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MAKING ROOM AT THE REORGANIZATION TABLE
FIELD DAY FOR HEDGEHOGS?

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Making Room at the Reorganization Table
Field Day for Hedgehogs?

Hedge Funds in Chapter 11 Cases
ABA Business Bankruptcy Committee Chapter 11 Subcommittee
October 11, 2007

Panelists:

James Sprayregan	**Andrew Kramer**	**Matthew R. Niemann**
Goldman Sachs	**UBS Investment Bank**	**Cerberus Capital Chicago, LLC**

Moderated by: Susan M. Freeman, Lewis and Roca LLP[1]

The number of hedge funds and the amount of money they control has expanded at an explosive pace in recent years. In the second quarter of 2007, investors added $58.7 billion into hedge funds, raising the total amount managed by hedge funds to $1.74 trillion, according to Hedge Fund Research.[2] While there are many types of hedge funds, a number seek profit by investing in distressed companies they believe to be undervalued, either by capitalizing on a successful turnaround or by controlling or strongly influencing restructuring negotiations, often intending to sell their investments on a short-term basis. Chapter 11 bankruptcy estates and entities headed for bankruptcy restructuring are obvious targets for such investments. Frequently, the hedge fund investments entail second-lien or Tranche B debt, which presents complications in bankruptcy cases.

The sophistication and expertise displayed by hedge fund management in bankruptcy reorganization cases and leveraged buyouts of entities destined for bankruptcy is increasingly evident. It is not universal, of course, and the vast amount of money involved elicits involvement of some hedge fund managers who are less skilled, and some who are frauds. Especially if the market continues to decline with the extension of sub-prime woes, numerous hedge funds may well find their trading strategies frustrated and their profits declining. Some will slip into the zone of insolvency with concomitant fiduciary duties and their own bankruptcy cases. On the flip side of that decline, those hedge funds and private equity funds with restructuring expertise likely will enjoy an array of opportunities to profit by de-leveraging companies that may have only recently received second-lien and other loans, some of which may also need operational changes. All in all, other players in Chapter 11 and restructuring cases benefit by understanding the dynamics of hedge fund involvement, as it is playing out in courtrooms and negotiations.

[1] This paper was principally prepared by Susan Freeman, with input from the panel participants. It does not necessarily represent the views of the participants or their firms.

[2] Andrew Osterland, *Hedgies Still Raking In the Dough: $58.7 Billion Added in Second Quarter*, Financial Week (July 23, 2007).

The Growth and Uniqueness of Hedge Funds, and Focus on Distressed Companies

As noted recently by the Court of Appeals for the D.C. Circuit, "'Hedge funds' are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition. The term is commonly used as a catch-all for 'any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.'"[3]

Hedge funds are similar to other investment funds in that they have members who invest a certain minimum amount and then share the return on the total investment. While hedge funds invest in many of the same assets as mutual funds, insurance companies and other large investors, including high yield bonds, collateralized loan obligation bonds, bank debt and common stock, hedge funds may have minimum investments of well over $1 million dollars per member and are designed to avoid regulation and oversight by the Securities and Exchange Committee.[4] Managers of hedge funds are paid a fee similar to those of mutual fund managers but are also given a share, often twenty percent, of the profits.[5] This is a strong performance incentive, and attracts aggressive management. The aggressive strategies of hedge funds have worked, such that as a whole they have been able to obtain double and even triple digit returns on their investments. The enormous returns have sparked the interest of investors and the number of hedge funds has increased from 300 in 1990 to over 8,000 as of 2005.[6] The Economist reports that according to Standard & Poor's, non-banks such as hedge funds currently comprise roughly half of all high-yielding leveraged loans and most of the secondary market.[7] The investors in hedge funds often consist of pension funds and other institutions.[8]

[3] *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873, 874-75 (D.C. Cir. 2006), citing SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (citing fourteen different definitions found in government and industry publications); President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 1 (1999) ("Working Group Report"); *see also* Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission 3 (2003) ("Staff Report") (defining "hedge fund" as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act").

[4] *Goldstein*, 451 F.3d at 875; David Skeel, *Behind the Hedge*, 2005-DEC Legal Aff. 28, 30-31 (November/December 2005).

[5] *Goldstein* at 876, *citing* Staff Report at 9-10, 61; Skeel, *supra*; Steven R. Strom, *Hedge Fund Power Plays in the Distressed Arena*, Turnaround Management Association, Journal of Corporate Renewal at 8 (December 2005).

[6] Skeel, *supra*; see also *Hedge Fund Information for Investors*, www.fbi.gov (march 2007) ("Industry trade publications indicate that hedge funds have quadrupled in number (from approximately 2,100 in 1996 to approximately 8,800 in 2006), have over $1.3 trillion under management and account for 20% to 50% of the daily trading volume on the New York Stock Exchange").

[7] *The Vultures Take Wing*, The Economist (March 29, 2007).

[8] Skeel, *supra*.

Unlike other types of funds, hedge funds are not required to make disclosures of their investments or strategies.[9] Mutual funds must register with the SEC and disclose their investment positions and financial condition, while hedge funds typically remain secretive about their positions and strategies, even to their own investors.[10] As of September 10, 2007, however, an SEC anti-fraud rule will begin applying to hedge fund and private equity fund advisors, enabling the SEC to sue for lying about investment strategies, performance, a manager's experience or risk.[11] Still, hedge funds are not bound by the same limitations on investments as mutual funds.[12] They can pursue aggressive and high risk investment strategies that include selling short, investing in derivatives and unregistered securities. "Hedging" transactions, from which the term "hedge fund" developed, involve taking both long and short positions on debt and equity securities to reduce risk.[13]

Notably, hedge funds may also invest in distressed companies and claims against such companies, including by providing debtor-in-possession ("DIP") financing and reorganization plan exit financing as debt or equity, or acquiring secured or unsecured debt or equity interests in the company. Hedge funds look for companies they believe to be undervalued but over-leveraged that will be profitable after restructuring.[14] A loan may be made with the intent to sell it to other investors, and the fund may "hedge" the loan by shorting stock or bonds of the distressed company, helping to protect the debt investment but also diminishing the fund's vested interest in the borrower's survival.[15] Alternatively, the hedge fund may intend to use information and leverage gained as a secured lender or unsecured or equity investor to acquire the company or a significant part of it: "loan to own."[16]

Loan to own typically takes the form of a fully-documented secured loan and a non-controlling equity investment in a distressed company with board membership. If the borrower succeeds in becoming stronger and healthier with that new money, the investor's equity stake becomes more valuable and its loan is repaid or sold at a profit. If the borrower does not work

[9] *Goldstein* at 875-76.

[10] *Id.*, *citing* 15 U.S.C. §§ 80a-8, 80a-29; Staff Report at 46-47.

[11] 17 C.F.R. 275, RIN 3235-AJ67, http://www.sec.gov/rules/final/2007/ia-2628.pdf.

[12] *Id.*, *citing* 15 U.S.C. § 80a-12(a)(1), (3), 80a-13(a)(2) (registered investment companies foreclosed from trading on margin or engaging in short sales, and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities). These transactions are all core elements of most hedge funds' trading strategies. *Id.*, *citing Staff Report*, *supra*, at 33-43.

[13] *Goldstein*, 451 F.3d at 875-76, *citing* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 Temp. L. Rev. 681, 684-85 & n.18 (2000).

[14] Dion Friedland, *Distressed Securities Investing*, available at http://www.magnum.com/About.aspx?RowID=38&GroupName=DionArticles, last accessed August 8, 2007.

[15] Henny Sender, *Hedge Funds Shake Up Lending Arena*, The Wall Street Journal (July 18, 2005).

[16] David Peress, Thomas C. Prinzhorn, *Nontraditional Lenders and the Impact of Loan-to-Own Strategies on the Restructuring Process*, 25-3 American Bankruptcy Institute Journal 48 (April 2006).

its way out of its financial distress, the investor exercises its secured creditor rights to eliminate unsecured creditors – including those nominally secured – while paying creditors necessary to the business, squeezing out the equity and converting its secured debt to ownership of the company, often through a fast-track bankruptcy case with a Section 363 sale. The investor effectively forces the result, but is not a controlling shareholder and does not participate in key board decisions, thereby reducing the risk of a successful legal challenge by other stakeholders.[17] The restructured, de-leveraged company can be sold at a profit by the investor. In the words of one commentator, "borrowers have been compelled to accept lenders whose primary goal is to achieve equity returns while taking secured-lending risks."[18]

Distressed Securities Investing From a Bankruptcy Perspective

Hedge funds invest in distressed companies by making or acquiring loans, and by equity securities purchases, or both. These two avenues allow hedge funds to influence any restructuring that takes place, and to have a potential ownership interest in the company after restructuring.[19]

Debt Investments

Debt investments give hedge funds more clout and priority than equity investments. Pre-bankruptcy, hedge funds may offer second-lien financings, or consolidate or "roll" multiple secured loans into a single credit facility. By investing in distressed company debt prepetition, hedge funds can position themselves to become the DIP lenders, and influence initial bankruptcy filing decisions such as when and where to file. Postpetition, they may offer secured debtor-in-possession ("DIP") financing. Hedge funds also purchase unsecured debt in the form of bond, trade and note claims at significant discounts from creditors that are unwilling or unable to continue holding claims in a financially troubled company.

Senior Secured and DIP Financing. This generally gives hedge funds the most leverage over a debtor company's restructuring. DIP loans often prime existing secured loans, are collateralized by all or virtually all of the estate's assets, and receive administrative super-priority status to enjoy the first right to repayment. Secured creditors, especially DIP lenders, gain access to confidential debtor information, and the right to credit bid in the event of collateral asset sales. Through their role as senior or DIP lenders, hedge funds can steer a debtor toward such sales, furthering a loan to own strategy. DIP loans also must be paid upon plan confirmation, giving the lender a significant voice in the debtor's exit strategy, and often include exit financing opportunity rights. In addition, DIP financing terms generally include financial covenants that may be difficult to achieve. Any time a waiver of those covenants is required, the

[17] Jonathan Landers, *Loan to Own*, New York Law Journal (scheduled publication September 7, 2007); The Vultures Take Wing, The Economist (March 29, 2007).

[18] Peress and Prinzhorn at 49.

[19] See Strom at 10.

DIP lender hedge fund is placed at a significant advantage in negotiations with the debtor and its other creditors and parties in interest.[20]

Second-lien loans. Over the last five years, issuance of second-lien debt has dramatically expanded, much of it acquired by hedge funds.[21] It serves the function of mezzanine financing between senior secured debt and subordinated high-yield debt without violating anti-layering covenants. The debt is payable *pari passu* with the senior debt, but secured by a subordinate second lien, usually a blanket lien on all assets. Holders of such loans enjoy the preferred status of a secured creditor with the right to excess collateral value that reduces the risk of non-payment more than traditional unsecured or subordinated notes. Interest rates accordingly are priced below such debt, although higher than the senior debt.[22] In the context of a bankruptcy case, the second lien lenders' include adequate protection of their collateral interests, cash collateral leverage, credit bidding opportunities, and a significant voice in the debtor's restructuring plan.[23]

While senior secured loans are generally underwritten with an asset-based analysis of collateral, however, much of the current second lien debt is undersecured, especially in the event of a debtor's bankruptcy.[24] When the second-lien debt is issued, inter-creditor and subordination agreements are executed with the holders of senior secured debt, and the terms of such agreements with various waiver and consent provisions vary widely.

Unsecured Claims When acquiring unsecured debt, hedge funds take advantage of investment professionals who specialize in researching distressed companies to understand their true value. Hedge funds can capitalize on such knowledge and on flexibility and patience other creditors may lack. Often banks and other creditors do not want to wait, or cannot wait for a plan distribution at the end of a lengthy restructuring process. Hedge funds may gain simply on account of their sophisticated analysis of appropriate discounts for unsecured claims. But depending on the amount of debt acquired, they may also gain control over a class of creditors or a creditors committee, and thereby gain influence over the debtor's reorganization.

The restructuring of *Barney's* in New York City is a classic example. Barney's was a strong company that had simply over-borrowed and needed to reduce its debt. Clothing designers sold their trade claims for pennies on the dollar in an attempt to recoup their costs of

[20] *Bad News is Good News: 'Distressed for Control' Investing* (*Bad News*), (April 26, 2006) available at http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1455, last accessed August 8, 2007; *The New Squeeze – Coming Second Lien Bankruptcy Issues* (*The New Squeeze*) 20, Thirteenth Annual ABI Bankruptcy Battleground West, March 4, 2005.

[21] Peress and Prinzhorn, *supra*; David M. Feldman and J. Eric Wise, *Second Lien Loans: A Market Matures*, The Metropolitan Corporate Counsel (April 2007).

[22] David Batty, *"Silent" Second Liens – Will Bankruptcy Courts Keep the Peace*, 9 N.C. Banking Inst. 1, 16 (April 2005); *Nature of Tranche B or "Second Lien" Loans*, Vedder Price Special Report (May 2004), www.vedderprice.com.

[23] Christopher Rockers, *Exploring the Possibilities for No. 2*, 14-FEB Bus. L. Today 35, 39 (2005).

[24] Marie Leone, *Second Liens: Borrower Beware*, CFO.com (April 21, 2005).

production. After restructuring, Barney's paid back a large portion of the trade claims and the price rose 50% in one month after a potential buyer for Barney's was found.

It is not uncommon for unsecured creditors' claims to be satisfied through a distribution of stock in the reorganized company instead of cash, and that stock is worth much more than the prepetition stock because the company has emerged from its Chapter 11 case with restructured debt and a strong balance sheet. Hedge funds may expect and seek such treatment, or attempt to force it on the debtor, anticipating their ability to profit through selling those shares at the true value of the company.

Equity Investments

Equity investment by a hedge fund into a distressed company is similar to debt investment, but with lower priority and more risk. Hedge funds may buy stock before or after the Chapter 11 case begins, often at steep discounts as other investors attempt to unload the company's stock. Hedge funds can then attempt to require appointment of equity committees that will have an official voice in shaping the reorganization plan, with professionals generally paid by the bankruptcy estate. For example, Appaloosa Management L.P. bought 9.3% of Delphi stock two days after Delphi filed its Chapter 11 petitions. At Appaloosa's request, the bankruptcy court ordered the creation of an equity committee, although the United States Trustee did not appoint Appaloosa as a member, a decision upheld by the bankruptcy court.

Hedge funds' principal goal in making equity investments is the same as their debt investments: participate in restructuring an undervalued corporation and then sell the stock or the company at a profit.[25]

The Benefits and Problems of Hedge Fund Involvement in Chapter 11 Cases

There are benefits and problems with hedge funds participating in Chapter 11 proceedings. Hedge funds present the opportunity to infuse a company with cash and help bring about a successful restructuring. They may also cause the restructuring proceedings to drag on for significant periods of time and pose serious roadblocks to any plans that do not benefit their investment interests.

Benefits of hedge fund investments

Hedge funds can be a source of capital for distressed companies when more traditional lenders shy away. Second-lien investing may enable a financially troubled company to correct current problems and avoid bankruptcy altogether.[26] DIP financing from a non-traditional lender like a hedge fund may be critical to a successful Chapter 11 case if bankruptcy is necessary.

[25] Peress and Prinzhorn at 48.

[26] *The New Squeeze* at 20; Peress and Prinzhorn at 58.

Indeed, hedge fund involvement has led to financing terms that are more competitive and to increased liquidity in debt markets.[27]

Another benefit of hedge fund involvement in restructuring of companies is that they are not constrained to making a single type of investment or restricted by banking regulations. That enables hedge funds to be more nimble than traditional lenders, and allows them able to adapt their strategies to the particular needs of a debtor and its creditor constituencies.[28] There is also real market value to hedge fund willingness to purchase secured and unsecured debt, in that it allows creditors to move on and invest their money in other transactions better suited to their own goals and needs.

Problems of hedge fund investments

For the most part, the problems of hedge fund investments in bankruptcy debtors and creditors turns on the fact that their incentives are often different than the conventional creditors and equity holders whose claims and interests they acquired, and the fact that a hedge fund may be involved in multiple ways.

Unlike banks which generally aim to preserve overall going-concern value with an ongoing stream of interest, and unlike private equity firms which tend to get involved early in a company's restructuring process with a view toward long-term gains, most hedge funds focus on short-term strategies to maintain sufficient fund liquidity.[29] In a bankruptcy context, that is likely to mean forcing a sale of the underlying assets (even at a discounted price) in order to realize quick gains on debt that was likely purchased at a discount from its face value.[30] Similarly, while trade creditors are usually motivated by the prospect of transacting future business with the debtor and want it to successfully reorganize as well as to satisfy their claims, hedge funds are less likely to care about the company's future success as a going concern. And hedge funds may hold "short" trading positions in debtor stock, distinguishing their interests from those of other equity-holders who want the share value to increase.[31] In a typical loan to own scenario, the hedge fund may strongly support squeezing out all equity interests, including the equity it acquired, because it will own the reorganized company through conversion of its secured debt to equity. Hedge funds can accordingly change the entire landscape of a Chapter 11 case, and can make it more complicated and expensive.

Committee Cost It is not uncommon for hedge funds to seek appointment of a separate official committee to advocate for their interests, adding costs and administrative burdens to an already struggling debtor's business. Alternatively, they may acquire claims held by members of

[27] Eric B. Fisher, Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25-10 American Bankruptcy Institute Journal 24 (December 2006-January 2007).

[28] Mark Berman, *Hedge Funds: Lessons Learned from the Radnor Decision*, 26-1 American Bankruptcy Institute Journal 30 (February 2007).

[29] Fisher and Buck at 24.

[30] *Id.* at 24.

[31] *Id.* at 86-87.

existing committees, and seek to also acquire the right to committee membership with rights to confidential information and even taking majority control of committee decision-making. In the absence of effective committee bylaws precluding such actions, such tactics might succeed. Official committees are formed by the United States Trustee with the goal of accomplishing a representative selection of holders of the particular class of debt or equity the committee represents, however. Unsecured committees generally reflect a balance of bond debt, bank debt and trade debt. If the committee balance is destroyed by hedge fund acquisitions, the committee may need to be restructured, at the expense of time, costs and professional fees the bankruptcy estate often can ill afford. In the *Adelphia Communications* case, distressed debt traders and investors bought so much Adelphia bond and other debt that the creditor's committee had to be reorganized with additional members to give a meaningful voice to trade claimants.[32]

Committee Member Trading Restrictions When hedge funds acquire debt and equity holdings in debtor companies, they generally intend to trade those interests, not hold them for the long run. Bankruptcy committee members need commercially sensitive inside information to fulfill their functions and duties effectively.[33] Some bankruptcy courts prohibit all trading by official committee members, while some allow trading if appropriate restrictions are in place to screen personnel engaged in trading from those receiving insider information.[34] Even with trading restrictions in place, the SEC has detected and in several cases proved insider trading in the debtor's stock or trade debt by hedge funds serving on committees.[35]

Other Committee Conflicts Even if the hedge fund committee member complies with all trading restrictions, it may cause the committee to have difficulty meeting its fiduciary duties of fidelity, undivided loyalty, and impartial service to committee constituents.[36] Not only are the

[32] *In re Adelphia Communications Corp.*, 336 B.R. 610, 623 (Bankr. S.D.N.Y. 2006).

[33] *In re Refco, Inc.*, 336 B.R. 187, 195-96 (Bankr. S.D.N.Y. 2006).

[34] *Refco*, 336 B.R. at 196 citing *In re Federated Dep't Stores*, 1991 Bankr. LEXIS 288, 1991 WL 79143 (Bankr. S.D. Ohio 1991) (recognizing ability of creditors committee members to trade in the debtor's securities, subject to applicable securities laws, provided that such members institute procedures for screening personnel engaged in trading from personnel involved in committee work); *In re Spiegel*, 292 B.R. 748, 750-51 (Bankr. S.D.N.Y. 2003) (court discussed concerns regarding committee members' trading in the debtor's securities even if information blocking procedures were to be adopted).

[35] SEC Litigation Release No. 20132, *SEC v. Barclays Bank PLC and Steven J. Landzberg*, 07-CV-04427 (S.D.N.Y.) (May 30, 2007) (Barclays Bank paid $10.9 million to settle charges of insider trading on creditors committee information in six bankruptcy cases); Otis Bilodeau, *SEC Probes Bankruptcy Committees for Hedge Fund Fraud (Update 1)*, Bloomberg.com (November 29, 2006); *More Heat on Hedge Funds*, Business Week (February 6, 2006); Jenny Anderson, *Hedge Funds Draw Insider Scrutiny*, New York Times (October 16, 2006).

[36] *Westmoreland Human Opportunities, Inc. v. Walsh*, 246 F.3d 233, 256 (3d Cir. 2001) (fiduciary duty on the part of members of a creditor's committee violated by pursuing a course of action that furthers its self-interest to the potential detriment of fellow committee members); *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000) (fiduciary duties of committee members); *In re Bohack Corp.*, 607 F.2d 258, 262 (2d Cir. 1979) (committee owes a fiduciary duty to the creditors, and must guide its actions so as to safeguard as much as possible the rights of minority as well as majority creditors, citing *Woods v. City National Bank & Trust Co.*, 312 U.S. 262, 61 S. Ct. 493, 85 L. Ed. 820 (1941)).

incentives and goals often different, but the hedge fund likely bought its claims at a discount and holds different classes of debt. This can cause difficulty in the committee reaching consensus, but also difficulty on the part of committee counsel advising the committee and seeing to it that all constituent creditors' interests are considered fairly.[37] These conflicts and particularly the trading restrictions may lead hedge funds to forego official committee membership and instead to join with each other into *ad hoc* committees. Such committees lack the benefit of estate payment of committee professional fees, but *ad hoc* committee membership still offers an avenue for similar creditors to increase their leverage in the bankruptcy case while sharing professional fees and costs.[38] That increased leverage generally means increased litigation that has the potential to jeopardize the overall reorganization.[39]

Rule 2019 Disclosures The conflicting interests of hedge fund participants in bankruptcy cases and the clout they seek to exercise by *ad hoc* committee membership has led some debtors to seek orders requiring such committee members to provide full disclosure of the nature and amount of their claims or interests, the time of acquisition, and "the times when acquired, the amounts paid therefore, and any sales or other disposition thereof" as provided in Bankruptcy Rule 2019. The Bankruptcy Court for the Southern District of New York required such filings in the *Northwest Airlines* case, and then refused to order the filing to be sealed.[40] While appealing the ruling, the hedge fund ad hoc committee members eventually complied with the court's order.[41]

A Corpus Christi, Texas Bankruptcy Court held that Rule 2019 did not apply to an *ad hoc* committee that represented only its members, not others, concluding it was only a "group."[42] A commentator has also noted that even if applicable, Rule 2019 would not technically require disclosure of short sales, even though that clearly has a bearing on the kind of interests the disclosure rule should identify. Rule 2019 requires disclosure of stock interests in the debtor. The short seller borrowers the debtor's stock and sells it with the hope that the stock value will

[37] *In re Dana Corp.*, 344 B.R. 35 (Bankr. S.D.N.Y. 2006) (variety of committee member views does not require separate committees unless impaired ability of committee to reach consensus); *Pension Ben. Guaranty Corp. v. Pincus, Verlin, Hahn, Reich & Goldstein Professional Corp.*, 42 B.R. 960, 964 (D. Pa. 1984) (committee counsel obligation to utilize due care in seeing to consideration of all constituent creditors' interests); see Report of Harvey R. Miller as Examiner, U.S. Bankr. D. Vt. No. 04-10463 (Dkt. 1805) (committee counsel criticized for facilitating and doing nothing to rectify one member's domination of and disrespect for other members).

[38] Fisher and Buck at 87.

[39] *Id.*

[40] *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re Northwest Airlines Corp.*, 363 BR. 704 (Bankr. S.D.N.Y. 2007).

[41] Mark Berman, *Will the Sunlight of Disclosure Chill Hedge Funds?*, 26-4 American Bankruptcy Institute Journal 24, 63 (May 2007).

[42] John J. Voorhees Jr., *Bankruptcy Rule 2019: A New Battleground*, 48-10 Bankruptcy Court Decisions Weekly News & Comment at 4-5 (July 3, 2007), describing ruling in *In re Scotia Development LLC.*, Case No. 07-20027 (Bankr. S.D. TX).

go down before the short seller is required to return the stock, rendering the rule technically inapplicable.[43] Whether courts in future cases follow *Northwest Airlines* remains to be seen.

Complications from Inter-creditor Agreements. The inter-creditor agreements between holders of second-lien debt and senior secured debt affect cash collateral usage, DIP loans that prime the second-lien debt, asset sales free and clear of liens and plan confirmation. Such agreements are particularly important because, unlike typical subordinated debt, second-lien creditors have subordinated lien rights but equal payment rights – although some will subordinate the right to payment as well in the event of a default on the senior note. The lack of uniformity in intercreditor agreements, and the nature and goals of the parties to the agreements, tends to engender disputes and litigation over their meaning and enforceability, to the detriment of the company itself and other creditors.[44] Further, the participants in a second-lien financing may trade during the restructuring, and the syndicated groups of second-lien and first-lien lenders may well have the same administrative agent, raising an issue over who acts for the second-lien group in negotiations with the borrower and first-lien lenders.[45]

To the extent a first lien creditor's fees and interest are paid as part of its adequate protection, collateral value securing the undersecured second lien may be depleted. There may well be no additional assets to collateralize the second-lien creditor's diminution in collateral value and meet its adequate protection rights. The second-lien creditor will accordingly seek regular payments, reducing available cash and affecting the DIP financing budget and ability to meet other estate needs and the exercise of fiduciary duties to unsecured creditors in managing the case. The same considerations underlie the second-lien creditor's concerns and potential objections with respect to DIP financing priming liens. A second-lien lender's right to credit bid and to impede an asset sale under Code § 363(f) are sources of leverage and disruption, cost and delay in bankruptcy cases.

Inter-creditor agreements generally address these bankruptcy issues and overall control of enforcement action, and restrict the second lien lenders' rights to different degrees and on various terms and conditions. An inter-creditor agreement may include the second-lien lender's consent to a priming DIP financing lien up to a certain dollar amount that may not be sufficient to meet reorganization needs, for example, or restrict the second lien creditor's rights as a secured creditor only for a limited period of time that may not suffice to move the case through to plan confirmation.[46] In the *Tower Automotive* case, the inter-creditor agreement provided that the second lien creditors agreed to be primed by a DIP facility of no more than $15 million. The debtor needed a revolving facility of $300 million, and the second-lien creditors extracted concessions including a 1.75% increase in their interest rate to allow that facility, despite restriction of adequate protection to replacement liens in their intercreditor agreement. The senior secured lenders in turn required that the DIP line be increased to $425 million and repay its prepetition debt in full. The intercreditor agreement might authorize a priming DIP financing

[43] Fisher and Buck at 88.

[44] Peress and Prinzhorn at 57; Vedder Price Special Report at 4.

[45] Eric Goodison, *Second Lien Loans Workouts – What Can Be Expected if the Credit Cycle Turns?*, 3-3 International Corporate Rescue (2006).

[46] Vedder Price Special Report at 5.

lien by the senior secured lenders, but not include authorization for third-party loans supported by the senior lender, restricting the debtor's options.

An intercreditor agreement may also provide for an assignment of voting rights to holders of the senior secured debt, or require the second-lien lenders to vote for any plan not inconsistent with the subordination agreement.[47] While subordination agreements are generally enforceable under Bankruptcy Code Section 510(a), waivers and voting provisions may exceed the scope of Section 510(a). Voting rights assignments certainly may prompt expensive and time-consuming litigation that adversely affects other parties in interest. *See In re Curtis Center Ltd.*, 192 B.R. 648, 659-60 (Bankr. E.D. Pa. 1996) (voting assignment provision enforceable); *In re 203 North La Salle Street Partnership*, 246 B.R. 325, 331-32 (Bankr. N.D. Ill. 2000) (voting assignment provision not enforced).

Voting Control Hedge funds can also buy enough debt of one class that they effectively control that class of debt and its vote on any reorganization plan. That enables the hedge fund to exert enormous pressure and force a restructuring plan that is favorable to its own investment plan, regardless of the best long-term interest of the company.[48] Exercising such power, the hedge fund may pressure the company to sell most of its assets quickly in furtherance of the hedge fund's goal of making short-term profits, despite the negative impact that strategy may have on the ultimate well-being of the company or its ultimate restructuring success.[49] Whether taking control of a class through buying claims/votes or by acquiring a blocking position or control on a committee, hedge funds can destroy months of effort and compromise to force restructuring plans that are beneficial to their short-term profit goals.

Even before plan confirmation proceedings, hedge funds holding significant claims may pressure a bankruptcy case into a direction favorable to their interests. Litigation over early disputes can force potentially viable companies out of Chapter 11 and into Chapter 7 liquidation proceedings. For example, DIP financing efforts in the *American Remanufacturers* case were cut short when two hedge funds opposed a financing plan that was contrary to their investment goals. The resulting delay and litigation cost forced American Remanufacturers into Chapter 7 because the corporation ran out of cash.[50]

Hedge funds also interject uncertainty into bankruptcy cases and out-of-court work-outs. It is difficult for a distressed corporation to be sure of its future when a hedge fund invests significant amounts of money and time into the restructuring process. The secrecy of hedge funds makes it difficult for corporations to know whether the hedge fund is there to rebuild the company into a financially stronger entity with greater stock value, or acquiring interests to force a break-up and sale of the pieces. The uncertainty created when hedge funds square off with other creditors over DIP financing arrangements, committee membership, plan votes and other

[47] Feldman and Wise, *supra*.

[48] Skeel at 32.

[49] James Drummond, *Hedge Funds: Value or Vultures, They Play a Critical Role*, Financial Times, March 10, 2005.

[50] Peress and Prinzhorn at 57.

reorganization strategies and actions forces "managers to leave, inhibits investment in product developments, and may ultimately lead to operational stagnation."[51]

Hedge Funds' Own Financial Distress?

Hedge funds along with banks and private equity have competed for years to place money into loans, with increasingly reduced lending standards providing more capital to under-performing companies, with more lax covenants. The meltdown of the subprime market appears to be seeping into better-quality loans, raising fears of broader market turmoil. There is a risk that the deterioration is spreading to rest of the secondary mortgage loan market and construction industry, leading to falling housing prices and an overall reduction of consumer spending. Even the best-rated assets are reportedly coming under pressure, and more hedge funds are "in the red" and selling off assets.[52] The significant extent to which the funds are leveraged exacerbates the effects of a market downturn, as lenders and derivative dealers demand more collateral to cover potential losses, and investors dump stocks and bonds to raise cash, in turn accelerating the drop in prices and losses.[53]

Tightening market conditions will likely push more distressed companies into bankruptcy sooner instead of later. Fundamentally, the ability of any business to bear debt turns on its management and operations, its cash flow and EBITDA, rather than the amount of debt investors that are available in the market. As one commentator opined, "over-leverage, combined with ignoring the root cause of why the business is underperforming, has resulted in a potential house of cards when working capital tightens due to real operational issues or, on the capital structure side, when economic conditions tighten--*i.e.,* a rise in interest rates. As these falsely supported companies begin to unravel, the decline may end up being so great that, in conjunction with the new bankruptcy laws, the implosion will result in liquidations where the debt will have a similar risk to what, in the past, was reserved for equity players."[54]

The likely results for hedge funds of a market downturn include increased litigation risks, more hedge fund bankruptcies, and more opportunities for those hedge funds and private equity funds that have strong turnaround management expertise.

Potential litigation against hedge funds by investors for deals gone wrong

Professor David Skeel has noted that the combination of minimal oversight, performance-based compensation, and extravagant earnings expectations has encouraged some outright hedge

[51] *Id.*

[52] See Gregory Zuckerman, David Gauthier-Villars, Kate Kelly, *Hedge-Fund Meltdown Heats Up*, The Wall Street Journal (August 10, 2007); Dan Freed, *Banks Prepare for a Downcycle: Credit Suisse Follows Goldman and Cerberus with Investment in Liquidation Firm*, Investment Dealers Digest (August 6, 2007).

[53] Randall Smith, Susan Pulliam, *As Funds Leverage Up, Fears of Reckoning Rise*, The Wall Street Journal (April 30, 2007).

[54] Michael A. Cavan, *"DebtQuity": A Perspective on the Current Blur Between Debt and Equity*, 25-6 American Bankruptcy Institute Journal 14 (July-August 2006)

fund fraud along with a lot of aggressive behavior.[55] He cited 51 cases against hedge fund managers in the past five years, and pointed out that the sophisticated financial contracts that hedge funds invest in are so difficult to value that determining whether reported profits are real is hard, and their complexity provides cover for evading regulations and rigging markets.[56] Since managers of many hedge funds are paid based in part on the fund's performance, it is in their interest to "mark" or price their assets aggressively, even though many are illiquid and difficult to value.[57]

Increased losses in an economic downturn prompt those suffering the losses to look for recourse somewhere. "The combination of aggressive lending strategies, participation in equity and very deep pockets surely points to a bull's eye on hedge funds."[58] Hedge funds accordingly face risks of lawsuits seeking to designate their reorganization plan votes as made in bad faith, or deny them findings of good faith in sale transactions.[59] Lawsuits may also seek remedies in the form of equitable subordination of claims, damages for alleged fraud and aiding and abetting management breaches of fiduciary duties, and the like.[60] While the SEC may have succeeded in some of its recent litigation against hedge funds, private parties are faring worse in at least some recent court decisions. In a case where the SEC obtained a restraining order to halt fraudulent conduct and a court-appointed receiver liquidated the hedge fund's assets, a federal district court found no requirement on the part of the hedge fund to report on asset values or investment strategies.[61] In another case the court found a Ponzi scheme by the borrower, but declined to require its hedge fund lender's debt to be recharacterized. The court said the hedge fund's level of due diligence was a bad business practice, the loan's were questionable, and the borrower was assuredly undercapitalized when the loan was made, but still found no fraud.[62]

The Delaware Bankruptcy Court recently ruled for the hedge fund in a case where it had loaned money prepetition to a distressed company, and made a DIP loan that allowed the company to survive during a Section 363 sale process. The asset-purchase agreement allowed the hedge fund to purchase all of the borrower/debtor's assets as a going concern and to use its secured claims to credit bid in the Section 363 sale. The creditors committee accused the hedge fund of having entered into the loans with no expectation of the borrower being able to repay, but rather as a way to acquire the company, a loan to own strategy. In the creditors' committee's view, the hedge fund insisted on terms for the secured loan that it knew the borrower could not

[55] Skeel, *supra*.

[56] *Id.*

[57] Justin Lahart, Aaron Lucchetti, *Wall Street Fears Bear Stearns Is Tip of an Iceberg*, The Wall Street Journal (June 25, 2007).

[58] Berman at 30.

[59] 11 U.S.C. §§ 363(m), 1126(e).

[60] See *In re Exide Technologies, Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003) based on alleged misuse of considerable lender-leverage; see Landers, *supra*, discussion of theories.

[61] *Verona Partners, LLC v. Tenet Capital Partners Convertible Opportunities Fund LP*, 2006 U.S. Dist. LEXIS 69488 (D. Cal. 2006).

[62] *Sender v. Bronze Group, Ltd. (In re Hedged-Investments Assocs.)*, 380 F.3d 1292, 1302 (10th Cir. 2004).

meet and that guaranteed the loan would go into default.[63] The Delaware bankruptcy court refused to recharacterize the debt, focusing on the parties' intent when the transaction was initially structured and funded, and the lack of evidence that the hedge fund intended to acquire the company when making the loan.[64] It also refused to hold the hedge fund liable on an equitable-subordination or deepening insolvency theory.[65]

A lawsuit by the bankruptcy trustee of a hedge fund against Bear Stearns, which had acted as the Fund's prime broker, providing margin and stock lending services in connection with the Fund's short selling activities, remains pending with the district court having recently withdrawn the reference from the bankruptcy court. The Trustee in that proceeding I seeking to recover margin payments, short sale proceeds and the repayment of securities loaned to the Fund by Bear, Stearns. The Trustee alleges that Berger made these payments to Bear, Stearns with the specific intent to defraud the Fund's investors, entitling her to avoid those transfers.[66]

In the *Bayou Group* bankruptcy, investors have not succeeded in getting a suit dismissed alleging that three hedge fund debtors operated as a massive Ponzi scheme. Hundreds of investor creditors lost all of their principal investments totaling approximately $ 250 million. The alleged fraudulent conveyances sought to be recovered were payments to the investors of non-existent principal and fictitious profits in redemption of the investors' purported but non-existent interests in the funds as reflected in the funds' false financial reports.[67]

Hedge Fund Bankruptcy Cases

The Bayou Group cases and recent bankruptcy cases filed by two Bear Stearns hedge funds[68] may be the tip of the iceberg for hedge fund bankruptcies. The assets available for creditors in hedge fund bankruptcy cases are likely to be of limited value to creditors, and difficult to liquidate, depending of course on the nature of the particular hedge fund and its investment strategies and valuation methods.[69] "Mortgage related securities or mortgage loans" are included within the definition of a "repurchase agreement" in the Bankruptcy Code.[70] Setoff of such transactions by a repo participant or financial participant is not automatically stayed.[71] Such transactions would be liquidated promptly in the ordinary course, leaving no business to reorganize, and only potential lawsuits against responsible parties as assets.

[63] *In re Radnor Holdings Corp.*, 353 B.R. 820 (Bankr. D. Del. 2006); Berman at 66-67.

[64] *Radnor*, 353 B.R. at 829, 838.

[65] *Radnor*, 353 B.R. at 840-41; See Berman at 30.

[66] *Bear, Stearns Sec. Corp. v. Gredd*, 2001 U.S. Dist. LEXIS 10324 (D.N.Y. 2001).

[67] *In re Bayou Group, LLC*, 362 B.R. 624 (Bankr. S.D.N.Y. 2007)

[68] *Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Case No. 07-12383-brl, U.S. Bankr. S.D.N.Y.; *Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Case No. 07-12384-brl, U.S. Bankr. S.D.N.Y.

[69] Alan Jacobs, Ron Brandon, *Financial Statements: When the Music Stops...Hedge Funds -- Looking Behind the Numbers*, 18-4 American Bankruptcy Institute Journal 24 (May 1999).

[70] 11 U.S.C. § 101(47)(A).

[71] 11 U.S.C. § 362(b)(7).

Down-Market Opportunities

In a declining market, borrower/debtor operational problems that are no longer masked by easily-available credit cry for attention, and the extent of over-leveraging stands out. Hedge fund debt, especially second-lien debt, manifests as merely equity.[72] Extracting value in those circumstances, to the extent it exists, requires operational change and expertise. It entails bringing in new managers, and renegotiating labor and supply contracts, and changes of strategy.

Many hedge funds are quintessentially traders with short investment horizons, however, including some of those that have engaged in loan to own transactions. As one commentator noted, "Buying equity and managing a restructuring process do not fall into the core expertise of a hedge fund. Successful investors will have to partner with professionals that will manage that process, improve their investment's operational structure, increase its enterprise value and develop an exit scenario that will ensure a successful exit and timely transition to new equity-holders."[73]

Firms such as Goldman Sachs providing management services to hedge funds with a depth of expertise in bankruptcy restructuring, and Cerberus with its hybrid qualities of a private equity firm and a hedge fund, can take advantage of opportunities to rehabilitate businesses that are indeed salvageable at a profit.[74] Some other hedge fund managers apparently perceive the benefits of lining up management teams that are skilled in restructuring too, and are making investments in and alliances with asset liquidation experts.[75]

Conclusion

Hedge funds are likely to continue to play significant roles in Chapter 11 cases for the foreseeable future, and will be a considerable force to be reckoned with in such cases. If the current market downturn continues, more hedge funds will likely end up as bankruptcy debtors themselves, as well. When easy money gets increasingly tight, there is a significant premium to restructuring skills and expertise. The investors who poured money into hedge funds will need and value of that expertise more than ever.

[72] Cavan at 14.

[73] Peress and Prinzhorn at 57.

[74] See *Cerberus: Inside the Wall Street Power-House*, 156-4 Fortune 37 (August 20, 2007).

[75] Freed, *supra*.