement between lenders to the Rochester Hills, Mich.-based company was said to be especially loose, giving second lienholders little power to enforce their rights.

"This was about as silent a second as one could imagine," said Kurt Mayr, an attorney representing the second lienholders with the law firm of **Bracewell & Giuliani**.

The rights offering that Dura proposed on July 13 would raise capital to pay all secured lenders, including second lienholders, in full.

Senior bondholders are likely to come away with control of Dura, after the \$140 million to \$160 million offering. But holders of \$561 million in 9% subordinated bonds are likely to receive nothing.

A source close to the sub bondholders, who asked to remain anonymous, said the group believes the rights offering is based on too low of a valuation of the company. It would therefore allow senior bondholders too big of a reward for swapping the \$419 million owed on their bonds, and extra cash, for the new equity.

If a deal cannot be worked out for a better return, sub bondholders are likely to file opposition papers before an Aug. 1 hearing on the offering, the source said. An investment bank was engaged by the group last week to study options.

Under the proposal, hedge fund managers **Pacificor**, **Bennett Management** and **Wilfrid Aubrey**, which hold large senior bond positions, would provide \$140 mil-

lion to \$160 million to backstop the entire offering in exchange for up to 43% of the new shares. The remaining shares would be offered first to other senior bondholders and then to general unsecured creditors (not including the sub bondholders) on a pro rata basis. If the remaining equity is not purchased by other creditors, Pacificor, Bennett and Wilfred Aubrey would be obligated to purchase it.

The source close to the junior bondholders said that they were riled that the offering potentially provides for the three funds to buy shares not claimed by the other senior bondholders at a substantial discount. The sub bondholders also consider the funds' backstop commitment fee of 4% of the offering price to be excessive.

"If the shares were shopped better, the company would be worth more and could get the sub debt into the money," the person said. "Dura's management is just rushing to get this thing through as quickly as possible."

Dura Automotive may have an incentive to exit bankruptcy before Oct. 31. Then, an agreement for the company to continue making monthly interest payments to second lien debtholders will expire and would have to be renegotiated, the attorney Mayr said. As it stands now, money generated from the rights offering would be contributed towards paying the second lien lenders their entire \$225 million claim.

The second lien lenders secured their monthly interest payments, as so-called adequate-protection payments, last November, shortly after Dura Automotive filed for Chapter 11 protection. The initial intercreditor contract did not allow for any such obligation. The second lien lenders secured the payments, however, in an agreement with first lien lenders and Dura as part of a condition for senior lenders to provide debtor-in-possession financing.

Dura and the first lien lenders gave in to the second lienholders' demand for ade-

quate-protection payments, in hope that it would help the company exit bankruptcy quickly. Mayr said the second lienholders had threatened to litigate the enforceability of their loosely structured intercreditor contract.

Under the proposed equity rights offering, the holders of convertible trust preferred securities, owed \$58 million, would also receive nothing. A representative of holders of those securities declined to comment.

Clearwire Puts \$1B Loan to Work with Sprint Nextel

Clearwire, after closing the first tranche of a \$1 billion loan, agreed to team up with **Sprint Nextel** to build a massive WiMax network and offer wireless Internet access at a speed comparable to that of DSL service.

Market reaction was enthusiastic, and Clearwire shares rose 34.4% to \$33.30 after the plan was announced July 19.

Clearwire, founded by cellular phone service magnate Craig McCaw, announced the debt financing earlier this month and said it would use the facility to pay off older debt and expand operations. **Morgan Stanley**, **Merrill Lynch**, **JP Morgan**, and **Citigroup** led the secured term loan transaction.

Under Clearwire's 20-year agreement with Sprint, they may ultimately provide service to 300 million customers, Clearwire said in a statement. They forecast reaching as many as 100 million by the end of next year. The companies will provide roaming service to each other's customers and market the WiMax service under a single brand.

The Department of Justice and Federal Communication Commission will need to approve some aspects of the agreement before it can be implemented.

Sprint is seeking investment for the WiMax service from private equity firms and cable television companies, the *Wall Street Journal* reported. ■

SDR

Transaction Activity

DEAL

Flow

NATURAL GAS COMPANY TO REPURCHASE \$250M IN NOTES

Kendle Intl. Completes \$200M Convertible Offering

Natural gas driller **Targa Resources** offered to repurchase \$250 million in 8 ½% senior notes due 2013.

The Houston-based company retained **Credit Suisse Securities** as dealer manager of the offer.

The offer, which was announced on July 19, will expire on Aug. 15. Targa is offering a \$30 consent payment for every \$1,000 in principal tendered by Aug. 1.

Targa had previously said on July 17 that it's seeking to arrange new senior bank facilities.

The company's losses have been shrinking lately. For the first quarter, Targa's publicly traded limited partnership unit, **Targa Resource Partners**, reported a

net loss of \$4.71 million, compared with \$10.2 million a year earlier. Revenue declined 2.8% to \$93.6 million.

In another large debt transaction by a middle market company, **Kendle International** completed a \$200 million offering of convertible senior notes. The Cincinnati-based company provides clinical research services to the pharmaceutical industry.

The notes Kendle offered bear 3.375% annual interest and convert into stock at \$47.71 a share. That was a 32.5% premium to Kendle's share price on July 10. The closing of the offering was announced July 16.

Kendle said it will use at least \$146 mil-

lion of the proceeds to repay debt owed on a previous term loan.

In another deal by a smaller energy company, **Texas American Resources** raised \$160 million in financing with a first lien term loan arranged by **BNP Paribas**.

The loan bears interest of LIBOR plus 4.5% and will mature on June 29, 2012, Texas American said.

The Austin, Texas, company said July 17 that it will use the proceeds to repay older debt and expand oil drilling on its Colorado and East Texas properties. —AS

Have news that may be of interest to readers? Please e-mail us at editor@dealflowmedia.com

Recent Middle Market Debt Transactions

Arranger/Lender	Amount	Form	Borrower	Purpose	Other Financing	Date Disclosed
Commercial Bank of China, Communication Bank of China	\$50M	Loan of undisclosed terms	Canadian Solar	Expansion of manufacturing facilities in China		Jul 19
Wells Fargo, Amegy Bank	\$50M	5-year revolver	Luby's Inc.	Expansion		Jul 19
Deerfield Management	\$30M	3-year non-interest bearing loans	Dynavax	Growth		Jul 18
JPMorgan Chase Bank, Bank of Scotland	\$100M	1-year senior secured facility	Serica Energy	Development of oil fields		Jul 18
Undisclosed investors	C\$600,000 to C\$1M	Private placement of 9% unsecured convertible debentures and 12% unsecured convertible debentures	Madison Energy	Growth		Jul 18
Undisclosed investors	\$1.5M	3-year unsecured convertible debenture: \$1M at 10%, \$500,000 at 12%	StonePoint Global Brands	Growth		Jul 18
Undisclosed strategic investors	\$1M	Fixed price convertible debt	Sionix	Product rollout		Jul 18

SDR

Transaction Activity

Recent Middle Market Debt Transactions

Arranger/Lender	Amount	Form	Borrower	Purpose	Other Financing	Date Disclosed
Alpha Capital Anstalt	\$750,000	24.99% secured promissory note	bioMETRX Inc.	Fulfill orders		Jul 17
American Capital Strategies	\$50M	Second lien term note	Welsh, Carson, Anderson & Stowe	Acquisition of TransFirst Holdings		Jul 17
BlueCrest Capital Finance	\$2M	Debt financing of unknown terms	ImageTree Corp.	Growth		Jul 17
BNP Paribas as sole book runner	\$160M	5-year first lien term loan at LIBOR + 4.5%	Texas American Resources	Expand drilling program		Jul 17
GE Antares as administrative agent	\$113M	Senior secured facility: \$93M term loan and \$20M revolver	Industrial Growth Partners	Acquisition of API Heat Transfer Holding Co.		Jul 17
Investors led by Little Bear Investments	\$600,000	15% secured promissory notes	Brendan Technologies	Bridge financing		Jul 17
Miscellaneous funds and trusts	\$1.1M	15-month 8% unsecured convertible promissory note	Osage Development Corp.	Growth	Warrants	Jul 17
Trinad Capital Master Fund	\$100,000 maximum	10% loan	Asianada Inc.	Growth		Jul 17
Undisclosed PIPE investors	\$60M	5-year 5% convertible bonds	BMB Munai	Expansion of oil and gas production in western Kazakhstan		Jul 17
CK Life Sciences Intl.	\$14.89M	2-year convertible debenture at LIBOR + 4%	WEX Pharmaceuticals	Clinical trials, working capital		Jul 16
Investment Quebec	C\$550,000	Loan of undisclosed terms	Biophage Pharma	Growth	Warrants	Jul 16
RBC Centura Bank	\$500,000	Added equipment loan to two existing ones	etrials Worldwide	Growth		Jul 16
Morgan Stanley Senior Funding	\$150M	Term loans with expansion provisions	NightHawk Radiology Holdings	Acquiring assets of health care firm		Jul 13
Unidentified investors	\$8M	2-year 9% senior secured convertible notes	Local.com	Working capital		Jul 13
GE Antares as sole book runner	\$118M	Senior secured facility	Graham Partners	Acquisition of Schneller Inc.		Jul 12
Undisclosed investors	\$500,000	Private placement of 5% secured convertible debenture	Global Energy	Growth	Investor may purchase \$3.5M in additional debentures	Jul 12
Hercules Technology Growth Capital	\$3M	Venture debt	Prism Education Group	Growth		Jul 11
Private investor	\$1.3M	Debt of undisclosed terms	EMTA Holdings	Part of proceeds to fund acquisition of Dyson Properties		Jul 11
Standard Bank Plc	\$15M	1-year revolver	High River Gold Mines Ltd.	Growth		Jul 11

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Transaction Activity

Recent Middle Market Debt Transactions

Arranger/Lender	Amount	Form	Borrower	Purpose	Other Financing	Date Disclosed
LINLEY Management S.A.	\$1.3M	Loan of undisclosed terms	Phantom Entertainment	Expansion, production		Jul 10
GE Antares as administrative agent	\$71M	Senior secured facility with \$61M first lien term loan and \$10M revolver	Chicago Growth Partners	Acquisition of Jonathan Engineered Solutions		Jul 10
Amcore Bank; Houlihan Smith & Co. as advisor	Not disclosed	Credit facility and leasing facility	BSC Ventures, BSC Equipment	Growth		Jul 9
Bank of Montreal	C\$47.5M	Term, revolver, risk management loans	Maxim Power Corp	Growth, retirement of previous BMO loan		Jul 9
Bank of Montreal as agent; Ares Capital for unsecured term	\$155M	Secured \$35 and \$70M term loans, \$20M revolver, \$30M unsecured term loan from Ares	American Community Newspapers	Growth		Jul 9
Cohen & Co.'s Emporia Capital	\$33.5M	Senior and second lien debt	Stone Arch Capital	Recapitalization of Natural Resources Group		Jul 9
First National Bank of Omaha	\$10M	Drew \$10M from \$73M facility	Little Sioux Corn Processors	Expansion of ethanol plant		Jul 9
Goldman Sachs, Highland Crusader Offshore Partners, Communications Media Advisors	\$25M	14% senior secured notes due 2011	Grande Communications Holdings	Growth	Add-on to \$168M in previous notes	Jul 9
Hercules Technology Growth Capital	\$15M	Venture debt	Purcell Systems	Growth		Jul 9
Investors	\$150M	Senior convertible notes due 2014	SonoSite	Acquisitions and general purposes		Jul 9
Madison Capital, ClearLight Partners	Not disclosed	Madison provided senior debt	Katzkin Leather Interiors	Recapitalization	ClearLight provided equity and mezzanine financing	Jul 9
Undisclosed investors	C\$3.14M	2-year 10% convertible secured debentures	Aspen Group Resources	Growth		Jul 9
Note purchasers	\$110M	Offering of 2.5% convertible senior notes due 2014	Aspect Medical Systems	Part of proceeds will go to buying back debtor's stock from Boston Scientific		Jul 6
RBC Centura Bank	\$55M	3-year revolver	Wilson Holdings	Growth		Jul 6

SDR

Transaction Activity

Recent Changes to Terms of Middle Market Debt

Arranger/Lender	Amount	Form	Borrower	Purpose	Other Financing	Date Disclosed
Undisclosed lender	\$50M	Credit facility increased from \$200M to \$250M	Hiland Partners	Growth		Jul 19
Bank of America as agent, KeyBanc as syndicator	\$40M	Reduction in facility from \$115M to \$75M	Rex Radio and Television	Amendment for reduction of capacity		Jul 18
Undisclosed lenders	\$70M	Used accordion option to expand revolver from \$250M to \$320M and	Centerline Holding Co.	Growth		Jul 17
Toronto Dominion	C\$10M	Renewed facility and extended from C\$20M to C\$30M	Badger Income Fund	Finance acquisition of Benko Sewer Service and other assets		Jul 16
Benaroya Capital	Unknown	Increased facility to \$10M	Tully's Coffee Corp.	Growth		Jul 13
Undisclosed lender	Not specified	Amended credit agreement to reduce margin by 0.75%	Otelco			Jul 13
Unspecified lender	\$5M	Increased 8.75% line of credit to \$6.6M	VCG Holding Corp.	Acquisition of nightclubs		Jul 11
S&T Bank	Not disclosed	Amended agreement to include receivables aged more than 120 days in borrowing base	Allin Corp.			Jul 9
Existing noteholders	Not specified	Seeking consent to modify reporting covenants of 11% senior secured notes due 2012	Gundle/SLT Environmental	Amendment for flexibility		Jul 9
Citicorp North America as administrative agent	Not disclosed	Amendments to change financial ratio covenants and limit buyback of equity	InPhonic			Jul 6
Bank of America	\$5M	Facility increased from \$15M to \$20M	I-trax Inc.	Working capital		Jul 6
JPMorgan Chase Bank as agent; Fortis	€10M	Agreement with JPMorgan allows subsidiary to receive €10M facility from Fortis	Empire Resources subsidiary Imbali Metals Bvba			Jul 6
Undisclosed lenders	\$1.1M	Increase to \$8.25M senior secured convertible loan	Medirect Latino	Growth		Jul 6
Undisclosed lenders	\$100M	Facility decreased to \$100M	DreamWorks Animation SKG			Jul 6

SDR

Transaction Activity

Middle Market Repayments & Redemptions

Arranger/Lender	Amount	Form	Borrower	Purpose	Other Financing	Date Disclosed
JMP, Potomac Capital, Special Situations Funds, SRB	\$5M	3-year 8% convertible notes	Interlink Electronics	Pay down line of credit, working capital	Warrants	Jul 20
Investors	\$150M	Offering of senior notes due 2014	Parallel Petroleum	Pay down credit facility and second lien term loan		Jul 19
Noteholders	\$250M	Commenced tender offer for 8.5% senior notes due 2013	Targa Resources	Cash tender		Jul 19
New York Business Development Corp.	\$200,000	Repaid balance of senior loan	WiseBuys Stores			Jul 17
Note purchasers	\$200M	Completed offering of 3.375% convertible senior notes due 2012	Kendle Intl.	Repay outstanding debt, general purposes		Jul 16
Wells Fargo	\$75M	\$50M unsecured revolver and \$25M secured letter of credit	SunPower Corp.	Replaced two other lines of credit		Jul 16
KeyBanc Capital Markets	\$115M	Senior credit facility	Jupitermedia	Drew \$75M to pay off another credit line; \$20M for acquisition of Mediabistro		Jul 13
Silicon Valley Bank	\$4.7M	Repaid debt	Applix			Jul 13
Existing noteholders	Not specified	Offering to purchase 8.75% senior notes due 2014	Hawk Corp.	Offer to purchase notes		Jul 11
Existing noteholders	Not specified	Seeks to exchange 6.25% senior convertible notes due 2008 for similar notes due 2009	Indevus Pharmaceuticals	Exchange to extend maturity and change terms; New series has limited redemption proceeds and variable conversion feature		Jul 9

Cancellations

Arranger/Lender	Amount	Form	Borrower	Purpose	Other Financing	Date Disclosed
Rule 144A buyers	\$140M	Cancelled 6% convertible redeemable note offering because of market conditions	Panda Ethanol			Jul 10

Continued from front page

points over three-month LIBOR; it had originally been marketed at 24 basis points. A \$16 million double-A-rated tranche priced at 50 basis points over LIBOR, after being marketed at 45 basis points. A single-A-rated tranche will pay 100 basis points over LIBOR, compared with a marketed spread of 85 basis points. A \$14.5 million triple-B rated tranche will pay 250 basis points over LIBOR; it had been marketed at 230 basis points. And a \$15 million double-B-rated tranche priced at 475 basis points over LIBOR, expanding out from its marketed spread of 435 basis points.

The CLO consisted about 60% of middle market loans and 40% of highly syndicated loans to larger companies.

Pangaea had difficulty marketing its CLO at favorable pricing despite the deep experience of the new Chicago-based asset manager's executive team. The firm was started in March by three former top executives of **GE Antares Capital** in 1996, became president after **GE Capital** acquired Antares in 2005. At Antares, Shear oversaw more than \$3 billion in CLO offerings.

Pangaea is tapping a \$550 million warehouse line from **Citigroup**, which served as lead manager on the first deal.

Middle Market Liquidity

Pangaea's difficulty could presage a broader drying up of liquidity in the CLO market. If so, middle market borrowers are likely to be the first to be affected, said Mark duFour, a managing director in the Boston-based middle market lending group of **NewStar Financial**.

Standard and Poor's Leveraged Commentary & Data recently estimated that CLOs now fund about 50% of all new loans to companies that generate from

\$20 million to \$50 million in annual EBITDA. CLOs fund about 20% of loans to companies with less than \$20 million in EBITDA, duFour said. In the highly syndicated leveraged loan market, LCD said CLOs have been funding about 60% of new issuance.

Pangaea's difficulty could presage a broader drying up of liquidity in the CLO market. If so, middle market borrowers are likely to be the first to be affected.

In the much larger market of CLOs backed by widely syndicated loans, spreads for lower rated tranches have reached their widest levels in at least 18 months, **Deutsche Bank** researcher Elen Callahan said. These spreads have widened significantly in the last few weeks.

Single-A-rated tranches went from 95 basis points over three-month LIBOR to 110 basis points as of July 13, according to Deutsche Bank researcher Lily Lau. Triple-B-rated tranches went from 225 basis points to 265 basis points. Double-B-rated tranches moved from 485 basis points to 550 basis points. All of the classes were already at their widest levels in more than a year at the end of the second quarter.

Only a few middle market CLOs were being marketed last week, including deals from **Merrill Lynch Capital** and **GSO Capital Partners**. The pipeline has traditionally slowed for August when market players leave for vacation.

Brian McManus, managing director of collateralized debt obligation research at **Wachovia Bank** in Charlotte, N.C., said he was aware of managers holding back on deals. "The climate for CLOs is less than enthusiastic," he said. "We are seeing a general withdrawal of liquid-

ity in the CLO market at the mezzanine level."

Lenders are starting to have trouble generating interest in CLO classes rated below triple-A without a premium to investors. CLO managers and other syndicated buyers are also demanding higher yields on the loans they're purchasing.

"What we are seeing with CLOs is all part of the general re-pricing of risk across the entire debt market," McManus said. The wider spreads being paid by CLO issuers demonstrate "a healthy reassessment of the risk."

Until recently, CLO activity remained as brisk as ever. Deutsche Bank's Callahan said that \$49 billion of CLOs, including middle market offerings, have been issued this year as of July 10. That's slightly more volume than last year's at this time, and \$25 billion of this year's issuance came in the second quarter.

Wider Spreads from Larger Borrowers

Ken Kencel, a managing director for CLO issuer **Churchill Capital** in New York, noted that the spreads paid by highly syndicated CLOs have uncharacteristically gotten wider than those of middle market offerings in recent weeks. Loans to medium-sized borrowers have generally in the past been considered riskier and less liquid. Now, however, investors are demanding more compensation for the risk they perceive in the broadly syndicated debt market, with the advent covenant-lite loans, PIK toggle features and higher leverage. Middle market loans do not include these structures as frequently, Kencel said.

Kencel said CLOs have had more difficulty raising equity lately. He questioned what this will mean to the continued funding of what has been anticipated to be a heavy pipeline of leveraged buyouts

for the remainder of the year. He said that spreads on lower-rated tranches of highly-syndicated CLOs have widened by some 50 basis points in recent weeks.

One asset manager expressed confidence that spreads will return to lower levels. Bruce Ferguson, co-head of Winnetka, Ill.-based **Apex Fundamental Partners**, said his firm will continue marketing equity in its first CLO. Apex plans to bring the \$400 million offering around the middle of next year.

Willem Sels, chief credit strategist at **Dresdner Kleinwort** in London, said rising spreads reflects investors' concern that the same loose lending standards that are now resulting in the subprime residential mortgage blowup were also being applied in the corporate lending market, with covenant-lite terms and loans features such as PIK toggles.

Moody's, Standard and Poor's, and Fitch Ratings have each in the last few weeks downgraded or placed on ratings watch hundreds of tranches of subprime mortgage-backed securities and collateralized debt obligations backed by mortgages. Several high-yield bond and loan issues also have been postponed in the last few weeks.

Concerns are also evident in the credit default swap market, according to Sels. The benchmark CDS index for the U.S. has recorded yields that have nearly doubled since the beginning of May from 143 basis points to 280 basis points.

Credit tightening also caused the postponements in recent weeks of several high-yield bond and loan issues. On July 20, for example, **Alliance Boots** announced the postponement of an \$18 billion issue. The offering was to finance the LBO of the U.K. drug store chain by **Kohlberg Kravis Roberts & Co.** If completed, it will be Europe's largest leveraged buyout.

Clogged Pipeline

Eric Tutterow, a managing director of leveraged finance for Fitch Ratings in Chicago, noted that investors have been demanding a premium to absorb a clogged pipeline of new high-yield loan and bond issues. That pipeline recently totaled \$300 billion, compared with

Sources are concerned that banks will reduce capital for lending to preserve capital for bridge loans that will be needed by companies whose bond and syndicate loan offerings are delayed.

\$70 billion at this time last year. Tutterow said that yields have widened by about 25%, or 60 basis points, in the last month.

In addition, Tutterow estimates that \$415 billion in leveraged loans, including larger loans of more than \$200 million to middle market borrowers, are maturing and will need to be refinanced by year-end.

Sources are concerned that banks will reduce capital for lending to preserve capital for bridge loans that will be needed by companies whose bond and syndicate loan offerings are delayed.

These kinds of conditions have precipitated past waves of defaults, Tutterow said. Interest rates could increase for borrowers, while lenders close off new financing, causing default rates to creep up from the present historic lows.

A liquidity crunch is likely to strike the middle market first because less liquid loans to unrated borrowers are perceived to carry the greatest risk.

Sels said that hedge fund investors, spooked by declining returns, may start seeking redemptions next quarter, as hedge funds are heavily invested in credit default swaps and vehicles collateralized by subprime mortgages.

But the liquidity crunch doesn't appear yet to have hit the middle market, according to J. Scott Victor, co-head of the special situations group of workout advisory **SSG Capital Advisors**, a unit of **National City**. He pointed to LCD's research finding middle market loan volume for the first half at \$17.3 billion, on pace for the full year's total volume to reach or surpass last year's record of \$33.2 billion. Meanwhile, the rate of defaults on leveraged loans stood at 1.2% at the end of the second quarter, the lowest level since 1997, according to LCD. The research firm also found the percentage of these loans, including larger middle market loans of over \$200 million, in payment default or bankruptcy has fallen to 0.6%, the lowest level since 1996, according to Victor.

Ferguson, with Apex Fundamental, said a downturn could be forestalled for a long time by a "massive amount of dry powder" still available for investment. He said that private equity firms have hundreds of millions of dollars in commitments from limited partners that they haven't invested. With leverage, even conservative leverage of 5x equity, P.E. firms may still have trillions of dollars to invest. "This kind of money could keep the market afloat for a long time," Ferguson said. ■

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Hopkins said it is a big mistake to rush in and change the management, hoping for a quick fix. "The management may be at fault for making some mistakes," he said. "But seldom is the management the sole and fundamental problem. You've got to find out what the fundamental problems are. At this stage, you have got to get it right."

Based on Kestrel Consulting's analysis of 100 distressed situations that the firm has worked on, Hopkins said most troubled companies fall into one of three categories:

Undisciplined Racehorses: Growth businesses that often suffer from isolated and correctable strategic errors or operating deficiencies.

Overburdened Workhorses: Mature viable businesses with an established market position that have been saddled

with excessive debt service obligations.

Aging Mules: Companies in decline, stubbornly clinging to strategies better suited for the past while being outpaced by nimbler, more flexible competitors.

Anticipating a flood of companies slipping into difficulty, Hopkins and his son, a principal in the firm, wrote the new book, "Crafting Solutions for Troubled Business." It was recently released by business and law book publisher Beard Books.

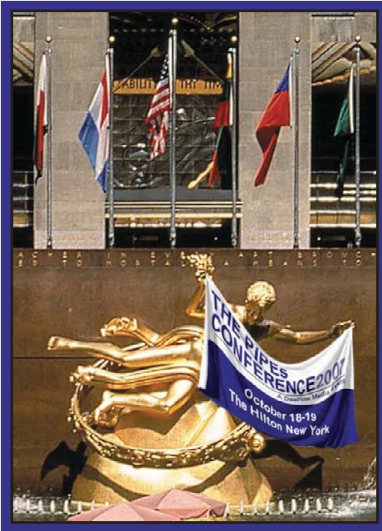
So, is a herd of troubled racehorses, workhorses and mules headed our way? The Turnaround Management Association (TMA), an international non-profit group supporting corporate renewal and turnarounds, polled its members on that question. The response of turnaround professionals, released last month, was a 100% "yes."

Sixty-five percent predicted a "blowup" by the end of 2008. Twenty-one percent look for a sharp upturn in debt default rates in the second half of 2007. Fourteen percent believe default rates will remain stable until 2009 or possibly later. The last and smallest group pegged its hopes on two factors: Some suggest that the 2008 presidential election and military spending for the wars in Iraq and Afghanistan will delay a sharp downturn.

Flush Times for Bankruptcy Lawyers

Tom Henderson, a Houston attorney and chairman of the TMA Trend Watch Committee, said the stepped-up recruiting by corporate law firms with corporate bankruptcy practices is a better indicator of when the crunch is going to hit.

"The traditional lag time is roughly two-



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and-a-half years between when a large number of high-yield distressed debt deals are made and when the default rate on those transactions rises significantly," Henderson said. "But the traditional norms don't hold now. While the timing of a decline in economic conditions remains uncertain, it's notable that legal firms in the larger financial markets are hiring more corporate bankruptcy attorneys in anticipation of more work in the near future."

Another early indicator of an impending downturn might be publicly traded and listed middle market companies with debt-to-total-capital ratios substantially above commonly accepted benchmarks. One popular rule of thumb for corporate debt is that investors should be wary of companies with debt-to-total-capital ratios greater than 0.5. By comparison, the average debt ratio for all companies in the Standard & Poor's 500 Index and the Dow Jones Industrial Average is 0.3. The average for the Russell 2000 is 0.2. The average debt ratio for the Nasdaq is 0.1.

Using data from SmartMoney.com, a screen of major-exchange-listed companies with annual sales of \$50 million or less and debt to total capital ratios of 1.0 or more identified 39 companies. All of the companies are reporting negative returns on assets. Many have been notified by their exchanges that they are in danger of losing their listings.

With a 5.3 debt ratio, **JED Oil Inc.** heads the list of hyper-leveraged middle market players. The Didsbury, Alberta, oil exploration company is reporting a negative return on assets of 110.3%. JED says it has a turnaround plan that it will implement on its own, without hiring a consultant.

"Our turnaround plan is based upon our announced proposed acquisition of **Caribou Resources Corp.** and our drilling plans for 2007 and 2008," said Marcia L. Johnston, JED's vice president for legal and corporate affairs. She

said it would be improper to comment further because that would constitute selective disclosure.

Based on its securities filings, JED plans to make a private placement of securities in Canada after the Caribou deal closes. After that, it plans to raise cash by selling some of the assets of Caribou Resources. JED projects that the sale of oil after the acquisition of Caribou will generate enough revenue in 2008 to further reduce its debt.

"There are no investment banks or turnaround consultants involved with JED," Johnston said. "We are not looking to raise capital through additional equity, except for the Caribou acquisition, or additional debt outside our normal bank operating line."

Although JED decided against using a consultant, it has bolstered its financial management staff. JED recently hired long-time oil and gas industry accountant Kurt Musch to be its controller.

Nobody Beats the Wiz

Video phone seller **WorldGate Communications**, with a 2.2 debt ratio and a negative return on assets of 210.8%, decided it needed to get some help. The company turned to a once prominent industry figure who hasn't been heard of for some time.

WorldGate said it contracted with former electronics retailer Marvin Jemal to bring in a team of marketing sales professionals to overhaul its retail distribution strategy. "Together, Jemal and WorldGate will further develop an aggressive retail distribution plan that is intended to position and showcase WorldGate's 'Ojo' video phones and services through the marquee big box retail and specialty stores in North America," the company said in a written statement.

The company noted that Jemal was the CEO and founder of New York electronics chain **Nobody Beats the Wiz**, which was sold in 1998 to **Cablevision Systems Corp.** While literally true, what became

of Nobody Beats the Wiz isn't quite that simple.

The sale of Nobody Beats the Wiz, which later became just "The Wiz," to Cablevision Systems was part of a bankruptcy proceeding. Five years later, Cablevision divested itself of the chain and it was shut down by liquidators.

Since selling The Wiz, Jemal has had legal problems.

In 2003, he was named as a defendant in a Federal Trade Commission lawsuit. The FTC action accused **TecnoZone International LLC** of making false and unsupported claims to sell a product that supposedly protected consumers from harmful radiation from their cell phones, video monitors, televisions, and other devices. The company's web site identified Jemal as founder and CEO of TecnoZone.

Jemal, TecnoZone, and its affiliates settled the lawsuit by agreeing to a permanent injunction against making further misleading and unsupported claims for the product. It also paid \$85,000 into an FTC "redress fund." WorldGate Chairman and CEO Hal Krisberg, CFO Joel Boyarski and Vice President for Marketing James E. McLoughlin declined to respond to questions about Jemal's relationship with WorldGate and whether the company knew about his problems with the FTC. The company has not disclosed Jemal's role in the FTC lawsuit in its own securities filings.

A woman answering an Allenhurst, N.J., telephone number listed to Jemal said he wasn't available for comment. She declined to give another telephone number where he could be reached and refused to take a message.

Meanwhile, WorldGate is appealing Nasdaq's decision to delist its shares. A hearing is set for Aug. 9. The exchange informed WorldGate of its intention to delist the company earlier this year after its share price dropped below \$1. The company is burning through its remain-

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Downturn

ing cash at a breathtaking rate. Cash on hand fell from just over \$10 million at the end of 2006 to just under \$5 million at the end of the first quarter of 2007.

Although WordGate presents a grim picture, it is the kind of situation that Portland, Ore., turnaround consultant Renee Fellman, owner of **Renee Fellman & Associates**, said she is attracted to. "I'm a challenge junkie," she said. "I do one turnaround at a time. I just stay with it until it is done."

Fellman normally insists on having full operating authority over companies she works with. The reason for that is quite simple. Her clients' companies are generally in such deep trouble by the time Fellman is brought in that there is no alternative, she says. Fellman specializes in "process" problems such as inadequate procedures and equipment. She works with companies valued at less than \$100 million.

"With one of my recent clients, when I went in, 50% of the deliveries were on time," she said. "When I left, 98% were on time." The improved delivery performance not only improved cash flow, Fellman said. It also opened the door for the company to start winning back its old customers.

"Over 20 years of turnarounds, not much has changed," Fellman said. "Year after year, it's always the management."

Fellman offered straightforward advice for companies sliding into difficulty: "Get help right away. If you waste any more time, you're going to be in deep trouble."

William E. J. Skelly, president of the Turnaround Management Association, said one of the most important innovations in the turnaround field has been the acceptance of a new position in executive management, the chief restructuring

officer, or CRO.

"The chief restructuring officer is a temporary position," he said. "Everybody knows he's not going to be there for 10 years. But everybody knows the CRO is going to be there for 12 to 18 months, after which the company can be turned back to management."

This approach amounts to a middle ground between bringing in all new management, on the one hand, and relying on a consultant who is outside the management structure of the company, on the other. "There are people reporting to the CRO," Skelly said. "He's not just a consultant over there in the corner." Skelly is a partner in the Business Law Group of law firm **Heenan Blaikie LLP** in its Vancouver, Canada, office. ■

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