HEDGE FUNDS:
THE NEW MASTERS OF THE BANKRUPTCY UNIVERSE

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It should come as no surprise to restructuring professionals of all stripes that hedge funds are very significant investors in distressed companies, and concomitantly have become extremely active participants in court-supervised insolvency proceedings and other workouts. This can have either positive or negative impacts on the a company's restructuring process, depending (among other things) on the company, the company's debt leverage and financial performance, the identity of the hedge funds involved, and the participating hedge funds' positions in the company's capital structure. In any event, it is safe to assume that hedge funds will remain vital participants in restructurings for a long time to come. Accordingly, it is important for restructuring professionals to understand exactly what hedge funds are, what their investment strategies tend to be in the distressed debt world, and how to handle the restructuring process when significant participants in the company's capital structure simply do not fit within the "traditional investor" mold.

I. WHAT ARE HEDGE FUNDS?

Hedge funds have become extraordinarily popular investment vehicles for investors who seek to diversify their portfolios, or who seek to profit from investment strategies that differ from those offered by banks, mutual funds and other more traditional institutions. Indeed, in recent times, the growth in hedge fund assets under management has far exceeded the growth of mutual funds and the equity markets as a whole.[1] Moreover, funds that invest in hedge funds (*i.e.*, "funds of funds") have increased the accessibility of hedge funds for those who perhaps cannot meet the traditional hedge fund investment thresholds.[2] As hedge funds receive more investment money from investors and seek new places in which to put that money to work, distressed companies have become increasingly popular investment targets. Even in the current tight credit market, many hedge funds continue to provide substantial returns to their investors (and managers). Some of these outstanding returns are results of investments in distressed or bankrupt companies around the world.

A single definition of "hedge fund" is extremely difficult, if not impossible, to derive. The term appears nowhere in the U.S. securities laws, and even people in the investment community cannot agree on a single definition.[3] The term may be used to describe any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.[4] They are not mutual funds, private equity funds, venture capital funds or commodity pools, which generally have a much higher degree of regulation and long-term investment strategies.[5] Hedge funds typically are exempt from

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[1] *See* Carl J. Nelson, *Hedge Fund Regulation: A Proposal to Maintain Hedge Funds' Effectiveness Without SEC Regulation*, 2 Brook. J. Corp. Fin. & Com. L. 221 (2007).

[2] *See id*.

[3] *See Goldstein v. S.E.C.*, 451 F.3d 873, 874-75 (D.C. Cir. 2006) (noting that fourteen different definitions are found in government and industry publications).

[4] *See id.* at 875.

[5] Mutual funds are regulated under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. *See, e.g.*, Nelson, *supra* note 2, at 223.

coverage under the Investment Company Act of 1940, either because they have one hundred or fewer beneficial owners and do not offer their securities to the public, or because their investors are only "qualified" individuals or institutions.[6] By limiting beneficial holders to 100, limiting the number of "clients" to 14, and refraining from offering securities to the public, hedge funds have been able to avoid registration with the U.S. Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.[7]

Because hedge funds are not registered with the SEC, they generally are not obligated to comply with the disclosure requirements that other investors must satisfy. Thus, hedge funds are not required to disclose their investment positions and strategies, and they are allowed to make the types of investments that mutual funds and other regulated investment advisers cannot make.[8] Hedge funds' management structure and the way they compensate their managers also differ from other investment vehicles. Unlike mutual funds, which often are organized as corporations and must comply with a number of governance requirements (including having independent boards of directors),[9] hedge funds normally are structured as limited partnerships to achieve separation of ownership and management. Typically, the general partner is responsible for managing the hedge fund, and the limited investors do not participate in management.[10] Hedge fund investment advisers typically receive as compensation a management fee based on the amount of assets under management, plus a share of the capital gains or some other allocation based on the fund's investment performance. The so-called "2-and-20" compensation arrangement (*i.e.*, 2 percent of assets under management and 20 percent of profits above a pre-determined benchmark) is typical. This fee structure creates incentives for hedge fund managers to exceed financial return benchmarks, not just to manage a larger asset pool. In addition, hedge fund advisers often invest significant amounts of their own money into the funds that they manage.[11]

II. HEDGE FUNDS' INVESTMENTS IN DISTRESSED COMPANIES

Distressed companies, both in and out of bankruptcy, have become significant components of basic hedge fund investment strategy. Hedge funds also can invest in the equity of companies *after* they exit bankruptcy, with the expectation that the reorganized companies

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[6] *See* 15 U.S.C. § 80a-3(c).

[7] *See* Nelson, *supra* note 2, at 223. For a discussion of the SEC's failed attempt to regulate hedge funds, *see* Peter M. Gilhuly et al., *Living on the [H]edge: New Ethical Challenges*, National Conference of Bankruptcy Judges 81st Annual Conference (October 2007).

[8] *See Goldstein*, *supra* note 4, at 875 (noting that the Investment Company Act places significant restrictions on the types of transactions in which registered investment companies may engage).

[9] *See* 15 U.S.C. § 80a-10; Nelson, *supra* note 2, at 223.

[10] *See Goldstein*, *supra* note 5, at 876, citing *See* Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission, at viii (2003).

[11] *See* Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission, at ix.

will pay generous dividends to shareholders, buy back stock, or be acquired. In addition, hedge funds can participate in a bankrupt company's exit financing credit facility. Hedge funds have the potential to interject significant uncertainty into bankruptcy cases and out-of-court corporate restructurings, because the veil of secrecy under which they tend to operate makes it difficult for distressed companies to know whether their investors intend to rebuild them into financially stronger entities, or intend to force a break-up and sale of their pieces.[12] In any event, it is clear that as the number of hedge funds and the amount of money they attract from investors grow, they will continue to have an enormous influence over the restructuring process for financially troubled companies.

There are a number of reasons why distressed companies might find that negotiating the terms of a workout with hedge funds is different than doing so with other types of investors. One reason is hedge funds' generally short-term investment horizon. Investors like banks and private equity firms tend to become involved early in the restructuring process with a view toward rehabilitating the company and reaping the long-term gains as a result thereof. On the other hand, hedge funds may not be designed to build value in the long run, and this could create conflicting interests with other creditors and shareholders.[13] While some hedge funds unmistakably do have long-term investment philosophies, the permissive redemption policies offered by most hedge funds require their managers to engage in more short-term strategies to maintain sufficient fund liquidity. Hedge funds typically demand an exit strategy when they invest in a company's debt or equity. Some hedge funds seek a "quick flip" of their investments, while others engage in a "loan to own" strategy, in which they make loans to a distressed company with the intent to convert that debt to equity after the company defaults on the loans and restructures the debt. In sum, hedge funds are more likely than more traditional investors to seek short-term returns that are not necessarily tied to the debtor's successful reorganization.[14]

Hedge funds can invest in multiple segments of a company's capital structure. This is a deviation from the practice of more traditional investors, which tend to focus on only one segment of a company's capital structure. Hedge funds' varied holdings present different strategic alternatives that put their interests at odds with those of other types of investors and creditors. For example, assume that a hedge fund invested in a distressed company's secured bank debt, purchased unsecured claims from trade creditors at a discount and sold short the company's common stock. The company's other secured bank creditors would have an incentive to preserve the company's long-term going concern value to ensure a continued stream of interest payments. In contrast, the hedge fund may seek to force a sale of the company's underlying assets to realize easy gains on the unsecured debt that it had purchased at a discount.[15] Similarly, the hedge fund would not share the incentives of the company's other

[12] *See* Gilhuly, *supra* note 8, at 5.

[13] *Id*. This is not always the case, however, because some hedge funds have hired turnaround specialists to help them restructure the distressed companies that they acquire.

[14] *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, American Bankruptcy Institute Journal 24 (Dec../Jan. 2007).

[15] *See* Fisher & Buck, *supra* note 15; *see also* Gilhuly, *supra* note 8, at 9.

trade creditors, who seek to engage in future business with the company. In addition, because of its short position, the hedge fund's interests would be directly adverse to those of the company's shareholders.[16] The best result for this hedge fund would be for the company to be able to pay off its secured and unsecured debt in full, but for shareholders to receive nothing.

Hedge funds can and do invest in distressed companies inside and outside of bankruptcy in a number of different ways, including the following:

1. DIP Loans

By being DIP lenders, hedge funds can collect significant fees, obtain first-priority liens on substantially all of a debtor's assets, and obtain super-priority administrative expense claims for repayment. As a DIP lender, a hedge fund also will gain access to confidential information concerning the debtor, as well as the ability to influence the course of the debtor's reorganization. In addition, whenever a waiver of financial and other covenants is required, the hedge funds that participate in a DIP loan would have a significant advantage in negotiations with the debtor, and can earn significant amendment fees and other consideration.

2. Pre-Petition Secured Loans

Secured lenders have ample clout in an out-of-court restructuring or a bankruptcy case. Prior to a company's bankruptcy, secured lenders' right to foreclose on valuable collateral gives them great leverage in restructuring negotiations. When a company enters chapter 11, secured creditors are stayed from foreclosing on their collateral, but they have a number of other rights. These include the right to adequate protection of their interests in the debtor's property, leverage in negotiating the debtor's continued use of cash collateral, credit bidding opportunities in asset sales, and significant leverage in the negotiations over the debtor's chapter 11 reorganization plan.[17] For example, in connection with the post-petition DIP loan the company may require immediately following the bankruptcy, pre-petition secured lenders are in a position to obtain significant consideration (such as post-petition interest, expense reimbursements, and even cross-collateralization or a roll-up of their pre-petition debt) as adequate protection. A debtor that is unwilling to partake in a lien priming fight has a powerful incentive to accede to pre-petition secured lenders' adequate protection demands.

The adequate protection package that was granted to pre-petition secured lenders in the *Buffets Holdings, Inc.* bankruptcy case is but one example of the benefits pre-petition secured lenders can gain as part of a debtor's need to obtain additional liquidity in bankruptcy.[18] In connection with the debtors' $85 million new money DIP loan, the debtors granted adequate

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[16] *See* Fisher & Buck, *supra* note 15; *see also* Gilhuly, *supra* note 8, at 9.

[17] *See* Gilhuly, *supra* note 8, at 5.

[18] *In re Buffets Holdings, Inc., et al.*, Case No 08-10141 (Bankr. D. Del.).

protection to their pre-petition secured lenders that included the roll-up of $200 million of approximately $635 million outstanding debt under a pre-petition secured credit facility, as well as the cash payment of interest at a rate that exceeded the default rate of interest stated in the pre-petition credit agreement. This adequate protection package was provided by the debtors, even though the pre-petition secured lenders funded the $85 million new money DIP loan, so no third party lender was even granted a priming lien in that case.

In the last few years, hedge funds have been particularly active in the second lien loan market. By investing in second lien debt, hedge funds benefited from the best of both worlds – a loan that was secured by collateral, and interest at rates that exceeded rates paid to first lien lenders. In light of the current credit markets, however, new second lien deals have become much rarer, and existing second lien debt has become less attractive to investors as current second lien paper issued by many companies has fallen in value.

3. Pre-Petition Unsecured Debt

In recent years, hedge funds have become very active in purchasing bankrupt companies' unsecured debt. Distressed debt trading has become a multi-billion dollar a year industry. Trading in unsecured claims can provide tremendous liquidity to pre-petition unsecured creditors, and can also result in generous profits for investors that are sophisticated enough to understand the restructuring process and that have sufficient access to information to take appropriate risks.[19] Depending on the amount of unsecured debt acquired, hedge funds also may gain control over a class of creditors or a creditors' committee, and therefore obtain considerable influence over the debtor's reorganization.[20]

Because there are relatively few buyers of unsecured debt in the market (though the number of buyers is growing), and because smaller and less sophisticated creditors often require liquidity and will accept an offer to sell their unsecured claims early in a bankruptcy case, hedge funds can purchase unsecured debt at a very significant discount. In addition, banks and other professional investors generally are constrained to limit exposure, and cannot carry on their books large defaulted loans that must be marked to market. To achieve liquidity and limit losses, banks often will trade the debt they hold.[21]

Distressed debt investors typically will purchase unsecured claims if they believe that: (a) the reorganization will yield a higher return than the cost of purchasing the claims and (b) the company's reorganization plan will be confirmed and consummated before the investor's cost of

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[19] *See* Gilhuly, *supra* note 8, at 6.

[20] *See* Gilhuly, *supra* note 8, at 5.

[21] *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 Vand. L. Rev. 1987, 2014-15 (2002).

carrying the investment consumes the profit it makes on the discount.[22] In making investments in unsecured debt, hedge funds tend to utilize the services of investment professionals who specialize in bankruptcy and in researching distressed companies to understand the true value of the debt. Hedge funds can capitalize on their knowledge, flexibility and patience, which other creditors might lack. Hedge funds also can profit simply on account of their sophisticated analysis of appropriate discounts for unsecured claims.

4. Pre-Petition Equity

Investment in the stock of distressed companies is similar to investment in debt, but with lower priority and higher risk. When a bankrupt company is insolvent, shareholders are not legally entitled to receive any distribution under a plan on account of their equity interest. However, hedge funds may buy stock in a debtor after a chapter 11 case begins, betting that the shareholders actually will receive a distribution under a reorganization plan, as a result of negotiations with creditors, litigation, or both.

One example of a hedge fund profiting from an investment in a distressed company's equity is the case of *Foamex International Inc.* Prior to its bankruptcy, Foamex's stock had traded at levels as low as 15 cents. After the bankruptcy filing, one hedge fund bought a total over 2 million shares of Foamex (representing approximately 10% of the company's equity) in a number of different transactions on the open market. The hedge fund made its first purchase at approximately 24 cents per share. By the time the hedge fund had made its last purchase, the stock was trading at $1.31 per share. The shares later almost reached $5.00 per share, generating a gain of over 650% for the hedge fund.[23] On February 12, 2007, Foamex exited chapter 11 protection pursuant to a reorganization plan in which shareholders retained their interests in the company.

5. Post-Emergence Equity Investments

Hedge funds have also been active in making equity investments in companies after they emerge from chapter 11. Such investments can take the form of (among other things) direct purchases of stock of the reorganized debtor upon its emergence from chapter 11, or backstopping a rights offering of common or preferred stock of the reorganized debtor. By making these investments, hedge funds can earn large commitment and other fees, and have the opportunity to purchase the equity at a discount to their value as estimated in connection with the debtor's plan of reorganization. Other stakeholders often support these equity investments, as the infusion of new money by the hedge funds increase the cash distributions that unsecured creditors and even equity holders could receive on account of their claims and interests under the chapter 11 plan. Debtors tend to support these equity investments as well, because they would

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[22] *See id.* at 2015, citing Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 Cardozo L. Rev. 1, 13 (1990).

[23] *See* Christopher Byron, *The Big Bounce – Funds Reap Huge Returns on a Bankrupt Foam Maker*, New York Post 35 (June 12, 2006); Gilhuly, *supra* note 8, at 7.

allow the company to borrow less under an exit credit facility, leaving the company less levered upon emergence from bankruptcy.

Post-emergence equity investors often have large positions in the debtor's pre-petition capital structure. These investors can achieve at least two objectives by investing in the company upon its emergence from bankruptcy: (a) getting an opportunity to earn large fees and to achieve short-term, medium-term and potentially long-term profits on their equity investments by negotiating a significant discount to the estimated value of the equity, and (b) using their role as post-emergence investors to buttress their negotiating leverage in connection with the debtor's plan of reorganization, thus protecting their investments in the pre-petition capital structure.

Proposed post-emergence equity investments have become increasingly common recently, particularly in cases involving automotive supply companies such as Delphi Corporation, Dana Corporation, and Dura Automotive Systems, Inc. However, not all proposed equity investments are ultimately consummated, as the Delphi Corporation and Dura Automotive Systems, Inc. cases demonstrate.

6. Other Investments

Hedge funds also may make other investments in distressed companies. For example, hedge funds could sell short the company's unsecured debt and buy long the secured credit facilities. When the company's secured credit facilities require covenant or other waivers, the hedge funds would be in a position to extract steep concessions (including large amendment fees) from the company. Moreover, if the company has to file a bankruptcy petition, the unsecured notes likely would decline in value, resulting in a gain for the hedge fund's short position.[24]

A number of hedge funds also engage in credit default swaps. While banks probably remain the largest buyers and sellers of credit default swaps, hedge funds and other investment management firms have become major participants in this market. Credit default swaps are contracts in which one party "buys" protection from credit risk and the counterparty "sells" that protection. The protection buyer (which tends to own the underlying credit asset) pays a periodic fee to the protection seller. In return, the protection seller agrees to pay the protection buyer a stated amount if a credit event occurs. Credit default swaps differ from loan syndications in terms of control rights. When a bank syndicates loans, it also sells all of the applicable control rights in connection with the loans that are syndicated. However, when a bank lender purchases credit risk protection, that bank lender typically still retains the control rights that accompany the loan.[25] The presence of credit default swaps may fundamentally change the economic interest of lenders. When they purchase credit risk protection, lenders will not have as much to lose if the

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[24] *See* Gilhuly, *supra* note 8, at 8.

[25] *See id.*

debtor defaults. Indeed, if a lender purchases enough credit protection, it may even benefit the lender for the loan to go into default.[26]

III. POTENTIAL EFFECTS OF HEDGE FUNDS' INVOLVEMENT IN BANKRUPTCY CASES

Hedge funds are extremely pervasive and activist participants in corporate restructurings both inside and outside of bankruptcy. Investment and participation by hedge funds can create benefits for distressed companies, creditors and shareholders alike. For example, hedge funds can be a reliable source of capital when more traditional lenders are unwilling to lend (particularly in the current credit markets). Investments by hedge funds may enable a troubled company to correct its problems and avoid bankruptcy altogether. DIP financing from hedge funds may be critical to a successful chapter 11 case, if bankruptcy becomes necessary.[27] In addition, hedge fund purchases of secured and unsecured debt permit other creditors to realize some recovery quickly on the pre-petition credit they had extended to the bankrupt companies. This can be extremely important for ordinary-course trade creditors, parties with litigation claims against bankrupt companies, and other parties who cannot wait until the effective date of a plan of reorganization to obtain a recovery on their claims. Moreover, given that a bankrupt company might propose to provide distributions to unsecured creditors under a reorganization plan in the form of stock or debt, creditors could benefit from the ability to sell their claims to hedge funds for cash.

However, hedge fund involvement in chapter 11 cases can create a number of concerns for debtors, creditors and shareholders. Partly as a result of hedge funds' short-term investment horizon and investments in multiple segments of a company's capital structure, hedge funds' interests are not always aligned with those of debtors and other parties. The focus by a number of hedge funds on the maximization of short-term returns often has caused tensions among the parties to a restructuring, and may conflict with the Bankruptcy Code's emphasis on the rehabilitation of debtors. Some experts have noted that in the early days of the Bankruptcy Code, there was a more symbiotic relationship between debtors and creditors than there tends to be today. Generally, in the past, financial institutions that extended credit to debtors generally maintained and supported long-established relationships with the debtors.[28] However, distressed debt trading and changes in bankruptcy relationships have frayed the symbiotic relationship between debtors and creditors. Creditors who purchase debt at substantial discounts are likely to be much more interested in the return on their investment, than in the debtors' long-term viability.[29]

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[26] *See id.*

[27] *See id*. at 9.

[28] *See* Miller, *supra* note 22, at 2014.

[29] *See id.* at 2014-15.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (which significantly amended the Bankruptcy Code) provides hedge funds and other creditors additional leverage over debtors. For example, that act amended the Bankruptcy Code to provide that the exclusive period during which only the debtor can propose a plan of reorganization cannot be extended beyond eighteen months following the petition date. In large, complex bankruptcy cases, debtors generally require more than eighteen months to stabilize their operations, create a sustainable business plan, and negotiate and formulate a reorganization plan. The hard-and-fast eighteen-month limit on the exclusive period to propose a plan may reduce hedge funds' incentives to reach consensus with the debtor and other creditors, because they would be able to propose their own plans after the exclusive period expires.[30]

The Bankruptcy Code provides that an official committee of unsecured creditors generally should be appointed. However, the United States Trustee has the authority to form other official committees, such as committees of equity security holders and other committees of various types of unsecured creditors. Hedge funds may request the Office of the United States Trustee to form an additional official committee to advocate for the interests of the type of claims and interests they hold. If the U.S. Trustee refuses, then the hedge funds may request a court order mandating the appointment of such committee. There are a number of benefits that hedge funds can derive from this strategy. First, the fees and expense reimbursements of official committee professionals are paid by the debtor's estate, and not by the individual members of the committee. Second, members of official committees are in a position to exert substantial influence over the debtor's reorganization path. Indeed, courts tend to lend the views of official committees greater weight than views of individual creditors. Third, members of official committees are privy to confidential information concerning the debtor. Cognizant of these facts, hedge funds and other parties have sought the appointment of official equity committees in recent cases such as Delphi Corporation, Northwest Airlines Corporation, Kmart Corporation, Solutia Inc. and Granite Broadcasting Corporation. Hedge funds also may try to obtain seats on an existing official committee by acquiring substantial claims or equity interests after the petition date, and requesting the United States Trustee to appoint them to that committee (and may request the bankruptcy court to order the United States Trustee to do so, if it refuses).[31]

As beneficial as membership on an official committee may appear, there are certain disadvantages. For example, members of official committees owe fiduciary duties to their constituents.[32] These fiduciary duties should serve as a check to hedge fund committee members acting solely in their own interests, though hedge funds' views of what is best for the debtor's estate may differ from the views of other creditors and shareholders. In addition, because they receive substantial confidential information about the debtor and its bankruptcy case, members of official committees typically are prohibited from buying and selling the debtor's securities.

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[30] *See* Stephen M. Gross *et al.*, *Auto Cases: Where is This Road Going?*, 061506 ABI-CLE 281 (June 2006).

[31] *See* Gilhuly, *supra* note 8, at 10.

[32] *See, e.g.*, *Johns-Manville Sales Corp. v. Doan (In re Johns-Manville Corp.)*, 26 B.R. 919, 924 (Bankr. S.D.N.Y. 1983), citing *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262 (1941); *In re Realty Associates Securities Corp.*, 56 F. Supp. 1008, 1009 (E.D.N.Y. 1944).

Such trading would contravene committee members' fiduciary duties, and could violate applicable securities laws. In an effort to serve on official committees while continuing to trade in the applicable securities, committees (or individual members thereof) often request court approval of "screening walls" and other procedures. Screening walls are designed to ensure that non-public information obtained by committee members is not shared with the committee members' securities trading personnel. Courts commonly grant requests for such screening walls, as long as the proposed walls are appropriate. Court orders approving screening walls typically provide that if the procedures set forth in the order are followed, then committee members would not, by their trading activity alone, *per se* be in violation of their fiduciary duties and their claims or equity interests would not *per se* be subject to adverse treatment on that basis.[33]

A hedge fund that is not a member of an official committee and that does not hold enough claims or equity to control a class can still obtain bargaining leverage by forming an unofficial *ad hoc* committee with other investors. *Ad hoc* committees provide similarly-situated creditors and shareholders the ability to bargain with the debtor and other creditors as a single unit.[34] Members of these committees can also demand and receive confidential information regarding the debtor and its restructuring. Though *ad hoc* committees lack certain benefits of official committees, such as the estates' payment of professionals' fees, members of *ad hoc* committees are not hindered by fiduciary duties to a broader constituency and thus are completely free to pursue their own parochial interests. If the bankruptcy case is particularly complex with multiple layers of debt of differing structural and legal priorities, a number of *ad hoc* committees could be formed to share legal costs and advance common agendas.[35] Drawbacks to forming an *ad hoc* committee in a bankruptcy case include the potential application of the disclosure requirements of Federal Rule of Bankruptcy Procedure 2019, which is discussed *infra*.

A. Hedge Fund Narrative 1: The *American Remanufacturers Case*

The *American Remanufacturers, Inc.* saga is a sobering tale of the potentially unfortunate outcomes that may occur when hedge funds (or any other type of investor) pursue their own agendas to the detriment of other constituents. American Remanufacturers filed its chapter 11 bankruptcy petition in November 2005 in Delaware for the purpose of conducting a sale of substantially all of its assets pursuant to section 363 of the Bankruptcy Code. On its bankruptcy petition date, the company had a $50 million first lien loan and a $40 million second lien loan outstanding. Both loans were secured by substantially all of the company's assets. The first lien lender agent was both the agent for the first lien lenders and controlled the first lien position. On

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[33] *See* Honorable Theodore C. Albert *et al.*, *Navigating the Minefields of Representing Chapter 11 Committees – Getting Employed, Managing Inter-Committee Conflicts & Complying With BAPCPA*, 060907 ABI-CLE 189 (Sept. 2006).

[34] *See* Gilhuly, *supra* note 8, at 11.

[35] *See* Fisher & Buck, *supra* note 15.

the first day of the bankruptcy case, the debtor requested that the bankruptcy court approve a post-petition debtor-in-possession (DIP) credit facility that was to be provided by the first lien lenders.

The debtor's request created a firestorm of conflict between the first lien lenders and the second lien lenders. The second lien lenders would not consent to having their pre-petition liens primed by the DIP facility that was proposed by the first lien lenders, while the first lien lenders would not consent to having *their* pre-petition liens primed by a DIP facility from the second lien lenders. During the interim hearing to consider approval of the DIP loan, the company introduced testimony establishing that (a) the aggregate value of the company's assets on a going concern basis was less than $30 million, thus the second lien lenders would not receive any recovery in a going concern sale or a liquidation; (b) the company had no real alternative to a section 363 sale and (c) the company would not be able to operate in chapter 11 without the proposed DIP financing. The second lien lenders objected to the proposed DIP facility on the basis that under the intercreditor agreement with the first lien lenders, the first lien agent could not consent to the subordination of the first lien debt to the DIP financing without causing the first lien and second lien to become equal in priority. The relevant language of the intercreditor agreement provided as follows:

> "if the First Lien Agent voluntarily agrees to subordinate any Liens on any Collateral securing the First Lien Obligations to any Liens securing obligations owing from the company or the other Credit Parties to any third party … then the provisions relating to the priority of Liens and subordination of payments set forth herein shall not be effective with respect to the Collateral which is the subject of the Liens securing the First Lien Obligations that were voluntarily made subordinate to the Liens securing the obligations owing to third parties."

The second lien lenders argued that this intercreditor agreement provision, coupled with the proposed priming liens of the DIP lenders, rendered the first lien lenders' lien *pari passu* with the second lien lenders' lien. In a preliminary ruling, the bankruptcy court stated that the second lien lenders' interpretation of the intercreditor agreement was correct. Unwilling to risk losing the priority of its first lien, the first lien agent withdrew its offer to fund the DIP facility. With no available DIP financing and no way to break the impasse between the first lien lenders and the second lien lenders, the case was converted to a chapter 7 liquidation. At that time, the company's operations were shut down and 1,400 employees lost their jobs. After the case was converted, the bankruptcy court approved a sale of substantially all of the company's assets for less than $10 million.

B. Hedge Fund Narrative 2: The *Radnor Holdings Corporation* Adversary Proceeding

The *American Remanufacturing* case reminds us that hedge funds and other types of investors might pursue their own interests to the detriment of others. However, simply asserting that hedge funds are behaving badly does not lead to successful litigation against them, as the official committee of unsecured creditors found in the *Radnor Holdings Corporation* chapter 11 case. There, after an eight-day trial, the bankruptcy court ruled in favor of hedge fund Tennenbaum Capital Partners, LLC, two of its affiliates,[36] and a Tennenbaum partner with respect to all counts in an adversary proceeding brought against them by the creditors' committee.

The background of the case is as follows: approximately ten months before Radnor filed its chapter 11 bankruptcy case, Tennenbaum made an initial investment in Radnor through a commitment to purchase $25 million of series A preferred stock and a commitment to lend $95 million in senior secured debt.[37] Radnor used the funds to redeem $70 million of its senior secured notes, refinance other existing debt and enhance its liquidity. Radnor and Tennenbaum also entered into an investor rights agreement, pursuant to which Tennenbaum had the right to appoint one member and one observer to Radnor's board of directors, and had the right to increase its representation on the board if Radnor failed to achieve certain EBITDA targets.[38]

Radnor fared poorly after its transaction with Tennenbaum closed. Higher than expected raw material costs, delays in expected price increases, and a severe negative impact from the Gulf Coast hurricanes led to a devastating decline in Radnor's earnings in the fourth quarter of 2005 and the first quarter of 2006. As a result, Radnor faced cash flow and liquidity problems and had to request an additional $23.5 million advance from Tennenbaum to bridge the liquidity gap.[39] However, Radnor continued to struggle even after receiving this additional loan. Radnor's revolving secured lenders (who were not affiliated with Tennenbaum) ceased funding under its working capital facility in July 2006. Thereafter, Tennenbaum and Radnor entered into an asset purchase agreement whereby Tennenbaum would act as the stalking horse bidder in a section 363 sale. Tennenbaum and Radnor were convinced that absent a sale of these assets, Radnor likely would face a "free-fall" bankruptcy that likely would result in a chapter 7 liquidation.[40] The asset purchase agreement permitted Tennenbaum to purchase substantially all of Radnor's assets and to use its secured claims to credit bid in an auction.[41] Radnor and certain of its affiliates filed their chapter 11 petitions in August 2006, and the bankruptcy court approved bidding procedures in September 2006.

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[36] For ease of reference, Tennenbaum Capital Partners, LLC and its two affiliated hedge funds Special Value Opportunities Fund, LLC and Special Value Expansion Fund, LLC collectively are referred to herein simply as "Tennenbaum."

[37] *See Official Committee of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.),* 353 B.R. 820, 829 (Bankr. D. Del. 2006).

[38] *See id.*

[39] *See id.* at 832.

[40] *See id.* at 835.

[41] Section 363(k) of the Bankruptcy Code provides: "[a]t a sale under [section 363(b)] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. § 363(k).

The creditors' committee supported the entry of the bidding procedures order, and waived its right to object to the sale. However, the creditors' committee did reserve the right to challenge Tennenbaum's decision to act as the staking horse bidder. For example, the creditors' committee found Tennenbaum's stalking horse bid objectionable because it contemplated payment of the purchase price through a credit bid, which would have left few assets for distribution to unsecured creditors. In October 2006, the creditors' committee commenced an adversary proceeding complaint against Tennenbaum. In its complaint, the creditors' committee asserted that Tennenbaum did not make its loans with the expectation that Radnor would be able to repay them, but rather as part of a "loan to own" strategy. The creditors' committee asserted various causes of action, including (a) recharacterizing Tennenbaum's secured loans as equity, (b) equitable subordination of Tennenbaum's secured claims, (c) damages for Tennenbaum's alleged breach of its fiduciary duties arising from its status as Radnor's *de facto* controlling shareholder,[42] (d) aiding and abetting the Radnor board's breach of its fiduciary duties, (e) prohibiting Tennenbaum from using its secured claim to credit bid for Radnor's assets, (f) avoidance of the security interests granted to Tennenbaum as fraudulent transfers and (g) avoidance of payments made to Tennenbaum within the one year prior to Radnor's bankruptcy as preferential payments to an insider.[43]

In ruling in favor of the defendants, the bankruptcy court found that the creditors' committee had not proven its case and that the applicable statutory and case law precluded it from succeeding in its lawsuit. In fact, in ruling against the creditors' committee on its equitable subordination claim, the bankruptcy court expressly determined that "[Tennenbaum] did *not* engage in misconduct; [Tennenbaum] did *not* seek to benefit itself at the expense of others; [Tennenbaum] did *not* seek to mislead trade creditors, public noteholders or other stakeholders; [Tennenbaum] at all times acted in good faith with a view to maximize Radnor's value to all constituents. The testimony on these issues was consistent and credible."[44]

III. BANKRUPTCY RULE 2019

Federal Rule of Bankruptcy Procedure 2019(a) requires any entity that represents more than one creditor or equity security holder in connection with a bankruptcy case to file a verified statement identifying each client and the nature of their claims or interests, together with certain facts about the attorney's employment. The rule requires disclosure of specific information relating to the identity of the clients, the nature of the claims and the circumstances surrounding the employment of the attorney. In particular, Rule 2019(a) states as follows:

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[42] The bankruptcy court determined that the committee's breach of fiduciary duty claims were nothing more than a deepening insolvency claim, which has been rejected in Delaware both as a cause of action and as a theory of damages. *See Radnor Holdings*, 353 B.R. at 842, citing *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006) (rejecting deepening insolvency as a cause of action under Delaware law); *Seitz v. Detweiler, Hershey & Assoc. (In re CitX Corp)*, 448 F.3d 672 (3d Cir. 2006) (rejecting deepening insolvency as a theory of damages).

[43] *See* Mark Berman & Jo Ann J. Brighton, *Hedge Funds: Lessons Learned From the Radnor Decision*, 26-Feb Am. Bankr. Inst. J. 30 (Feb. 2007).

[44] *Radnor Holdings Corp.*, 353 B.R. at 841 (emphasis in original).

> "In a … chapter 11 reorganization case, except with respect to a committee appointed pursuant to § 1102 or 1114 of the Code, every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof. …"[45]

The Rule 2019(a) disclosure requirement is designed to afford the bankruptcy court and parties-in-interest information regarding multiple representations by an attorney and can be used by courts as a vehicle to ensure adherence to ethical responsibilities.[46] If an attorney fails to comply with Rule 2019(a), then on motion of any party in interest or on its own initiative, the bankruptcy court may refuse to permit the attorney to be heard further or to intervene in the case.[47]

The bankruptcy judge presiding over the *Northwest Airlines Corporation* chapter 11 case ordered the members of an *ad hoc* committee of stockholders (which consisted of hedge funds) to file a Rule 2019(a) statement that discloses the amount of the equity interests owned by the members of the *ad hoc* committee, the times when the interests were acquired, the amounts paid for the interests and any sales or other dispositions of the interests. In ordering the disclosure, the bankruptcy court determined that the prior Rule 2019(a) statements filed by counsel for the *ad hoc* committee were insufficient because they had failed to disclose that information.[48] In its opinion, the bankruptcy court noted that *ad hoc* committees generally play an important role in reorganization cases, because their members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings.[49] The bankruptcy court further noted that the purpose of the Rule 2019(a) statement is to require these influential informal committees to disclose possible conflicts of interest.

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[45] Fed. R. Bankr. P. 2019(a).

[46] *See, e.g.*, *City of Lafayette v. Oklahoma P.A.C. First Limited Partnership (In re Oklahoma P.A.C. First Limited Partnership)*, 122 B.R. 387, 392 (Bankr. D. Ariz. 1990) (stating that counsel representing multiple creditors in a bankruptcy case must comply with Rule 2019(a) and that, as a result of those disclosures, counsel could be forced to withdraw from representation of some creditors where a conflict of interest was found).

[47] *See* Fed. R. Bankr. P. 2019(b).

[48] *See In re Northwest Airlines Corp.*, No. 05-17930, 2007 WL 609214, *2 (Bankr. S.D.N.Y. 2007).

[49] *See id.* at *3.

The *ad hoc* committee appealed to the district court the bankruptcy court's order requiring the additional disclosure, and also requested that the bankruptcy court allow it to file portions of its enhanced Rule 2019(a) statement under seal.[50] On March 9, 2007, the bankruptcy court denied the *ad hoc* committee's request to file the Rule 2019(a) statement under seal. In its opinion accompanying the order denying the request, the bankruptcy court noted that even though the *ad hoc* committee did not purport to act as a fiduciary for other stockholders, Rule 2019(a) is based on the premise that other stockholders have a right to information as to *ad hoc* committee member purchases and sales. This information would allow the other stockholders to decide on an informed basis whether the *ad hoc* committee truly represents their interests, or whether they should consider forming another committee of their own. The bankruptcy court also noted that the information required by Rule 2019(a) provides all parties a greater ability to gauge the credibility of the *ad hoc* committee, which had chosen voluntarily to appear in the bankruptcy case and play a major role in it.[51]

Because hedge funds typically guard their trading secrets fiercely, it was believed that the *Northwest Airlines* decision might curtail hedge funds' involvement in bankruptcy cases in the future, or at least dampen their desire to band together with others to form *ad hoc* committees.[52] For example, in an *amicus curiae* brief in opposition to Scotia Pacific Company LLC's motion for an order compelling members of an *ad hoc* committee of noteholders to file a Rule 2019(a) statement (discussed below), two of the nation's leading industry groups in the debt and equity markets argued that a requirement that certain parties publicly disclose their trading activities would "in all likelihood erect a substantial obstacle to the participation of certain parties and stakeholders in bankruptcy cases," which would both prevent involvement by sophisticated parties that frequently have made positive contributions to reorganizations, as well as negatively impact the markets that create liquidity in a debtor's securities.[53] In another *amicus curiae* brief in opposition to the official creditors' committee of Sea Containers Services, Ltd.'s motion for an order compelling members of a group of unsecured noteholders to file an enhanced Rule 2019(a) statement, one industry group stated:

> "[i]f courts regularly apply Rule 2019 in a manner that requires members of informal groups to reveal not only their holdings, but also extensive trading histories including the prices at which these entities purchased their securities, then financial institutions are likely to develop a strong reluctance to participate in the restructuring process. Given the choice between disclosing their highly confidential and proprietary trading

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[50] The *ad hoc* committee proposed to seal the portion of its enhanced Rule 2019(a) statement that discloses the specifics of the purchases and sales of the Debtors' securities made by members of that committee. The *ad hoc* committee argued that the information it sought to seal would allow the members' competitors to discern the members' investment strategies.

[51] On March 21, 2007, the *ad hoc* committee publicly filed its enhanced Rule 2019(a) statement. *See Verified Amended Statement of the Ad Hoc Committee of Equity Security Holders Pursuant to Bankruptcy Rule 2019(a)*, Case No. 05-17930 (Bankr. S.D.N.Y.), Docket No. 5446.

[52] *See, e.g.*, Gilhuly, *supra* note 8, at 25.

[53] *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 610, at 2.

strategies, on the one hand, and not participating in informal groups, on the other, many institutions may choose the latter. And that result will threaten serious disruption of the otherwise well balanced mechanisms of the chapter 11 process, since those holders – often the largest true economic stakeholders in a case – will decline to participate."[54]

Though the *Northwest Airlines* rulings may have deterred some hedge funds from banding together to form *ad hoc* committees, it is doubtful that the rulings have had any real impact on hedge funds' willingness to participate in chapter 11 cases so far, or to form informal groups to assert their rights. At most, it appears that the *Northwest Airlines* decisions have caused hedge funds and their counsel to become a bit more creative in describing their group (*e.g.*, shunning the label "*ad hoc* committee" and instead labeling themselves "certain creditors," a "bunch of creditors"[55] or the like).

The *Northwest Airlines* rulings prompted other parties (such as the debtors in Dura Automotive Systems, Inc. and the official creditors' committee of Sea Containers Services, Ltd.)[56] to request court orders requiring disclosure by hedge funds and other parties under Rule 2019(a). However, one court refused to follow the *Northwest Airlines* rulings, and denied the debtor's motion for an order directing disclosure under Rule 2019(a). In that case, Scotia Pacific Company LLC, a chapter 11 debtor in a bankruptcy case pending in the Southern District of Texas, requested a bankruptcy court order compelling an *ad hoc* committee of noteholders (whose members included several hedge funds) to file a Rule 2019(a) statement.[57] It also requested that the bankruptcy court refuse to consider the *ad hoc* committee's pleadings until that committee filed an appropriate Rule 2019(a) statement. In support of its motion, Scotia Pacific alleged that the *ad hoc* committee distracted the reorganization process by adopting an aggressive and improper litigation posture and by filing "patently absurd" pleadings with the bankruptcy court. Scotia Pacific further alleged that the *ad hoc* committee adopted this aggressive posture while "hiding behind a veil of secrecy that is patently contrary to the open disclosure policies underlying the Bankruptcy Code and the express provisions of Bankruptcy Rule 2019(a)."[58]

In an *amicus curiae* brief in opposition to Scotia Pacific's motion, the Securities Industry and Financial Markets Association and the Loan Syndications and Trading Association argued that a public disclosure requirement would create unearned windfalls in favor of debtors and destroy the incentive for investors to purchase claims against debtors. According to these industry groups, such windfalls would occur because if parties are required to disclose their basis

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[54] *In re Sea Containers Ltd.*, Case No. 06-11156 (Bankr. D. Del.), Docket No. 1750.

[55] *In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), April 17, 2007 Hrg. Tr. at 4-5.

[56] *In re Dura Automotive Systems, Inc.*, Case No. 06-11202 (Bankr. D. Del.), Docket No. 2162; *In re Sea Containers Ltd.*, Case No. 06-11156 (Bankr. D. Del.), Docket No. 1537.

[57] *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 492.

[58] *Id.* at 1-2.

in debtors' securities, debtors and other parties would use that information to their advantage in negotiations over such matters as the treatment of the securities under a reorganization plan and the price of the securities in a subsequent disposition thereof. According to these two groups, "[b]y simply requiring that such information be disclosed, the terms of negotiation will unavoidably shift from being focused on the obligations of the debtor under the terms of the relevant instrument to consideration of the relative return to the specific stakeholder, thereby effectuating a significant departure from well-settled law and customary practice."[59]

The bankruptcy court denied Scotia Pacific's motion, ruling that the *ad hoc* committee was not a "committee" within the meaning of Rule 2019.[60] The bankruptcy court also denied Scotia Pacific's subsequent motion to reconsider that ruling.[61] The *Scotia Pacific* court's decision gives some credence to the theory of some hedge funds and their counsel that multiple creditors that hire a single counsel are nothing more than that, and accordingly that no special disclosure requirements should be imposed on them. In an *amicus curiae* brief filed in the *Sea Containers Ltd.* bankruptcy case, the Loan Syndications and Trading Association argued that the Scotia Pacific court's rationale was correct. That industry group argued that a "committee" constitutes a "group of people that act on behalf of others," and that (while informal groups of creditors and interest holders had labeled themselves "*ad hoc* committees") they actually are not true committees, because they typically do not act on behalf of anyone but themselves and do not stand in a fiduciary capacity with respect to others."[62] Rather, "[e]ach seeks only to do what is best in its individual economic interest at that particular time. … Indeed, should some – even a majority – of an informal group wish to pursue a path that does not meet with unanimous approval, the dissenters remain free to take their own action and, if they choose, oppose the group effort."[63]

Hedge funds' varied investments in a bankrupt company can raise other Rule 2019(a) disclosure issues for hedge fund attorneys who also represent other clients in a particular bankruptcy case. For example, suppose that a hedge fund purchases unsecured bonds issued by a distressed company and also obtains a short position in the company's stock. Suppose further that after the company commences a chapter 11 case, that hedge fund joins an *ad hoc* committee of unsecured bondholders. Must the hedge fund's short position in the stock be disclosed when counsel for the *ad hoc* committee files its Rule 2019(a) statement? Technically, the requirements

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[59] *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 610, at 5-6.

[60] *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 659.

[61] *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 844. After the bankruptcy court denied the motion for reconsideration, Scotia Pacific filed another motion to compel successor counsel to the *ad hoc* committee of noteholders to file a Rule 2019(a) statement. *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 934. That motion was never brought for a hearing. However, during the plan confirmation in the case, the bankruptcy court apparently suggested that it may revisit its previous Rule 2019(a) rulings because of the potential conflicts of interest among the members of the *ad hoc* committee. *See In re Scotia Development LLC*, Case No. 07-20027 (Bankr. S.D. Tex.), Docket No. 2767, at 2.

[62] *In re Sea Containers Ltd.*, Case No. 06-11156 (Bankr. D. Del.), Docket No. 1750, at 10.

[63] *Id*. at 11.

of Rule 2019(a) relate only to present holdings of claims and interests in the debtor. Because the hedge fund does not own stock issued by the debtor, Rule 2019(a) may not require disclosure of the short position.[64] However, if the hedge fund becomes active during the bankruptcy case, then the fact of its short position would relevant to understanding its goals and motivations. Attorneys representing groups of creditors that include hedge funds should be aware of all of the investments the hedge funds in the group have made, and should consider whether any short positions should be disclosed, even though Rule 2019(a) technically may not require such disclosure.[65]

IV. CONCLUSION

It certainly appears that hedge funds will continue to participate in distressed companies' capital structures (and remain extremely involved in the corporate restructuring process) for a long time to come. Restructuring professionals must adapt to this new paradigm quickly. Business negotiation dynamics have already changed with the advent of significant hedge fund participation in distressed companies. In addition, the law with respect to many bankruptcy-related matters likely will evolve over the years, as hedge fund activity promises to alter the manner in which the restructuring process functions.

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64 *See* Fisher & Buck, *supra* note 15; Gilhuly, *supra* note 8, at 26.

65 *See* Gilhuly, *supra* note 8, at 26.