



Reformers Eye Distressed-Debt Investors

Do hedge funds and other buyers of the securities of failed companies adversely affect the bankruptcy process?

By Vincent Ryan, November 8, 2012

The American Bankruptcy Institute's commission studying reforms of the U.S. bankruptcy code has distressed-debt investors near the top of its agenda. But so far the institute's not getting much backing from the bankruptcy lawyers and academics appearing at its meetings on the issue.

The ABI, a nonpartisan trade organization for lawyers and turnaround specialists, formed a commission around bankruptcy reform earlier this year. The commission's mission statement says the growth of distressed-debt markets has lessened the effectiveness of the 34-year-old U.S. bankruptcy code. But experts appearing at two field hearings ABI held in October disagreed, contending that the buyers of high-risk assets bring hefty value to the process, and that without them some companies would never exit Chapter 11.

There seems to be little disagreement that the 1978 Bankruptcy Code is simply outdated. As Robert J. Keach, co-chair of the commission and a partner at Bernstein Shur, said in his opening remarks at the field hearing in San Diego, "the way both courts and commentators discuss the purpose of Chapter 11 has changed."

Early court decisions after the 1978 Bankruptcy Code, as well as the law's legislative history, stressed that "the primary purposes of the code were the rehabilitation of businesses, and the preservation of jobs and tax bases at the state, local, and federal levels," Keach said.

But more recent discussions of Chapter 11 emphasize the maximization of asset value "to the exclusion of other goals and purposes" of the U.S. restructuring regime, said Keach. Those "other goals" include achieving a balance between debtor and creditor interests.

In particular, Keach noted the "marked increase" in the use of secured credit at all levels of companies' capital structures. "Many of the 1978 code's provisions assume [the presence of asset value above the secured debt](#), asset value that is often not present in many of today's Chapter 11 cases," according to Keach.

The growth of distressed-debt markets and bankruptcy-claims trading is another challenge bankruptcy reform needs to address, said Keach.

The complaints against distressed-debt investors have been building for years. Company executives and some restructuring advisers rarely want investors like hedge funds buying up

distressed senior debt in the secondary markets. They especially abhor those that buy debt to gain a position on the creditor's committee and then push for the firm's liquidation.

And hedge funds that pursue a "loan to own" strategy, extending credit to a distressed firm in the hope that it will be converted to equity ownership when the company fails, also don't have many fans. Claims flipping by some hedge funds is seen as another trend that bankruptcy reform needs to address.

But there's a lot of evidence of the positive role distressed-debt investors play in bankruptcy, and much of the testimony at the first two ABI hearings reflected that.

Speaking at a commission field hearing in New York in mid-October, Edith Hotchkiss, a professor of finance at Boston College's Carroll School of Management, said any reforms to Chapter 11 that would curb claims trading or weaken the rights of creditors who buy debt in the secondary market would be counterproductive.

"My research and that of others in the field demonstrates that a liquid secondary market for debt has tangible benefits for the bankruptcy process," Hotchkiss said in her prepared testimony. They include "more effective corporate governance and oversight, greater efficiency, a greater likelihood that the debtor will continue as a going concern, and a greater likelihood that the reorganized debtor will succeed following bankruptcy."

In particular, Hotchkiss cited academic studies of the past few years that found that the consolidation of creditor claims from distressed-debt investing boosts the efficiency of the Chapter 11 process. In cases in which active distressed-debt investors took seats on the company's board or gained control of a firm from stock distributions the bankrupt company's performance post-reorganization improved, another study found.

Other academic studies show that that senior lenders (secured debt holders) often take the view that "they can realize more value from a security interest in a debtor's assets by lending additional capital to facilitate a reorganization than pushing for the firm's liquidation," according to Hotchkiss.

In her own study of 353 defaulting firms conducted last year, Hotchkiss found that senior lenders that emerged as majority owners of a bankrupt firm (in 20% of cases it was hedge funds), provided capital to fund the reorganization plan. That happens because these lenders "wish to maintain and if possible enhance the underlying value of their collateral," Hotchkiss said.

Still, Hotchkiss admitted that some "passive" distressed-debt investors just want to profit from increases in the value of purchased claims or "seek to influence restructurings in a way that increases payoffs to a particular class of claims."

Besides targeting distressed debt investors, the ABI Commission may also examine the possibility of rolling back changes to the bankruptcy code made in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

In a statement at the San Diego hearing, John Collen, a partner at Tressler LLP, suggested that BAPCPA's shortening of the time bankrupt firms have for decision making and operational changes has been detrimental. In particular, Collen said that [the 210-day maximum period to assume or reject leases](#) was not enough time to make an informed election, which can result in "rejection of a lease which would otherwise have been of value to the estate."

Collen also spoke out against the absolute limit of 18 months for a debtor's exclusive right to file a reorganization plan. He said that's not enough time to "make operational changes and measure their effect in constructing a feasible plan." Collen wants to repeal the BAPCPA-imposed deadlines on lease approvals and rejections and modify the limit on the debtor's exclusivity period "to permit extensions of time beyond 18 months, but perhaps with a heightened showing of need – something higher than 'cause.'"

After holding a series of field hearings and studying the issues, the ABI commission plans to produce a report that combines a blueprint for reform of Chapter 11 as well as "a catalog of open issues and current options," Keach said.

Total commercial bankruptcy filings for the month of October rose 19% over September, ABI reported recently, with Chapter 11 cases increasing 3% in the period.

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