TRENDS IN DISTRESSED DEBT INVESTING: AN EMPIRICAL STUDY OF INVESTORS' OBJECTIVES

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INTRODUCTION

Increased creditor control in chapter 11 cases has generated considerable debate over the past several years. Proponents of creditor control argue that, among other things, it promotes efficiency in corporate reorganizations.[1] Critics assert that it destroys corporate value and frequently forces otherwise viable entities to liquidate.[2]

The increasing involvement of professional distressed debt investors in chapter 11 cases has intensified this debate.[3] These investors are purchasing positions in multiple tranches of the debtor's capital structure, obtaining seats on the statutory committee of unsecured creditors and even acting as the debtor's post-petition lender. The latter role has given rise to a practice known as "loaning to own," where the investor extends debtor in possession financing to the debtor in order to facilitate the investor's eventual ownership of the debtor's business, through a debt-for-equity exchange, sale transaction or otherwise.[4]

In this article, I present and analyze empirical data regarding the investment practices and strategies of distressed debt investors. Based on these data and actual case reports, I reach two primary conclusions. First, although relatively few in number, activist distressed debt investors are well-financed and relatively successful in their attempts to influence change at or to acquire troubled companies. Second, unchecked creditor control by distressed debt investors or others has the potential to lead to creditor self-dealing, to the detriment of the debtor and its other stakeholders.

The precise impact and future implications of the involvement of distressed debt investors in chapter 11 cases are difficult to determine. These investors and

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[1] *See generally* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 239 (2004) (arguing "[c]hapter 11 is not for every firm, and the Bankruptcy Code should not permit chapter 11 to be an option for a debtor with a corporate charter that provides an alternative process in the event of default"); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211 (2006) (hereinafter *Private Debt*) (discussing larger role creditor plays in today's affairs of corporation); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 778–89 (2002) (hereinafter *End of Bankruptcy*) (highlighting effect of control rights in corporate bankruptcies); David A. Skeel, *Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918 (2003) ("Whereas the debtor and its managers seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast.").

[2] *See generally* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 129–31 (2005) (discussing negative impact of excessive creditor control on chapter 11 process).

[3] As used here, the term "distressed debt investor" generally refers to hedge funds, private equity firms, banks with proprietary trading desks and other non-traditional lenders. These investors typically do not have prior lending relationships with the company. Rather, they purchase the company's debt strictly as an investment opportunity. For example, they may believe that the debt is undervalued or that underutilized or untapped value exists at the company. Their investment strategies and workout approaches often differ from those of traditional lenders in the restructuring context. *See infra* notes 28–29.

[4] *See* Jonathan M. Landers, *Reflections on Loan-to-Own Trends*, 26 AM. BANKR. INST. J. 1, 44–46 (Oct. 2007) (explaining substance and implications of loan-to-own transactions); *The Vultures Take Wing: Investing in Distress*, THE ECONOMIST, Mar. 31, 2007, at 77–78 (discussing developing practice of loaning to own through debtor in possession financing facilities).

their investment practices are largely unregulated.[5] Distressed debt investors rarely disclose their investment strategies or the targets of their investments. In fact, a troubled company may not know that a distressed debt investor holds its debt until a financial restructuring or bankruptcy filing.[6] Unless they are purchasing claims against a bankruptcy estate, distressed debt investors generally are not required to report their distressed debt holdings.[7]

The lack of transparency in the activities of distressed debt investors creates uncertainty and unease with respect to their involvement in chapter 11 cases. Some commentators and practitioners suggest that distressed debt investors are always vying for control of the debtor, at the expense of the debtor and its other stakeholders.[8] This view casts the distressed debt investor as a "vulture." Others suggest that these investors add value to the restructuring process and may be the only source of rescue financing available to the debtor.[9] Consequently, the

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[5] Whether the activities of hedge funds and private equity firms—two of the most active types of distressed debt investors—should be regulated by the federal or state government is subject to debate. *See* Jonathan Bevilacqua, Comment, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251, 265–71 (May 2006) (collecting commentary on regulation issue); *see also* Erik J. Greupner, *Hedge Funds Are Headed Down-market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1585–96 (2003) (discussing hedge fund regulation debate). In addition, other than Rule 3001(e) of the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules"), no meaningful regulation of claims trading exists in bankruptcy. *See, e.g.*, Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 571–72 (2002) (exploring gaps in claims trading regulation left by Bankruptcy Rule 3001(e) and application of federal securities laws to claims trading activities).

[6] Even if a bankruptcy case is filed, the debtor still may not know of a distressed debt investor's involvement until the debtor commences the claims process contemplated by sections 501 and 502 of the Bankruptcy Code and Bankruptcy Rules 3001–3003, or until the investor purchases a claim against the bankruptcy estate that requires disclosure under Bankruptcy Rule 3001(e). *See infra* note 88 (discussing secrecy generally prevalent in distressed debt market).

[7] Bankruptcy Rule 3001(e) requires purchasers of claims against the bankruptcy estate to provide certain information to the bankruptcy court. FED. R. BANKR. P. 3001(e). In addition, at least one court has determined that, under Bankruptcy Rule 2019, distressed debt investors should be required to disclose the details of their investments in a debtor when a lawyer seeks to represent more than one investor as part of an *ad hoc* committee. *In re* Nw. Airlines Corp., 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007) (holding investors participating as members of *ad hoc* committees must make extensive Rule 2019 public disclosure regarding claims and interests, including complete trading histories in debtor's securities); *In re* Nw. Airlines Corp., 363 B.R. 701, 702–03 (Bankr. S.D.N.Y. 2007) (requiring firm to include claim information in disclosure statement); *see* Evan D. Flaschen & Kurt A. Mayr, *Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds*, 26 AM. BANKR. INST. J. 16, 46–48 (Sep. 2007) (discussing *Northwest* decision and noting at least one bankruptcy court has disagreed with holding in *Northwest*).

[8] *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2016 (2002) ("In that environment, distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments."); *see also Rich Pickings*, FUND STRATEGY, Apr. 3, 2006, at 20 ("Vultures are basically value investors, trying to buy an asset for a price well below its intrinsic or fair value.").

[9] *See* Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 259 (2005) ("The arrival of distressed debt investors can add new, positive energy to the reorganization process."); Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 404 (1997) ("Both the post-restructuring performance and the valuation effects associated with vulture claim

distressed debt investor may be either a vulture or a phoenix, at least from the perspective of a chapter 11 debtor.[10]

So which is it? I seek to provide a partial answer here. Specifically, I consider the actual practices of investors in the distressed debt market and analyze the implications of these practices on the chapter 11 process. I do not provide a definitive answer to whether the practices of distressed debt investors are value-destructive or value-enhancing in the chapter 11 context. More research, including further empirical work, is necessary to answer that question with any degree of certainty.

I base this article on an empirical study of 364 institutional investors, 82 of which indicated experience in distressed debt investing.[11] The data confirm several of the common perceptions of distressed debt investors. For example, 65.5% of the distressed debt respondents responding to the applicable question stated that they use their distressed debt investments to try to influence board or management decisions.[12] Likewise, the data show that the distressed debt respondents have a relatively short investment horizon.[13] This investment horizon may or may not correlate with a restructuring timeline that serves the best interests of the company.[14]

The data, however, also suggest that several common perceptions of distressed debt investors may not be accurate. For example, 59.4% of the distressed debt respondents responding to the applicable question indicated that they do not purchase distressed debt to try to acquire a controlling ownership interest in the debtor.[15] Further, only 30.4% of the distressed debt respondents responding to the applicable question stated that they are willing to lend money directly to a troubled company.[16]

Overall, the data indicate that distressed debt investors have significant assets to invest in the distressed debt market. These investors are willing to use their debt holdings to try to influence financial and operational decisions, presumably to increase the return on their investments. Moreover, the overwhelming majority of the distressed debt respondents intend to maintain or increase their investments in

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purchases suggest that vulture investors can bring managerial skills to the target firm, and that vultures' poor public image is not justified by empirical evidence.").

[10] *See* Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 153 (2007) ("The past decades have seen the rise of distressed debt investors—so called 'vulture' or 'phoenix' funds, like the Funds in *Enron*.").

[11] *See infra* Part III (describing details of survey and methodology). I refer to these 82 respondents as the distressed debt respondents.

[12] *See infra* Part IV.C (describing survey results).

[13] *See id.*

[14] I recognize that exactly what "serves the best interests" of the company in a restructuring is subject to debate. For purposes of this article, I use the term to indicate a course of action that maximizes the value of the bankruptcy estate. This concept is discussed further in Parts V and VI below.

[15] *See infra* Part IV.C (describing survey results).

[16] *See infra* Part V.B.3.

the distressed debt market in 2008. Accordingly, the presence of distressed debt investors in the chapter 11 process is unlikely to abate in the near future.

What does this mean for chapter 11 debtors and the bankruptcy process? Most likely, increased investment activity in distressed debt indicates that battles for control of the chapter 11 process between the debtor and its creditors will continue and intensify. In turn, memories of a primarily debtor-controlled restructuring process will continue to fade. Is a primarily creditor-controlled restructuring process more efficient? Based on the survey data suggesting potential conflicts in creditor agendas and actual case reports, the answer is no—at least under the existing regime.[17]

The Bankruptcy Code, as currently structured, presents opportunities not only for creditor control, but also for creditor self-dealing.[18] Creditor self-dealing leads to potential abuse of committee appointments, intercreditor disputes, delay and additional expense.[19] Of course, debtor self-dealing also may occur in chapter 11 cases and, among other negative effects, may engender delay and additional expense.[20] Consequently, either extreme—*i.e.*, a debtor-controlled process or a creditor-controlled process—may promote inefficiency. Striking an appropriate balance between the two extremes may maximize efficiency. It also may further the two traditional goals of chapter 11: the reorganization of viable companies and the maximization of creditor recoveries.[21] But can this balance be achieved?

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[17] In Parts V and VI, I suggest that distressed debt investors have a productive role to play in corporate restructurings. Nevertheless, some oversight of their activities is needed and, for the most part, is absent in restructurings both in and outside of chapter 11. *See infra* Parts V and VI.

[18] *See generally* 11 U.S.C. §§ 101–1532 (2006) (Bankruptcy Code).

[19] *See* Andrew J. Nussbaum, *Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code*, 57 U. CHI. L. REV. 603, 630 (1990) (discussing importance of preventing self-dealing to maintaining "the integrity of the bankruptcy process").

[20] *See, e.g.*, Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 103 (1998) ("Protected from the normal contractual and market forces that restrain the behavior of managers of healthy companies, managers of firms in bankruptcy, the harshest critics charge, use delay and other strategies to enrich themselves and the shareholders at the expense of the firm's creditors.") I do not focus on debtor-controlled restructurings or debtor self-dealing in this article. The potential solutions to mitigate creditor self-dealing and the need for a more balanced chapter 11 process discussed in Parts V and VI, however, also apply to the debtor-controlled/debtor self-dealing scenario.

[21] *See* Toibb v. Radloff, 501 U.S. 157, 163–64 (1991) (discussing two traditional goals of chapter 11); *see also* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336 (1993) (discussing traditional goals of chapter 11). I recognize that some commentators assert that economic efficiency should be the primary goal of bankruptcy. *See, e.g.*, Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 228–29 (2000) (explaining different views on underlying goals of chapter 11 and characterizing them as "traditionalists" and "free marketers"); Steven L. Schwarcz, *Global Decentralization and the Subnational Debt Problem*, 51 DUKE L.J. 1179, 1196–97 (2002). For purposes of this article, however, I focus on the two goals of chapter 11 traditionally endorsed by case law and legislative history. *See, e.g.*, S. REP. NO. 95-989, at 10 (1978) (recognizing fundamental aspect of reorganization is to provide safeguards to protect interests of creditors and public investors); H.R. REP. NO. 95-595, at 220 (1977) ("The purpose of a business reorganization case [under chapter 11] . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."); *In re* Aurora Cord & Cable Co., 2 B.R. 342, 346 (Bankr. N.D. Ill. 1980) ("The essence of Chapter 11, however, is to prevent the

In analyzing the survey data and actual case reports, I suggest one possible legislative change to create a more balanced, estate-focused chapter 11 process.[22] This change would entail eliminating the concept of statutory committees and replacing it with an estate representative.[23] The estate representative could be an independent professional appointed by the court or the Office of the United States Trustee to oversee the activities of the debtor in possession and to communicate with the debtor's creditors and other stakeholders. This independent fiduciary could reduce opportunities for both debtor and creditor self-dealing. It also could serve as a disinterested agent to act on behalf of all of the estate's beneficiaries.

The concept of an estate representative is just one proposal; certainly, alternative or complementary legislative changes could create a more balanced playing field in chapter 11 cases. I discuss a few of these prospective changes here. Moreover, the concept of an estate representative is a preliminary proposal. Further research and study is necessary to develop this and related concepts.

I embarked on the empirical study underlying this article in the hope of gaining some insight into the practices and intentions of distressed debt investors. The data presented here fill this void, but expose other unanswered questions regarding the chapter 11 process. I introduce the role of distressed debt investors in chapter 11 cases in Part II of this article. I then discuss the methodology that I used in the empirical study in Part III, and I present the data in Part IV.

The data invite further study and dialogue regarding the constituencies in the chapter 11 process and their appropriate roles, as well as the appropriate role of the court and the statutory scheme itself. I seek to encourage this dialogue by analyzing the data and the implications in chapter 11 in Part V. I conclude in Part VI by describing the existing chapter 11 regime and the need to pursue a more estate-focused reorganization process.

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unnecessary dismemberment of viable corporations and to provide a maximum distribution to creditors who would be likely to receive nothing in the event of liquidation."); *see also* United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) ("By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners . . . . Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap.'").

[22] *See infra* Parts V and VI. For a discussion of the role of "neutrality" in the bankruptcy system, see Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 825–27 (2004). The estate-focused approach to chapter 11 discussed here would introduce aspects of neutrality to the debtor- or creditor-controlled process.

[23] The estate representative would not replace the debtor in possession or any individual creditors. Rather, each of these parties would maintain their respective rights and remedies under applicable law. The estate representative, however, would act as a fiduciary for the bankruptcy estate, charged with protecting and maximizing the value of the estate. *See infra* Part VI. In this respect, the estate representative is a variation of the "neutral manager" posited by Professor Westbrook. *See* Westbrook, *supra* note 22, at 825–27.

I. THE ROLE OF DISTRESSED DEBT INVESTORS IN THE CHAPTER 11 PROCESS

A distressed debt investor is an entity that purchases the debt of a financially troubled company at a discount against the face value of the debt.[24] The amount of the discount varies by situation, but can range from a low discount of 20% to a high discount of 60% or perhaps even 80%.[25] The investor seeks to make a profit on its investment primarily by reselling the debt, through recoveries on the debt in the restructuring process or by converting the debt into an equity position in the reorganized debtor.

The practice of distressed debt investing is not new; however, the market for distressed debt has expanded significantly since its inception.[26] Trade vendors no longer are the only creditors that desire to liquidate their claims against a debtor quickly. Rather, traditional financial institutions and long-term institutional investors, such as banks and insurance companies, are now quick to sell troubled credits.[27] Banks and other traditional lenders also are increasingly syndicating commercial loans at the outset.[28] These practices make it easy for traditional lenders

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[24] *See, e.g.*, FRANCOIS-SERGE L'HABITANT, HEDGE FUNDS: MYTHS AND LIMITS 100 (John Wiley & Sons, Inc., 2002); *see also* STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING 198 (John Wiley & Sons, Inc., 2001) ("After publicly traded bonds go into default, they typically trade at about 30 percent of their face value; the average discount for more junior bonds is even larger.").

[25] For example, before its restructuring, Kmart Corporation's bonds traded at approximately 20% of face value. *See* Joann Muller, *Kmart: A Fix-Up on Fast Forward*, BUS. WK., Oct. 14, 2002, *available at* http://www.businessweek.com/magazine/content/02_41/b3803095.htm (remarking bondholders will seek speedy reorganization so they can sell out and recoup loses). The law firm Jones Day represented the Financial Institutions' Committee in the Kmart chapter 11 case. I was a lawyer at Jones Day at the time, but did not work on the engagement. My husband also was a lawyer at Jones Day at the time and did actively work on the engagement. Nonetheless, my knowledge of, and all information in this article regarding, the Kmart cases is based on the publicly available sources cited.

[26] For a discussion of the history of the distressed debt market, see *The Vulture Investors*. HILARY ROSENBERG, THE VULTURE INVESTORS 16–19 (John Wiley & Sons, Inc., 2000) (detailing growth of "vultures" during 1980s, and how they had increased role in "restructuring of corporate America . . . ." and changed "dynamics of bankruptcy" so creditors have increased influence. By the late 1990s, the "vulture market had matured" so "new activist" players were raising money to invest in these "downtrodden companies . . . ."). *See also* Jay Krasoff & John O'Neill, *The Role of Distressed Investing and Hedge Funds in Turnarounds and Buyouts and How this Affects Middle-Market Companies*, J. PRIVATE EQUITY, Spring 2006, at 17 (explaining how distressed debt investing has long history, stretching as far back as moneychangers in Bible, and noting changes accompanying "credit-oriented hedge funds" becoming more "proactive in the distressed investing market and the accompanying restructuring process"). For a discussion of the growth in the market, see Heidi Moore, *Distressed Debt Fundraising Hits Record*, FIN. NEWS (ONLINE US), July 13, 2007. Ms. Moore's article states that "high leverage levels and sub-prime downgrades" created doubt with respect to credit markets, noting that distressed-debt firms raised more in the first six months of 2007 than at the end of 2006, and observing that some "firms are rushing to get part of the distressed-debt markets." *Id.*

[27] *See, e.g.*, Joe F. Lassiter, III, *The Marketability of Loans Under Alabama Law Where the Original Loan Documents Were Lost, Destroyed or Stolen*, 53 ALA. L. REV. 1289, 1291 (2002) ("Due to the costs associated with collecting and servicing problem loans, banks often utilize the secondary loan market to remove distressed debt from their books.").

[28] *See, e.g.*, EDWARD I. ALTMAN, NYU SALOMON CTR., ARE HISTORICALLY BASED DEFAULT AND RECOVERY MODELS IN THE HIGH-YIELD AND DISTRESSED DEBT MARKETS STILL RELEVANT IN TODAY'S CREDIT ENVIRONMENT? 3 (Oct. 2006), http://pages.stern.nyu.edu/~ealtman ("Syndicated lending has risen

and investors to exit, and hedge funds, private equity firms and other nontraditional lenders to enter, troubled situations.

The presence of nontraditional lenders in troubled situations changes the dynamics of corporate restructurings, including corporate chapter 11 cases. As one commentator observed, most distressed debt investors are "far less image conscious—they do not have the white-shoe, gentlemanly workout orientation of commercial banks, previously the biggest creditors in bankruptcies."[29] The concept of "relationship lending," where a bank would work with a troubled company to develop a mutually-agreeable restructuring plan to foster repeat business with the company, is now the rare exception rather than the rule. Most distressed debt investors are repeat players in the market, but not with respect to a particular company or management team.[30]

The upshot for troubled companies is that they now face increasing demands and pressures from their debt holders. Even before the filing of a chapter 11 case, the company may lose control of its restructuring process to one or more distressed debt investors. Investors may obtain this type of leverage over a company through contractual covenants, promises of post-bankruptcy financing, statutory rights under Article 9 of the Uniform Commercial Code or chapter 11 of the Bankruptcy Code or some combination of the foregoing.[31] The end result is a more creditor-controlled restructuring process.

Some commentators have suggested that this process replaces the traditional "debtor in possession" with a "creditor in possession."[32] They view increased creditor control in chapter 11 cases as a negative development that elevates the interests of one or a few creditors over those of the debtor and its other stakeholders, including junior creditors, shareholders and employees.[33] They also attribute premature liquidations of otherwise viable companies to enhanced creditor control.[34]

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more than 60 percent in the last three years and rose to total outstandings of $1.5 trillion in 2005"); Hugh Thomas & Zhiqiang Wang, *The Integration of Bank Syndicated Loan and Junk Bond Markets*, 28 J. BANK. & FIN. 299, 301–05 (2004) (discussing growth in loan syndication market).

[29] *Shareholder Recoveries Get Squeezed in Chapter 11*, CORP. FIN. WK., Nov. 19, 1990, at 1, *cited in* John D. Ayer, *1992 Survey of Books Relating to the Law*, 90 MICH. L. REV. 1584, 1601 n.74 (1992).

[30] *See* M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1568 (2007) ("We are repeat players, but not with [management]. At least we and they hope not.") (quoting distressed debt investor).

[31] *See* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing* 77 FORDHAM L. REV. __ (2008) (forthcoming) (discussing opportunities for creditor influence in corporate restructurings in United States and United Kingdom); *see also* GILSON, *supra* note 24, at 189–230 (discussing various strategies for investing in distressed debt).

[32] Miller & Waisman, *supra* note 2, at 152–56.

[33] *See id.* at 170 ("Excessive creditor control remains undesirable because such influence may cause the debtor's operations to be managed solely in the interests of the particular controlling creditor group, thereby foreclosing the debtor's restructuring options.").

[34] *See id.* ("[T]he provisions of a DIP agreement can constrain the debtor's flexibility and take away altogether the option of a possible successful reorganization, leaving a sale as the only viable alternative."); *see also* Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos In Delaware (And Elsewhere)*, 32 J. CORP. L. 491, 524–25 (2007); Miller &

Other commentators suggest that creditor control in chapter 11 cases is a welcome development that introduces market efficiencies into the restructuring process.[35] These commentators generally support a chapter 11 regime that reflects the market for corporate control.[36] Under this approach, contractual covenants that favor creditor control in distressed situations allow creditors to monitor and address management bias towards reorganization.[37] Creditors can better recognize the economic failure that often accompanies financial distress and facilitate a sale of the debtor's assets more efficiently than entrenched management.[38]

Whether creditor control is a positive or negative development turns, to some extent, on the creditor's intentions for, and use of, the control. For example, if the creditor is using its leverage to acquire the debtor for a price at or above an objective market value, then perhaps creditor control maximizes recoveries for all creditors and is an efficient result. If the creditor is not willing to pay a market price, however, or is interested only in a quick liquidation of its debt, regardless of the viability of the debtor, then perhaps creditor control frustrates both creditor recoveries and debtor rehabilitation.

Consequently, information regarding the strategies and practices of distressed debt investors is necessary to evaluate accurately the impact of creditor control—at least control exercised by this group of creditors—on the chapter 11 process. I sought to acquire this information through a written survey directed to certain institutional investors. The details and results of the survey are described below.

II. SURVEY METHODOLOGY

The title of the survey was "Trends in Distressed Debt Investing." The survey questions focused on the attributes of distressed debt investors and their targets and the investors' investment objectives and strategies. The primary purpose of the survey was to collect information to help assess the prevalence of distressed debt

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Waisman, *supra* note 2, at 170; Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935, 1950 (2004) (noting premature liquidations by influence of unsecured creditors "are becoming relics of the past").

[35] *See Private Debt, supra* note 1, at 1251 ("We view cautiously the new landscape in which creditor control has become a significant lever of corporate governance.").

[36] *See* Skeel, *supra* note 1, at 918 ("The endless negotiations and mind-numbing bureaucratic process that seemed to characterize bankruptcy in the 1980s have been replaced by transactions that look more like the market for corporate control."); *see also supra* note 1 (supporting notion that there has been increased role of creditors in corporate chapter 11 cases).

[37] *See, e.g., End of Bankruptcy, supra* note 1, at 785 ("As a comparative matter, the senior lender who will not be paid in full will more likely exercise control in a sensible fashion than will managers whose net worth depends on continuation or a bankruptcy judge whose training is usually not in business operations.").

[38] *See* Goldschmid, *supra* note 9, at 198 (discussing difference between financially distressed company and economically distressed company and whether creditors can in fact act as "true residual actor . . . capable of making this basic distinction in a balanced manner that would satisfy the public policy interest in economic efficiency").

investing and its impact on corporate restructurings in the United States and the United Kingdom.[39]

The survey efforts were coordinated with two other departments at the University of Nebraska-Lincoln—the Bureau of Sociological Research (BOSR) and the Survey, Statistics, and Psychometrics Core Facility (SSP). Specifically, SSP assisted in identifying an appropriate sample size and designing the survey questions. BOSR then assisted in administering the survey and collecting survey responses. To the extent possible, The Tailored Design Method of survey methodology was followed to enhance the rate and quality of responses.[40]

The survey consisted of 26 questions.[41] The first set of questions asked about the amount of the respondent's investments in distressed debt for 2006 and 2007, as well as its anticipated investments for 2008. The next set of questions focused on the investor's general investment practices, e.g., the primary objectives of its investments, its investment horizon, etc. The third set of questions related to the investor's investment strategies and whether it invests in distressed debt to attempt to influence board and management decisions or to acquire a controlling ownership interest in the company. The final set of questions asked about the investor's basic demographic information.[42] A copy of the survey is attached at Appendix A.

The survey was directed to institutional investors whose investment profiles indicated that they actively invest, or would be likely to invest, in distressed debt. Further, for purposes of the survey, the definition of "institutional investors" was limited to hedge funds and private equity firms.[43] Appendix B lists the databases and search terms used to identify the sample.

The final sample included 1,773 firms.[44] BOSR mailed an initial survey to the firms located within the United States on June 30, 2007, and to the firms located

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[39] *See* Harner, *supra* note 31 (survey study discussed here was conducted for purposes of this article and separate article that analyzes and compares impact of distressed debt investors on corporate restructurings in United States and United Kingdom).

[40] *See* DON A. DILLMAN, MAIL AND INTERNET SURVEYS 3–31, 323–51 (John Wiley & Sons, Inc., 2d ed. 2007) (explaining The Tailored Design Method).

[41] BOSR and SSP assisted in drafting the questions and answer options included in the survey. Comments on the survey questions and answers also were solicited from 15 restructuring professionals, including lawyers, financial advisers and former fund managers, to identify any potential ambiguities or omissions in the survey. The survey then was modified based on these comments. The final survey distributed to the sample included these modifications.

[42] The final question on the survey asked whether the respondent would be willing to participate in a follow up interview. Twenty-five percent of the respondents indicated that they would participate in such an interview. Nevertheless, as a result of funding and timing constraints, these interviews have not yet been conducted.

[43] In addition, certain banks with proprietary trading desks were identified as either a hedge fund or private equity firm in the databases used to identify the sample and thus were included in the sample.

[44] To identify an appropriate sample size, the following factors were considered: the number of investors known to invest in distressed debt, the number of other investors that might invest in distressed debt and the anticipated difficulty in getting this particular population to respond to a survey. An informal power analysis of the proposed study also was conducted. *See* Factors in Designing Statistical Power Analysis Studies, http://cc.uoregon.edu/cnews/summer2000/statpower.html (last visited Feb. 28, 2008) (explaining the power analysis technique); Pete Sedlmeier & Gerd Gigerenzer, *Do Studies of Statistical Power Have an Effect on the Power of Studies*, 105 PYSCHOL. BULL. 2, 309–16 (1989) *available at* http://library.mpib-

outside of the United States on July 2, 2007.[45] BOSR then employed several modes of communication to follow up with the sample during July, August and September 2007.[46] BOSR also collected and coded the data into a Statistical Package for the Social Sciences (SPSS) data file.[47]

Of the 1,773 firms included in the sample, 82 completed the survey; five indicated that they did not invest in distressed debt but completed the survey; and 253 indicated that they did not invest in distressed debt and thus did not complete the survey.[48] In addition, 24 firms refused to participate in the survey, three firms were no longer in business and 165 firms had no good working address. Of the 1,605 eligible survey participants (i.e., firms believed to be in business with good working addresses), 340 firms responded to the survey, resulting in a response rate of 21.2%. This response rate is an acceptable response rate for a written survey directed primarily to institutions.[49]

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berlin.mpg.de/ft/gg/GG_Do%20Studies_1989.pdf (studying the effect of power analyses on statistical studies); Robert A. Yaffee, *The Perils of Insufficient Statistical Power A Comparative Evaluation of Power and Sample Size Analysis Programs*, Sept. 1, 1997, http://www.nyu.edu/its/pubs/connect/archives/97fall/yaffeeperils.html (comparing power and sample size analyses).

[45] In addition to the survey, the mailing included a cover letter providing the option and directions to complete the survey online, a postage-paid envelope to return the paper version of the questionnaire, and a small notepad of paper as a token of appreciation for completing the survey. BOSR also provided international business reply envelopes to companies with mailing addresses outside of the United States.

[46] *See* DILLMAN, *supra* note 40, at 177–85 (suggesting procedures for follow-up contacts with sample). Copies of the postcard and email reminders are on file with the author. Specifically, BOSR mailed a postcard reminder to firms located within the United States on July 12, 2007, and to firms located outside of the United States on July 16, 2007. BOSR then sent four email reminders to non-respondents with email addresses listed in the sample database during July and August 2007. A final email reminder was sent on September 20, 2007. In addition, BOSR selected 117 firms to receive a telephone reminder. The telephone reminder was employed to try to increase responses from this sample, but no surveys were completed during the telephone calls. Consequently, no further telephone contact was made with non-respondents.

[47] *See* SPSS, Inc. Corporate FAQ's, http://www.spss.com/corpinfo/faqs.htm (providing information on software used to create and maintain data file). To facilitate this process, BOSR assigned each firm a unique identification number, or token, that allowed the respondent to access the online version of the survey. The token also made the process and results confidential. BOSR cleaned and checked the data and corrected known errors. The mail surveys produced some inconsistencies because respondents did not always follow the instructions for skip patterns or did not answer all of the survey questions. BOSR and SSP assisted in reconciling inconsistencies where possible. If an inconsistency could not be reconciled, the response was excluded from the data. SSP also assisted in recoding responses provided by respondents under the "other" category in Questions 5, 6, 9, 12, 17 and 25. Responses were recoded only if the respondent's open-ended answer satisfied one of the specified answer options to the particular question.

[48] Of the 87 completed surveys, 41 surveys were completed online and 46 surveys were completed by mail. No significant variations among the two different modes were observed, other than the increased likelihood for inconsistencies on the mail survey discussed at note 47. *See* DILLMAN, *supra* note 40, at 342–43 (suggesting mixed-mode survey design may enhance response rates in business context).

[49] *See id.* at 323 (noting "a review of 183 business surveys (in selected business journals published since 1990) revealed an average response rate of 21%"). The response rate was likely affected by several factors, including the secrecy prevalent in the distressed debt market. In addition, contact names were not provided for all of the firms; most of the firms likely have gatekeepers and thus no assurance exists that the survey ever reached the intended recipient, even if known; email addresses were not provided for all of the firms; and the survey was only available in English. *See id.* at 340 (listing some reasons typically given for low response rates in business surveys). These factors and the resulting non-response rate warrant some caution because the completed surveys may reflect a self-selection bias by respondents.

The survey results presented below are based on the 82 surveys completed by firms that indicated some investment experience in distressed debt. These 82 respondents are referred to here as the distressed debt respondents. As discussed below in Part IV.A, some of these firms did not invest in distressed debt during 2006 and 2007, and some do not anticipate investing in distressed debt in 2008. Accordingly, where possible, the presentation of the data denotes responses provided by these currently inactive distressed debt investors.[50]

Commentators suggest that the total number of distressed debt investors is relatively small. One commentator estimates the number of U.S.-based distressed debt investors at approximately 170.[51] Considering this observation and subject to the caveat regarding inactive distressed debt investors, the 82 distressed debt respondents arguably represent a meaningful percentage of investors in the distressed debt market.[52]

III. SURVEY DATA

As discussed above, the survey questions fall into four general categories: amounts invested in distressed debt on an annual basis; general investment practices; general investment strategies; and basic demographic information.[53] The survey data are presented according to these general categories.[54] For purposes of the survey, the term "distressed debt" was defined as "indebtedness of an entity that is experiencing, or that you expect to experience, financial distress, including indebtedness with a yield to maturity greater than 10% over the riskless rate of

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[50] *See infra* Part IV.

[51] EDWARD I. ALTMAN & JEFFREY SWANSON, NYU SALOMON CTR., THE INVESTMENT PERFORMANCE AND MARKET SIZE OF DEFAULTED BONDS AND BANK LOANS: 2006 REVIEW AND 2007 OUTLOOK 3 (2007), http://pages.stern.nyu.edu/~ealtman/2006%20InvestPerf.pdf (estimating number of distressed securities investment institutions at 170 with combined assets of over $250 billion, claiming this number has doubled in just a few years).

[52] Of the 82 distressed debt respondents, 75% indicated that they are U.S.-based firms.

[53] As noted above, the survey data were coded into a SPSS data file. The data were analyzed using SPSS frequency and cross-tabulation tables.

> Frequencies are basically the breakdown of actual responses for each item, e.g., 30% said 'yes' and 70% said 'no' to a particular question. Cross-tabulations are the frequency breakdowns for a particular value of an item, e.g., all female responses to an item compared to all male responses to that same item.

Federal Court Survey, *2004–2005 Assessment of the Services of the United States District Court for the District of North Dakota*, 81 N.D. L. REV. 235, 241 (2005) (explaining SPSS database and analytical tools in context of federal court survey).

[54] This article focuses on key data concerning distressed debt investors' practices and strategies with respect to distressed debt. A complete report of the survey results is on file with the author.

return."[55] In addition, the term "firm" was defined as "your firm, management company or fund, as applicable."[56]

The survey data presented here are based on the number of valid responses to each survey question and the corresponding valid percentages. Each of the 82 distressed debt respondents did not respond to each of the survey questions. The number of valid responses thus varies by question. The number of distressed debt respondents responding to each question is identified in the relevant text or the accompanying footnotes.

A. Amounts Invested in Distressed Debt

The survey first asked respondents to disclose the level of their investments in distressed debt for 2006 and 2007.[57] Of the 82 distressed debt respondents, 55 firms (67.1%) invested at least one percent of their total assets in distressed debt in either 2006 or 2007. The breakdown of the assets invested in distressed debt by these firms is set forth in Table 1.

Table 1: Distressed Debt Investing: 2006–2007

Frequency (Valid %) for Percentage of Assets Invested (Valid N = 55)

	1–10%	**11–25%**	**26–50%**	**51–75%**	**76–100%**
2006	28 (50.9%)	12 (21.8%)	8 (14.5%)	2 (3.6%)	5 (9.1%)
2007	26 (47.3%)	13 (23.6%)	8 (14.5%)	3 (5.5%)	5 (9.1%)

The survey also asked respondents to indicate their anticipated level of investment in distressed debt for 2008.[58] Of the 82 distressed debt respondents, 44 firms (53.7%) indicated that there would be no change in their distressed debt investing in 2008, 30 firms (36.6%) indicated that their distressed debt investing would increase in 2008, and three firms (3.7%) indicated that their distressed debt investing would decrease in 2008. Five firms (6.1%) did not provide information about their 2008 investments.

Seventy-four of the 82 distressed debt respondents provided information regarding both their 2007 and their 2008 investments. These data generate additional information that is useful in analyzing possible activity in the distressed

[55] *See infra* Appendix A. The survey used a broad definition for the term "distressed debt." The term itself is subject to multiple definitions and may imply only defaulted debt or indebtedness with a yield to maturity of 1,000 basis points over the riskless rate of return. *See* Harner, *supra* note 31, at Part II.A.1.

[56] *See infra* Appendix A.

[57] *See infra* Appendix A, Questions 1, 2.

[58] *See infra* Appendix A, Question 3.

debt market in 2008.[59] Specifically, a cross-tabulation of these data indicates the following: (i) 49 firms (66.2%) will maintain or increase their investments in distressed debt in 2008 while three firms (4.1%) investing 11–25% of their assets in 2007 will decrease their investments in distressed debt in 2008; and (ii) three firms (4.1%) not investing in 2007 will participate in distressed debt investing in 2008 while the remaining 19 firms (25.7%) will continue not to invest in distressed debt in 2008.[60]

B. Investment Practices

The second set of questions in the survey focused on the investment practices of the respondents.[61] Of the 82 distressed debt respondents, 61 firms (74.4%) responded to the question asking firms to identify their primary investment practice with respect to distressed debt while 21 firms (25.6%) did not. Of those responding, 32 firms (52.5%) indicated that their primary investment practice is to pursue an exchange of the debt for equity, 12 firms (19.7%) indicated that their primary investment practice is to sell the debt before maturity or redemption, 10 firms (16.4%) indicated that their primary investment practice is to pursue payment of the debt at maturity or redemption, three firms (4.9%) indicated that their primary investment practice included all three of the above, and four firms (6.6%) indicated that they do not have a primary investment practice.[62]

The survey also asked respondents to identify their secondary investment practice with respect to distressed debt. The results for this question are very similar to that above for respondents' primary investment practice. In particular, of the 59 responding firms, 26 firms (44.1%) indicated that their secondary investment practice is to sell the debt before maturity or redemption, 18 firms (30.5%) indicated that their secondary investment practice is to pursue an exchange of the debt for equity, nine firms (15.3%) indicated that their secondary investment practice is to pursue payment of the debt at maturity or redemption, four firms (6.8%) indicated that their secondary investment practice includes all three of the above, and two firms (3.4%) indicated that do not have a secondary investment practice.[63]

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[59] Although it is impossible to predict future activity with any accuracy, the data and related cross-tabulations provide information regarding the respondents' intended investment activity in 2008.

[60] This analysis is based on a cross-tabulation of the responses to Questions 2 and 3 provided by the 74 distressed debt respondents answering both of these questions.

[61] *See infra* Appendix A, Questions 5, 6.

[62] Four of the firms that indicated their primary investment practice as an exchange of the debt for equity can be classified as inactive distressed debt investors. *See supra* note 50 and accompanying text.

[63] Of the 82 distressed debt respondents, 59 firms (72%) provided their secondary investment practice of distressed debt investing while 23 firms (28%) did not. In addition, four of the firms that indicated their secondary investment practice as the sale of the debt before maturity or redemption and one of the firms that indicated their secondary investment practice as an exchange of the debt for equity can be classified as inactive distressed debt investors. *See supra* note 50 and accompanying text.

A key aspect of a distressed debt investor's investment practices is its investment horizon. An investor's investment horizon generally indicates how long the investor is willing to maintain a debt or equity position in a company before liquidating the investment. The investment horizons of the distressed debt respondents are set forth in Table 2.[64]

Table 2: Investment Horizons of Distressed Debt Investors

Investment Horizon	**Frequency (Valid %) for Holding Before Selling or Receiving Payment on Debt (Valid N = 50)**	**Frequency (Valid %) for Holding Equity After Debt-for-Equity Exchange (Valid N = 48)**
Less than 3 months	1 (2%)	3 (6.3%)
3-6 months	4 (8%)	7 (14.6%)
7-9 months	0 (0%)	4 (8.3%)
10-12 months	12 (24%)	5 (10.4%)
13-18 months	13 (26%)	10 (20.8%)
19-24 months	6 (12%)	4 (8.3%)
25-36 months	8 (16%)	9 (18.8%)
37-48 months	2 (4%)	3 (6.3%)
More than 48 months	4 (8%)	3 (6.3%)

The final questions in this part of the survey asked respondents about their preferred type of debt investment and whether they invested in multiple tranches of a single company's debt. Of the 82 distressed debt respondents, 58 firms (70.7%) responded to the question asking firms to identify their preferred debt investment while 24 firms (29.3%) did not. Of those responding, 20 firms (34.5%) indicated that their first choice for investment purposes is senior secured bank debt, 15 firms (25.9%) answered high yield bonds, nine firms (15.5%) answered mezzanine loans, two firms (3.4%) answered second lien bank debt, one firm (1.7%) answered trade debt, six firms (10.3%) answered all of the foregoing, two firms (3.4%) identified a type of debt not listed in the responses and three firms (5.2%) responded none.[65] Notably, 49 firms (77.8%) indicated that they invest in more than one tranche of a company's debt more than 1% of the time.[66]

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[64] *See infra* Appendix A, Questions 7, 8. With respect to Question 7, 50 of the distressed debt respondents (61%) responded to this question while 32 firms (39%) did not provide a response. With respect to Question 8, 48 of the distressed debt respondents (58.5%) responded to this question while 34 firms (41.5%) did not provide a response.

[65] *See infra* Appendix A, Question 9.

[66] *See infra* Appendix A, Question 10. Sixty-three of the distressed debt respondents (76.8%) responded to this question while 19 firms (23.2%) did not provide a response.

C. Investment Strategies

The core of the survey focused on the investment strategies of distressed debt investors. Specifically, these questions relate to whether the respondents use their distressed debt holdings to attempt to influence board and management decisions and whether they invest in distressed debt to try to acquire a controlling ownership interest in the issuing company.

1. Use of Distressed Debt to Influence

The first question in this part asked respondents, "How often (on average) does your firm use its position in a company's distressed debt to try to influence board or management decisions at the company (such as by invoking covenant, default or other rights associated with the debt instrument)?"[67] Of the 82 distressed debt respondents, 55 firms (67.1%) indicated whether or not they use their distressed debt holdings for this purpose. Nineteen firms (23.2%) did not provide a response to this question and the remaining eight firms (9.8%) provided inconsistent responses to this question and a question assessing the success of their attempts. Of the 55 firms responding to this question without any inconsistencies, 36 firms (65.5%) indicated that they engage in this practice at least 1% of the time while the remaining 19 firms (34.5%) indicated that they never engage in this practice.[68]

Notably, of the 36 firms willing to use their distressed debt holdings to try to influence change at the company, 33 firms responded to a question regarding their estimated success rate. Eighteen of these firms (54.5%) indicated that, based on past attempts, they are successful in bringing about change at least 50% of the time.[69] A breakdown of the distressed debt respondents' attempts to influence, and their success at influencing, board and management decisions through distressed debt investments is set forth in Table 3.

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[67] *See infra* Appendix A, Question 11.

[68] One of the firms that indicated it uses its distressed debt investments to try to influence board or management decisions between 1–10% of the time can be classified as an inactive distressed debt investor. *See supra* note 50 and accompanying text.

[69] *See infra* Appendix A, Question 13; *infra* Table 7 (reporting cross-tabulations for 36 respondents indicating willingness to use their distressed debt holdings to try to influence change at company).

Table 3: Attempts to Influence and Success Rate[70]

q11 How often does your firm use position in DD to influence board or management decisions at the company * q13 How often is your firm successful influencing board or management decisions through DD investments Crosstabulation

Count

		q13 How often is your firm successful influencing board or management through DD investments						
		1 1–10% of the time	2 11–25% of the time	3 26–50% of the time	4 More than 50% of the time	5 Never	6 Do not use investments for such purposes.	Total
q11 How often does your firm use position in DD to influence board or management decisions at the company	1 1–10% of the time	3	1	2	2	0	0	8
	2 11–25% of the time	0	0	4	3	0	0	7
	3 26–50% of the time	0	2	2	3	0	0	7
	4 More than 50% of the time	1	0	0	10	0	0	11
	5 Never	0	0	0	0	4	13	17
Total		4	3	8	18	4	13	50

This set of questions also asked respondents to identify the types of board and management decisions that they seek to influence. The results of this question suggest that respondents use their distressed debt investments first to try to influence the company's operational strategies and asset holdings, and second to try to change management personnel or influence the company to file for bankruptcy.[71]

2. Investing in Distressed Debt to Acquire Ownership

With respect to ownership strategies, the survey asked respondents, "How often (on average) does your firm invest in a company's distressed debt to try to acquire the company or a controlling ownership position in the company?"[72] Of the 82 distressed debt respondents, 64 firms (78.0%) provided a response to this question while 15 firms (18.3%) did not. Three firms (3.7%) provided inconsistent responses to this question and a question assessing the success of their attempts. Of the 64 firms responding to this question without any inconsistencies, 26 firms (40.1%) indicated that they engage in this practice at least 1% of the time while 38 firms (59.4%) indicated that they never engage in this practice.[73]

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[70] Table 3 includes only 50 distressed debt respondents because five firms that responded to Question 11 did not respond to Question 13. One of the firms that indicated it is successful in its attempts to use its distressed debt investments to try to influence board or management decisions between 11–25% of the time can be classified as an inactive distressed debt investor. *See supra* note 50 and accompanying text.

[71] *See infra* Appendix A, Question 12. Respondents were asked to identify all strategies for trying to influence change at a troubled company through their distressed debt investments. Twenty-nine firms indicated that they try to influence assets acquisitions and dispositions or operational decisions; 24 firms indicated that they try to influence management personnel or the filing of a bankruptcy or administration case; 22 firms indicated that they try to influence board composition; 20 firms indicated that they try to influence management compensation; one firm indicated that they use all strategies; and 23 firms indicated that they do not use any of the strategies.

[72] *See infra* Appendix A, Question 14.

[73] One of the firms that indicated it uses its distressed debt investments to try to acquire a controlling ownership interest in the company between 26–50% of the time can be classified as an inactive distressed debt investor. *See supra* note 50 and accompanying text.

Similar to the predicted success rate for influencing company change discussed above, approximately one-half of the distressed debt respondents indicating that they attempt to acquire an ownership interest in the company also stated that they are successful in these attempts at least 50% of the time.[74] A breakdown of the distressed debt respondents' attempts to acquire, and their success in acquiring, an ownership interest in the company is set forth in Table 4.

Table 4: Attempts to Acquire and Success Rate[75]

q14 How often does your firm invest in a company's DD to try to acquire the company or controlling ownership * q15 How often is your firm successful in acquiring at least a controlling ownership position Crosstabulation

Count

		q15 How often is your firm successful in acquiring at least controlling ownership position					
		1 1–10% of the time	2 11–25% of the time	4 More than 50% of the time	5 Never	6 Do not use investments for such purposes.	Total
q14 How often does your firm invest in a Company's DD to try to acquire the company or controlling ownership	1 1–10% of the time	4	0	0	6	0	10
	2 11–25% of the time	0	1	3	0	0	4
	3 26–50% of the time	0	1	1	0	0	2
	4 More than 50% of the time	0	0	9	0	0	9
	5 Never	0	0	0	8	27	35
Total		4	2	13	14	27	60

This set of questions also asked respondents to identify their approach to management and board personnel after an acquisition. The results of this question suggest that respondents first prefer to work with existing management and second to replace certain key members of management in these circumstances.[76] Table 5 sets forth the respondents' answers to the question, "How often (on average) does your firm seek to obtain control of the board of directors of a company in which it acquires an ownership interest through distressed debt investments?"

[74] *See* Appendix A, Question 15; *see also infra* Table 8 (reporting cross-tabulations for 26 respondents indicating willingness to use their distressed debt holdings to acquire ownership interest in company).

[75] Table 4 includes only 60 distressed debt respondents because four firms that responded to Question 14 did not respond to Question 15. One of the firms that indicated it is successful in its attempts to acquire a controlling ownership interest in the company between 11–25% of the time can be classified as an inactive distressed debt investor. *See supra* note 50 and accompanying text.

[76] *See infra* Appendix A, Question 17. Respondents were asked to identify all strategies used with respect to management of a company acquired through distressed debt investments. Thirty-six firms indicated that they seek to work with existing management; 30 firms indicated that they replace certain key members of management; and 18 firms indicated that they either replace management in its entirety or take a hands off approach to management.

Table 5: Attempts to Acquire Control of Board of Directors[77]

	Frequency (Valid %) (Valid N = 63)
1–10% of the time	7 (11.1%)
11–25% of the time	6 (9.5%)
26–50% of the time	4 (6.3%)
More than 50% of the time	10 (15.9%)
Never	36 (57.1%)

D. Basic Demographics

The last set of questions asked about the respondents' basic demographic information.[78] The majority of the respondents indicating the location of their firms, 56 firms (74.7%), are U.S.-based firms, with 9 firms (12%) being located in the United Kingdom and 10 firms (13.3%) being located elsewhere.[79] Likewise, the largest percentage of the respondents (36.6%) invests primarily in U.S.-based companies, with 2.8% investing only in U.K.-based companies and 31% investing in both U.S.- and U.K.-based companies.[80] Notably, 35 (44.9%) of the respondents identified themselves as hedge funds, 33 (42.3%) identified themselves as private equity firms, three (3.8%) identified themselves as venture capitalists, one (1.3%) identified itself as a bank and six (7.7%) identified a different characterization.[81]

The survey also gathered information about the estimated value of the assets managed by the respondents and the average yearly revenue of the companies in which the respondents invest.[82] The results of these questions are set forth in Table 6.

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[77] *See infra* Appendix A, Question 18. Sixty-three of the distressed debt respondents (76.8%) responded to this question while 19 firms (23.2%) did not provide a response.

[78] *See infra* Appendix A, Questions 23, 24, 25.

[79] Seventy-five of the distressed debt respondents (91.5%) responded to this question while seven firms (8.5%) did not provide a response.

[80] Seventy-one of the distressed debt respondents (86.6%) responded to this question while 11 firms (13.4%) did not provide a response.

[81] Seventy-eight of the distressed debt respondents (95.1%) responded to this question while four firms (4.9%) did not provide a response.

[82] *See infra* Appendix A, Questions 21, 22. With respect to Question 21, 71 of the distressed debt respondents (86.6%) responded to this question while 11 firms (13.4%) did not provide a response. With respect to Question 22, 54 of the distressed debt respondents (65.9%) responded to this question while 28 firms (34.1%) did not provide a response.

Table 6: Managed Assets and Company Revenue

	Frequency (Valid %) for Estimated Value of Assets Managed by Firm (Valid N = 71)	**Frequency (Valid %) for Average Yearly Revenue of Companies in Which Firms Invest (Valid N = 54)**
Less than $50 million	10 (14.1%)	9 (16.7%)
$50–499 million	22 (31%)	21 (38.9%)
$500–999 million	10 (14.1%)	15 (27.7%)
More than $1 billion	29 (40.8%)	9 (16.7%)

IV. ANALYSIS OF DATA

The data provide insight into the investment practices and strategies of some distressed debt investors. I exercise caution in generalizing the data for the entire sample because of potential response bias and the deal-specific nature of many investment decisions. Nevertheless, reported restructurings involving distressed debt investors and an industry study regarding investors' expectations for the distressed debt market in 2007 suggest that the data are meaningful and generally representative of many distressed debt investors.[83]

Notably, only 82 of the 340 respondents (24%) indicated some experience with distressed debt investing. This percentage suggests that distressed debt investing continues to be a specialized investment strategy that is not pursued by most institutional investors.[84] This percentage also is consistent with the existing

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[83] *See* chapter 11 cases discussed in Parts V.B. and V.C.; Harner, *supra* note 31, at Part III (case studies of Allied Holdings, Inc., Kmart Corporation, Schefenacker plc and Jarvis plc restructurings); *see also North American Distressed Debt Market Outlook 2007*, DEBTWIRE (Jan. 2007) (on file with author) [hereinafter *Distressed Debt Market Outlook*]. The *Distressed Debt Market Outlook* surveyed 106 hedge funds and proprietary trading desks via telephone interviews in November 2006. *Id.* at 1. The interviews focused on the respondents' expectations for the distressed debt market in 2007. *Id.* The *Distressed Debt Market Outlook* survey overlaps with the survey discussed here primarily on the loan-to-own issue. For example, the *Distressed Debt Market Outlook* survey reports that approximately 5–10% of respondents include a loan-to-own strategy in their core investment practices and that approximately 35% of respondents pursue this strategy on an exceptional basis. *Id.* at 20. Moreover, 40% of the remaining respondents indicated that they do not "seek equity control via a 'loan to own' strategy," but "are interested in acquiring non-control positions via debt-for-equity swaps." *Id.* The *Distressed Debt Market Outlook* survey, however, does report a higher percentage of respondents, approximately 52%, lending directly to companies. *Id.* at 10. This difference may relate to the financial condition of the company borrower. The survey discussed here focused on direct lending to "troubled companies," whereas the *Distressed Debt Market Outlook* survey does not qualify the question in this respect.

[84] *See* Henderson, *supra* note 30, at 1568 & n.127 ("While the market for the debt and trade claims of distressed firms is growing, it remains a small component of traditional debt and equity markets, and is inhabited largely by firms that specialize in this type of investing.").

literature that places the number of U.S.-based distressed debt investors at approximately 170 firms.[85]

A. Activist Investor Profiles

The data clearly show that some distressed debt investors are activist investors. They are using their positions in a troubled company's debt, rather than (or perhaps in addition to) the company's equity, to try to influence change at or to acquire the company.[86] This finding in and of itself is not new or novel.[87] Nevertheless, the details concerning the practices and strategies of activist investors included in the data provide new information that furthers our understanding of these investors and our analysis of their impact on corporate restructurings.

For example, the data provide information about the specific investment strategies and target companies of distressed debt investors. This type of information is not generally available for most distressed debt investors because of the proprietary nature of the information and investors' desire to keep the information confidential.[88] The survey results offer some insight into the often closed practices of distressed debt investors.

The data are generally descriptive in nature, but their utility is enhanced with cross-tabulations.[89] Using cross-tabulations, two investor profiles were generated—one of an investor that uses its distressed debt holdings to try to influence change at a company and one of an investor that uses its distressed debt holdings to try to acquire the company.[90] These profiles are not intended to predict future investment

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[85] *See* ALTMAN & SWANSON, *supra* note 51, at 3 (listing some strategies used by these 170 or so institutional investors, including: traditional passive buy-and-hold and arbitrage plays, direct lending to distressed companies, active-control elements, foreign investing, emerging equity purchases, and even equity plays while the firms are going through reorganization in bankruptcy).

[86] Distressed debt investors may pursue investment strategies in a company's debt and equity simultaneously. *See* Donna Klinger, *Here Be Dragons*, NACUBO BUS. OFFICER, Apr. 2002, at 33 (explaining "distressed arbitrage" as investing that "involves purchasing publicly traded bonds of bankrupt companies and selling their common stock short").

[87] *See, e.g.*, L'HABITANT, *supra* note 24 (discussing distressed debt investment practices of hedge funds); ROSENBERG, *supra* note 26 (discussing early instances of distressed debt investor activism); Hotchkiss & Mooradian, *supra* note 9 (providing empirical support for activist tendencies of distressed debt investors); *see also* Goldschmid, *supra* note 9, at 204 (detailing distressed debt investor involvement in chapter 11 cases in 2001–2002).

[88] *See* Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1738 & n.261 (1996) (explaining "market for distressed securities is completely private" and information regarding transactions in this market is "strictly confidential"); Charles Duhigg, *Can Private Equity Build a Public Face?*, N.Y. TIMES, Dec. 24, 2006, at 1 ("'Secrecy gives you access to private information. It lets you bid on companies before the competition is aware they are for sale. Secrecy is part of how this industry works.'") (quoting Professor Henry T. Hu); *see also supra* notes 5–7.

[89] *See supra* note 53 (discussing SPSS analytical tools).

[90] The investor profile set forth in Table 7 is based on cross-tabulations of the responses to Question 11 with those to Questions 1, 2, 3, 5, 7, 8, 9, 10, 12, 13, 16, 21, 22, 23 provided by the 36 distressed debt respondents indicating that they use their distressed debt holdings to try to influence board and management decisions at the company at least 1% of the time. The investor profile set forth in Table 8 is based on cross-tabulations of the responses to Question 14 with those to Questions 1, 2, 3, 5, 7, 8, 9, 10, 15, 16, 21, 22, 23

activity. Rather, the profiles provide a snapshot view of the characteristics of each type of investor based on the survey responses. These profiles are set forth in Tables 7 and 8.

Table 7: Profile of Investor Using Debt to Influence[91]

	Response with Highest Frequency (Valid %)	**Response with Second Highest Frequency (Valid %)**	**Valid N**
Percentage of Assets Invested in 2006	1–10% of assets (37.1%)	11–25% of assets (31.4%)	35
Percentage of Assets Invested in 2007	1–10% of assets (37.1%)	11–25% of assets (22.9%)	35
Anticipated Investment in 2008	Increase Investment (58.8%)	No Change (38.2%)	34
Primary Investment Practice	Exchange Debt for Equity (61.8%)	Sale Debt Before Maturity or Redemption (17.6%)	34
Investment Horizon for Selling Debt	13–18 months (32.3%)	10–12 months (22.6%)	31
Investment Horizon for Converting Debt to Equity	13–18 months (25.8%)	10–12 months (16.1%)	31
Preferred Type of Debt	Senior Secured Bank Debt (31.3%)	High-Yield Bonds (25%)	32
Multiple Tranche Investments	Yes, 1–10% of the time (34.3%)	Yes, 26–50% of the time (31.4%)	35
Preferred Decisions to Influence	Operational Strategy (72.2%); Asset	Management Personnel (58.3%) Bankruptcy Filing	N/A

provided by the 26 distressed debt respondents indicating that they invest in distressed debt to try to acquire the company or a controlling ownership interest in the company at least 1% of the time.

[91] Of these 36 firms, the average assets under management for the firms indicating that they invested between 1–10% of their assets in distressed debt investments in 2006 and 2007 is between $2–5.2 billion and $3–7.3 billion, respectively.

	Acquisitions/Dispositions (72.2%)	(58.3%)	
Success in Influencing	More than 50% of the time (54.5%)	16–50% of the time (24.2%)	33
Coordinate Efforts with Others	Yes, 11–25% of the time (28.1%)	Yes, 26–50% of the time (21.9%)	32
U.S. or U.K. Investments	U.S. (52.8%)	Both U.S. and U.K. (36.1%)	36
Value of Assets Managed by Firm	More than $1 billion (41.2%)	$100–249 million (20.6%)	34
Annual Revenue of Target Companies	$100–249 million (24.1%)	More than $1 billion (20.7%); $500–749 million (20.7%)	29

Table 8: Profile of Investor Using Debt to Acquire[92]

	Response with Highest Frequency (Valid %)	**Response with Second Highest Frequency (Valid %)**	**Valid N**
Percentage of Assets Invested in 2006	1–10% of assets (36%)	11–25% of assets (24%)	25
Percentage of Assets Invested in 2007	1–10% of assets (48%)	None (16%)	25
Anticipated Investment in 2008	Increase Investment (53.8%)	No Change (38.5%)	26
Primary Investment Practice	Exchange Debt for Equity (68%)	Sale Debt Before Maturity or Redemption (20%)	25
Investment Horizon for Selling Debt	13–18 months (23.8%)	3–6 months (19%); 10–12 months (19%)	21

[92] Of these 26 firms, the average assets under management for the firms indicating that they invested between 1–10% of their assets in distressed debt investments in 2006 and 2007 is between $2.7–6.7 billion and $3–7.2 billion, respectively.

Investment Horizon for Converting Debt to Equity	13–18 months (26.1%)	25–36 months (21.7%)	23
Preferred Type of Debt	Senior Secured Bank Debt (37.5%)	High-Yield Bonds (20.8%); Mezzanine Loans (20.8%)	24
Multiple Tranche Investments	Yes, 1–10% of the time (34.6%)	Yes, 26–50% of the time (26.9%)	26
Success in Acquiring Company	More than 50% of the time (52%)	Never (24%)	25
Coordinate Efforts with Others	Yes, 11–25% of the time (29.2%)	Yes, 26–50% of the time (25%)	24
U.S. or U.K. Investments	U.S. (61.5%)	Both U.S. and U.K. (19.2%)	26
Value of Assets Managed by Firm	More than $1 billion (42.3%)	$250–499 million (19.2%)	26
Annual Revenue of Target Companies	$100–249 million (27.3%)	$500–749 million (18.2%); $50–99 million (18.2%)	22

These investor profiles indicate that activist distressed debt investors intend to continue their investments in distressed debt at current or increased levels in 2008. Consequently, the debate regarding the value of creditor control in chapter 11 cases is likely to continue. I discuss my general observations regarding the data and the implications in the chapter 11 context below.

B. General Observations

I draw three key inferences from the data. First, the practices of activist distressed debt investors may lead to potential conflicts among creditors in the chapter 11 context. Second, activist distressed debt investors seek to exert control over the company, placing the company's board and management in a difficult position. Finally, the number of investors that actually seek to acquire a controlling ownership interest in the debtor—either through their distressed debt holdings or direct loans—is relatively small. These investors, however, possess the financial resources to influence the restructuring market.

1. Potential Conflicts Among Investors

Distressed debt investors with different investment strategies but the same investment target may lead to potential conflicts among creditors. For example, 36 of the distressed debt respondents indicated that they use their distressed debt holdings to influence board and management decisions—i.e., they are activist investors.[93] These respondents further indicated a willingness to use one or more means to exert influence, including replacing members of the board and management team. If, as is likely, more than one investor holds the distressed debt of the same company, a conflict in approach may preclude either from being successful and, in the process, may damage the company.[94]

Examples of possible conflicts among investors include one investor wanting to sell the business to a third party and one investor wanting to acquire the company through a debt for equity exchange. As the data show, 22 of the distressed debt respondents pursue a sale of or payment on the debt as their primary investment objective while 32 of the distressed debt respondents pursue a debt for equity exchange.[95] Alternatively, two different investors holding two different tranches of debt may want to implement a debt for equity exchange involving only its tranche of debt.[96] Both investors cannot win.

The restructurings of American Remanufacturers, Inc. and FiberMark, Inc. are two examples of this type of conflict among investors.[97] In American Remanufacturers, the debtor's senior secured lender and two of its junior debtholders disagreed on the appropriate restructuring path for the debtor. The senior secured lender wanted to extend post-petition financing to the debtor and

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[93] *See supra* Part IV.C.

[94] *See* Goldschmid, *supra* note 9, at 204 (identifying 24 chapter 11 cases during 2001–2002 involving distressed debt investors, with 20 of these cases involving more than one distressed debt investor).

[95] *See supra* Part IV.B.

[96] This type of conflict between distressed debt investors developed in the restructuring of Vantico Group S.A., a European-based global epoxy resin producer. The distressed debt investors held different tranches of Vantico's debt and each favored a restructuring plan that would convert its tranche of debt into equity, leaving the other tranche of debt in place. *See* Goldschmid, *supra* note 9, at 262 (describing Vantico conflict).

[97] The Adelphia Communications Corp. consolidated chapter 11 case is another good example of this type of conflict. Adelphia and its subsidiaries filed for chapter 11 protection in 2002. The Adelphia debtors filed four different plans of reorganization, with their fourth amended plan, filed in November 2005, proposing a sale of substantially all of their assets to Time Warner NY Cable LLC. *See* Debtors' Mot. Pursuant to Sections 105, 363, 365 and 1146(c) of the Bankruptcy Code, at 4–13, *In re* Adelphia Commc'ns Corp., No. 02-41729(REG), slip op. (Bankr. S.D.N.Y. May 26, 2006). Disputes among the debtors' various creditor and equity holder groups, however, prevented the debtors from pursuing any of these plans. *See id.*; *see also In re* Adelphia Commc'ns Corp., 359 B.R. 54, 58–59 (Bankr. S.D.N.Y. 2006) (detailing certain aspects of intercreditor disputes). The intercreditor disputes delayed the debtors' chapter 11 cases for over four years and delayed the sale of the debtors' assets to Time Warner for almost one year. The debtors ultimately sought and received bankruptcy court approval of the sale separate and apart from a plan of reorganization in June 2006. *See In re* Adelphia Commc'ns Corp., No. 02-41729, slip op. (Bankr. S.D.N.Y. June 28, 2006). The bankruptcy court confirmed the debtors' fifth plan of reorganization on January 5, 2007. *See In re* Adelphia Commc'ns Corp., No. 02-41729, slip op. (Bankr. S.D.N.Y. Jan 5, 2007).

then credit bid this position in a quick sale of the debtor.[98] The two junior debtholders wanted to serve as the debtor's post-petition lenders and pursue a standalone restructuring plan for the debtor.[99] The delay and expense created by the creditor dispute forced the debtor into a chapter 7 liquidation.[100]

Likewise, in FiberMark, a dispute over post-confirmation control of the debtor developed among three distressed debt investors appointed to the creditors' committee. According to the examiner's report filed in the case, this intercreditor dispute delayed the debtor's plan confirmation and reduced the value available to pay unsecured creditors by $60 million.[101] The parties ultimately settled their dispute. Under the settlement, two of the investors sold their debt to the third investor, thereby ceding control of the reorganized debtor to the third investor.[102]

In addition, the activist investor profiles set forth above report investor practices that may lead to conflicts of interest for the individual investor. For example, the profiles suggest that these investors are diversified, investing only a percentage of their assets under management in distressed debt.[103] To the extent these investors are investing in equity positions that include the equity of their distressed debt issuers, a potential conflict of interest exists that may impact how they try to influence management decisions.[104] The majority of these investors also frequently invest in more than one tranche of the company's debt.[105] Again, this multi-investment approach may lead to potential conflicts of interest. The investor may choose to influence or acquire the company in a manner that benefits one tranche of the company's debt, to the potential detriment of others. Although the investor does

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[98] *See* Mot. for an Order Pursuant to Sections 361, 363 and 364 of the Bankruptcy Code (1) Authorizing the Debtors to Obtain Postpetition Financing, (2) Authorizing the Use of Cash Collateral, (3) Authorizing Repayment of Certain Prepetition Secured Debt, (4) Granting Liens and Superpriority Administrative Expense Status, (5) Providing Adequate Protection and (6) Scheduling and Approving the Form and Method of Notice of Final Hr'g, *In re* Am. Remfr.s, Inc., No. 05-20022(PJW), slip op. at 7 (Bankr. D. Del. Nov. 7, 2007).

[99] *See* Objection of DDJ Capital Management, LLC and Arlie Opportunity Master Fund Ltd. to the Debtors' Mot. for an Order Pursuant to Sections 361, 363 and 364 of the Bankruptcy Code (1) Authorizing the Debtors to Obtain Postpetition Financing, (2) Authorizing the Use of Cash Collateral, (3) Authorizing Repayment of Certain Prepetition Secured Debt, (4) Granting Liens and Superpriority Administrative Expense Status, (5) Providing Adequate Protection and (6) Scheduling and Approving the Form and Method of Notice of Final Hr'g, *In re* Am. Remfr.s, Inc., No. 05-20022(PJW), slip op. (Bankr. D. Del. Nov. 9, 2007).

[100] *See In re* Am. Remfr.s, Inc., No. 05-20022(PJW), slip op. (Bankr. D. Del. Nov. 17, 2007) (converting chapter 11 cases to chapter 7 cases); *see also* David Peress & Thomas C. Prinzhorn, *Nontraditional Lenders and the Impact of Loan-to-Own Strategies on the Restructuring Process*, 25 AM. BANKR. INST. J 48, 57–58 (Apr. 2006) ("After four days of confusing disputes about definitions of third parties, priming and subordination, the company lawyers informed the court that the company had run out of cash and converted to a chapter 7 petition.").

[101] *See* Report of Harvey R. Miller, as Examiner, *In re* FiberMark, Inc., No. 04-10463, slip op. at 12 (Bankr. D. Vt. Aug. 16, 2005).

[102] *See* Disclosure Statement with Respect to Am. Joint Plan of Reorg. Under Chapter 11, *In re* FiberMark, Inc., No. 04-10463, slip op. at 53–56 (Bankr. D. Vt. Nov. 1, 2005).

[103] *See supra* Part V.A.

[104] *See supra* note 86 (discussing investment practice of distressed arbitrage).

[105] *See supra* Part V.A.

not owe any duty to other holders of the company's debt, these potential conflicts must be factored into any discussion of creditor control in chapter 11 cases.[106]

2. Pursuit of Control

The data show that distressed debt investors are willing to exert control over a debtor to achieve their investment objectives. This control may be directed at one or more management and board decisions or the management and board members themselves. Twenty-four of the distressed debt respondents indicated a willingness to replace members of the management team.[107] Twenty-two of the distressed debt respondents indicated a willingness to replace members of the board.[108] Moreover, 33 of the distressed debt respondents estimate that they are successful in their efforts to influence change at the company at least 1% of the time.[109]

The expressed willingness of certain of the distressed debt respondents to use their debt for control purposes reflects growing creditor control in chapter 11 cases. Examples of creditor control in chapter 11 cases include the cases of Allied Holdings, Inc., Bally's Total Fitness, Inc., Granite Broadcasting, Inc., Kmart Corporation, Radnor Holding Corp. and Werner Co.[110] In each of these cases, distressed debt investors used their contractual and statutory rights to influence the direction of the debtor's chapter 11 case. In three of these cases—Granite Broadcasting, Radnor and Werner—the investor acted as the debtor's post-petition lender and used its debt position to acquire the debtor or its assets.[111]

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[106] Creditors generally do not owe fiduciary duties to other creditors. Nevertheless, they may be subject to liability for wrongful or overreaching conduct under other theories such as lender liability, equitable subordination and recharacterization. *See, e.g.*, Douglas Baird & Robert Rasmussen, *Debt as a Lever of Corporate Control: The Prime Directive*, 75 U. CIN. L. REV. 921, 939–40 (2007). In addition, controlling creditors have faced, but defeated, claims under a deepening insolvency theory. *See, e.g., In re* Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006) (rejecting deepening insolvency claim against distressed debt investor).

[107] *See supra* Part IV.C.1.

[108] *Id.*

[109] *Id.*

[110] *See, e.g., Radnor Holdings*, 353 B.R. at 829–30 (citing to *Radnor* case); Disclosure Statement with Respect to Joint Prepackaged Chapter 11 Plan of Reorganization of Bally Total Fitness Holding Corp. & Its Affiliated Debtors, *In re* Bally Total Fitness of Greater N.Y., Inc., No. 07-12395-brl, slip op. at 20–49 (Bankr. S.D.N.Y. June 27, 2007) (describing *Bally* case); John. R. Emshwiller, *Controversy, by the Truckload*, WALL ST. J., May 2, 2007, at A4 (describing *Allied* case); Ben Fidler, *Judge to Rule on Granite Plan*, DAILY DEAL, May 2, 2007 (describing Granite Broadcasting case); Michael Roknick, *Werner Sale a Done Deal; Jobs Safe Under Terms of Sale*, HERALD, June 11, 2007 (citing to *Werner* case); *Kmart Exits Chapter 11, Names New Chairman*, CHI. TRIB., May 7, 2003, at 5 (citing to *Kmart* case); *see also* Stephen M. Brecher, et al., *"Alternative" Investment Managers and Bankruptcy: The Brave New World of Chapter 11*, J. PRIVATE EQUITY, Mar. 22, 2007, at 47(5) (listing other examples of distressed debt investors' involvement in chapter 11 cases, including Ormet Corporation, Foamex Corporation and Crescent Jewelers).

[111] *See supra* note 110 and accompany text; *see also* Goldschmid, *supra* note 9, at 252–54 (listing 22 chapter 11 cases in which distressed debt investors provided at least partial debtor in possession financing and indicating whether this financing was converted into long-term investments or ownership interests in company); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1929–32 (2004) (discussing potential abuses in loan-to-own transactions).

An activist investor creates potential issues for the debtor's management and board. In theory, in each of the foregoing chapter 11 cases, the course of action proposed by the distressed debt investor was in the best interest of the debtor's estate. Otherwise, the debtor's management and board and the bankruptcy court would not have approved the proposal.[112] In reality, however, the debtor's management and board may have been backed into a corner. The investor might be the debtor's only or best financing source or the investor might have teamed up with other stakeholders. The bankruptcy court, in turn, might be presented a consensual deal and have no cause to look for alternatives.[113]

For example, in Allied Holdings, the distressed debt investor, which held a majority of the debtor's outstanding debt, struck a deal with the debtor's labor union.[114] The investor and the labor union then presented a joint plan of reorganization to the debtor. Although the debtor's management team and board requested and received an extension of time from the bankruptcy court to review the proposed plan, query whether they really had any other meaningful choice.[115]

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[112] *See, e.g., In re* Cenargo Int'l, PLC, 294 B.R. 571, 599 n.32 (S.D.N.Y. 2003) ("There is no question that a debtor in possession is a fiduciary, like a chapter 11 trustee, for the estate, creditors and shareholders.") (citations omitted); Rutheford B. Campbell, Jr. and Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. CORP. L. 491, 493 & nn. 85–87 (2007) ("[W]hen the company enters bankruptcy and is operating under Chapter 11, the cases hold or suggest that the obligation [of the debtor's management] is to maximize the total interests of creditors and shareholders as a whole."); *see also* 11 U.S.C. § 1129(a)(3) (2006) (requiring debtor (or plan proponent) to propose plan in good faith); Richmond Leasing Co. v. Capital Bank, 762 F.2d 1303, 1312 (5th Cir. 1985) ("Even for a sale of *all* the debtor's assets, a considerably more radical action that the modification of a lease, those courts that have permitted such a sale under § 363(b) read the section as requiring only that the bankruptcy court consider whether there is an emergency, whether other buyers have been solicited, and whether the sale is in the best interests of the estate.") (emphasis in original).

[113] The debtor (or other party in interest) must obtain bankruptcy court approval to sell the debtor's assets under section 363(b) of the Bankruptcy Code or to confirm a plan of reorganization under section 1129 of the Bankruptcy Code. The bankruptcy court thus has the ability to assess the proposed transaction and determine whether it satisfies the requirements of the Bankruptcy Code and applicable case law. The bankruptcy court's determination, however, typically is based on the information provided by the debtor and other parties in interest, which may not provide a complete picture of the proposed transaction and surrounding circumstances. *See* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 189 (2004) ("Once the [consensual] plan is presented, the bankruptcy court is without means to independently assess the plan's feasibility and overcome the weight of the combined creditors and submerged debtors appearing before it urging confirmation."); Frost, *supra* note 20, at 114 ("[T]he bankruptcy judge can only act on information and transactions that are presented to her.").

[114] Disclosure Statement for Second Amended Joint Plan of Reorganization of Allied Holdings, Inc. & Affiliated Debtors Proposed by the Debtors, Yucaipa & the Teamsters Nat'l Auto. Transp. Indus. Negotiating Comm. at 14–15, 34–35, *In re* Allied Holdings, Inc., No. 05-12515, slip op. (Bankr. N.D. Ga. Mar. 2, 2007) (discussing Allied Disclosure Statement).

[115] *Allied Management Asks for More Time to Review Yucaipa Plan*, TEAMSTER NEWS (Int'l Bhd. of Teamsters), Feb. 14, 2007, *available at* http://www.teamster.org/07news/hn_070214_1.asp ("During a hearing today in U.S. Bankruptcy Court, Allied Holdings' management requested more time for its board to review a reorganization plan filed by the Yucaipa Cos. that would protect Teamster members' pensions, health and welfare benefits and preserve the union contract.").

In a separate article, I posit that this shift in power from a debtor's management to its creditors is creating a more management-neutral restructuring process.[116] Management no longer is leading the corporate restructuring process; rather, it is assuming a secondary role in which it largely responds and often accommodates creditors' demands. This shift in power may eliminate agency costs by placing management decisions in the hands of the true "residual owners" of the company.[117] It may further impair the rights of junior creditors and shareholders, however, which may still hold an interest in the company. If management's duties are owed to a constituent other than the controlling creditor, management may be unable to satisfy its fiduciary duties in a management-neutral restructuring process.[118]

3. Distressed Debt Investors and Loaning to Own

For purposes of analyzing the data, I consider both direct lending to a troubled company and the purchasing of the company's debt to be potential loan-to-own scenarios, if the investor lends or buys the debt with the intention of pursuing an ownership interest in the company. According to the data, 26 of the distressed debt respondents invest in distressed debt for this purpose, and 21 loan money directly to the company with a view towards acquiring an ownership stake.[119] Fourteen of the distressed debt respondents engage in both acquisition strategies.

More investors appear to use their distressed debt investments for influence at the company rather than for acquisition purposes.[120] These data, however, do not lessen the importance of the loan-to-own investment strategy.[121]

Of those distressed debt respondents that indicated that they invest in distressed debt or extend loans in order to acquire a controlling ownership interest in the

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[116] *See* Harner, *supra* note 31, at Part IV.C (discussing development of management-neutral restructuring process). Management neutrality and creditor control are, in most cases, synonymous. I use the term management neutrality, however, to focus on management's loss of control and the resulting consequences for the company and its stakeholders.

[117] *See id.*; *see also* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 775 (1988) ("[T]he law of corporate reorganizations should focus on identifying the residual owner, limiting agency problems in representing the residual owner, and making sure that the residual owner has control over the negotiations that the firm must make while it is restructuring."); Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341, 1343–47 (2004) (discussing concept of residual owner in bankruptcy and difficulty in identifying true residual owner).

[118] Harner, *supra* note 31, at Part IV.C.4 (discussing potential conflicts for management in trying to fulfill fiduciary duties in management-neutral restructuring process).

[119] *See supra* Part IV.C. Some distressed debt investors acknowledge this investment strategy. *See* Jim Parker, *May 24 Vote Set on Plan by Polymer*, THE POST AND COURIER, Apr. 18, 2002 (noting that CSFB Global was selected to manage $500 million for the Canada Pension Plan Investment Board and that "the board said CSFB Global 'will invest in distressed securities, usually debt, with the ultimate goal of acquiring control of companies requiring reorganization'").

[120] *See supra* Part IV.C.

[121] As discussed above, actual case reports evidence distressed debt investors pursuing loan-to-own strategies. *See supra* note 110 (naming instances where creditors gained control in bankrupt chapter 11 corporations by investing in them).

company, 11 report assets under management in excess of $1 billion.[122] Consequently, these investors have the resources to pursue multiple transactions and acquire portfolio companies through loan-to-own strategies.[123]

C. Implications in Chapter 11

The data suggest good and bad news for financially troubled companies. The good news is that some investors, including some investors with significant resources, are willing to invest in the distressed debt market. An active distressed debt market can lead to a lower cost of capital for potentially troubled companies.[124] For example, the existence of a readily available exit strategy may make institutions more willing to lend to potentially troubled companies. Competition in the distressed lending market may reduce the cost of financing, including debtor in possession financing.[125] It also introduces an additional source of financing for troubled companies, i.e., hedge funds, private equity firms and other nontraditional lenders.

The bad news, however, is that this capital often comes at a price: the company loses control of the restructuring process. An activist distressed debt investor may not physically replace the management team, but it likely will replace management as the company's decision-maker on key restructuring issues.[126] This shift in control changes the dynamics in a chapter 11 case and may work to the disadvantage of the company and its junior creditors and shareholders. The potential impact of this shift in control on the chapter 11 process is discussed below.

1. Intercreditor Disputes

As discussed above, the data suggest that both external and internal conflicts may arise from the investment strategies of activist distressed debt investors. External conflicts include disputes among creditors regarding the appropriate

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[122] *See supra* Part IV.D. (asking questions about respondents' basic demographic information).

[123] *See* Goldschmid, *supra* note 9, at 202–03 (noting two well-known distressed debt investors, Oaktree Capital Management and Cerberus Capital Management, control approximately $25 billion and $10 billion in assets, respectively).

[124] In general, the cost of debt and equity financing increases as a company becomes financially troubled. *See, e.g.*, Israel Shaked & Allen Michel, *Value & Cents: Valuing the Financially Distressed Firm*, 18 AM. BANKR. INST. J. 34 (Apr. 1999) (discussing costs of capital for distressed companies). An active distressed debt market does not eliminate this increase in cost, but it can mitigate the increase by, among other things, providing financing alternatives.

[125] *See, e.g.*, Kim Moore, *EaglePicher DIP to Be Reworked*, CREDIT INV. NEWS, Nov. 23, 2005, at 1(2) (explaining that "[c]ompetitive pricing helped Goldman Sachs snap up EaglePicher's exit financing in the first place" and quoting EaglePicher's CFO as saying, "It is a competitive landscape . . . . We go for the best pricing").

[126] *See supra* Part IV.C. (referring to survey discussed here that concentrates on the investment strategies of distressed debt investors, and whether they use their distressed debt holdings try to "influence board and management decisions and whether they invest in distressed debt to try to acquire a controlling ownership interest in the issuing company").

restructuring plan for the debtor. Internal conflicts include an investor's decision to pursue a restructuring plan that benefits one of its investments in the debtor to the detriment of investments in other tranches of the debtor's debt and equity.[127]

Creditor conflict can exist in a debtor-controlled restructuring process as well; however, in a creditor-controlled process, the controlling creditor likely is a party to the dispute and the party influencing the debtor's and perhaps the creditors' committee's view of the dispute.[128] For these types of reasons, creditor disputes in a creditor-controlled process may be more intense and more costly because, among other things, the non-controlling creditor likely must fight harder to be heard. In fact, the non-controlling creditor may need to escalate the dispute to formal filings with the bankruptcy court because the court may be the only available unbiased party to mitigate the dispute.[129]

2. Role of the Committee

Often, a controlling creditor obtains a seat on the statutory committee of unsecured creditors. In theory, members of the creditors' committee act as fiduciaries for all unsecured creditors.[130] In practice, members of the creditors' committee may act as fiduciaries, but they also obtain valuable information regarding the debtor and its restructuring process and a useful platform to further their own investment agendas.[131]

In most chapter 11 cases, the United States trustee appoints five to nine of the debtor's largest unsecured creditors to the creditors' committee.[132] To be considered for a committee appointment, a creditor completes a "Creditors Committee Acceptance Form," which asks the creditor to identify the nature and amount of its

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[127] *See supra* Part V.B.1. (discussing potential conflicts that may arise among investors).

[128] *See infra* Part V.C.2 (discussing interplay between statutory committees and distressed debt investors).

[129] I use the term "unbiased" here to mean a party that is not influenced by or pursuing the same course of action as the controlling creditor.

[130] *See, e.g.*, *In re* Fas Mart Convenience Stores, 265 B.R. 427, 432 (Bankr. E.D. Va. 2001) ("Members of the committee also have another duty—a fiduciary duty to all creditors represented by the committee.") (citations omitted); *In re* Firstplus Fin., 254 B.R. 888, 894 (Bankr. N.D. Tex. 2000) ("In a Chapter 11 case, an Unsecured Creditors' Committee is appointed by the Office of the United States Trustee and owes a fiduciary duty to act on behalf of all unsecured creditors.").

[131] *See, e.g.*, Carl A. Eklund & Lynn W. Roberts, *The Problem With Creditors' Committees in Chapter 11: How to Manage the Inherent Conflicts Without Loss of Function*, 5 AM. BANKR. INST. L. REV. 129, 129–30 (1997) (noting creditor's "acceptance of an active participatory role in a bankruptcy proceeding through service on a committee is most likely motivated by each committee member's interest in obtaining the maximum possible return on its claim").

[132] 11 U.S.C. § 1102(a)(1) (2006) (providing "the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders"); 11 U.S.C. § 1102(b)(1) (2006) (providing creditors' committee "shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee"). For a general discussion of the formation of a creditors' committee, *see* Greg M. Zipes & Lisa L. Lambert, *Creditors' Committee Formation Dynamics: Issues in the Real World*, 77 AM. BANKR. L.J. 229 (2003) (listing some United States trustee considerations in forming creditors' committees: size of interest creditor has, fiduciary duty entailed by being on committee, and diversifying types of creditors such as contingent, disputed, and partially secured claims creditors).

claim against the debtor and whether the creditor is represented by counsel, part of an *ad hoc* committee or an officer or director (or related to an officer or director) of the debtor.[133] The form generally does not ask the creditor about its other claims against the debtor or its intentions with respect to the debtor. These types of issues, if known, can be raised with the United States trustee or the bankruptcy court.[134] Nevertheless, in many cases, these issues are either not known or not raised.

An appointment to the creditors' committee can enhance the controlling creditor's involvement in the debtor's restructuring.[135] The creditor can recommend and vote on professionals to serve as the committee's counsel and financial advisors. It typically receives non-public information regarding the debtor and its restructuring process. It also has an opportunity to develop a relationship with other members of the committee through committee meetings and deliberations. Consequently, even if a controlling creditor later withdraws from the committee or abstains from certain votes, serving on the committee provides the creditor with an opportunity to further its investment agenda.

Consider the distressed debt investor that holds the debtor's unsecured bonds and obtains a seat on the creditors' committee. If this investor desires to pursue a debt-for-equity exchange, it can try to enlist the support of the committee and the committee's counsel. The investor's negotiating position with the debtor is substantially increased if the investor has the support of the committee. The debtor no longer can negotiate with the threat of a committee veto.

Not every distressed debt investor appointed to the creditors' committee will abuse its position or endorse a restructuring course that maximizes only its return. Nevertheless, the potential for abuse exists and must be considered.[136] The presence of a distressed debt investor on the creditors' committee may further eliminate the number of unbiased parties involved in the restructuring and may lead to additional creditor disputes.

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[133] The questions typically included on the Creditors Committee Acceptance Form are reproduced at Appendix C. Examples of the form are available at http://www.usdoj.gov/ust/ (forms available on some divisions' pages, *e.g.*, www.usdoj.gov/ust/r02/manhattan/faqs.htm).

[134] *See, e.g.*, Burke Gappmayer, *Protecting the Insolvent: How a Creditor's Committee Can Prevent Its Constituents from Misusing a Debtor's Nonpublic Information and Preserve Chapter 11 Reorganizations*, 2006 UTAH L. REV. 439, 445–46 (2006) (explaining "courts have consistently refused to allow creditors to serve on the committee if they have a conflict of interest that would give rise to a breach of their fiduciary duties") (citing applicable case law).

[135] *See* Zipes & Lambert, *supra* note 132, at 231 ("Congress . . . allowed committees to 'consult with the trustee or debtor concerning the administration of the case, to evaluate the debtor's financial dealings and current financial condition so the committee can evaluate . . . viability and . . . prospects for a plan, to negotiate plan terms, and . . . seek appointment of . . . trustee or examiner.'") (citations omitted); *see also* 11 U.S.C. § 1103(c) (2006) (describing powers and duties of creditors' committee).

[136] The *FiberMark* case discussed *supra* Part V.B.1 is just one example of questionable creditor conduct leading to conflict among creditors' committee's members. *Supra* notes 101–02 and accompanying text (highlighting $60 million reduction in value available to unsecured creditors resulting from power struggle between three distressed debt investors); *see* Michael P. Richman & Jonathan E. Aberman, *Creditors' Committees Under the Microscope: Recent Developments Highlight Hazards of Self-Dealing*, 26 AM. BANKR. INST. J. 22 *passim* (Sept. 2007) (discussing apparent self-dealing by creditors' committee members in chapter 11 cases of FiberMark, Galey & Lord, and WorldCom).

3. Management Turnover

Based on the data and actual case reports, the involvement of distressed debt investors in the chapter 11 process may increase management turnover, either before or in connection with the chapter 11 case.[137] The data suggest that distressed debt investors are flexible in their approach to management. In some situations, they are willing to work with existing management and in others they work to replace at least key members of the management team.[138] A reasonable inference from the data is that investors keep managers who are willing to pursue the investors' objectives and replace managers who are not.

Management turnover, in and of itself, is not necessarily a bad thing. Management may be ineffective or even malfeasant. Replacing management under these types of circumstances may benefit all of the debtor's stakeholders. Replacing management simply because it does not agree with the investor's vision for the company, however, may or may not benefit all parties.[139] The implications of the latter scenario depend on the facts of the particular chapter 11 restructuring.

4. Impact on Junior Creditors and Shareholders

Junior creditors and shareholders typically receive only cents on the dollar, or perhaps nothing, in a chapter 11 case. This result is a byproduct of most debtors' poor financial condition and the absolute priority rule. The absolute priority rule requires that, unless otherwise agreed by the holders of the claim, each class of claims must be paid in full before any junior class of claims or equity interests receives any distribution.[140]

The presence of an activist distressed debt investor in the chapter 11 case may, if possible, worsen the plight of junior creditors and shareholders. An activist investor maximizes either its return on the debt or its ownership interest in the reorganized company by reducing or even eliminating distributions to junior

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[137] *See supra* Part IV.C.2 (discussing use of influence by distressed debt investors to replace key members of management); *see also* Henderson, *supra* note 30, at 1595–96 (concluding, based on an empirical study of firms during 1992–2003, 60% of CEOs were replaced in zone of insolvency, with 70% being replaced by firm outsiders).

[138] *See supra* note 76 and accompanying text (discussing survey results regarding investors' approaches to entrenched management).

[139] *See* Harner, *supra* note 31, at Part IV.B.1 (discussing examples of management turnover relating to disagreements between executive and distressed debt investor and simple preference of distressed debt investors).

[140] *See* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 81–86 (4th ed. 2006) (explaining absolute priority rule); *see also* Jason Brege, Note, *An Efficiency Model of Section 363(b) Sales*, 92 VA. L. REV. 1639, 1655 (2006) ("In the vast majority of reorganizations, the senior secured creditors will receive significant payment while most junior unsecured creditors will receive only a small return on each dollar they are owed. Finally, equity holders will probably end up with no recovery or ownership stake in the reorganized company.").

creditors and shareholders.[141] Every cent or share not distributed to these junior classes benefits the activist investor.

In a debtor-controlled restructuring, the debtor typically does not have a bias towards senior creditors. In fact, if a bias exists, it often runs in favor of shareholders.[142] A shareholder bias can either help or hurt creditors. It can force a debtor to identify a restructuring plan that maximizes returns to all senior claim classes in order to allow a distribution to shareholders. Alternatively, it can cause the debtor to delay the case in pursuit of a plan that is not feasible. Unlike the controlling-creditor scenario, however, the debtor rarely has incentive to minimize distributions to junior creditors and shareholders.

5. Restructuring Timeline

Time is money, and an activist distressed debt investor wants to maximize the return on its investment in the debtor.[143] For this reason, activist investors frequently prefer prepackaged or pre-arranged chapter 11 cases or quicker free-fall chapter 11 cases. Quicker restructurings also better suit the typical investment horizon of 10–18 months of most activist investors.[144]

Quicker restructurings are not necessarily bad for debtors. Again, it depends on the particular circumstances of the debtor's restructuring. For example, a stand-alone restructuring that is negotiated before the chapter 11 filing, or the quick going-concern sale that preserves value by preserving the debtor's customers, personnel and goodwill, may be in the best interests of the debtor.[145] Nevertheless, these same restructuring options may work to the debtor's and its stakeholders'

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[141] *See* Duhigg, *supra* note 88, at 1 ("Distressed-debt investors get paid by shouldering aside other stakeholders and gambling that faltering companies can be rehabilitated."); *see also* Westbrook, *supra* note 22, at 843–44 (discussing "incentive problem" inherent in actions taken by secured creditors whereby such creditors may "want to liquidate a debtor quickly to maximize the value of their security interests, even if delayed liquidation or reorganization might be in the best interests of other stakeholders"). *But see Private Debt*, *supra* note 1, at 1245–48 (suggesting secured creditors do not necessarily have a liquidation bias and "can promote their own economic well-being by maximizing the value of the business").

[142] *See* Frost, *supra* note 20, at 122 ("The continued participation of managers in the running of the corporation creates a bias in favor of reorganization. Shareholders and managers of insolvent companies have every reason to desire an attempt at reorganization regardless of the efficiency of such an attempt.").

[143] *See, e.g.*, *Private Debt, supra* note 1, at 1245 (explaining "[p]rivate lenders are not charitable institutions. They will act to maximize their rate of return when they engineer the appointment of a CRO or otherwise exercise their influence"); *see also Stanfield Capital Partners Names Robert Paine as Senior Portfolio Manager*, BUSINESS WIRE, Apr. 8, 2002 (explaining investment goal of Stanfield Capital LLC as follows: "In each of its investment areas, from leveraged loans, high yield bonds, and mezzanine debt to investment grade debt and investments in the distressed arena, Stanfield seeks out inefficient credit markets with the goal of achieving attractive returns while avoiding undue risk").

[144] *See supra* Part IV.B (discussing survey results showing investment horizon as key aspect of distressed debt investor's investment practices, with 10–18 months as most common investment horizon).

[145] *See generally* Conrad B. Duberstein, *Out-of-Court Workouts*, 1 AM. BANKR. INST. L. REV. 347, 365 (1993) ("'Since the prepackaged plan is negotiated *before* the Chapter 11 case starts, it can take advantage of all the benefits available under the Code without the detriments of a prolonged and expensive proceeding . . . .'") (quoting Marc S. Kirschner et al., *Prepackaged Bankruptcy Plans: The Deleveraging Tool of the '90s in the Wake of OID and Tax Concerns*, 21 SETON HALL L. REV. 643, 663 (1991)) (emphasis in original).

detriment if the terms of the restructuring are not well researched, based on overly-optimistic and rushed forecasts or not properly vetted or marketed.[146]

D. An Appropriate Role for Distressed Debt Investors

Distressed debt investors do have financial resources and, in some instances, operational expertise that may benefit a debtor's restructuring efforts.[147] Consequently, I am hesitant to conclude that they should have no role in chapter 11 cases. The investment strategies of distressed debt investors, and activist investors in particular, however, can impact negatively a debtor's viability and the ultimate return to the debtor's creditors and shareholders.[148] Accordingly, defining an appropriate role for distressed debt investors in the chapter 11 process is a delicate balance.

The incentives and goals of distressed debt investors are a good starting point for analyzing an appropriate role for these investors in chapter 11. Distressed debt investors want to maximize the return on their investment in the debtor.[149] They have their own investors (typically, limited partners) to whom they owe fiduciary and contractual duties—duties that translate into getting the greatest return possible on the distressed debt investment.[150] The compensation of most managers of

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[146] *See* Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933, 1972–73 (2002) (concluding based on empirical data, "prepackaged reorganizations are more prone to failure than nonprepackaged", but suggesting failure is not related to speed of proceedings); Allen Michel et al., *Chapter 22s: Lessons of Two-Time Bankruptcies*, THE FINANCIER, 10, 10 (Summer/Autumn 1999) (suggesting speed may contribute to chapter 11 failures and noting "[s]ince firms emerging from Chapter 11 quickly typically were prepackaged bankruptcies, the sizeable number of two-time filers emerging within two months (i.e. 6 of 23 firms, or 26%) may signal that pre-packs do not represent a long-term solution for ailing firms").

[147] The Kmart chapter 11 case is an example of value creation. *See, e.g.*, David M. Berkowitz, *Kmart: A Case for the Bankruptcy History Books?*, HEDGEFUND J., Jan. 2006 (noting common stock issued to certain pre-petition creditors under Kmart's chapter 11 reorganization plan "skyrocketed in value – up 65% over three months, 92% over six months and 543% for an 18-month holding period."); *see also* Mark Berman & Jo Ann Brighton, *Will the Sunlight of Disclosure Chill Hedge Funds?*, 26 AM. BANKR. INST. J. 24, 24 (May 2007) (noting "hedge funds can be particularly useful in the restructuring context because they are not constrained to make only a single type of investment and [are] not bound by banking regulations, which make them much more nimble than traditional lenders").

[148] *See, e.g.*, ROSENBERG, *supra* note 26, at 32, 89–91, 99 (noting blocking tactics of vulture investors can delay restructuring process and citing case examples); *see also* Kit. R. Roane, *Hedging Their Debts*, U.S. NEWS & WORLD REP., Apr. 10, 2006, at 38–39 (discussing *FiberMark* chapter 11 case and noting it cost creditors "about $60 million over the course of seven months").

[149] *See supra* note 143 (discussing primary goal of distressed debt investors).

[150] *See* Goldschmid, *supra* note 9, at 213 (noting hedge funds are under constant pressure to report high rates of return to their investors). Most funds are structured as limited partnerships. *See, e.g.*, Edward Pekarek, *Pruning the Hedge: Who is the "Client" and Whom Does an Adviser Advise?*, 12 FORDHAM J. CORP. & FIN. L. 913, 916–17 n.22 (2007) (noting most hedge funds are structured as limited partnerships); *Hotel California and Other Possible Longer Term Stumbling Blocks for Hedge Funds*, INFOVEST21 NEWS, Apr. 11, 2007. General partners of a limited partnership generally owe fiduciary duties to the limited partners. *See* UNIF. LTD. P'SHP ACT § 408(a) (2001); REVISED UNIF. LTD. P'SHP ACT § 403 (1976) (as amended); *see also In re* Adelphia Commc'ns Corp., 322 B.R. 509, 530 (Bankr. S.D.N.Y. 2005) (discussing fiduciary duties of general partner in limited partnership under Delaware law).

distressed debt investors also is tied to the amount of the return on the investment.[151] The strategies of activist investors are not surprising in light of these factors. As one distressed debt respondent indicated on the survey, it pursues whatever investment strategy that will "maximize its risk adjusted return."[152]

The law should not penalize distressed debt investors for pursuing, within the bounds of the law, what is in the best interests of their partners. The law must account for this reality, however, when addressing the involvement of distressed debt investors in chapter 11 cases. What is in the best interests of the distressed debt investor may or may not be in the best interests of the debtor and its stakeholders generally.[153] The chapter 11 process needs to provide an objective, unbiased mechanism to evaluate this issue and determine whether the interests of the debtor and the investor are in fact aligned.[154]

Unfortunately, under the existing regime, a controlling or activist distressed debt investor may taint the evaluation process. An activist investor may have significant influence over one or both of the debtor and the creditors' committee. These entities are the two parties charged in the first instance with evaluating the conduct of, or a restructuring plan influenced by, a distressed debt investor in a chapter 11 case.[155] The bankruptcy court ultimately is and should be involved in the evaluation process, but it may not have the background or information necessary to understand the dynamics of and fully assess the situation.[156] The challenge is to find a mechanism to evaluate effectively the involvement of distressed debt investors in the chapter 11 process.

Eliminating—either directly or indirectly through disclosure and other formal regulations—the involvement of distressed debt investors in chapter 11 is an extreme and overbroad solution. It may resolve some of the immediate concerns regarding creditor control in chapter 11 because those creditors with the financial incentives or statutory or contractual rights to influence the debtor may not

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[151] *See, e.g.*, Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 684 (2000) ("The fund manager's compensation is based on the performance of the fund and ordinarily ranges from ten to twenty percent of the fund's profit.").

[152] This response was provided in connection with Question 5 to the survey. *See infra* Appendix A.

[153] *See e.g., Private Debt*, *supra* note 1, at 1245–46 (recognizing potential conflicts in interests of lender and debtor). Professors Baird and Rasmussen acknowledge that the interests of the controlling creditor may not align with those of the debtor. Nevertheless, they assert that in most instances, the senior lender, which is the focus of their discussion, will pursue a course of action that benefits junior creditors as well. As discussed below, at least with respect to distressed debt investors, I suggest that the opportunity for conflict and self-dealing is more prevalent and requires some intervention.

[154] For the meaning of unbiased as used here, *see supra* note 129.

[155] *See* 11 U.S.C. §§ 1103, 1107 (2006) (listing duties of creditors' committee and explaining rights, duties of debtors in possession in chapter 11 cases); *see also supra* notes 112, 135.

[156] *See* 11 U.S.C. §§ 363(b), 1129 (2006) (requiring bankruptcy court approval of transactions out of the ordinary course of business and of any proposed plan of reorganization in chapter 11); *see also supra* note 113 (discussing restraints on role of bankruptcy court).

participate in the chapter 11 process. But it also may eliminate distressed debt investors as a restructuring resource for troubled companies.[157]

Allowing the markets to define the role of distressed debt investors in corporate restructurings is an attractive, but also ultimately unsatisfying, solution. The two primary problems with relying solely on the markets are that the markets may not be fully informed and the markets provide little protection against creditor self-dealing.[158] For example, an activist investor that desires to acquire a troubled company through a debt-for-equity exchange or other mechanism has the incentive to perform the necessary due diligence. Other investors in the market may not be so motivated and the information may not otherwise be available. The activist investor's proposed transaction thus may not be adequately tested by the market.[159] Likewise, other investors and creditors have no effective or efficient means to challenge potentially overreaching provisions included in a lending or acquisition agreement by an activist investor.[160] Rather, the markets can complement nicely

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[157] In the context of the dispute regarding the application of the disclosure requirements of Bankruptcy Rule 2019 to distressed debt investors, the investors asserted that such requirements would chill the investors' active participation in bankruptcy cases. *See* Berman & Brighton, *supra* note 147, at 64–65 (describing circumstances surrounding dispute in *Northwest Airlines*, where court held that hedge funds must abide by the same disclosure rules as all others involved in bankruptcy proceedings); *see also supra* note 7 (noting one bankruptcy court required distressed debt investors, as members of *ad hoc* committee, to make 2019 disclosures). Nonetheless, nine of the 11 distressed debt investors ultimately did file the disclosures required by the bankruptcy court. *See* Berman & Brighton, *supra* note 147, at 63 ("[O]n March 21, 2007, the *ad hoc* committee filed a further amended Rule 2019 Statement in which nine members of the *ad hoc* committee provided information regarding their aggregate holdings of their holdings of Northwest Airlines shares . . . ."). Accordingly, the chilling effect of any regulation may depend on the extent of the regulation and the interests at stake.

[158] Existing scholarship thoroughly evaluates the role of the markets in the corporate restructuring process. *See, e.g.*, David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 479–81 (1993) (recognizing while options approach retains chapter 11 benefit of potential reorganization, exercise of options only works in perfectly efficient market); Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 812–16 (1993) (discussing debate between theorists in support of option scheme during bankruptcy and theorists supporting court intervention and chapter 11). In the context of distressed debt investors, I suggest that the markets can complement but should not replace statutory regulation of bankruptcy transactions.

[159] As one commentator has noted, "(1) markets do not work perfectly, and (2) transaction costs do exist." Tabb, *supra* note 158, at 813. Consequently, the market may not, and most likely would not, have access to the non-public information likely available to the distressed debt investor. Non-public information in this context could include information about both the debtor and the investor's holdings, investment strategies and the like. *Cf.* John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1218–20 (1991) (discussing non-public nature of information in the context of public bondholders and proposed recapitalizations); Tung, *supra* note 88, at 1736–40 (discussing non-public nature of information in bankruptcy claims trading context). *See generally supra* note 88 (discussing secrecy generally prevalent in distressed debt market).

[160] Indeed, other creditors and market participants may not be aware of the facts underlying the questionable conduct. *See supra* note 159 (discussing lack of public information in distressed debt trading market). To the extent that the conduct is known, a creditor may have standing to seek an appropriate remedy. *See supra* note 106 (discussing potential causes of action against distressed debt investors engaging in wrongful or overreaching conduct). In the bankruptcy context, a creditor most likely would have standing under section 1109(b) of the Bankruptcy Code. *See* 11 U.S.C. § 1109(b) (2006) ("A party in interest, including . . . a creditor, . . . may raise and may appear and be heard on any issue in a case under this chapter.").

laws tailored to address balance in the debtor-creditor relationship, such as the Bankruptcy Code.

Amending the Bankruptcy Code to create new (or enhance existing) checks on creditor self-dealing is the better solution. This approach would seek to create a workable role for distressed debt investors in the restructuring process. It also would update relevant provisions of the Bankruptcy Code to reflect the changing dynamics of the debtor-creditor relationship. A thorough analysis of potential changes to the Bankruptcy Code is beyond the scope of this article. Nevertheless, these changes might include:

- adding restrictions to who can serve on a creditors' committee;[161]
- identifying additional duties for creditors' committees and consequences for breaching those duties;[162]
- identifying additional duties for debtors in possession and consequences for breaching those duties;[163]
- specifying additional grounds for designating a creditor's vote on a chapter 11 plan under section 1126(e) or subordinating a creditor's claims under section 510 of the Bankruptcy Code;[164] and
- restricting the circumstances under which creditors can be reimbursed for expenses incurred in connection with the chapter 11 case under section 503(b) of the Bankruptcy Code.[165]

In addition, as further discussed below, rather than trying to rework the role of creditors' committees, these committees could be replaced by an estate representative that acts as a fiduciary for the bankruptcy estate and stakeholders generally.[166]

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[161] *See* 11 U.S.C. § 1102 (2006) (explaining existing requirements for service on creditors' and equity holders' committees); *see also supra* note 133 and accompanying text (discussing Creditors Committee Acceptance Form).

[162] *See* 11 U.S.C. § 1103 (2006) (listing existing powers and duties of committees).

[163] *See* 11 U.S.C. § 1107 (2006) (listing existing powers and duties of debtors in possession).

[164] *See* 11 U.S.C. § 1126(e) (2006) (providing existing grounds for designating vote on chapter 11 plan); 11 U.S.C. § 510 (2006) (providing existing grounds for subordinating a creditor's claim in the bankruptcy case). Under the existing regime, courts generally are reluctant to use section 1126(e) to address alleged creditor misconduct. *See In re* Adelphia Commc'ns Corp., 359 B.R. 54, 65 (Bankr. S.D.N.Y. 2006) (denying motion to designate creditors' votes on plan of reorganization and noting "imposing the disqualification rule sought here in the absence of a clearer statutory or case law foundation would be too much of a jump"). *But see In re* Allegheny Int'l, 118 B.R. 282, 289–93, 319–20 (Bankr. W.D. Pa. 1990) (holding creditor misconduct may warrant designation under section 1126(e)).

[165] *See* 11 U.S.C. § 503(b) (2006) (granting administrative expense status to "the actual, necessary costs and expenses of preserving the estate"); *In re* Romano, 52 B.R. 590, 593 (Bankr. M.D. Fla. 1985) (reasoning prior court approval is required for creditor to collect reasonable fees and expenses under section 503(b)(3)(B)); *see also* Allied Disclosure Statement, *supra* note 114, at 45 (explaining distressed debt investor would receive allowed substantial contribution claim under section 503(b) of Bankruptcy Code for its fees and expenses incurred in connection with its participation in debtor's chapter 11 case).

[166] *See infra* Part VI.

Distressed debt investors have a role to play in corporate restructurings. Expecting distressed debt investors to act first in the best interests of the debtor, however, is potentially unreasonable. Lawmakers should acknowledge this reality and amend the Bankruptcy Code to provide better balance in the debtor-creditor relationship.

CONCLUSION: THE NEED FOR BALANCE IN CHAPTER 11

Distressed debt investors are actively pursuing investments in troubled companies, including chapter 11 debtors. The data show that some of these investors are willing to use their investments to effect change at or to acquire the company. Moreover, these activist investors have the financial resources to be successful and, in fact, report being successful in their efforts. Their primary goal is to maximize the return on their investments for the benefit of their own partners.[167]

On the other hand, the primary goals of the chapter 11 process are the rehabilitation of the debtor and the maximization of returns to all of the debtor's creditors.[168] These dual goals guide a debtor's restructuring efforts and encourage the debtor to maximize the value of its bankruptcy estate through the financial and perhaps operational reorganization of its business. A debtor cannot always satisfy both goals, and in those instances, a liquidation of the debtor focusing solely on maximizing returns to creditors follows.[169] Nevertheless, a debtor typically does and, under the existing regime, should try to reorganize first. A debtor's attempts to satisfy both goals of the chapter 11 process may or may not further the primary goal of the distressed debt investor.

An activist distressed debt investor that assumes control of the debtor's restructuring process may thwart the debtor's attempts to reorganize its business or to maximize returns to all creditors. As discussed above, the investor might favor a quick sale of the debtor or a larger distribution to only one class of creditors.[170] In theory, the debtor and the creditors' committee should be able to evaluate the investors' objectives and prevent the investor from pursuing a course of action that is detrimental to the debtor's reorganization efforts.[171] In practice, however, the debtor and the creditors' committee may be unable or unwilling to assume these responsibilities because of, among other things, a lack of negotiating leverage, a relationship or shared business plan with the investor or, with respect to management, the desire to remain employed.[172]

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[167] *See supra* note 143 (discussing primary goal of distressed debt investors).

[168] *See supra* note 21 (discussing primary goals of chapter 11).

[169] *See* Frost, *supra* note 20, at 105 ("The problem is that meeting both of these goals is impossible when liquidation is the choice that maximizes the value of the business assets.").

[170] *See supra* Parts V.B.1, V.C.5.

[171] *See supra* Part V.B.2.

[172] *See id.*

This unbalanced situation is not necessarily the fault of the distressed debt investor.[173] The investor has no duty to act on behalf of the debtor's other creditors or shareholders, but does have a duty to act in the best interests of its own partners. The challenge then is to create a more balanced playing field in bankruptcy to provide an effective check on investors' activities and a meaningful fiduciary to protect the interests of the debtor's estate.

As discussed above, lawmakers could amend the Bankruptcy Code to enhance the duties and incentives of the existing chapter 11 fiduciaries—i.e., the debtor and the creditors' committee.[174] They also could change the fiduciary balance in chapter 11, however, by replacing all statutory committees with an estate representative.[175] The estate representative could be a fiduciary charged to protect and act in the best interests of the bankruptcy estate.[176]

The Bankruptcy Code could explicitly set forth the duties and responsibilities of the estate representative. For example, the Bankruptcy Code could direct the estate representative to fulfill its fiduciary duties to the bankruptcy estate by working with the debtor to maximize the value of the estate, first by exploring the debtor's reorganization opportunities; second by exploring a going-concern or orderly sale of the debtor; and finally by exploring the liquidation of the debtor under either chapter 11 or chapter 7 of the Bankruptcy Code.[177] The estate representative could

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[173] Absent bad faith, overreaching or other wrongful conduct, a distressed debt investor should be free to pursue transactions in the best interests of its partners. *See supra* note 106 (discussing potential causes of action against distressed debt investors engaging in wrongful or overreaching conduct).

[174] *See supra* Part V.D.

[175] As discussed above, in theory, a debtor in possession should act in the best interests of the bankruptcy estate and all creditors and shareholders. *See supra* note 112. Nevertheless, in practice, it often is difficult for a debtor in possession (or any party in interest, including a creditors' committee or controlling creditor) to maintain this balanced approach. I propose an estate representative as a safeguard for this balance and as a means to help the debtor in possession achieve a restructuring that is in the best interests of all stakeholders. *See* Westbrook, *supra* note 22, at 826 (discussing need for neutrality and neutral manager in "a system [such as that in the United States] that encourages the market to decide on the appropriate combination of secured credit, unsecured credit, and equity financing for each business"); *see also supra* notes 22, 23.

[176] The bankruptcy estate is defined by section 541 of the Bankruptcy Code and includes, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a) (2006). A chapter 11 debtor in possession uses property of the bankruptcy estate to operate its business and make distributions to creditors and shareholders. Thus, creditors and shareholders have an interest in the bankruptcy estate. The estate representative would be charged to protect and maximize the value of this collective interest in the estate. In this respect, the estate representative's duties would be similar to those of a chapter 7 trustee. *See* 11 U.S.C. § 704 (2006) (discussing duties of chapter 7 trustee); Westbrook, *supra* note 22, at n.119 (explaining "the case law has long imposed on a trustee in bankruptcy fiduciary duties to all those interested in the estate").

[177] Specific statutory duties would reduce disputes and litigation regarding the appropriate role of an estate representative and provide the representative with guidance in balancing the often competing interests in a chapter 11 case. Similar guidelines could be incorporated into the Bankruptcy Code for the debtor in possession as well. *See supra* note 163. The United Kingdom provides this type of statutory guidance, on a limited basis, to administrators in administrations under the Insolvency Act. *See* Insolvency Act, 1986, c. 45, sched. B1, ¶ 3(1), *amended by* Enterprise Act, 2002, c. 40, sched. 16 (U.K.)

> [A]dministrator of a company must perform his functions with the objective of—(a) rescuing the company as a going concern, or (b) achieving a better result for the

both assist the debtor in possession in formulating a chapter 11 plan and monitor the activities of the debtor and its creditors and shareholders.[178]

The details concerning the estate representative concept are numerous, and I am still working to develop the concept and related alternatives fully. For example, the estate representative should be a disinterested person under the Bankruptcy Code[179] and could be appointed by the bankruptcy court or the United States trustee from a standing panel or from the recommendations of the debtor and its stakeholders.[180] The estate representative should have all of the duties and powers given to statutory committees under section 1103 of the Bankruptcy Code and perhaps some of the powers given to trustee and examiners under section 1106 of the Bankruptcy Code.[181]

The appointment of an estate representative also could reduce conflicts and costs in chapter 11 cases. As discussed above, intercreditor disputes on creditors' committees can produce delay and additional expense in chapter 11 cases.[182] In addition, the request for a change in committee composition or the appointment of additional committees can do the same.[183] Moreover, as discussed in a detailed fee

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> company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors.

Id. An administration is one of the statutory bankruptcy schemes applicable to corporate entities in the United Kingdom. *See* Harner, *supra* note 31, at Part IV.A.2.a.

[178] The estate representative would not displace the chapter 11 debtor in possession. As a fiduciary for the bankruptcy estate, however, the estate representative would be able to monitor both debtor and creditor self-dealing. In this respect, the estate representative concept differs from the neutral manager concept proposed by Professor Westbrook. *See supra* notes 22, 23.

[179] *See* 11 U.S.C. § 101(14) (2006) (defining "disinterested person"). A disinterested person under the Bankruptcy Code is, among other things, "not a creditor, an equity security holder, or an insider." *Id.*

[180] Chapter 7 trustees generally are appointed from a standing "panel of private trustees established under section 586(a)(1) of title 28." 11 U.S.C. § 701(a)(1) (2006). Certain creditors then may request a meeting to elect a chapter 7 trustee different from the person appointed by the United States trustee. *See* 11 U.S.C. § 702 (2006) ("[C]reditors may elect one person to serve as trustee in the case . . . ."); FED. R. BANKR. P. 2003(b) (laying out creditors' right to vote for trustee in chapter 7 liquidation). Likewise, if a motion to appoint a chapter 11 trustee is granted by the bankruptcy court, creditors may request a meeting to elect the trustee. *See* 11 U.S.C. § 1104 (2006) ("[O]n request of a party in interest . . . the court shall order the appointment of a trustee . . ."); FED. R. BANKR. P. 2007.1(b) (setting forth procedure for convening meeting of creditors to elect chapter 11 trustee to be approved by court). Similar procedures may work in the context of an estate representative, but undue creditor or debtor influence over the election process would need to be considered and addressed.

[181] *See* 11 U.S.C. § 1103 (2006) (describing powers and duties of committees, which include oversight of debtor); 11 U.S.C. § 1106 (2006) (providing for powers and duties of chapter 11 trustees and examiners, which include "investigat[ing] . . . any other matter relevant to the case or the formulation of a plan").

[182] *See supra* note 136 (observing how debt investors with different investment strategies may clash over control of debtor post-petition, producing delays in confirmation and reducing value of estate).

[183] *See* Thomas H. Coleman & David E. Woodruff, *Looking Out for Shareholders: The Role of the Equity Committee in Chapter 11 Reorganization Cases of Large, Publicly Held Companies*, 68 AM. BANKR. L.J. 295 (analyzing issues that may arise in context of requests for appointment of equity holders' committee); Eklund & Roberts, *supra* note 131, at 153 ("[I]n a bankruptcy proceeding the time delays caused by litigation can equal the time value of a creditor's claims and add an extra layer of risk and expense."); Kurt F. Gwynne, *Intra-Committee Conflicts, Multiple Creditors' Committees, Altering Committee Membership and*

study, the fees and costs of committees and their professionals, which are paid by the bankruptcy estate, are significant.[184] An estate representative should be entitled to compensation and the reimbursement of its professional fees from the estate. Nevertheless, a single estate representative that likely will reduce conflicts and help to facilitate quicker restructurings should reduce overall costs to the estate.

Some change is needed to accommodate distressed debt investors and other controlling creditors in a chapter 11 process that values corporate rehabilitation and the maximization of returns to all creditors. Whether lawmakers choose to effect this change through piecemeal or wholesale changes to the Bankruptcy Code can and should be debated. I hope this article provokes such a debate. A debtor in chapter 11 should pursue all restructuring options, including investments by or assistance from distressed debt investors. The shift in control that often accompanies this debtor-creditor relationship, however, warrants legislative change that better protects the debtor and all of its stakeholders.

Other Alternatives for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code, 14 AM. BANKR. INST. L. REV. 109, 140–41 (2006) (discussing problem of adequate representation on creditors' committee and how courts may fashion less costly remedies than appointing new committee).

[184] *See* STEPHEN J. LUBBEN, CHAPTER 11 PROFESSIONAL FEE STUDY 35–38 (American Bankruptcy Institute 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020477 (reporting mean committee fees and expenses requested in weighted random sample dataset and big case dataset as $403,489.74 and $1,807,553.54, respectively).