

## CHAPTER 1

# Investing in Distressed Situations

## Strategies, Opportunities, and Risks

Over the past two decades, corporate bankruptcies have increasingly seen the active participation of investors who specialize in buying and selling the debts of financially distressed firms. Known sometimes as “vultures,” these investors sit on vast pools of capital and often seek to directly control the companies in which they invest. Over time, they have had an increasingly important role in determining how financially distressed firms are restructured.

The business of trading in distressed debt is not new. In the chaos that immediately followed the American Revolution, Treasury Secretary Alexander Hamilton proposed to restore confidence in the financial system by redeeming, at face value, the bonds the American states had issued to finance the war. On the heels of this proposal, speculators acquired large quantities of the bonds, which had fallen greatly in value under the weight of high inflation and the massive war debt, in the hope that Hamilton’s program would be completed.<sup>1</sup>

As the market has matured, and general familiarity with corporate bankruptcy practices has spread, distressed debt has come into its own as a legitimate “mainstream” asset class. Trading now occurs in virtually every kind of distressed claim: bank loans, public bonds, trade payables, private

<sup>1</sup>See J. Steele Gordon. 1988. *The Scarlet Woman of Wall Street* (New York: Weidenfeld & Nicolson).

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debt placements, asset-backed securities, and real estate mortgages—even claims for legal damages and rejected lease contracts. Investors in distressed debt are also an eclectic lot, including hedge funds, private equity firms, and investment banks—but also public pension funds, university endowments, foundations, and individuals. In the wake of the 2008 credit market meltdown, some might even add the U.S. government to this list.

The strategies that these investors follow are as diverse as the claims they trade and the companies they target. Some seek to acquire the debt of a firm while it tries to reorganize under Chapter 11 so they can either influence the terms of the reorganization or convert their debt into a major equity stake that can be used to direct company policy. Other investors provide distressed firms with new debt or equity financing, or purchase their assets in bankruptcy court. Some investors prefer to purchase senior claims, some target junior claims, and some spread their purchases over the entire capital structure. Other investors take a more passive approach, holding distressed debt as part of a broad portfolio diversification strategy. And while most investors focus on the U.S. market, where capital for distressed investing has historically been concentrated, many funds actively seek to invest outside the United States.

Opportunities to invest in distressed debt, as well as the amount of capital directed at these opportunities, reached historic highs during the credit market crisis of 2008–2009, where at one point the total amount of defaulted and “distressed” debt issued by U.S. corporations alone was estimated to be \$3.6 trillion.<sup>2</sup> Despite the growth of distressed debt as an asset class, however, the strategies that distress investors follow are sometimes controversial. These strategies are also not always fully understood by the outside world, given the intricacies of bankruptcy law, and the relative lack of transparency in what these investors do. This chapter explains the key strategies that distress investors use to acquire and trade in the debt of financially distressed firms, as well as the challenges and risks—business, financial, and legal—they must overcome to be successful.

<sup>2</sup>This figure includes both publicly traded bonds and the estimated amount of private debt outstanding. “Distressed” debt is defined as debt that yields more than 1000 basis points over long-term U.S. Treasury bonds. See E. I. Altman and B. J. Karlin, “Special Report on Defaults and Returns in the High-Yield Market: First-Half 2009 Review,” *New York University Salomon Center Series on Financial Markets and Institutions* (August 2009). Estimating the amount of capital managed by distress funds is more difficult, but one source estimates the figure at \$150 billion at the start of 2005. See E. I. Altman and E. Hotchkiss. 2006. *Corporate Financial Distress and Bankruptcy, Third Edition* (Hoboken, NJ: John Wiley & Sons). In 2008, Oaktree Capital raised the largest distressed debt fund ever, at \$10.6 billion. See K. Skelly, “Oaktree Sets Record with \$10.6B Distressed Debt Fund,” *Dow Jones Newswire* (May 15, 2008).

## **BASIC RESTRUCTURING OPTIONS**

Investing in distressed situations involves purchasing the financial claims or assets of firms that have either filed for legal bankruptcy protection or are attempting to avoid bankruptcy by restructuring their debt out of court. In the United States, corporate bankruptcy reorganization takes place under Chapter 11 of the U.S. Bankruptcy Code. Firms liquidate by filing under Chapter 7 of the Code. (A basic primer on the Chapter 11 process can be found in the appendix at the end of this chapter. Readers who are unfamiliar with Chapter 11 should read the appendix first before continuing with this chapter.)

If the firm is worth saving as a going concern, whether it makes more sense to restructure out of court or file for Chapter 11 depends on the relative costs and benefits of each option. In principle, restructuring out of court can be much less costly than going through a formal court-supervised bankruptcy. In Chapter 11, legal and other professional fees can rapidly escalate. The process can be administratively burdensome and litigious. Management decisions outside the ordinary course of business must be approved by the judge, often in a formal hearing in which creditors have the opportunity to object. Official committees are formed to represent unsecured creditors and other claimholders, and these committees hire their own professional advisors (at the firm's expense). Beyond these out-of-pocket costs, Chapter 11 can weigh heavily on the firm's business. Customers and suppliers may be reluctant to transact with a bankrupt firm. Attracting and retaining employees may become more difficult. And management, while dealing with the legal and administrative demands of Chapter 11, will be less focused on solving the firm's business problems.<sup>3</sup>

Although Chapter 11 can be costly, it also provides distressed firms with a number of often sizable benefits. While it operates as a Chapter 11 "debtor in possession," the firm is automatically protected by an injunction known as the "automatic stay," which prevents creditors from seizing collateral and interfering in the business. The firm does not have to pay, or even accrue, interest on its unsecured debt (and it only has to accrue interest

<sup>3</sup>Consistent with this cost differential, one academic study finds that the stock market value of firms that successfully restructure their debt out of court increases by 30 percent on average over the period of restructuring, while firms that fail to restructure, and end up filing for bankruptcy, lose 30 percent of their value. (These figures represent "abnormal" returns, adjusting for risk and market movements.) See S. C. Gilson, K. John, and L. H. P. Lang, "Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default," *Journal of Financial Economics* 27: 315–353.

on its secured debt to the extent the debt is overcollateralized). Chapter 11 allows the firm to reject unfavorable “executory” contracts, including leases, supply agreements, and union labor contracts. While in Chapter 11, the firm can raise substantial financing by offering new lenders superpriority over existing lenders (through so-called “debtor-in-possession” or “DIP” financing). Chapter 11 establishes an expedited process for selling off assets. Finally, voting rules and the threat of “cramdown” in Chapter 11 make it more difficult for dissenting minorities of creditors to block a reorganization plan (in contrast to an out of court restructuring, where creditors’ unanimous consent may be required).

Even if consideration of these factors suggests a firm would benefit from restructuring out of court, Chapter 11 may still follow if creditors cannot agree on how to split the value differential. In general, reaching a consensus out of court is more difficult when the firm’s capital structure is more complicated, and it has more creditors.<sup>4</sup>

To take advantage of Chapter 11’s more favorable voting rules, while still avoiding the high costs of an extended stay in bankruptcy court, firms can pursue a “prepackaged” or “prenegotiated” bankruptcy. In both of these options, the firm lines up creditor support for a financial restructuring plan prior to filing for Chapter 11 and then enters Chapter 11 only long enough to vote on the plan. In principle, the entire bankruptcy can be completed in a matter of weeks.<sup>5</sup>

## **STRATEGIES FOR CREATING VALUE**

The Bankruptcy Code does not explicitly regulate trading in distressed claims. As a general legal principle, an investor who purchases a distressed claim enjoys the same “rights and disabilities” as the original claim holder. Thus, with some exceptions, the investor can assert the claim’s full face value in a bankruptcy or restructuring, regardless of how much he or she paid to acquire it.

A simple but useful framework for analyzing the returns to distress investing is to view the firm as a pie. The size of the pie represents the present value of the firm’s free cash flows or its “enterprise value.” The pie is cut into slices, with each slice representing a financial claim on

<sup>4</sup>See Gilson et al., “Troubled Debt Restructurings.”

<sup>5</sup>Prepackaged and prenegotiated bankruptcies are discussed in the introduction to the first module (Restructuring Debt and Liabilities) and in Chapter 9 (Arch Wireless, Inc.).

the firm's cash flows (e.g., common stock, bonds, bank debt, and trade claims). A distress investor purchases one or more slices of the pie and profits if the slice grows larger.

Viewed this way, there are three things the investor can do to generate a return on this investment. He or she can:

- Make the entire pie larger by taking an active management role in the firm, causing its assets to be deployed more productively.
- Make someone else's slice smaller, thereby increasing the size of the investor's slice (even if the total size of the pie does not increase).
- Buy or sell mispriced financial claims in the secondary market and wait for the pricing error to be eventually corrected.

The first two approaches are *proactive* investment strategies: To profit, the investor must either influence the outcome of the reorganization proceedings or exercise some degree of control over the firm. The third approach is represented by various *trading* strategies: The investor takes long or short positions in the firm's traded financial claims, based on perceived mistakes in how these claims are priced in the market. No direct intervention in the firm's operations, or in the reorganization, is required. Of course, some combination of all three strategies is also possible.

## **PROACTIVE INVESTMENT STRATEGIES**

An appealing analogy can be drawn between the market for distressed debt and the market for corporate control. In both markets, proactive investors seek to profit either by redirecting the flow of corporate resources to more highly valued uses or by bargaining for a larger share of those resources. The mechanisms for acquiring and exercising influence in these two markets differ in fundamental ways, however.

### **Taking Control of the Business**

In Chapter 11, there are a number of ways that an investor can influence how the firm's assets are deployed. He or she can:

- *Submit a reorganization plan* to the court for a formal vote by the firm's claimholders. The reorganization plan determines creditor recoveries and ownership of the firm's equity after Chapter 11. This option is only available after the debtor's exclusivity period expires (currently 18 months after the commencement of the case). Although in principle

any claimholder can propose a plan, and the judge can permit more than one plan to be voted on at the same time, a competing plan will have more credibility with the court and with creditors if the plan proposer also owns a significant amount of the firm's claims.

In the Chapter 11 bankruptcy of Revco D.S., a total of five plans were filed during the case, including two by the debtor, one by a coalition of creditors and preferred stockholders, and one each by two competitors (Jack Eckerd and Rite-Aid). Competing plans were also filed in the bankruptcies of Montgomery Ward (two), Hawaiian Airlines (two), Pacific Lumber (five), and W.R. Grace (two, including one filed by asbestos injury claimants).

- *Purchase currently outstanding debt claims* with the expectation that these eventually will be converted into a significant amount of common stock under the firm's reorganization plan. Owning a large share of the reorganized firm's equity will enable the investor to exercise control over the firm's assets after it leaves Chapter 11 or restructures. The key to this strategy is to correctly identify the "fulcrum" security, i.e., the point in the capital structure at which value runs out, and where most of the new equity is likely to be distributed.

During the Chapter 11 bankruptcy of Carter Hawley Hale Stores, for example, investor Sam Zell made a tender offer for the company's bonds and trade claims explicitly for the purpose of becoming the company's majority stockholder once these claims were converted into common stock under the reorganization plan. In the end, Zell's fund acquired 73 percent of the retailer's equity.<sup>6</sup> More recently, Oaktree Capital and Phillip Anschutz were able to acquire Regal Cinemas by purchasing Regal's senior bank debt at less than 25 cents on the dollar and converting it into a controlling equity stake through an expedited prepackaged bankruptcy. Anschutz later merged Regal with a number of other theater properties he had acquired and converted 22% of his interest into cash through a \$342 million IPO.<sup>7</sup>

- *Purchase new voting stock (and other securities)* that are to be issued under the firm's reorganization plan. This approach is known as "funding the plan." Proceeds from the investment can either be used to help finance cash distributions to prepetition claimholders (thus giving them

<sup>6</sup>As Zell remarked at the time, "I clearly have no intention of being a bondholder. . . . If I'm going to make an investment, I'm going to be an owner of equity." See F. Schwadel, "Zell 'Vulture Fund' Offers Investment in Carter Hawley," *Wall Street Journal* (July 25, 1991).

<sup>7</sup>K. Pate, "Denver Billionaire Seeks Initial Public Offering for His Cinema Holdings," *The Denver Post* (March 12, 2002).

an added incentive to approve the plan), or retained by the company to help support the business after bankruptcy.

Continental Airlines' exit from bankruptcy was based on a \$450 million investment by a group of outside investors, including Air Canada and an investor group led by David Bonderman, in exchange for a majority of Continental's common stock and a package of notes, warrants, and preferred stock. More recently, Kmart's Chapter 11 reorganization plan included a \$109 million equity investment by investor Edward Lampert and his hedge fund, ESL Investments. Lampert had also acquired \$2 billion of Kmart's debt in the secondary market, which was converted into equity under the reorganization plan. When Kmart emerged from Chapter 11 in May 2003, Lampert owned 49% of the stock. (Kmart was later merged with Sears, Roebuck & Co., in which Lampert also held a major stake.)

- *Purchase some or all of the firm's assets*, either in a court-supervised auction pursuant to Section 363 of the U.S. Bankruptcy Code or as part of a formal plan of reorganization. Section 363 permits a firm operating in Chapter 11 to sell assets with the approval of the judge, provided the sale has a legitimate business purpose, is proposed in "good faith," and is justified by the firm's current difficult financial circumstances (i.e., absent the sale, the value of the firm, and creditor recoveries, will be lower). The firm must also provide adequate notice of the sale to all interested parties.<sup>8</sup> Section 363 sales occur in a court-supervised competitive auction, designed to yield the "highest and best" offer (based both on the amount bid, and on various nonfinancial considerations such as the buyer's ability to obtain financing). Typically the firm selects a "stalking horse" to make the initial bid. Because bidders who compete in the auction are permitted to see each others' offers, the stalking horse must be provided with certain protections and guarantees to compensate for the risk that he or she will lose to another buyer.<sup>9</sup> Once the winner is chosen, the judge enters a formal sale

<sup>8</sup>For an excellent discussion of the asset sale process in Chapter 11, see C. Ball and J. K. Kane, "A Practical Guide to Distress M&A," *The M&A Lawyer* (January/February 2003).

<sup>9</sup>Two common forms of protection are *break-up fees* and *topping fees*, paid to the stalking horse if its bid fails. Break-up fees are typically set at 2 to 3 percent of the stalking horse's bid. Topping fees are calculated as a percentage (typically 20 to 25 percent) of the amount by which the winning bid exceeds the stalking horse's initial bid. Other protections include the right to be reimbursed for expenses, rights of first refusal, and window-shop clauses. See L. P. Goldberger, "Bidding Incentives in Bankruptcy Sales Part 2," *The Journal of Corporate Renewal* (June 1999).

order. This order in effect “blesses” the transaction and provides that any liens on the assets to be sold are removed and transferred to the sale proceeds.

Section 363 sales are attractive to potential buyers because they can acquire the assets free and clear of most successor liability claims and leave certain liabilities behind with the selling firm (e.g., “legacy costs” such as unfunded future obligations under company pension and retiree medical plans). Given the transparency of the process and the involvement of the court, it is also highly unlikely the sale can later be successfully challenged on legal grounds (e.g., as a fraudulent conveyance or transfer). Finally, the assets can be “cleaned up” prior to sale, through the seller’s use of Section 365 of the Bankruptcy Code to reject unfavorable leases, supply agreements, and other executory contracts.<sup>10</sup> For all these reasons, it is generally less advantageous to purchase assets of a distressed firm outside of Chapter 11. Section 363 sales have figured prominently in a number of high-profile Chapter 11 cases, including General Motors, Chrysler, Lehman Brothers, LTV Steel, Burlington Industries, Polaroid, Trans World Airlines, and Adelphia Communications.

Some investors have pursued a hybrid strategy of first providing senior secured debt financing to the firm (either prior to, or during, its bankruptcy) and then making an offer to buy the assets that secure the debt, paying for the purchase in whole or part by forgiving the debt (a practice known as “credit bidding”).<sup>11</sup> The advantage of credit bidding is that the investor will have gained prior access to information about the firm in its role as a lender, and it may have developed a positive

<sup>10</sup>Alternatively, the seller can assume these contracts (after curing all defaults and arrearages) and assign them to third parties—even if the contracts contain anti-assignment clauses. Such assignment might be desirable to the buyer but be impossible to achieve outside of a Section 363 sale.

<sup>11</sup>Under Section 363(k) of the Bankruptcy Code, credit bids are only permitted with respect to the lender’s collateral. Legal commentators suggest that a secured lender can credit bid the full face amount of its claim, even when this exceeds the value of the collateral, and that a credit bid may be considered the “highest and best” offer, even when a competing bidder offers to pay cash, if the amount of debt to be forgiven exceeds the amount of the cash bid. See J. C. McCarroll, R. P. Norton, S. R. Strom, and D. Turetsky, “Secured Lenders Face Variety of Issues in Credit Bidding,” *The Journal of Corporate Renewal* (July 2007), and M. G. Douglas, “Making the Most of an Undersecured Creditor’s Claim: The Nuances of Credit Bidding in Bankruptcy,” *Business Restructuring Review*, Jones Day (May/June 2006).



working relationship with management, making it the preferred stalking horse in any Section 363 sale. Investors have employed credit bidding in such cases as WestPoint Stevens, Submicron Systems, Radnor Holdings, and Delphi.

As an alternative to a Section 363 sale, an investor can also acquire the assets of a firm in Chapter 11 pursuant to a formal plan of reorganization. Typically this approach involves selling most or all or most of the firm's assets and operations, and structurally it resembles a conventional acquisition or buyout. A key difference from a Section 363 sale, however, is that the reorganization plan (and the sale) must be approved by creditors, following the usual plan confirmation process. A potential advantage of this approach is that if the investor works with management, and the debtor has "exclusivity" to file a plan, there may be less competition from other investors.

- *"Loan-to-Own"*: Jointly make a secured loan and provide new equity financing to a financially distressed firm outside of bankruptcy, with the expectation that either (1) the firm will avoid bankruptcy, increasing the value of the equity stake, or (2) the firm will file for Chapter 11, as a result of which the secured debt will be converted into a controlling equity stake.<sup>12</sup> Typically this strategy anticipates that any debt restructuring or bankruptcy will occur on an expedited basis (e.g., through a prepackaged Chapter 11) and that, in the event of bankruptcy, enterprise value is just high enough to provide a full recovery to the investor's secured debt claim, but little or no recovery to more junior claims. In addition, the percentage equity investment is generally less than 25%, so the investor is not considered a "controlling shareholder" (thus limiting his/her potential exposure to litigation).<sup>13</sup> Loan-to-own strategies figured prominently in the Chapter 11 bankruptcies of Granite Broadcasting and Radnor Holdings. In the Radnor case, hedge fund Tennenbaum Capital Partners provided the firm with \$95 million in secured debt financing and purchased new preferred stock and warrants (representing roughly 15% of Radnor's common stock). In addition, Tennenbaum was entitled to designate one of the firm's directors. After Radnor filed for Chapter 11, Tennenbaum additionally provided the firm with a "debtor-in-possession" loan and entered into an asset

<sup>12</sup>A variant of this strategy includes only the secured loan and no equity investment. This was the approach taken by hedge fund Silver Point Capital in its investment in Granite Broadcasting Corp.

<sup>13</sup>Legal risks of the loan-to-own strategy are discussed later in this chapter.

purchase agreement, under which Tennenbaum would acquire Radnor's assets in a Section 363 sale and partially pay for the assets by credit bidding its secured claims.<sup>14</sup>

In pursuing the above strategies, the investor's ultimate goal is to create value by causing the firm's assets to be managed more productively, whether this involves taking a direct management role in the firm, effecting management change through control of the reorganization process, exercising control over the firm as a significant owner, or acquiring specific assets from the firm and redeploying them. Quite simply, by increasing the market value of the firm's assets, the investor realizes a return by increasing the value of the financial claims that he or she has purchased against those assets.

**Serving on Creditors Committees** By acquiring the firm's debt, an investor may also be able to gain influence in a bankruptcy proceeding by becoming a member of the official Unsecured Creditors Committee (UCC). A UCC is formed in every Chapter 11 case and normally consists of the seven or so largest unsecured creditors who are willing to serve.<sup>15</sup> In the bankruptcy of Finova Group, six of the ten members of the UCC were distress investment funds. In some cases official committees may also be formed to represent secured lenders or equity holders.

From an investor's perspective, the advantage of committee membership is that the committee has preferred access to debtor management and the bankruptcy court and can retain, at the firm's expense, legal and financial professionals to advise it. However, serving on the UCC can also severely limit an investor's ability to trade in the firm's claims, because committee members gain access to nonpublic information about the firm and have a fiduciary duty to all unsecured creditors. Investors who sit on a committee and actively trade therefore risk being charged with insider trading violations (discussed below).

**Investing in Distressed Equity** Outside bankruptcy, investors can seek to gain control of a distressed firm's assets by purchasing enough of the firm's stock to wage an effective proxy contest or force management to hold a special shareholders' meeting. In principle, special shareholders' meetings can also be held in Chapter 11, subject to the judge's approval. One goal

<sup>14</sup>See M. Berman and J. A. J. Brighton, "Hedge Funds: Lessons Learned from the Radnor Decision," *ABI Journal* (February 2007).

<sup>15</sup>In practice, the size of committees has varied depending on the particulars of the case.

of having such a meeting might be to force management to propose a more “shareholder friendly” reorganization plan. Such meetings were allowed in the bankruptcies of Allegheny International, Johns–Manville, and U.S. Energy Systems.<sup>16</sup>

In practice, however, purchasing equity is generally an ineffective way to acquire control of a distressed company. Most bankruptcy judges are reluctant to approve special shareholders’ meetings. The Bankruptcy Code already includes a procedure for replacing management (with a “trustee”) when management is shown to be guilty of “fraud, dishonesty, incompetence, or gross mismanagement.”<sup>17</sup> In addition, given directors’ fiduciary duty to the corporation, when the firm’s equity is significantly out of the money, directors may implicitly favor the interests of creditors, who, as “shareholders in waiting,” are effectively the firm’s new residual claimants.<sup>18</sup> Finally, shareholders are usually severely diluted by the issuance of new shares under the firm’s reorganization or restructuring plan. In the vast majority of Chapter 11 cases, shareholders receive no recovery.<sup>19</sup> Any “control” one enjoys by virtue of being a large shareholder is therefore usually short-lived.

### **Provision of Debtor-in-Possession (DIP) Financing**

Under Section 364 of the Bankruptcy Code, lenders or investors who provide a Chapter 11 debtor with postpetition debt financing (“DIP” financing) receive a priority claim that ranks ahead of the firm’s prepetition unsecured debt. DIP lenders are therefore among the first to be repaid under the plan

<sup>16</sup>In the U.S. Energy Systems case, the Delaware Chancery Court ruled in favor of the company’s former CEO, who sought to call a special shareholders meeting in order to replace the board of directors. The court held that “corporate governance does not cease when a company files a petition under Chapter 11 and that issues of corporate governance are best left to the courts of the state of incorporation.” *Fogel v. U.S. Energy Sys., Inc.*, No. 3271-CC (Del. Ch. Filed Oct. 4, 2007).

<sup>17</sup>Section 1104(a) of the U.S. Bankruptcy Code.

<sup>18</sup>A 2007 decision by the Supreme Court of Delaware clarified that corporate directors have a fiduciary duty to the corporation and not to creditors directly, even if the firm is insolvent or in the “zone of insolvency.” However, the court also ruled that creditors have standing to bring derivative claims against directors when the firm is insolvent, just as shareholders can bring derivative claims against directors when the firm is solvent. *N. Amer. Cath. Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-103 (Del. 2007).

<sup>19</sup>One academic study finds that shareholders receive plan distributions in fewer than 8 percent of Chapter 11 cases. See K. Ayotte and E. Morrison. 2007. “Creditor Control and Conflict in Chapter 11.” Working paper, Columbia University.

of reorganization. If the DIP loan is unsecured, it will be treated as a superpriority administrative claim (see Exhibit 1.1). If the firm cannot attract financing on this basis, it can grant DIP lenders security in its assets (either a lien on unencumbered assets or a junior lien on assets that already secure some other debt). The firm can even grant DIP lenders a security interest that is *senior* to existing secured debt (known as “priming”), although the bankruptcy judge will only permit this if the collateral of the creditors who are being primed is “adequately protected.”<sup>20</sup> Currently most DIP financing is provided on a secured basis, although priming of existing secured debt is less common.<sup>21</sup>

Historically, DIP financing mostly has been provided by commercial banks and specialized finance companies. This has changed significantly in recent years, with increasing participation by distress-focused hedge funds and other institutional lenders. DIP lenders to Lyondell Chemical, which filed for Chapter 11 in early 2009, included such well-known distress investors as Cerberus, Oaktree, Apollo, Angelo Gordon, Silver Point, Appaloosa, and Strategic Value Partners. At \$8 billion, Lyondell’s DIP facility was one of the largest in history.<sup>22</sup>

Distress investors have been drawn to this market for a number of reasons. One is the high interest rates and fees that can be charged to a borrower “in need.” (Lyondell’s DIP facility, which had an original maturity of about one year, paid 13 percent annual interest and fees of 7 percent.) These rates seem highly attractive given the high priority granted to DIP loans and historically low DIP loan default rates of about 0.5 percent.<sup>23</sup> (As discussed later, however, DIP lending is not without risk.)

<sup>20</sup>Similar to financial lenders who provide DIP loans, vendors who provide ordinary-course unsecured trade financing to a firm during Chapter 11 receive administrative claim status in the reorganization plan.

<sup>21</sup>A study of 153 Chapter 11 and Chapter 7 filings from the second half of 2001 found that 92 percent of DIP lenders were granted a security interest in all of the firm’s assets. See Ayotte and Morrison, “Creditor Control.”

<sup>22</sup>Some other recent large DIP financings include Calpine (\$10 billion), Dana Corporation (\$1.75 billion), and Delta Air Lines (\$1.7 billion). In general, nontraditional DIP lenders like hedge funds prefer to participate in term loans rather than revolving (which need to be serviced and therefore require more back-office support than the funds have in-house).

<sup>23</sup>See W. Fahy et al., “Moody’s Comments on Debtor-in-Possession Lending,” *Moody’s Global Corporate Finance* (October 2008), 4. The quoted default rate is based on a monthly cohort analysis. Of 297 DIP loans analyzed by Moody’s, in only two cases—Marvel Entertainment and Winstar Communications—was there an interest or principal default.

Investors who hold prepetition debt in a bankrupt firm can also increase the value of this investment by providing the firm with new DIP financing and negotiating a “roll-up” of their existing debt into the new DIP loan. (This is sometimes known as a “defensive DIP.”) Under the terms of Lyondell’s DIP facility, for example, existing creditors lent the firm \$3.25 billion of new money on a secured, superpriority basis and were allowed to convert (roll up) an equal amount of their prepetition claims into the new DIP loan (effectively “leapfrogging” other creditors). In 2008, bankrupt retailer Circuit City announced a \$1.1 billion DIP facility that included only \$350 million of new money, with the rest being a roll up of its prepetition bank debt.

Another strategy is for investors to provide DIP financing in order to increase their control of the firm’s senior debt, thereby increasing the amount of equity they receive under the plan of reorganization (a variant on the “loan to own” strategy discussed earlier). Investors may also provide secured DIP financing so they can later credit bid the loan to buy the assets that collateralize the loan in a Section 363 transaction. Finally, by becoming a DIP lender, investors may be able to exercise more control over the outcome of the case by including certain veto rights in the loan indenture. In a number of cases, bankruptcy courts have upheld DIP financing agreements that required DIP lenders’ approval of the reorganization plan or a Section 363 sale.

### **Bondmail**

In Chapter 11, an investor may also acquire claims for the purpose of controlling how a particular class votes on the reorganization plan (rather than seeking to control how the firm’s assets are deployed). Because confirmation of a consensual plan requires every impaired class to approve the plan by at least two-thirds in value of claims, and one-half in number of claimholders, an investor need acquire only slightly more than a third of the outstanding claims in an impaired class to block approval of the entire plan. Some investors use this leverage to try to extract a higher recovery from the firm—a practice known as “bondmail.”

This strategy, while relatively common, has several limitations. First, an investor who holds a blocking position in a class cannot demand to be treated more favorably than other members of the class.<sup>24</sup> Second, although the investor may be able to prevent the class from approving a plan, he or

<sup>24</sup>Section 1123(a)(4) of the Bankruptcy Code requires that all claimholders within a class be treated identically under the reorganization plan. Therefore payment of “greenmail,” as seen in some hostile corporate takeover contests, is not allowed in Chapter 11.

she may never be able to force the class to *approve* a plan—even by acquiring over two-thirds of the claims in the class—because it may be impossible to satisfy the other requirement that at least one-half of the claimholders in the class approve the plan (known as “numerosity”). This will be the case as long as the investor is considered to be one claimholder.<sup>25</sup> Third, a blocking strategy can be undermined because the plan proposer gerrymanders voting classes in the plan to dilute the investor’s voting power.<sup>26</sup> Finally, an investor’s ability to coerce a higher payment from the firm will be limited by the threat of a bankruptcy “cramdown,” in which the investor’s vote is overruled by the judge.

### **TRADING STRATEGIES**

The explosive growth in the demand side of the distressed debt market has reduced the number of opportunities to buy underpriced claims. Many participants now consider this market to be relatively efficient, and several academic studies support this view. These studies consider buy-and-hold strategies that exploit possible overreaction of bond or stock prices in response to news that an issuer has defaulted. After publicly traded bonds go into default, they typically trade at only 20–40 percent of their face value (see Exhibit 1.2). Overreaction might seem plausible, given that many institutions (e.g., trusts, foundations, insurance companies, and banks) either are not permitted to hold distressed securities or consider these securities too risky and therefore sell off their holdings when an issuer defaults. Distressed firm securities may also be less closely followed by analysts. However, the research finds no evidence of abnormal returns to buying portfolios of distressed bonds at the end of the default month, the end of the bankruptcy-filing month, or on other key dates.<sup>27</sup> Systematic abnormal

<sup>25</sup>This is more likely to happen when the claims are identical (e.g., a public bond issue). In contrast, several court decisions suggest that an investor who consolidates claims within a class that are not strictly identical (e.g., bank loans or trade claims) may be allowed one separate vote for each claim.

<sup>26</sup>Recall the Code requires that a class contains “substantially similar” claims, but this term is not defined and is subject to interpretation.

<sup>27</sup>“Abnormal returns” are adjusted for risk, market-wide returns, and transaction costs. See A. Eberhart and R. Sweeney. 1992. “Does the Bond Market Predict Bankruptcy Settlements?” *Journal of Finance* 47: 943–980; E. I. Altman, A. Eberhart, and K. Zekavat. 1993. “Do Priority Provisions Protect a Bondholder’s Investment?” Working paper, New York University; and S. C. Gilson, E. Hotchkiss, and R. Ruback. 2000. “Valuation of Bankrupt Firms,” *The Review of Financial Studies* 13: 43–74.

returns also do not appear to be available from buying bankrupt firms' common stock.<sup>28</sup>

Academic research also suggests that profitable trading rules are unlikely to be found in the secondary market for distressed bank loans, as loan prices appear to be extremely sensitive to news of a firm's deteriorating financial condition.<sup>29</sup> This is consistent with the dramatic increase in the liquidity of the secondary bank loan market seen over the past two decades.

Due to lack of data, it is difficult to evaluate the profitability of more sophisticated trading strategies employed by distress investors. For example, some funds seek to profit from perceived *relative* mispricings of claims in a given capital structure. This strategy, known as "capital structure arbitrage," involves buying a firm's junior claims (e.g., junior unsecured bonds or common stock) and simultaneously shorting its more senior claims (or taking on equivalent exposure by buying credit default swaps).<sup>30</sup> The fund will expect to profit from this position if it believes the market is underestimating recoveries that will eventually be realized by the junior claims (and overestimating senior claimholder recoveries). Examples of funds that have pursued this strategy include CRT Capital, Harbinger Capital, and Angelo, Gordon & Co.

Finally, opportunities to purchase claims for less than their intrinsic value may be found through fundamental analysis of an individual firm's situation. Careful scrutiny of the covenants of a bond issue may, for example, turn up a weakness in a subordination agreement. Junior bondholders in the *Zale* and *R. H. Macy* bankruptcies realized higher-than-expected recoveries—at the expense of senior creditors—because they were able to successfully challenge subordination agreements. In the *Loewen* bankruptcy, the recoveries realized by several tranches of senior secured notes were significantly affected as a result of errors discovered in the collateral documents. Finding such opportunities generally means doing a "deep dive" into the

<sup>28</sup>See D. Morse and W. Shaw. 1988. "Investing in Bankrupt Firms," *Journal of Finance* 43: 1193–1206; and L. Boselovic, "Heard Off the Street: Buying Bankrupt Firms' Stock Isn't Investing, It's Gambling," *Pittsburgh Post-Gazette* (December 3, 2001).

<sup>29</sup>See E. I. Altman, A. Gande, and A. Sanders. 2004. "The Informational Efficiency of Loans Versus Bonds: Evidence from Secondary Market Prices." *Journal of Money, Credit and Banking*, forthcoming.

<sup>30</sup>In contrast to these buy-and-hold strategies, some investors alternatively specialize in shorting the common stock of companies that are in or near Chapter 11. The risk of potential loss is much greater, of course, and shares in distressed or bankrupt firms can be hard to locate. Short sellers are known to have made multimillion-dollar returns in such bankruptcies as *Circle K*, *ZZZZ*, *Best*, and *LTV*.

fine print of the bond indenture and having the resources and willingness to litigate.

### **RISKS OF INVESTING IN A DISTRESSED SITUATION**

The risks in investing in distressed claims are highly firm specific. Many are legal and institutional in nature, and most can be controlled through careful planning and by conducting adequate due diligence. Having a sound working knowledge of bankruptcy law is critical; many successful investors in this market are either former practicing bankruptcy attorneys or have access to legal counsel experienced in bankruptcy matters.

The following list of relevant risk factors is undeniably long, but the large number of risks alone has not prevented investors from earning huge returns in this market. Experience has shown that investors who understand and are adept at managing these risks consistently earn the highest returns investing in distressed debt.

#### **Risk of Buying "Defective Merchandise"**

An investor who purchases distressed debt may inherit certain legal "baggage" or liabilities from the original lenders that the investor had no role in creating. These liabilities can be significant and present a major risk to participants in this market.

**Fraudulent Conveyance** An investor who buys debt in a troubled LBO may become liable for damages under an outstanding fraudulent conveyance suit. Roughly speaking, a fraudulent conveyance occurs when (1) property is transferred from a firm in exchange for less than "reasonably equivalent" value, and (2) as a result, the firm is left insolvent (or it was insolvent when the transfer took place). The first criterion is almost always satisfied by an LBO.<sup>31</sup>

In filing a fraudulent conveyance suit, the debtor attempts to recover the property that was fraudulently transferred. In theory, this course of action may mean trying to recover the payments that were made to the

<sup>31</sup>In an LBO, the firm borrows a large sum of money and uses the proceeds to buy out the public stockholders. Under the law, this payout of cash is considered a transfer of assets. Neither the cash received by stockholders nor any appreciation in the value of the firm's assets due to the LBO, however, is included in the calculation of reasonably equivalent value.



selling shareholders; in practice, such efforts are mainly directed at large, deep-pocketed claimholders, who make attractive targets for litigation. An investor who buys up and consolidates a large number of smaller claims may be especially at risk. If a fraudulent conveyance action is successful, lenders' claims can be subordinated or stripped of their security interest if the debt is secured. Under Section 548 of the Bankruptcy Code, a fraudulent conveyance action can be brought within one year of an LBO.<sup>32</sup>

Fraudulent conveyance is also a risk faced by investors who buy assets from a distressed company outside of a Section 363 sale or reorganization plan. As discussed earlier, when assets are purchased from a company in Chapter 11, it is highly unlikely that the sale can be successfully challenged as a fraudulent conveyance or fraudulent transfer.

**Avoidable Preferences** Chapter 11 allows a debtor to recover certain payments, known as "avoidable preferences," that it made to creditors within 90 days prior to filing for bankruptcy.<sup>33</sup> The point of this provision is to discourage insolvent firms from cutting side deals with key creditors.<sup>34</sup> Payments made to creditors either in the normal course of business, or on normal business terms, are not recoverable.<sup>35</sup> Payments on LBO debt, however, may be recoverable, given the unusual nature of the transaction. Grants of additional security to a lender are also generally recoverable.

The Bankruptcy Code's treatment of preferences creates several risks for an investor in distressed debt. If the investor purchases debt in a firm that

<sup>32</sup>Fraudulent conveyance actions can also be brought under various state laws patterned after either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfers Act. Applicable state laws generally have a longer statute of limitations (up to six years). In practice, fraudulent conveyance suits are almost always settled before going to final judgment, typically for less than 10 cents on the dollar. See J. Friedman, "LBO Lawsuits Don't Pick Deep Pockets," *Wall Street Journal* (January 27, 1993). Such suits, however, are often brought as a negotiating ploy during a Chapter 11 case to induce larger concessions from the LBO lenders (or current holders of LBO debt). These concessions are an additional cost to the investor from a fraudulent conveyance attack.

<sup>33</sup>This period increases to one year if the creditors had an insider relationship with the debtor. Such a relationship might be deemed to exist, for example, if a lending bank is represented on the debtor's board of directors at the time the debtor files for Chapter 11.

<sup>34</sup>If preferential payments could not be recovered, creditors might, at the first hint of financial trouble, collectively rush to grab whatever of the firm's assets they could to protect their individual interests, making the firm's situation even worse.

<sup>35</sup>Defending against preference actions has become somewhat easier under the 2005 BAPCPA amendments; see Chapter 2.

subsequently files for bankruptcy, he or she may have to return payments that were received on the debt within the 90-day prefiling period. If the debt is purchased after the firm files for bankruptcy, the investor is not directly on the hook. The court, however, could still choose not to recognize the investor's claims until all such preferences are recovered (from the previous owners of the debt).

**Equitable Subordination** In Chapter 11, if an investor purchases a claim from a creditor who is found to have engaged in "inequitable conduct," thereby causing harm to other creditors or giving the claim an unfair advantage, the claim may be "equitably subordinated." Equitable subordination reduces the priority of the claim, which will almost always result in a lower recovery.<sup>36</sup> In determining whether inequitable conduct has occurred, basically the same standards apply as those used to assess lender liability outside of Chapter 11. A creditor may be considered guilty of inequitable conduct if it exercises excessive control over a firm's operations as a condition of lending the firm more money or refuses to advance funds under an existing credit line, thus impairing the firm's ability to pay its other creditors.

**Environmental Liabilities** Under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), lenders can be held liable for the costs of cleaning up hazardous substances found on the borrower's property. This liability is assessed based on who currently owns or operates the property rather than on who was responsible for creating the pollution. A lender who has a security interest in certain contaminated property may be considered an "owner" or an "operator" of the property—hence potentially liable under CERCLA—if it forecloses on its security interest or assumes an active role in managing the property.

An investor in distressed debt should investigate whether the seller has engaged in past behavior that might qualify it as an owner or an operator of contaminated property. CERCLA provides secured lenders with an exemption to its definition of property "owner," but the courts have differed on how widely this exemption applies; also, this exemption does not shield a lender from liability under various state environmental laws. As a general rule, lenders do not expose themselves to liability under CERCLA simply by exercising their ordinary right as creditors (e.g., by enforcing covenants, restructuring a loan, and foreclosing on a security interest and promptly disposing of the acquired property).

<sup>36</sup>Equitable subordination is addressed in Section 510(c) of the Bankruptcy Code.

**Protecting Against These Risks** Investors in distressed debt can reduce their exposure to these liabilities by obtaining appropriate representations, warranties, and indemnities from the seller. These protections are especially important in the case of bank, trade, and other nonpublic debt, on which less information is generally available from public sources. Representations and warranties, which effectively operate like put options, give the investor some assurance as to what “nonstandard” liabilities, if any, he or she may inherit as a result of buying the debt (especially those that arise from improper conduct by the seller).<sup>37</sup> As added protection, investors also often ask sellers to indemnify them against potential damages.

Obtaining representations, warranties, or indemnities can be difficult, however, because creditors who sell their claims most often wish to rid themselves of all ties to the firm. Bank loan sales have fallen through because banks have been unwilling to grant these protections to otherwise willing buyers.<sup>38</sup> This attitude has become more prevalent among banks as the overall demand for distressed debt has grown. Also, as liquidity in the distressed debt market has grown over time, trading has come to include a higher fraction of retrades (i.e., where the seller is not the original lender), resulting in much shorter average holding periods. In such an environment, representations, warranties, and indemnities may make less sense for both buyers and sellers.

As a result of these considerations, investors who are more familiar with the borrower’s operations and management (e.g., as a result of past business dealings or superior research) will have a comparative advantage in assessing these risks and in accurately valuing distressed claims.

The hazards of buying “defective merchandise” were dramatically illustrated in the Enron bankruptcy. After Enron filed for Chapter 11 in 2001, five hedge funds purchased \$47.5 million (face value) of Enron’s bank debt, representing debt originally owed to Fleet Bank. (Fleet Bank’s debt in turn represented its participation in a \$3 billion syndicated credit facility.) Four of the funds purchased their claims from other banks, which in turn had

<sup>37</sup>Most bank loan sale agreements transfer to the buyer responsibility for the “standard” risks and liabilities that can arise in a distressed (or nondistressed) situation, including the risk that the court will disallow part or all of the claim, the risk that the buyer will realize a lower recovery on the claim than he or she initially expected, and the risk that the buyer may have to lend funds to the borrower under the unfunded portion of any letter of credit.

<sup>38</sup>This happened, for example, in the out-of-court restructuring of Western Union and in the bankruptcies of Coleco Industries and Apex Oil. See C. Fortgang and T. Moers Mayer. 1990. “Trading Claims and Taking Control of Corporations in Chapter 11,” *Cardozo Law Review* 12: 1–115.

purchased the claims from Fleet; the fifth fund purchased its claims directly from Fleet. In 2003, the bankruptcy trustee commenced an adversary proceeding against Fleet and nine other banks, charging that the banks, by lending Enron the money, had “aided and abetted” its accounting fraud. In 2005, the trustee then sued the hedge funds, asking that their claims be equitably subordinated, or disallowed altogether—even though the funds themselves were not guilty of any misconduct (or aware of any alleged misconduct by Fleet when they purchased the claims). The bankruptcy court agreed with the trustee, but in 2007 the district court overturned this decision on appeal, arguing that liability for any misconduct should fall on those parties who were specifically responsible for the misconduct and did not automatically attach to the claim. The district court further argued that transfers of claims that are effected through a sale (as opposed to assignment) are not subject to causes of action. The practical implication of this ruling for investors is to reinforce the importance of obtaining representations and warranties where possible and to be careful to structure claims transfers as true sales.<sup>39</sup>

### Intercreditor Conflicts

Conflicts among creditors over the relative seniority and priority of their claims, and the value of assets available to support those claims, are common in distressed situations. Dealing with these disputes can be costly, cause delays, and make the outcome of a restructuring less predictable.

One area of conflict is between senior and junior creditors who hold claims against the same corporate entity. Since distributions to creditors under a plan of reorganization do not have to strictly follow the absolute priority rule, there is “wiggle room” to negotiate higher recoveries if one can gain influence in the proceedings. In the bankruptcy of drug store chain Revco, for example, distress fund Magten Investments purchased blocking positions in the firm’s subordinated bonds in an attempt to reduce recoveries by the senior bank debt holders. As discussed below (“Valuation Disputes”), senior (junior) creditors can also gain at the expense of junior (senior) creditors if they can successfully champion a reorganization plan that is premised on an artificially low (high) enterprise valuation.

Another area of conflict is between creditors who hold claims against different legal entities within the same corporate family and whose relative priorities are determined by the principle of “structural subordination.”

<sup>39</sup>See B. E. Scheler and A. N. Resnick. 2006. “Enron Ruling Impacts Claims Trading Industry,” *New York Law Journal* (March 6); and V. G. Milione and T. J. Norton. 2008. “Governing Law Regarding Claims Trading in Bankruptcy,” presentation at 15<sup>th</sup> Annual ABI Northeast Bankruptcy Conference.

Creditors who hold debt in an operating subsidiary are said to be “structurally senior” to creditors of the parent holding company, because they have a direct claim on the assets of the subsidiary. Parent company creditors, in contrast, only have a claim against the parent’s holding of stock in the subsidiary, which stands behind the subsidiary debt in priority of payment. All else equal, when the firm’s valuable operating assets are held by the subsidiary, subsidiary creditors stand to realize larger recoveries than parent creditors.<sup>40</sup> As a consequence, disputes between parent and subsidiary creditors can arise over which entity owns particular assets.<sup>41</sup> Disputes can also arise over the interpretation and enforceability of parent and subsidiary guarantees of each other’s debt and over the value of intercompany claims.

A related risk facing investors who purchase claims in complex holding company structures is that in Chapter 11, the judge may order the case to be “substantively consolidated.” What this effectively does is pool all of the assets and liabilities of the parent and its subsidiaries into a single entity, collapsing multiple bankruptcy proceedings and reorganization plans into one. Substantive consolidation therefore forces parent and subsidiary creditors to share more equally in the firm’s assets, undoing the effects of structural subordination. Substantive consolidation is not defined in the Bankruptcy Code but may be ordered by the judge if he or she determines that (1) doing so will benefit creditors and the estate (e.g., by reducing reorganization costs) and (2) the entities to be consolidated are not meaningfully “separate” (e.g., they have the same management, conduct the same business, use a single cash management system, and are so entwined that it would be prohibitively costly or impossible to separate their assets and liabilities).<sup>42</sup>

<sup>40</sup>Such relative priorities are generally reflected in the trading prices of the debt. In May 2006, two months before Adelphia Communications finalized the sale of its operating assets to Time Warner and Comcast under Section 363, bonds issued by the parent holding company were trading between 40 and 50 cents on the dollar, while trade claims against Adelphia’s operating subsidiaries were trading for as much as 120 cents on the dollar. See K. Laughlin, “Restructuring: Distressed Investing Gets more Complex,” *High Yield Report* (May 15, 2006).

<sup>41</sup>This happened in the Adelphia bankruptcy. At issue was whether an Adelphia operating entity belonged to the parent holding company (as argued by hedge fund W. R. Huff Asset Management, which had a significant position in the parent’s debt) or to the firm’s Arahova subsidiary (whose debt was held by hedge fund Appaloosa Management).

<sup>42</sup>Different bankruptcy and appellate courts have applied different standards for determining whether substantive consolidation is justified. See P. C. Sargent, “Third Circuit Reverses Owens Corning: Substantive Consolidation as a Shield, Not a Sword,” *Real Estate Finance* (December 2005).

In 2008, substantive consolidation was ordered in the bankruptcy of Calpine, which had 274 legally separate bankrupt entities. Although substantive consolidation is relatively uncommon, when it occurs creditor recoveries can be dramatically affected. In the WorldCom bankruptcy, the initial proposed plan of reorganization would have substantively consolidated WorldCom's more than 400 subsidiaries, leaving junior bondholders in the highly profitable and solvent MCI subsidiary with no recovery.<sup>43</sup>

A final area of conflict concerns "second lien" financing, which exploded in popularity during the mid-2000s buyout boom. Second-lien debt has a junior security interest in a common collateral pool, standing behind the security interest of more senior (first-lien) debt. If the collateral is liquidated, second-lien lenders are technically only entitled to any value that remains after first-lien lenders' claims have been fully satisfied. The rights and obligations of first- and second-lien lenders are specified in an "intercreditor agreement"; however, disputes over how the agreement should be interpreted often arise when the borrower files for bankruptcy.<sup>44</sup>

### **Risks in Debtor-in-Possession Financing**

Although historical default rates on DIP loans have been extremely low, in a small number of cases investor losses on DIP loans have been severe. In the 2001 Chapter 11 bankruptcy of Winstar Communications, for example, the company was ultimately liquidated and DIP lenders recovered only 20–30 percent of their claim.<sup>45</sup> In early 2009, portions of Delphi's DIP loan were trading in the secondary market for less than 20 cents on the dollar.<sup>46</sup> The likelihood of such losses depends on the severity of the firm's operating problems and how leveraged it is. DIP loans can also be at greater risk when the reorganization is more complex and there is greater conflict among the

<sup>43</sup>The bondholders later settled with the company for 45 cents on the dollar. "WorldCom, MCI and the second Circuit's Substantive Consolidation Doctrine: Asserting Creditors' Rights in the Largest Bankruptcy Case in History—Part II," *The Metropolitan Corporate Counsel* (January 2004).

<sup>44</sup>For example, intercreditor agreements often require second-lien lenders to waive their right to adequate protection if the collateral is sold or their right to challenge the validity and priority of the senior lien. In practice, second-lien lenders routinely challenge these provisions, and the courts' response to these challenges has been mixed. J. A. J. Brighton and M. N. Berman, "Second-Lien Financings: Enforcement of Intercreditor Agreements in Bankruptcy," *ABI Journal* (February 2006).

<sup>45</sup>Moody's Global Corporate Finance, "Moody's Comments," 4.

<sup>46</sup>"Lyondell Loan Exemplifies New Bankruptcy Landscape," *Bloomberg News* (February 4, 2009).

firm's constituencies, which make it more likely the reorganization will fail or run on for longer than anticipated (forcing DIP lenders to refinance the loan or exit their positions).

Investors who seek to provide superpriority DIP financing and roll up their prepetition secured claims may also face unexpected legal challenges from other creditors. In particular, if the firm's capital structure includes second-lien debt, and this debt is undersecured, then second-lien lenders may object to the DIP loan on the grounds they are being primed, and their collateral is not adequately protected. Cases in which such objections have been filed include Calpine and American Remanufacturers.

### **Risks in Section 363 Asset Sales**

Although purchasing assets through Section 363 has become increasingly common in Chapter 11, this investment strategy still carries a number of risks. Although the investor may wish to acquire the targeted assets quickly, and the court can approve the sale in as few as 20 days, in practice competition among bidders and procedural matters can cause delays. In the 2009 auction for Polaroid, a heated bidding contest between Patriarch Partners and Hilco Consumer Capital/Gordon Brothers helped draw the process out to five months. This example also points to an obvious risk for all potential buyers, that competition in the auction could be unexpectedly vigorous, resulting in a much higher transaction price. Hilco/Gordon Brothers' winning bid of \$87.6 million was 109 percent higher than the opening bid of \$42 million.

Competition also makes it less certain that any single buyer's bid will prevail. Although in principle break-up fees and related protections offer some consolation to a losing stalking horse bidder, in practice these protections are not ironclad or always available. For example, some courts need to see proof that proposed fees are necessary, and in several cases bankruptcy judges have either reduced or denied break-up fees.<sup>47</sup> Payment of break-up fees may also be at risk if they stand behind a DIP loan in priority of payment, and the sale proceeds are insufficient to fully repay the loan.<sup>48</sup>

Bidders who follow the stalking horse can be at a particular disadvantage in terms of obtaining information about the assets, increasing the risk they

<sup>47</sup>For example, the court denied a break-up fee in the Top-Flite bankruptcy. In the Burlington Industries bankruptcy, the judge reduced the fee from 2.4 percent of the bid price to a maximum of 1 percent of the final price. For an excellent discussion of these issues, see D. M. Glosband, "Pathology of Section 363 Sales (Not as Simple as they Look)," *Journal of Private Equity* (Fall 2004).

<sup>48</sup>*Ibid.*

will overpay or be outbid. In general they will have had less time to evaluate the assets than the stalking horse. They may also receive less information from the seller, who may favor the stalking horse. And the stalking horse may have superior information by virtue of having previously provided the debtor with DIP or other senior debt financing.

There can be additional uncertainty over the outcome of an auction because what constitutes the “highest and best” offer under Section 363 can hinge on the judge’s interpretation. Again in the Polaroid case, although Patriarch Partners ultimately bid the highest price, the Hilco/Gordon Brothers consortium, which bid half a million dollars less, was declared the winner because of its successful track record buying and managing bankrupt company brands (which was highly relevant to Polaroid’s creditors because 25 percent of the purchase price was paid in stock of the acquiring entity).

Investors should also be aware of the risk that a Section 363 transaction could potentially be disallowed even after the judge issues a final sale order, based on a 2008 decision by the Bankruptcy Appellate Panel (BAP) of the 9<sup>th</sup> U.S. Circuit Court of Appeals.<sup>49</sup> In principle, sales under Section 363 done in “good faith” are final and uncontestable after the fact.<sup>50</sup> Further, Section 363 allows investors to purchase assets free of “liens, claims, and other interests” (which remain with the seller and attach to the sale proceeds). In its decision, however, the court reversed a bankruptcy court’s sale order approving the sale of property by PW, LLC, a real estate developer, to its senior secured mortgage lender, which credit bid its outstanding \$40 million secured claim. At issue was a junior lien on the same property, securing a \$2.5 million debt held by Clear Channel. Clear Channel received nothing under the sale and appealed to have the sale reversed. Based on its interpretation of the language of Section 363, the BAP ruled that the property could not be sold “free and clear” of Clear Channel’s junior lien, which therefore was to remain attached to the property.<sup>51</sup>

Finally, although buyers of assets in Section 363 sales can leave most of the associated claims and liabilities behind with the seller, the courts are divided on whether Section 363 shields buyers from product liability

<sup>49</sup>*Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9<sup>th</sup> Cir. 2008).

<sup>50</sup>Under Section 363(m) of the Bankruptcy Code, if a buyer purchases property in good faith, the sale will remain valid even if the sale order is later reversed or modified on appeal.

<sup>51</sup>The court’s decision was highly controversial, and as of this writing the longer run implications of the ruling are unresolved. See C. Combest and F. B. Feinstein, “Clear Channel Raises Troubling Issues in Section 363 Sales But Case Doesn’t Spell the End of Free-and-Clear Sales,” *Journal of Corporate Renewal* (February 19, 2009).



claims.<sup>52</sup> In particular, if someone is injured by a product manufactured by a business before the business is sold in a Section 363 transaction, but the injury is not discovered until after the sale, the buyer could still be liable for damages.<sup>53</sup> In addition to product liability claims, Section 363 buyers may also be liable for certain environmental and employment claims.

### **Risks in Loan-to-Own Strategies**

As discussed above, the successful execution of a loan-to-own strategy in bankruptcy requires a reorganization plan that converts the investor's secured debt claim into a majority of the new equity and eliminates all more junior debt and equity classes. The investor therefore needs to hold the fulcrum security, where enterprise value runs out. "Out of the money" creditors and shareholders may challenge this outcome in court on a variety of grounds, including that enterprise value has been "low-balled"; that management and the board unduly favored the investor by giving him/her nonpublic information and discouraging competing bids; that the investor, as a significant shareholder and insider, improperly influenced management or the board in an effort to increase its recovery as a secured lender; or that the investor "rigged" the terms of the loan to guarantee that the firm would default (e.g., by including overly onerous covenants or repayment schedules). If these charges stick, the investor's claims could, for example, be equitably subordinated or recharacterized as equity, or its security interests could be voided as a fraudulent transfer.<sup>54</sup> Unsuccessful challenges to loan-to-own strategies in the Radnor Holdings and Granite Broadcasting bankruptcies suggest that investors will be better able to withstand such challenges if they clearly "act like lenders" when appropriate (e.g., by diligently enforcing loan covenants and repayment schedules) and take all steps necessary to avoid the appearance of insider dealing in their role as shareholders.<sup>55</sup>

<sup>52</sup>Glosband, "Pathology of Section 363 Sales."

<sup>53</sup>In General Motors' bankruptcy, the successor entity ("new GM") that purchased GM's prime assets agreed to assume responsibility for paying future product liability claims, following intense pressure to do so by more than a dozen state attorneys general. In Chrysler's bankruptcy, in contrast, Fiat assumed no liability for these claims following its purchase of Chrysler's assets.

<sup>54</sup>See J. M. Landers, "Reflections on Loan-to-Own Trends," *ABI Journal* (October 2007).

<sup>55</sup>In *Radnor*, for example, Tennenbaum Capital had the right to appoint one director to the firm's board, but he abstained from voting on issues that affected the fund. See M. Berman and J. A. J. Brighton, "Hedge Funds: Lessons Learned from the *Radnor* Decision," *ABI Journal* (February 2007).

### **Disputed and Contingent Claims**

In almost every Chapter 11 case, the status, seniority, or size of some claims is not resolved until well into the case. An investor's recovery in the case and percentage return can be greatly affected by how these disputed claims are resolved, especially if they rank senior or equal to the investor's claim in the firm's capital structure.

Claims can be disputed or contingent for many reasons. For example, creditors sometimes file multiple proofs of claim for the same underlying instrument. Another important source of dispute revolves around the issue of when a particular claim comes into existence. When the Environmental Protection Agency (EPA) has a claim outstanding against a bankrupt firm under CERCLA, for example, the debtor will typically try to argue that the claim arose before it filed its bankruptcy petition (e.g., because the actions that gave rise to the contamination occurred before the filing). The EPA, in contrast, will typically argue that the claim arose after the firm filed for bankruptcy (e.g., because the costs of cleaning up the contaminated site have yet to be actually incurred).

The date on which a claim comes into existence is important because under the Bankruptcy Code all prepetition claims are discharged when the firm leaves bankruptcy (to use an analogy, the debtor's record is wiped clean of all offenses committed before it filed for Chapter 11). If the EPA loses its case, then its claim will most likely be added to the pool of general unsecured claims, although it may still try to have its claim treated as a higher priority administrative expense (see Exhibit 1.2). The same issues come up when the Pension Benefit Guaranty Corporation brings a claim against a Chapter 11 debtor for unfunded pension liabilities.

Finally, Chapter 11 allows a firm to reject unfavorable leases and other "executory contracts" (including collective bargaining agreements). Any economic loss the owner of the leased property suffers as a result of such rejection becomes a general unsecured claim against the estate. The owner, however, may dispute the debtor's right to reject the lease or its estimate of losses from the rejection.

### **Credit Derivatives and Incentives to Restructure**

Restructuring outcomes may be harder to predict or control when creditors also hold credit derivatives like credit default swaps and total return swaps. Creditors are not required to disclose their positions in these instruments, which in principle can reward them for voting against an out-of-court restructuring plan, filing an involuntary bankruptcy petition, or, in some circumstances, pushing the firm into liquidation.

A credit default swap (CDS) is effectively an insurance contract that compensates the insured party (“protection buyer”) for any reduction in the value of a bond or other debt instrument that occurs when a specified borrower defaults or experiences some other defined “credit event” like a bankruptcy filing. (CDSs and other credit derivatives are discussed in detail in Chapter 14.) In exchange for receiving this insurance coverage, the protection buyer makes regular payments to the insurance provider (“protection seller”) over the life of the CDS, which can range from one to 10 years. The CDS terminates upon settlement. In a total return swap (TRS), two parties—similarly labeled protection buyer and protection seller—agree to make periodic payments to one another over a specified term, based on the total investment return generated by a hypothetical dollar investment in some corporate bond or other reference asset. At each payment date, the protection buyer pays the protection seller an amount of cash equal to interest and any capital gains that the investment generated; the protection seller simultaneously pays the protection buyer interest (calculated at a different rate) and any capital losses that the investment suffered. Unlike a CDS, a TRS does not expire if the reference company defaults or files for bankruptcy.

Because creditors who have purchased credit protection through either kind of derivative are rewarded if the firm files for bankruptcy or experiences any other event that reduces the market value of the firm’s debt, a number of commentators have expressed concern that these creditors’ interests are directly opposed to those of others who seek to restructure the firm and restore the business to financial health. Such conflicts have been alleged in the cases of AbitibiBowater and General Motors, although given the opaqueness of the derivatives market, it is hard to know how widespread these conflicts may be.<sup>55</sup>

### **Holding Period Risk**

By definition, an investor’s annual rate of return from buying distressed claims depends on two unknowns: the dollar recovery that the claims eventually realize in a restructuring or bankruptcy and amount of time it takes to receive this recovery. In the case of distressed debt, the potential dollar return is always “capped,” in the sense that the most an investor can receive for the claim is the debt’s face value (plus such interest that may accrue

<sup>55</sup>See H. Sender, “Shake-up of GM Complicated by Prospect of Credit Insurance Deals,” *Financial Times* (May 12, 2009), and G. Soros, “My Three Steps to Financial Reform,” *Financial Times* (June 17, 2009).

on secured debt in Chapter 11).<sup>57</sup> Thus, the investor's annual percentage return is highly dependent on how long it takes the firm to restructure or reorganize. It is not uncommon for investors in distressed claims to seek annual returns in the range of 25 to 35 percent. As shown in Exhibit 1.3, however, even modest extensions of the investor's holding period can result in substantial erosion of annualized returns, especially in the early years of a reorganization.

Large Chapter 11 reorganizations typically last two to three years, but business setbacks and disagreements among creditors can significantly extend this. LTV Corporation spent more than six years in bankruptcy court.<sup>58</sup> Negotiations generally take longer when firms have more complicated capital structures and face more serious operating problems.<sup>59</sup> As a result, some investors target companies whose problems are primarily financial rather than operational in nature (e.g., leveraged buyouts that go bust shortly after inception and have solid management in place).

Aside from how it impacts the holding period, delay also hurts the investor's return because legal and other out-of-pocket costs of bankruptcy increase over time. Professionals' fees in Chapter 11 can easily exceed a million dollars a month and increase sharply for larger, more complex cases. (In the Lehman Brothers bankruptcy, one law firm sought approval for \$55 million in fees for three months' work.<sup>60</sup>) As administrative expense claims, these fees directly reduce the value that remains for unsecured creditors and shareholders. Delay also reduces value because management is less focused on the business, and key customers and suppliers are more likely to defect.

<sup>57</sup>In Chapter 11, interest accrues on secured debt if the debt is overcollateralized but only up to the value of the excess collateral. As discussed earlier, no interest accrues on unsecured debt during Chapter 11.

<sup>58</sup>Prior to the 2005 BAPCPA amendments, which cap the debtor's exclusivity period at 18 months, cases also tended to take longer in certain jurisdictions (such as the Southern District of New York) where judges were more inclined to extend the debtor's exclusivity period. One study of the pre-BAPCPA period found that cases held in New York took an average of 2.8 years to complete, compared to 2.1 years for other jurisdictions. See L. M. LoPucki and W. C. Whitford. 1990. "Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies," *University of Pennsylvania Law Review*, 139: 125–196.

<sup>59</sup>Firms that do not exhibit these characteristics are more likely to be able to restructure their debt through a "fast-track" prepackaged or prenegotiated bankruptcy, or an out-of-court restructuring.

<sup>60</sup>M. Maynard and M. J. de la Merced, "Auto Troubles Touch Many Corners: Bankruptcy for G.M. Would Tax the Experts," *The New York Times* (May 26, 2009).

The holding period can also drag on unexpectedly because of delays in physically distributing cash and new securities to creditors under the restructuring or reorganization plan. In Chapter 11, the distribution date typically follows the plan confirmation date by several months. If new bonds are issued, the indenture must be approved by the SEC. Delays may also be more likely when the new securities are distributed through non-U.S. agents, who have less experience processing Chapter 11 distributions.<sup>61</sup>

### **Valuation Disputes**

In every distressed situation, an investor's return depends on two key values: the true value of the firm's assets ("true value") and the value of the firm's assets used in determining payouts to claimholders under the firm's reorganization or restructuring plan ("plan value"). These two values are almost always different, and an investor's returns can be significantly affected by changes in either value.

An investor should be aware that various parties in the case may have a significant financial interest in promoting plan values that differ materially from the firm's true value. Junior claimholders (e.g., common stockholders) benefit from a higher plan value because they are last in line to be paid. Conversely, senior claimholders (e.g., secured lenders) prefer a lower plan value because they then receive a larger fraction of the total consideration distributed under the plan (in effect, "squeezing out" more junior interests). These conflicting incentives exist even though both junior and senior claimholders may privately assign the same true value to the firm.

As a simple illustration, suppose that senior creditors are owed 200 and junior creditors are owed 100 (for total debt of 300). Suppose further that the true value of the firm's assets is 260. If this amount is also the plan value, then senior creditors are made whole in the restructuring, leaving only 60 for junior creditors and nothing for stockholders. (To simplify the example, I assume that payouts under the plan follow the absolute priority rule.) Stockholders would clearly prefer the plan value to exceed 300. Senior creditors, on the other hand, benefit when the plan value is less than the true value. For example, consider an alternative restructuring plan premised on a plan value of 180. In this case, senior creditors receive consideration nominally worth 180 (in the form of new debt and equity securities and possibly some cash), and junior creditors and stockholders both receive nothing. Because the firm is really worth 260, however, the new claims must eventually appreciate in value by 80 (i.e.,  $260 - 180$ )—a pure windfall to senior creditors.

<sup>61</sup>See T. Moers Mayer. 1994. "Claims Trading: Problems and Failures." Manuscript.

Disagreement over the plan value can be a major obstacle to reaching a consensus, creating delays and additional expense. In Chapter 11, the judge can order a full valuation hearing, in which competing experts present and defend their valuations in court. This occurred in the Exide Technologies bankruptcy. The debtor's proposed reorganization plan was premised on an enterprise value of \$866 million, while unsecured creditors argued that enterprise value was fully \$1.6 billion. After hearing testimony from both sides' experts, the judge ruled in favor of unsecured creditors, who otherwise would have received little or no recovery under the plan. Highly public valuation disputes also occurred in the bankruptcies of Flagstar Companies, Calpine, Mirant, Iridium, Vlasic Foods, and Nellson Nutraceutical.

The consequences of being on the losing side of a valuation fight can be severe. In the National Gypsum bankruptcy, junior creditors' proposed \$1 billion plan value was over *five times* as large as management's \$183 million value. The judge in this case ruled for management, but a year after bankruptcy National Gypsum's stock price had quadrupled and its enterprise value had risen to more than \$700 million—a huge windfall for senior creditors.<sup>62</sup> To protect themselves against such losses, investors can of course vote against the reorganization plan or propose their own competing plan. They can also litigate and petition the judge to hold a formal valuation hearing. Finally, academic research shows that the direction of any valuation bias can, in some cases, be predicted, offering investors guidance as to where they should focus their efforts.<sup>63</sup>

### **Lack of Information about Purchases and Purchasers**

Investors in distressed claims are able to operate in relative secrecy, since as a rule they do not have to publicly disclose detailed information about their trading activities. In Chapter 11, claims transfers are regulated by Federal Bankruptcy Rule 3001(e). The rule, which applies to nonpublicly traded

<sup>62</sup>During the valuation hearing, junior creditors alleged that management had, among other things, presented overly pessimistic revenue forecasts in an attempt to low-ball the enterprise value.

<sup>63</sup>See Gilson *et al.*, "Valuation of Bankrupt Firms." For example, the study shows that plan values are more likely to be low-balled or downward biased when senior creditors are more influential in the case, when senior managers receive stock or stock options under the reorganization plan, and when an outside investor funds the plan by purchasing new equity in the firm. Values tend to be upward biased when junior creditors are more in control and when incumbent senior managers keep their jobs.

claims, requires an investor who purchases claims to notify the court of the transaction. If the seller does not object to the transaction, the judge will automatically approve the transfer of ownership. However, the investor does not have to reveal either the number of claims purchased or sold or the price paid.

In the case of publicly traded bonds, ownership transfers are governed by applicable securities laws. Determining who owns the bonds is difficult, however, because the registry of ownership (maintained by the bond indenture trustee) typically will list as the holders of record only the brokerage firms or banks that hold the bonds “in street name,” not the true beneficial owners. In addition, investors who acquire distressed debt are unlikely to have to disclose their positions through a Schedule 13D or 14D-1 filing with the SEC (at least until after the firm’s restructuring or reorganization plan is completed).<sup>64</sup>

For investors in distressed debt, the lack of disclosure of investor trading histories can be a double-edged sword. Because no central record is kept of who owns a firm’s debt, an investor may—as a bargaining ploy—be able to claim significant ownership, when in fact his or her holdings are more modest. One investor tried to do this with the bonds of bankrupt MGF Oil. Only by polling other bondholders did management discover the investor actually owned only 7 percent of the issue.<sup>65</sup> Non-disclosure of ownership also makes it harder for an investor to know how many claims he or she should acquire, and at what price, when other investors are also seeking control.<sup>66</sup>

<sup>64</sup>A 13D filing must be made by any person who acquires more than 5 percent of an outstanding voting equity security, within 10 days of crossing the 5-percent threshold. A 13D filing is not required when an investor purchases debt securities but may be required later if and when these securities are converted into equity under the firm’s restructuring or reorganization plan. A 14D-1 filing must be made at the commencement of a tender offer for an equity security or a security that is convertible into equity. An investor who makes a tender offer for debt securities may therefore have to file a Schedule 14D-1 if the debt is to be converted into equity under a follow-on restructuring plan. A 14D-1 is not required if the tender offer is not made for “securities,” or the offer is part of a Chapter 11 reorganization plan. (The SEC has ruled that a debtor’s disclosure statement includes enough information to make a 14D-1 filing unnecessary.)

<sup>65</sup>M. Schifrin, “Sellers Beware,” *Forbes* (January 21, 1991). To mitigate this problem, firms will sometimes hire proxy firms to help them identify bond ownership.

<sup>66</sup>Investors’ ability to trade “offline” was directly challenged in 2007, when the judge in the Northwest Airlines bankruptcy ruled that investors who sat on an *ad hoc* creditors’ committee were fiduciaries and as such were required, under Bankruptcy Rule 2019, to publicly disclose their full trading history in respect of the firm’s

Investors who have superior information about claims ownership have a significant competitive advantage in trading claims and negotiating a restructuring plan. Following the collapse of Drexel Burnham Lambert, Apollo Advisors was thought to be especially well informed about the ownership of junk bonds that had been underwritten by Drexel, because many of the principals of Apollo were Drexel alumni. This superior knowledge has been credited with helping Apollo acquire the \$6 billion (face value) junk bond portfolio of bankrupt First Executive Life for \$2 billion less than its true value, according to one estimate.<sup>67</sup>

### Counting Votes

In Chapter 11, investors' ability to vote their claims can sometimes be undermined by administrative errors or delays in the vote tabulation process.<sup>68</sup> For example, if an investor purchases a claim too close to the official voting record date, there may not be enough time to register the investor as a "holder of record" with the claims-processing agent, and the investor may lose the opportunity to vote.<sup>69</sup> Similarly, when claims are held in "street name" with a brokerage firm, the brokerage firm is responsible for sending individual ballots to the actual owners, collecting the votes, and conveying the final vote tally to the balloting agent (in a "master ballot") by a specified deadline. In the bankruptcy of Spectradyne, an investor who held a blocking position in a preferred stock class was unable to prevent the class from accepting the plan because the broker missed the deadline, and the investor's votes were not recorded in time.

### Insider Trading Issues

Investors who buy or sell claims of a distressed firm can be subject to insider trading restrictions if they have access to material nonpublic information

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claims—including the timing and price of each purchase or sale. (A group of investors or creditors with common interests will sometimes form an "unofficial," *ad hoc* committee to provide an effective vehicle for communicating and negotiating with the debtor.) Soon thereafter, however, the judge in the Scotia Pacific Co. bankruptcy took up the same issue and reached the opposite conclusion.

<sup>67</sup>See H. DeAngelo, L. DeAngelo, and S. C. Gilson, 1994. "The Collapse of First Executive Corporation: Junk Bonds, Adverse Publicity, and the 'Run on the Bank' Phenomenon," *Journal of Financial Economics* 36: 287–336.

<sup>68</sup>This summary of voting issues is based on Mayer, "Claims Trading."

<sup>69</sup>This happened in the Hills Department Stores bankruptcy. To guard against this possibility, the purchase agreement could require the seller to transfer the ballot to the buyer, or give the buyer power of attorney to vote the claim on behalf of the seller.



about the firm. Insider trading is not explicitly addressed in the Bankruptcy Code. Under applicable nonbankruptcy law, an investor who trades on inside information can be held liable if he or she misappropriates confidential information or breaches some fiduciary duty (e.g., to creditors). Investors in distressed debt can therefore be at risk if they sit on the official unsecured creditors committee in a Chapter 11 proceeding (which makes them fiduciaries and gives them access to confidential information).<sup>70</sup> Also at risk are investors who provide the firm with professional advice (e.g., investment banks that have proprietary trading operations).

With respect to a bankrupt firm's publicly traded securities, investors who trade on inside information face the same sanctions under Section 10(b) of the Securities Exchange Act as investors in nondistressed securities. For example, an investor who has advance knowledge of the firm's reorganization plan would be prohibited from trading in the firm's public bonds. Whether these sanctions also apply to trading in the firm's nonpublic claims—which do not meet the legal definition of a “security”—is less clear, however.

Investors have several options for reducing their potential exposure. In the case of investors who sit on the unsecured creditors committee, they can agree to abstain from trading while serving on the committee; they can resign from the committee when they wish to resume trading (after a suitably long waiting period); or they can credibly commit—sometimes through a court order—not to share any nonpublic information that they obtain on the committee with their trading operations (by erecting a “screening wall”).

More generally, an investor who possesses nonpublic information can issue a so-called “big boy letter” when he or she trades with a less-informed counterparty. The letter is basically an acknowledgement that the investor may possess material nonpublic information and that the counterparty is still willing to trade with the investor despite knowing this. However, several recent court cases suggest that big boy letters do not protect investors from

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<sup>70</sup>During the bankruptcy of Papercraft Corporation, a failed LBO, a court-appointed examiner recommended that the trading profits made by two investors—Magten Asset Management and Citicorp Venture Capital Ltd.—be refunded to the debtor and that neither investor be allowed to fully vote its claims. The examiner's recommendation was based on the fact that both investors sat on the unsecured creditors committee and were therefore fiduciaries. Citicorp Venture Capital was also an original investor in the LBO and had the right to elect a director to Papercraft's board. Significantly, it made no difference to the examiner that one investor had disclosed its “insider” relationship to the sellers of the claims or that the other's intention in buying claims was to facilitate the reorganization (as well as to make a profit).

insider trading liability arising from breach of fiduciary duty, and when trading involves securities.<sup>71</sup>

### Liquidation Risk

In a Chapter 7 liquidation, the firm's assets are sold for cash by a trustee and the proceeds are paid to the firm's claimholders according to the absolute priority rule. An investor in distressed claims needs to be able to assess the risk that a firm will fail to reorganize and have to liquidate. As discussed in the appendix, the bankruptcy judge will convert a Chapter 11 case to Chapter 7 if agreement on a reorganization plan cannot be reached. In general, liquidation will be more likely when the firm's assets are relatively more tangible (e.g., inventories and equipment, as opposed to employee goodwill), as such assets typically retain more of their value when sold. Liquidation will also more likely for smaller firms, because such firms lack the resources and depth of management to endure a lengthy and complex Chapter 11 reorganization.

### Tax Liabilities

The specific strategy that an investor follows to acquire control in a distressed firm can have adverse corporate tax implications for the firm, reducing the investor's after-tax return. Higher corporate taxes can result from the loss of net operating loss carryforwards or from the creation or cancellation of indebtedness income. In general, the risk of being hit with an unexpectedly higher tax liability increases with the percentage of equity that investors acquire in the firm, either through direct purchases (e.g., as part of funding a reorganization plan) or through the exchange of stock for debt. A related risk is that trading restrictions may be placed on the firm's claims to preserve its tax attributes.

<sup>71</sup>For example, in *R2 Investments v. Salomon Smith Barney*, the plaintiff, R2, was a hedge fund that had purchased bonds in the bankrupt telecommunications firm, World Access. The bonds were purchased directly from a broker-dealer, Jefferies & Co., which had in turn purchased the bonds from Salomon Smith Barney. Salomon, which sat on the World Access unsecured creditors committee, issued a big boy letter when it sold the bonds to Jefferies; however, Jefferies did not disclose this fact to R2. The case settled for an undisclosed sum. See B. S. Fraser and T. E. Newbold, "Who's a Big Boy? Non-reliance Provisions and Claims of Insider Trading in Securities and Non-securities Markets," Richards Kibbe & Orbe LLP, New York, NY (undated manuscript).

**Preservation of Net Operating Losses** If an investor acquires a block of claims in a distressed firm for the purpose of acquiring control, the firm may lose significant tax deductions arising from its net operating loss carryforwards (NOLs). This loss can severely reduce the investor's return. NOLs are a sizable asset for many distressed firms.<sup>72</sup> When it filed for bankruptcy, General Motors had nearly \$16 billion in NOLs. Sirius XM's \$6 billion of NOLs were considered to be its most valuable asset, and a key draw for Liberty Media Corp., which provided Sirius with rescue financing.<sup>73</sup>

Under Section 382 of the Internal Revenue Code, a firm's ability to use its NOLs can be severely restricted when it experiences an "ownership change." An ownership change takes place when any group of stockholders collectively increases its total percentage ownership of the firm's common stock by more than 50 percentage points during any three-year period.<sup>74</sup> Purchasing a large block of equity or debt prior to the firm's reorganization or restructuring can greatly increase the risk of an ownership change, especially if the debt is exchanged for common stock.

If an ownership change does take place, the restrictions on NOL use are generally less severe if the firm is in Chapter 11, based on the "bankruptcy exception." In this case, the least severe restriction applies if more than 50 percent of the firm's stock continues to be held by its prepetition shareholders and "qualified" creditors (i.e., creditors who have been creditors for at least 18 months before the bankruptcy filing or who acquired their claims in the "ordinary course of business").<sup>75</sup> This condition can easily be violated, however, if an outside investor acquires control of the firm's equity by purchasing claims. The most severe restriction then applies: Annual NOL usage is limited to the value of shareholders' equity after the reorganization,

<sup>72</sup>One study of public company Chapter 11s reports that firms' NOLs are on average 200 percent higher than the book value of assets reported at the bankruptcy filing date. See S. C. Gilson, "Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms," *Journal of Finance* 52: 161–196.

<sup>73</sup>J. Drucker and M. Karnitschnig, "The Lure of Sirius: Tax Losses," *The Wall Street Journal* (February 21, 2009).

<sup>74</sup>In calculating the percentage ownership change, percentage reductions in ownership by individual stockholders are ignored and all stockholders who individually own less than 5 percent of the stock are collectively treated as a single holder. In addition, convertible securities and warrants are treated as actual common shares. The increase in ownership attributed to each stockholder is determined relative to the lowest percentage of the firm's stock owned by that holder during the three-year test period.

<sup>75</sup>NOLs are reduced by approximately one-half the amount of any debt forgiven in the reorganization (net of any new consideration distributed) plus any interest.

multiplied by a prescribed statutory federal interest rate. In practice, this calculation produces a relatively small number, making it unlikely the firm will be able to fully use its NOLs before they expire.<sup>76</sup> If an ownership change occurs while the firm is restructuring its debt out of court, it can lose its NOLs altogether.<sup>77</sup>

When the risk of a Section 382 ownership change is severe, trading in the firm's claims may be legally restricted. Such restrictions pose a considerable risk to investors, by limiting their ability to actively manage their positions. In Chapter 11, such restrictions may be requested by the firm, and ordered by the judge, at the very start of the case. Trading restrictions can take the form of a ban on all trading. More commonly, the court issues an order that requires investors to give the firm advance notice of their intention to trade, so the firm has an opportunity to object. (Of course, giving such notice is costly for investors because of the added delay and potential leakage of information about their intentions.) Such "claims trading motions" were entered in the bankruptcies of Dura Automotive Systems, Calpine, Delta Air Lines, WorldCom, Adelphia, and US Airways.

Investors can reduce their exposure to these risks by avoiding firms with disproportionately high NOLs and targeting relatively more solvent firms that are apt to issue less new equity in a reorganization or restructuring. To mitigate the risks associated with trading restrictions, investors can also agree to a "sell down" arrangement with the firm. Under this procedure, the advance notice period will be waived if, after being notified to do so by the firm, investors reduce their holdings below 5 percent of the reorganized firm's equity, making it more likely the firm's NOLs will be spared under the "bankruptcy exception."<sup>78</sup>

<sup>76</sup>Even if the firm manages to preserve some of its NOLs while in Chapter 11, however, it will forfeit them if it undergoes a subsequent ownership change within two years. Currently in the United States, NOLs can be carried back 2 years and then carried forward for 20. (Prior to August 5, 2007, the corresponding figures were 3 and 15 years.) A more generous carryback period (of up to five years) was briefly extended to small businesses under the American Recovery and Reinvestment Tax Act of 2009.

<sup>77</sup>Specifically, if the firm continues in its historic line of business, annual use of NOLs is limited to the value of shareholders' equity before the restructuring is implemented multiplied by the same statutory federal interest rate used in calculating the restriction for firms in Chapter 11. If the firm changes its line of business, however, all of its NOLs are lost.

<sup>78</sup>Under the *de minimus* rule, creditors who end up holding less than 5 percent of the reorganized firm's equity are considered "qualified" creditors for purposes of applying the bankruptcy exception. See J. P. Darcey. 2008. "Restrictions on Trading

**Cancellation of Indebtedness Income** In general, when a firm repurchases its debt for less than full face value—whether with cash or with stock—the difference is treated as taxable “cancellation of indebtedness” (COD) income. The tax liability can be significant, although under certain circumstances firms can defer recognition of COD income by using it to reduce certain outstanding tax attributes, including NOLs and the basis of depreciable property.<sup>79</sup> A related risk is that the parties may, in trying to avoid creating COD income, agree to a restructuring plan that keeps too much debt on the balance sheet, setting up the company to fail down the road.

### **DO DISTRESS INVESTORS CREATE OR DESTROY VALUE?**

The role of distress investors in corporate restructuring is often controversial. The very term “vulture” is pejorative, much like the term “corporate raider” used to describe investors who once waged war in the hostile takeover arena. Some take offense that distress investors are allowed to profit—sometimes spectacularly so—from a company’s misfortunes, while creditors, shareholders, and employees are told they must make material financial sacrifices.<sup>80</sup> The mixed record of some funds in running the companies they acquire cause some to question whether these investors possess the management skills needed to turn around troubled businesses.<sup>81</sup> Others view distress funds—and hedge funds more generally—with suspicion because they operate in secrecy and disclose little about their trading activities (which, it has been alleged, allows them to freely misrepresent these activities).<sup>82</sup> And

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Claims in Bankruptcy: Preservation of the Debtor’s NOLs,” presentation at the 15<sup>th</sup> Annual ABI Northeast Bankruptcy Conference.

<sup>79</sup>See Gilson, “Transaction Costs.” In general, COD income is taxed less in Chapter 11 than in an out of court restructuring. And recently, the American Recovery and Reinvestment Tax Act of 2009 allowed firms to defer COD income created during 2009–2010 for up to five years (and then spread the income over an additional five years).

<sup>80</sup>J. Goldman and L. Sandler, “Obama Says Chrysler Holdout Lenders Speculated on U.S. Bailout,” *Bloomberg* (April 30, 2009).

<sup>81</sup>L. Story, “For Private Equity, A Very Public Disaster,” *The New York Times* (August 9, 2009) (on Cerberus Capital’s investment in Chrysler) and M. Barbaro, “Sears’ Chairman Will Take a Step Back,” *The New York Times* (January 29, 2008) (on ESL Investment’s acquisition of Kmart and Sears Roebuck & Co.).

<sup>82</sup>S. Taub, “Hedge Fund Bankruptcy Role Seen Probed,” *CFO.com* (November 29, 2005).

some, including an increasing number of bankruptcy judges, frown on the aggressive tactics these investors sometimes employ to insert themselves in distressed companies.<sup>83</sup>

Such concerns, while possibly warranted in some cases, overlook the positive role that distress investors often play in troubled company restructurings. An obvious, but important, point is that trading in distressed claims is *voluntary*. Creditors choose to sell their claims rather than hold them until the end of a restructuring because they realize some benefit (or avoid some cost).

Commercial bank lenders, for example, may prefer to sell their claims at a discount for cash to avoid the uncertainty and expense of pursuing their interests in a protracted bankruptcy. Banks may also prefer to take cash up front if it appears likely that their claims will eventually be swapped for equity (which they have no interest in holding). And by selling off their distressed loans, banks may be able to reduce their regulatory capital requirements. Over time, banks have steadily disengaged from traditional loan workout activities, a transition that has been greatly facilitated by increases in the liquidity of the secondary bank loan market.<sup>84</sup>

Trade creditors can also benefit from selling their claims in a distressed firm. Smaller vendors often cannot afford to wait until the end of a bankruptcy or restructuring for their claims to be settled, and would rather receive cash up front. Other vendors may wish to continue doing business with the firm after it solves its financial problems, and therefore sell their claims rather than risk antagonizing the firm in an adversarial Chapter 11 or restructuring proceeding.

By buying up and consolidating distressed claims, distress investors can also facilitate out-of-court restructuring by reducing the creditor “holdout problem.” Distressed firms sometimes offer bondholders the opportunity to exchange their bonds for a package of new claims, consisting of new equity and/or new debt with a smaller face value, longer maturity, or lower interest rate.<sup>85</sup> Bondholders who own only a small fraction of the bonds have little incentive to participate, because whether or not they tender matters little

<sup>83</sup>See Hon. Allan L. Gropper, “Memorandum of Opinion,” *In re: Granite Broadcasting Corp., et al.*, Case No. 06-12984 (Bankr. S.D.N.Y.), May 18, 2007; and Hon. Robert E. Gerber, “Bench Decision on Confirmation,” *In re: Adelpia Communications Corp. et al.*, Case No. 02-41729 (Bankr. S.D.N.Y.), January 3, 2007.

<sup>84</sup>During 2001–2008, the total volume of trading in distressed bank loans was \$347.4 billion (face value), compared to only \$84.5 billion during the prior eight-year period. Source: Thomson Reuters LPC.

<sup>85</sup>Examples of firms that made out-of-court exchange offers include Charter Communications, Abitibi, D. R. Horton, Six Flags, and R. H. Donnelley.

to the final outcome. And if the restructuring succeeds, they will still hold the original bonds (with their better payment terms). If enough bondholders behave this way, however, the restructuring will almost certainly fail, and everyone will be worse off. By buying up and consolidating these smaller holdings, distress investors eliminate the source of this holdout problem.

Distress investors, as discount buyers, are also less wedded to receiving the full face value of their claims in a restructuring. As long as the claims were purchased for a low-enough price, even small percentage recoveries can produce large investment returns. Banks and insurance companies, in contrast, generally resist writing down their loan principal. Lender resistance to principal write-downs can result in firms being saddled with excessive leverage after they come out of a bankruptcy or restructuring, forcing them to restructure again in the future. (In practice, approximately one-third of all firms that reorganize in Chapter 11 eventually make a return trip to bankruptcy court.<sup>86</sup>) Distress investors therefore facilitate restructuring by giving distressed firms greater flexibility to choose optimal capital structures.

Because the rate of return that investors earn on distressed debt declines exponentially with the amount of time that it takes to realize a recovery (Exhibit 1.3), distress investors also have a strong economic incentive to reach a speedy resolution. To the extent such incentives translate into shorter restructurings, everyone potentially benefits.

Finally, distress investors can be a valuable source of new money and new ideas to troubled companies in need of both. As discussed above, many of these investors seek to control the companies in which they invest; they are not merely short-term traders. Distress hedge funds have also been important buyers of troubled company assets through Section 363 sales. And following the 2008 credit market collapse, distress funds stepped in to fill the void left by commercial banks and other traditional providers of DIP financing. (As discussed above, distress hedge funds underwrote a substantial part of Lyondell Chemical's \$8 billion DIP facility.)

Against these various benefits that distress investors bring to the restructuring table, however, one must weigh the potential costs associated with the lack of transparency in these investors' activities, and their alleged propensity to litigate. The SEC has investigated at least one hedge fund for having misrepresented its ownership of a bankrupt firm's bonds in order to gain a seat on the unsecured creditors committee.<sup>87</sup> And certainly there is

<sup>86</sup>See Gilson, "Transaction Costs." These repeat filers are sometimes facetiously referred to as "Chapter 22s" (or "33s" or "44s").

<sup>87</sup>O. Bilodeau, "SEC Probes Bankruptcy Committees for Hedge Fund Fraud," *Bloomberg.com* (November 29, 2005).

growing anecdotal evidence that bankruptcy has become increasingly litigious, although the extent to which distress investors are responsible for this is unclear.<sup>88</sup>

## **CONCLUSION**

Although the strategies for investing in distressed debt are many and varied, investors who are consistently successful in this market tend to exhibit certain key qualities. First is a superior ability to value troubled assets and businesses. This not only means being better at processing information; it also means being better at finding and collecting information. When firms are financially distressed, information from conventional sources often dries up or is not sufficiently timely.<sup>89</sup> The second defining quality of successful distress investors is superior negotiating skill. This skill in turn depends on investors' ability to value the firm's assets, to understand its capital structure (including the rights and incentives of other creditors), and to pursue appropriate legal strategies. Finally, successful distress investors understand the risks of investing in distressed situations. Distress investing is not for the faint of heart. Although some deals have produced extraordinary returns, returns earned in this sector have historically been extremely volatile.<sup>90</sup> Successful investors learn how to effectively manage these risks.

<sup>88</sup>Academic empirical research on the impact of distress investors is limited. One study finds that distressed firms' stock prices increase on average when distress investors acquire firms' junior claims and decline on average when the investors acquire more-senior claims. See E. Hotchkiss and R. Mooradian. 1997. "Vulture Investors and the Market for Control of Distressed Firms," *Journal of Financial Economics* 43: 401–432. The authors provide two possible interpretations of their evidence: (1) The distress investor's decision to purchase junior (senior) claims in the capital structure signals that he or she believes the firm has a high (low) value or (2) distress investors purchase senior claims to block the firm's reorganization plan and extract higher payments (at the expense of junior claims).

<sup>89</sup>In its bid to control Allegheny International, Japonica Partners engaged almost a hundred outsiders to help it value the company's assets; it extensively interviewed the company's distributors, customers, and line managers; and it relentlessly pressured management to provide it with detailed, timely operating data. This was fundamental analysis with a vengeance.

<sup>90</sup>During 2001–2008, average annual returns earned by U.S. distress debt funds ranged from a high of 30.2% in 2003 to a low of –22.0% in 2008 (*HedgeFund.Net*). During the first half of 2009, average returns rebounded to 39.5% (*Bank of America Merrill Lynch*).



How distress investing practices evolve over the coming years will depend on the nature and severity of future economic downturns, as well as on how companies finance themselves. What seems likely is that the market will continue to see the “convergence” of bankruptcy and traditional mergers and acquisitions activity, in which Chapter 11 provides a platform for acquiring or gaining control of troubled firms and their assets.<sup>91</sup> There is also every reason to expect that distress investment funds will continue to pursue greater opportunities around the world, although strategies will have to be adapted to deal with local bankruptcy laws and customs.

## **APPENDIX: A PRIMER ON CHAPTER 11**

To understand how Chapter 11 affects a firm’s business and capital structure, it can be helpful to conceptually represent the firm immediately prior to bankruptcy as a balance sheet that no longer “balances”: Total assets (measured at market value) are less than total debts (measured at face value). The market value of assets, or the firm’s “enterprise value,” equals the present value of cash flows generated by the firm’s business operations. The face value of the debt represents the amount that the firm owes its creditors from before the bankruptcy filing. A firm in this situation is “balance sheet insolvent.”<sup>92</sup>

### **Filing for Chapter 11**

Most often the decision to enter Chapter 11 is made by management, in what is known as a “voluntary” filing. (Alternatively, creditors can force the firm into Chapter 11 through an “involuntary” filing, although in practice these are relatively uncommon.<sup>93</sup>) While operating in Chapter 11, the firm is known as a “debtor in possession.”

<sup>91</sup>M. Spector and J. McCracken, “Distressed Takeovers Soar—Deals Reach \$84.4 billion as M&A Bankers Flock to Bankruptcy Court,” *The Wall Street Journal* (August 11, 2009).

<sup>92</sup>This example is intended to be illustrative, only. The Bankruptcy Code does not require that a firm be insolvent (under any definition) to be able to file for Chapter 11. Moreover, a firm can be solvent on a balance sheet basis, yet be “cash flow insolvent” in that it is unable to pay current interest or principal coming due (e.g., due to a temporary, albeit severe, decline in its financial fortunes).

<sup>93</sup>For firms with more than 12 creditors, an involuntary filing can be made by any three creditors who collectively hold more than \$10,000 in unsecured debt, and who can prove the firm is not current in paying the debt.

Filing for Chapter 11 immediately triggers an injunction called the “automatic stay,” which stops creditors from enforcing legal claims against the firm’s assets. Importantly, secured creditors cannot seize their collateral.<sup>94</sup> The stay remains in effect until the firm exits from bankruptcy with a confirmed plan of reorganization. In effect, the stay serves as a legal ring-fence that “protects” the firm’s assets from creditors. The purpose of the stay is to allow management to focus on restructuring the business, as well as reduce the risk of a “run on the bank” by creditors. In theory, the stay makes it more likely that a fundamentally viable business can be made profitable again, producing higher recoveries for all claimholders.

Shortly after filing for Chapter 11, the firm is required to file a schedule of assets and liabilities with the court, including the name and address of each creditor. The firm then sets a “bar date.” Creditors must file a “proof of claim” by this date or forfeit their right to participate in the reorganization plan. (Exhibit 1.4 shows the timeline of key events in a Chapter 11 reorganization.)

### **Restructuring the Business and Developing a Plan of Reorganization**

While afforded the protection of the automatic stay, management will generally take measures to improve the firm’s business operations, in addition to developing a financial plan for restructuring the firm’s liabilities and capital structure. Chapter 11 provides firms with a number of valuable tools for restructuring their business operations, including access to superpriority “debtor-in-possession” financing (Section 364 of the Code); the ability to break burdensome leases, supply agreements, and other “executory” contracts (Section 365); and an expedited process for selling off assets (Section 363). In addition, firms do not have to pay interest on their prepetition debt while operating in Chapter 11, which can free up substantial amounts of cash for capital investment and operating improvements.

Management must also devise a proposal to restructure the firm’s liabilities and capital structure, which will be put to creditors—for a formal

<sup>94</sup>Certain exceptions to the stay can be granted by the bankruptcy judge if he or she deems this to be in the best interest of the debtor’s estate. For example, it may be necessary to lift the stay to permit the sale of assets under Section 363 of the Bankruptcy Code. Also, the Code limits the automatic stay for firms that make multiple bankruptcy filings. Even though the automatic stay prevents secured creditors from enforcing liens or seizing collateral, however, it does not give management license to use the collateral any way it pleases, and the Code requires that secured creditors’ collateral must be “adequately protected.”

vote—in the “plan of reorganization.” This plan essentially addresses the aforementioned imbalance between the value of the firm’s assets and the amount of debt outstanding against those assets. This rebalancing is achieved by offering creditors the opportunity to exchange their debt for a package of new debt, new equity, or cash. Creditors who hold similar claims will be assigned to separate “classes” (e.g., bank debt, unsecured debentures, and unsecured trade claims), and a separate exchange offer will be made to each class. Voting on the plan of reorganization takes place on a class by class basis.<sup>95</sup>

To provide for an orderly process, debtor management has the exclusive right to file a plan of reorganization for a specified period of time following the Chapter 11 filing. After the debtor’s exclusivity period expires, other interested parties can file their own plans. Since enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) in 2005, the exclusivity period has been 18 months, with no extension possible.<sup>96</sup> Prior to BAPCPA, the bankruptcy judge could extend the exclusivity period indefinitely.

### **Typology of Reorganization Plans**

There are three general approaches available for effecting the exchange of new for old claims: (1) a stand-alone debt-to-equity conversion, (2) a new money/funded plan, and (3) a sale or merger of the firm.

**Stand-Alone Debt-to-Equity Conversion** In this approach, the firm in effect settles with its creditors “in kind.” As illustrated in Exhibit 1.5, a new capital structure is created, consisting of new debt and new equity. These new claims are swapped for the old debt, which is then extinguished. Finally, the new capital structure is “reattached” to the assets. The resulting balance sheet is less leveraged than the prebankruptcy balance sheet, and creditors who held only debt before the bankruptcy now hold both debt and equity.<sup>97</sup>

**New Money/Funded Plan** As illustrated in Exhibit 1.6, this approach combines a stand-alone debt-to-equity conversion with an investment of new

<sup>95</sup>Classes are unique to each reorganization plan and are defined by the plan proposer, subject to the requirement that all claims assigned to a particular class must be “substantially similar.”

<sup>96</sup>BAPCPA became effective on October 17, 2005.

<sup>97</sup>For expositional convenience this discussion focuses on the exchange of new for old claims entered into with the firm’s prepetition *creditors*; however, in principle prepetition shareholders can also receive some consideration under a Chapter 11 reorganization plan, even if their claims appear to be “out of the money.”

outside money. The investment may be in the form of new debt or equity. The new instruments or claims issued to the investor are brand new and bear no connection to the firm's prepetition claims, which are extinguished when it exits from Chapter 11.<sup>98</sup> The cash received from the investor at plan consummation may be retained for use in the firm's operations after Chapter 11. Alternatively, some or all of the cash may be paid to prepetition claimholders under the plan of reorganization to give them an additional incentive to approve the plan. (In the latter case, since prepetition claimholders will receive more cash in lieu of new claims in the reorganized entity, the investor's *relative* ownership of the firm's debt or equity after Chapter 11 will be increased.) The investor may also hold some of the firm's prepetition claims.

**Sale of the Firm** This approach very much resembles a traditional acquisition or buyout. As shown in Exhibit 1.7, the firm sells its assets to a third-party acquirer for cash. The asset sale may be proposed as part of a formal plan of reorganization plan, in which case the firm's claimholders must approve the sale (and the rest of the plan). Alternatively, the asset sale may be undertaken pursuant to Section 363 of the Bankruptcy Code, in which case it need only be approved by the bankruptcy judge without any formal vote by the firm's claimholders. In either case, the sale proceeds are retained by the firm and eventually distributed to creditors and other claimholders under the plan of reorganization.

Combinations of these three approaches are also possible. For example, management could propose to sell off a portion of the firm's assets for cash, raise new equity or other financing from an outside investor, and distribute new debt, equity, and cash to prepetition creditors.<sup>99</sup>

### **Absolute Priority Rule**

Under the "absolute priority rule" (APR), no claimholder is entitled to receive any payment unless all more-senior claims have been made whole.

<sup>98</sup>An exception to this occurs if the reorganization plan reinstates a claim on its original terms, in which case the claim survives the bankruptcy and is deemed "unimpaired." Unimpaired claims do not get to vote on the plan; however, there is disagreement in the courts over how much back interest and penalty charges must be paid to cure outstanding defaults on the claim. See M. G. Douglas, "Chapter 11 Plan Depriving Creditor of Default Rate Interest Not Proposed in Bad Faith," *Business Restructuring Review*, Jones Day (March 2003).

<sup>99</sup>This combination of approaches describes the Chapter 11 reorganizations of Chrysler and General Motors.

Distributions to creditors under a Chapter 11 plan of reorganization do *not* have to strictly follow the APR. (Exhibit 1.1 shows the hierarchy of claims in Chapter 11.) In practice, deviations from the APR are fairly common. One reason senior claimholders consent to such deviations is that it avoids a costly valuation fight with junior claimholders and ensures speedier passage (“confirmation”) of the plan. The APR must be followed in a Chapter 7 liquidation.

### **Disclosure Requirements**

Before creditors are allowed to vote on a proposed plan, the court must be satisfied that they have been given enough information to be able to cast an informed vote. This information is presented to creditors in the form of a court-approved “disclosure statement” (Exhibit 1.4). Similar to a financial prospectus, the disclosure statement contains extensive information about the firm’s history, business, and future plans. It also discusses the terms of the proposed financial restructuring and presents detailed firm financial projections (including an estimate of the firm’s enterprise value).

### **Voting Rules and Plan Confirmation**

A plan of reorganization can be either “consensual” or “nonconsensual.” Under a consensual plan of reorganization, every impaired class of claims must vote in favor of the plan. Acceptance of the plan by a particular class requires the approval of at least two-thirds of the face value of outstanding claims in that class, representing at least one-half of the claimholders in that class who vote. (Claimholders who do not vote or fail to show up are not counted.) The plan must also satisfy the “best-interests-of-creditors” test: Every dissenting member of every impaired class must receive consideration worth at least what he or she would receive in a liquidation.<sup>100</sup>

Under a nonconsensual plan of reorganization, one or more impaired classes has voted against the plan. For such a plan to be confirmed, two additional tests must be met: The plan must not “discriminate unfairly,” and it must be “fair and equitable.” If the plan meets these two conditions, then it can be crammed down on the dissenting classes. A plan is fair and equitable with respect to a dissenting class if the present value of the cash and securities to be distributed to the class equals the allowed value of the class members’ claims or if no more-junior class receives any consideration.

<sup>100</sup>Sometimes the disclosure statement will include an estimate of the firm’s liquidation value.

Stated differently, a plan is fair and equitable if the absolute priority rule holds for the dissenting class and for all more-junior classes. (More-senior classes are excluded from this test, and their recoveries need not conform to the absolute priority rule.) The test is more complicated in the case of secured debt.

Consider the hypothetical example in Exhibit 1.8. In this example, suppose the secured and senior unsecured classes vote for the plan, and the subordinated class votes against the plan (the common stock, which is to receive nothing, is automatically assumed to vote against the plan). The plan can be crammed down on both the subordinated and common stock classes (assuming the earlier best-interests-of-creditors test is also satisfied, as it must be under either type of plan). Note that the proposed distributions to the secured and senior unsecured classes do not conform to the absolute priority rule. Because both of these classes vote for the plan, there is no need to cramdown the plan on them.

In practice, cramdowns are uncommon because they require the court to hold a valuation hearing to determine the present value of the cash and securities to be distributed to dissenting classes. These hearings tend to be costly and time consuming, so it is usually in everyone's best interest to avoid them (although bargaining leverage may still be gained by threatening a cramdown).

With either type of plan (consensual or nonconsensual), confirmation requires that at least one impaired claimholder class vote for the plan. Absent this result, the judge may convert the case to Chapter 7. Finally, every plan must be "feasible." A plan is considered feasible if the firm can service its debt after exiting from bankruptcy. In practice, plan feasibility is assessed by comparing projected annual debt service costs with projected earnings or cash flows. Feasibility could also be assessed by considering whether the plan renders the firm insolvent on a balance sheet basis.

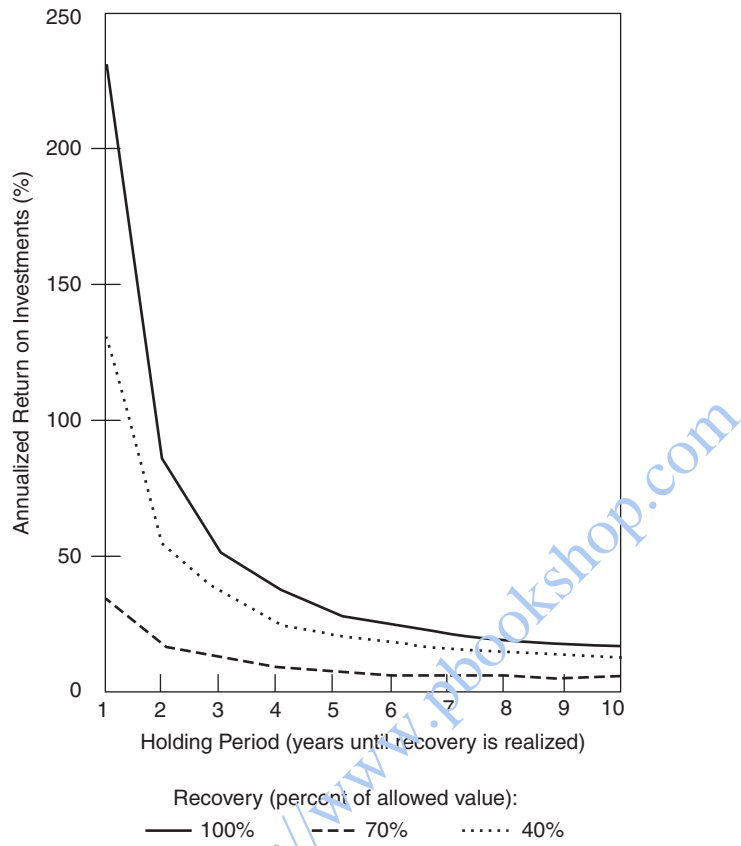
**EXHIBIT 1.1** Hierarchy of Claims in Chapter 11 from Most Senior to Most Junior

1. Secured claims
2. Superpriority claims (e.g., debtor-in-possession financing)
3. Priority claims
  - a. Administrative expenses (including legal and professional fees incurred in the case)
  - b. Wages, salaries, or commissions
  - c. Employee benefit claims
  - d. Claims against facilities that store grain or fish produce
  - e. Consumer deposits
  - f. Alimony and child support
  - g. Tax claims
  - h. Unsecured claims based on commitment to a federal depository institutions regulatory agency
4. General unsecured claims
5. Preferred stock
6. Common stock

**EXHIBIT 1.2** Issuer-Weighted Average Corporate Debt Recovery Rates

Priority	Price/Face Value	
	1982–2008	2008
Bank Loans		
Senior Secured	69.9%	63.4%
Second Lien	50.4	40.4
Senior Unsecured	52.5	29.8
Bonds		
Senior Secured	52.3	58.0
Senior Unsecured	36.4	33.8
Senior Subordinated	31.7	23.0
Subordinated	31.0	23.6
Junior Subordinated	24.0	—

*Source:* Moody's Investors Service, "Corporate Default and Recovery Rates, 1920–2008," February 2009. Recovery rates are measured by 30-day postdefault trading prices.



Assumption: Allowed value of claim = \$1,000. Price paid by Investor = \$300

**EXHIBIT 1.3** Annualized Return on Investment for a Hypothetical Purchase of Distressed Claims for Different Percentage Recoveries and Holding Periods

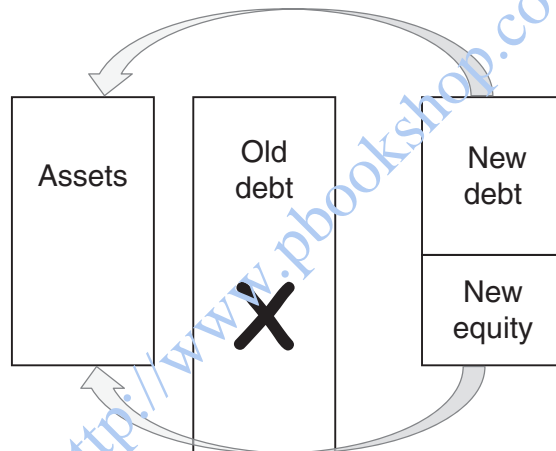


**EXHIBIT 1.4** Time Line of Key Events and Dates in a Chapter 11 Reorganization

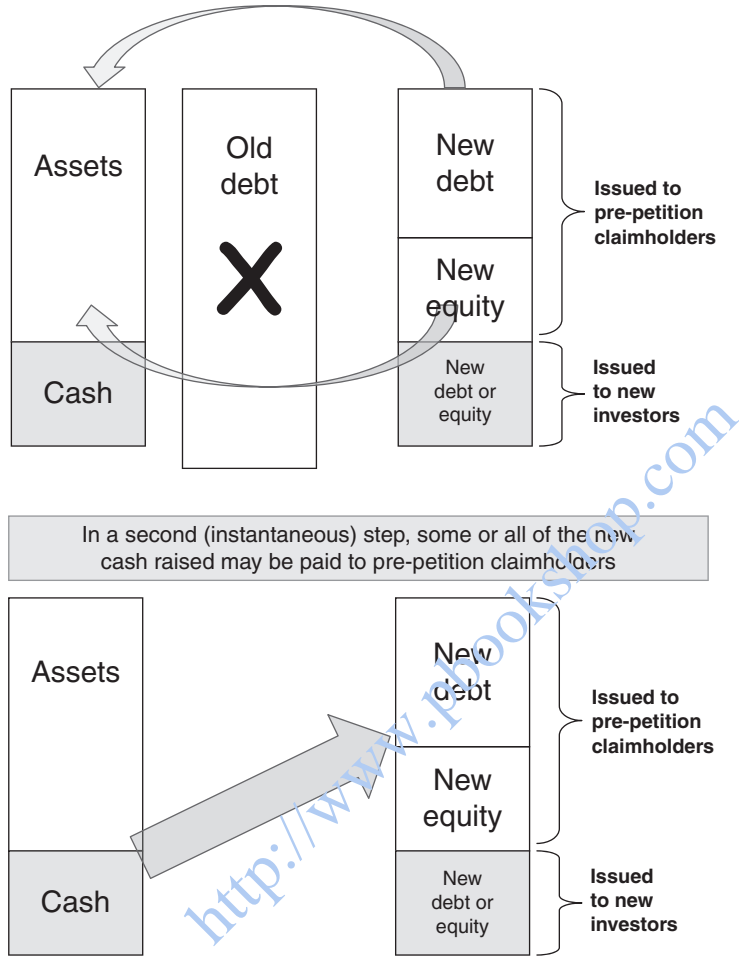
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Filing of Chapter 11 petition  
Filing of schedule of assets and liabilities  
Bar date  
Filing of plan of reorganization and disclosure statement  
Hearing on disclosure statement  
Balloting on plan  
Plan confirmation hearing  
Effective date of plan/distribution of new claims under plan

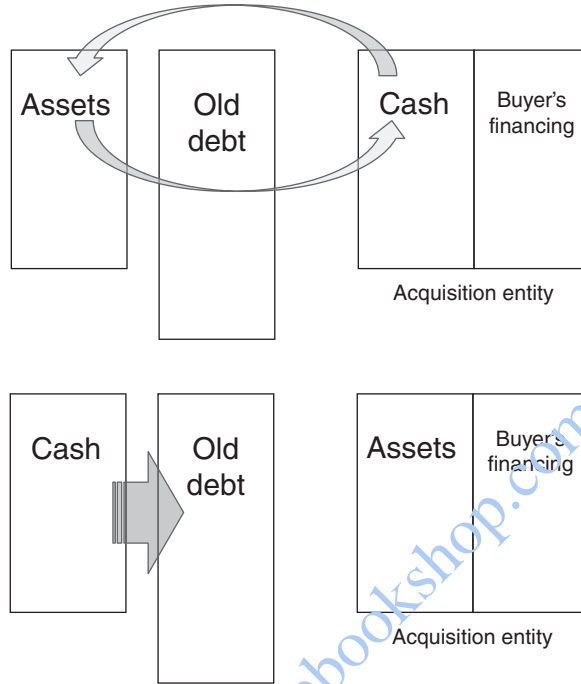
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**EXHIBIT 1.5** Stand-Alone Debt-to-Equity Conversion



**EXHIBIT 1.6** New Money / Funded Plan



**EXHIBIT 1.7** Sale of the Firm

**EXHIBIT 1.8** Hypothetical Chapter 11 Reorganization Plan

Claim	Allowed Value	Present Value of Consideration	Percentage Recovery
Secured debt	100	95	95%
Senior unsecured debt	240	203	85
Subordinated debt	150	90	60
Common stock	-	0	0

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