HEDGE FUNDS IN BANKRUPTCY

KEITH SHARFMAN[*] & G. RAY WARNER[**]

Hedge funds and other professional and institutional investors are playing an increasingly important role in bankruptcy cases.[1] As buyers of financially distressed securities, they provide a valuable outlet for holders of such securities who wish to exit those markets. They also facilitate the consolidation of distressed securities into the hands of owners who are well-equipped to press for outcomes in Chapter 11 cases that maximize the value of those securities. At the same time, the active participation of hedge funds in the bankruptcy process at times gives them access to nonpublic information that may afford them an undue advantage in their ongoing trading activities.

To balance these competing considerations, various practices have developed to regulate hedge funds in ways that attempt to preserve the value that they add to the bankruptcy process while also eliminating any improper advantage that participation in that process may confer. These measures and various proposals for their reform, which have been hotly debated within the bankruptcy and hedge fund communities, were the subject of a recent symposium at St. John's School of Law whose fruits you now have before you.

The eight papers that appear in this symposium issue of the *American Bankruptcy Institute Law Review* come from a diverse and distinguished group of scholars, practitioners, and public officials. In the grand tradition of interdisciplinarity that for nearly a century has informed academic discourse on bankruptcy law and policy,[2] these papers are representative of the very best in bankruptcy scholarship.

Judge James Peck's keynote address[3] offers a rare glimpse into the mind of a sitting bankruptcy judge acting at the behest of a fellow judge to serve as a bankruptcy mediator in a large Chapter 11 case. Drawing upon his experiences as

---

[*] Professor of Law & Associate Director of Bankruptcy Studies, St. John's University School of Law. Many thanks to all of the symposium authors and participants, to Andrew Serrao and the other editors and staff of the *American Bankruptcy Institute Law Review* for organizing the symposium and preparing the papers for publication, to Yvette Gutierrez and Maggie St. Denis for their administrative efforts, and to Dean Michael Simons for institutional support.

[**] Professor of Law & Associate Dean for Bankruptcy Studies, St. John's University School of Law.

[1] Mike Spector & Tom McGinity, *Bankruptcy Court Is Latest Battleground for Traders*, Sept. 7, 2010, http://online.wsj.com/news/articles/SB10001424052748703309704575413643530508422.

[2] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 245 n.11 (2001) (citing F. REGIS NOLL, A HISTORY OF THE BANKRUPTCY CLAUSE OF THE CONSTITUTION OF THE UNITED STATES OF AMERICA (1918) as an early instance). Later interdisciplinary bankruptcy scholarship includes the work of William O. Douglas, Walter Blum, Thomas Jackson, Douglas Baird, Theodore Eisenberg, Teresa Sullivan, Elizabeth Warren, Jay Westbrook, Edward Morrison, Robert Lawless, and many others.

[3] Hon. James M. Peck, *Settlement Talks in Chapter 11 After "*WaMu*": A Plan Mediator's Perspective*, 22 AM BANKR. INST. L. REV. 65 (2014).

the mediator in *Residential Capital*,[4] Judge Peck suggests that entering a so-called "*Vitro* Order"[5] that declaratively characterizes hedge fund investors as non-insiders who are free to engage in claims trading simultaneously with settlement discussions can usefully facilitate the mediation and settlement of large Chapter 11 cases in which hedge funds are active parties. Skillfully presented, Judge Peck's approach can be expected to serve in years to come as a template for future mediators in cases raising similar issues.

In contrast to Judge Peck, who relies primarily on anecdotal evidence to reach his conclusions, Professor Edward Altman has written an empirical study[6] that assesses the role of hedge fund participation in Chapter 11 cases in a more comprehensive fashion. Altman's study presents a wealth of bankruptcy data that is both new and relevant, including especially documentation of how distress investing has grown and recovery rates have improved over time. These data support the claim made by the industry that hedge funds add value to the reorganization process, an inference that is implicit rather than explicit in Altman's carefully stated conclusions.

Alistaire Bambach, the attorney who heads the bankruptcy group at the Securities & Exchange Commission ("SEC"), focuses in her published remarks[7] not on how to regulate hedge fund trading activity *ex ante* but rather on how to liquidate hedge funds when doing so becomes necessary from an enforcement perspective. Mechanisms that the SEC employs include the use of monitors, equity receivers, and the bankruptcy process itself. While insisting that the SEC does not systematically favor receiverships over the bankruptcy forum, Bambach makes a noteworthy admission that choosing the bankruptcy forum over a receivership in *SEC v. Landberg*[8] was in hindsight disadvantageous.[9] She also expresses uncertainty about whether the Bankruptcy Code's financial contract safe harbors for the settlement of securities contracts[10] are enforceable post-bankruptcy by creditor liquidation trusts. While Bambach's statement reflects only her own views and not necessarily those of the SEC, those who practice in this area or whose interests are otherwise affected by SEC enforcement policies would do well to take note.

Examining distress investing by hedge funds from the perspective of economic theory, Professor Anthony Casey argues in his contribution[11] that a post-petition public auction would be a more efficient mechanism for the regulation of claims

---

[4] *In re* Residential Capital, LLC, No. 12-12020 (MG) (Bankr. S.D.N.Y.).

[5] Order in Aid of Settlement Discussions, *In re Vitro*, S.A.B. de C.V., 473 B.R. 117 (Bankr. N.D. Tex. 2012).

[6] Edward I. Altman, *The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations*, 22 AM. BANKR. INST. L. REV. 75 (2014).

[7] Alistaire Bambach, *Issues that the SEC Confronts in the Liquidation of Hedge Funds*, 22 AM. BANKR. INST. L. REV. 125 (2014).

[8] Complaint, SEC v. William Landberg et al., No. 11 Civ 0404 (S.D.N.Y. Apr. 4, 2006), *available at* http://www.sec.gov/litigation/complaints/2011/comp-pr2011-17.pdf.

[9] Bambach, *supra* note 7, at 128.

[10] *See* 11 U.S.C. § 546 (2012).

[11] Anthony J. Casey, *Auction Design for Claims Trading*, 22 AM. BANKR. INST. L. REV. 133 (2014).

trading than the private market that now prevails. He therefore proposes to make such claims auctions a part of the bankruptcy process and to discourage pre-bankruptcy trading in circumvention of the auction by requiring pre-petition claim buyers to rebate to their sellers any discount that the buyer received relative to the initial, post-petition auction price. This ingenious but controversial proposal is likely to engender much expert commentary and discussion in the years ahead.

Eric Fisher, a leading practitioner who recently squared off against the hedge fund industry and then settled with it after mediation before Judge Peck in the *General Motors* case,[12] offers in his co-authored article[13] various doctrinal and policy grounds for rejecting the permissive *Vitro/Residential Capital* approach to hedge fund claims trading and embracing the stricter (later vacated) approach of Delaware Bankruptcy Judge Walrath, who in *Washington Mutual* refused to shield hedge funds that had traded claims while in plan negotiations from insider trading claims asserted by shareholders.[14] Rather than impose advisory orders insulating hedge funds from securities litigation *ex ante*, Fisher favors the use of strict pleading requirements *ex post* to weed out non-meritorious cases.

Professor Michelle Harner's co-authored empirical study,[15] like Professor Altman's, examines data on distress investing by hedge funds but ultimately is agnostic about the net effect that hedge fund investment in failing firms has upon firm value. Data on hedge fund participation in large Chapter 11 cases suggest that hedge funds can both harm or help the bankruptcy process, both lengthen and streamline it, and both add and detract from value. A good example to demonstrate these multiple effects is the *Tribune* case,[16] which involved hedge funds on different sides at both junior and senior levels of priority. Moving beyond *Tribune*, the Harner study provides a wealth of data and analysis on fund participation, convincingly showing that the effect of hedge fund investment on bankruptcy outcomes is complex and mixed. All of this data and analysis will no doubt stimulate further study by others in the future.

Professor Wulf Kaal, a leading expert on the disclosure rules that pertain to hedge funds, compares in his article[17] the various disclosure rules with respect to systemic risk that apply to distress investing by hedge funds both inside and outside of bankruptcy, finding that there is substantial overlap between the systemic risk disclosure requirements imposed by Title IV of the Dodd-Frank Act and the risk disclosures that claims trading hedge funds must make under Rule 2019 of the

---

[12] Stipulation and Agreed Order Appointing Mediator at 6, *In re* Motors Liquidation Co., (Bankr. S.D.N.Y. June 27, 2013) (No. 09-50026).

[13] Eric B. Fisher & Katie L. Weinstein, *The Aftermath of "WaMu": A Problem Still in Search of a Solution*, 22 AM. BANKR. INST. L. REV. 153 (2014).

[14] *In re* Wash. Mut., Inc., 461 B.R. 200, 266 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229, 2012 WL 1563880 (Bankr. D. Del. February 24, 2012).

[15] Michelle M. Harner, Jamie Marincic Griffin & Jennifer Ivey-Crickenberger, *Activist Investors, Distressed Companies, and Value Uncertainty*, 22 AM. BANKR. INST. L. REV. 167 (2014).

[16] *In re* Tribune Co., No. 08-13141 (Bankr. D. Del., Dec. 8, 2008).

[17] Wulf. A. Kaal, *Hedge Funds' Systemic Risk Disclosures in Bankruptcy*, 22 AM. BANKR. INST. L. REV. 195 (2014).

Federal Rules of Bankruptcy Procedure, as enforced by the SEC. Kaal suggests that hedge funds are sophisticated traders that may not need heightened disclosure requirements and further suggests that this may be why the SEC has yet to standardize its requirements in this area. In conclusion, Kaal speculates that the growing and increasingly aggressive role that hedge funds continue to play in distress markets may ultimately bring about heightened SEC enforcement in the market for distressed securities.

Daniel Kamensky, a partner at Paulson & Co. and a leading figure in the distress investment industry, offers in his article[18] a strong and comprehensive defense of the work that hedge funds do in the bankruptcy space. Among other evidence, Kamensky cites recent studies suggesting that creditor recoveries are higher and bankruptcy recidivism (the so-called "Chapter 22" phenomenon) is lower on account of active hedge fund participation in Chapter 11 cases.[19] Data from the studies by Professors Altman and Harner are also harnessed to good effect in support of Kamensky's pro-hedge fund thesis. After reading Kamensky's paper, one cannot help but conclude that the industry has been very well represented in this forum.

Individually and collectively, the work of these symposium authors is most impressive. They have substantially improved our understanding of the role that hedge funds play in the bankruptcy process, as well as raised new questions for further research and analysis. We are proud to publish their work and eagerly await reactions to it from our readership and the broader bankruptcy and hedge fund communities.

---

[18] Daniel B. Kamensky, *Furthering the Goals of Chapter 11: Considering the Positive Role of Hedge Funds in the Reorganization Process*, 22 AM. BANKR. INST. L. REV. 235 (2014).

[19] *See, e.g.*, Wei Jiang, Kai Li & Wei Wang , *Hedge Funds and Chapter 11*, 67 J. FIN. 513 (2012).