FURTHERING THE GOALS OF CHAPTER 11: CONSIDERING THE POSITIVE ROLE OF HEDGE FUNDS IN THE REORGANIZATION PROCESS

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INTRODUCTION

As an active distressed debt investor, my experience tells me that hedge funds can play a positive role in the chapter 11 bankruptcy process. Hedge funds are sophisticated creditors that can work productively with the debtor to achieve consensus and help create a transparent and efficient bankruptcy process. Through their actions, hedge funds can help achieve the goals of chapter 11, namely, to rehabilitate the debtor and maximize value for all stakeholders.

Because hedge funds can be a positive force both in improving the chapter 11 process and in ensuring a successful outcome, the Bankruptcy Code and chapter 11 practice should encourage hedge fund participation—particularly in light of recent empirical studies that confirm the positive effect hedge fund participation can have on the bankruptcy process.

I. THE CURRENT STATE OF PLAY

Hedge funds are private investment funds that provide sophisticated investment management to a diverse range of investors and myriad public trusts, including pension funds, charitable organizations, university endowments and foundations. Their structure makes them significantly more flexible than traditional investment vehicles such as banks; not only are they more likely to take positions in the full range of debt and equity investments, they are more often able to provide capital in times of market volatility and distress. Through these functions, hedge funds play an important role in our financial system: not only do they help investors diversify their individual security selection risk, they also provide liquidity and price discovery to capital markets, and capital to companies to allow them to grow or improve their businesses. In so doing, hedge funds help dampen general market volatility.[1] Accordingly, hedge funds are significant players in the modern capital markets that strengthen the U.S. capital markets as a whole.

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[1] *See, e.g.*, William P. Osterberg & James B. Thomson, *The Truth About Hedge Funds*, CLEV. FED. RES., May 1, 1999, http://www.clevelandfed.org/research/commentary/1999/0501.pdf (concluding "the funds' trading behavior tends to reduce, not increase, the volatility of prices").

Hedge funds also strengthen the U.S. bankruptcy system. Today, hedge funds are actively involved in a staggering percentage of all chapter 11 cases.[2] Hedge funds appear at every level of a distressed company's corporate structure, and may also take on new positions as debtor-in-possession or exit lenders or serve on formal and informal committees. Thus, hedge funds represent an important creditor group that essentially did not exist when Congress enacted the Bankruptcy Code in 1978. However, while the role of hedge funds in bankruptcy is one aspect out of many that presently is being considered as part of an ongoing discussion of revising the Bankruptcy Code generally,[3] the mere fact that hedge fund participation in bankruptcy proceedings has evolved over time is not a reason in and of itself to reform the Bankruptcy Code. Instead, the appropriate question to ask when considering reforms to the Bankruptcy Code or to the practice of chapter 11 is whether recent developments have improved the chapter 11 process and enhanced the Bankruptcy Code's twin goals of value maximization and rehabilitation. When considering increased hedge fund participation in chapter 11, the answer to both questions is yes.

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[2] Approximately 90%, according to one recent study. Wei Jiang, Kai Li & Wei Wang, *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 514 (2012) (sampling 474 chapter 11 reorganizations between 1996 and 2007). *See also* Michelle M. Harner, Jamie Marincic Griffin & Jennifer Ivey-Crickenberger, *Activist Investors, Distressed Companies, and Value Uncertainty*, 22 AM. BANKR. INST. L. REV. 167, 191 (2014) (concluding approximately 26% of large chapter 11s between 2000 and 2012 ended with hedge funds owning majority of the reorganized entity, either through controlling stake in the equity or through 363 sale of substantially all assets); 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, 76 (2014) (estimating there is currently between $400-450 billion in capital invested in distressed debt in U.S.).

[3] In particular, in June 2011, the American Bankruptcy Institute ("ABI") announced the creation of a commission to study chapter 11 reforms, which would focus in particular on what changes might be necessary "[i]n light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code[.]" *See* Purpose of Commission, *ABI Commission to Study the Reform of Chapter 11*, *available at* http://commission.abi.org/purpose-commission. *See also* Robert J. Keach, *Commission to Explore Overhauling Chapter 11*, AM. BANKR. INST. J., June 2011, at 36 ("This new column focuses on sections of the Bankruptcy Code and Rules that may be in need of improvement."). Members of the MFA, along with many other participants in chapter 11, practitioners, and academics, have submitted testimony to the ABI commission on various topics during field hearings, and also serve on subcommittees that are considering particular issues, including governance in chapter 11, claims trading, and valuation. It may be, however, that at the conclusion of this process, the commission determines that the best course of action is to make few, if any, structural or statutory modifications to the existing chapter 11 process.

II. HOW HEDGE FUND PARTICIPATION BENEFITS THE CHAPTER 11 PROCESS & FURTHERS THE GOALS OF THE BANKRUPTCY CODE

Chapter 11 works best when creditors are actively involved with the debtor. An active creditor body is essential to the debtor-in-possession model functioning as it was intended: through give-and-take between a debtor and its creditors to negotiate creatively to arrive at the best possible outcome for all parties in interest.[4] This is not a unique viewpoint. In the words of Professor Harner, who participated at this symposium:

> [T]he concept underlying chapter 11—bringing the debtor and all of its key stakeholders to the negotiating table to resolve the debtor's financial distress—has significant value . . . . Encouraging more parties to participate may enhance that dialogue by introducing additionally and potentially different perspectives on value creation.[5]

Hedge funds play an increasingly important role in this dynamic—as sophisticated financial actors, they have the interest, knowledge and flexibility to work with the debtor and other creditor constituencies to find creative solutions and push for the right outcomes.

A. Allocations of Capital & Other Process Efficiencies

Claims trading is a necessary by-product of hedge involvement in bankruptcy cases because hedge funds provide liquidity to original and secondary holders by purchasing claims. Some have debated whether the purchase and sale of claims against a debtor in the secondary market should be limited or subject to regulation. Because hedge funds create efficiencies in the chapter 11 process and improve the active, productive negotiations that are critical to maximizing value for all stakeholders[6] claims trading benefits chapter 11 and should not be limited during the chapter 11 process.[7]

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[4] *See* H.R. REP. NO. 95-595, at 235 (1977) ("[D]ebtor remains in possession and control, and must work with its creditors to formulate a plan and conduct its business. The need for cooperation is greater, and the need for negotiation more pronounced.").

[5] Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155, 1182 (2011). *See also* David L. Perechocky, *Should Ad Hoc Committees Have Fiduciary Duties?: Judicial Regulation of the Bankruptcy Market*, 86 AM. BANKR. L.J. 527, 529 & n.5 (2012) ("The common narrative is that the Bankruptcy Code strikes an appropriate balance between debtors and creditors, and is a system uniquely suited for situations involving multiple creditors" because of collective action problems outside of bankruptcy).

[6] *See, e.g.*, Michael DeMarino, *Rule 2019: The Debtor's New Weapon*, 42 J. MARSHALL L. REV. 165, 183 (2008) (emphasizing hedge fund ability to increase efficiency by increasing secondary debt liquidity); Davy V.H. Nguyen, *Too Big to Fail? Towards a Sovereign Bankruptcy Regime*, 45 CORNELL INT'L L.J. 697, 699 (2012) (stating hedge funds are "able to negotiate greater settlements with sovereign debtors").

[7] *See* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 5 (1990) ("In sum, creditors and shareholders of chapter 11 debtors benefit from the existence of public and nonpublic markets for their claims and stock.").

Specifically, claims trading promotes efficiencies by introducing sophisticated financial actors with the expertise and experience necessary to engage with the debtor and other constituencies in active and productive ways to unlock value.[8] Claims trading typically causes claim consolidation as well, as a handful of investors purchase myriad smaller claims to establish a larger position.[9] This can also encourage efficient negotiations, since a debtor can engage in targeted negotiations with the key creditors needed to confirm a plan.[10] Thus, claims trading facilitates the creation of an efficient and effective negotiating dynamic, which is a central tenet of the U.S. debtor-in-possession model.

Hedge funds and other distressed debt investors generally have the financial resources to invest in distressed enterprises (in contrast to most unsecured creditors) and a willingness to accept equity in exchange for their claims (in contrast to many traditional investors). Therefore, by bringing these parties into the bankruptcy process, claims trading can provide distressed companies with additional financing options at critical moments during the process, including the ability to reduce the cash needed to exit chapter 11 through debt-to-equity conversions.[11]

More generally, claims trading in bankruptcy supports the efficient allocation of capital in the broader markets.[12] It provides an exit for creditors who lack either the financial ability or the willingness to wait until the chapter 11 case concludes to realize a return on their claims.[13] For a wide range of creditors, from small trade vendors without the resources or knowledge to participate in the process, to institutional investors that may not own defaulted loans or bonds, the ability to cash out—even at a discount—is valuable because it allows them to adjust their own risk profiles. By freeing up capital and allowing creditors to deploy their resources as their risk/return perceptions may change over time, the secondary claims trading

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8 *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) (concluding that "the arrival of distressed debt investors can add new, positive energy to the reorganization process."); *see also* Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 71 (arguing that claims trading can "facilitate more efficient bankruptcy negotiations and help reorganizations").

9 *See* Levitin, *supra* note 8, at 73 (noting benefits of claims consolidation facilitated by claims trading).

10 *See* 11 U.S.C. § 1126(c) (2012) (prescribing class acceptance of plan as two-thirds in amount and at least one-half in number voting to accept).

11 *See generally* Martin Eisenberg, *When Hedge Funds Invest in Distressed Debt*, 238 N.Y. L.J. 11 (Oct. 15, 2007) ("A balanced assessment of the impact of distressed investing in bankruptcy proceedings demonstrates that distressed investors are beneficial to the reorganization process contributing, among other things, substantial resources in the form of capital, financial acumen and expertise."); Goldschmid, *supra* note 8, at 260–64 (using Vantico's restructuring, Exide Technologies' bankruptcy and empirical research to show how hedge funds use claims trading to provide efficient options for distressed companies).

12 *See* Levitin, *supra* note 8, at 74 (analyzing benefits of claims trading to "emphasize efficiency gains both in bankruptcy and in the capital markets").

13 *See id.* at 73 (favoring claims trading because it allows exit for creditors who want to cut loose from bankruptcy process because of liquidity constraints, administrative hassle, expense, and to avoid adversarial relationship with debtor).

market increases availability and decreases the cost of capital in the broader markets.[14]

B. Improving Post-Emergence Results

Hedge funds can help ensure that plans of reorganization are feasible. At confirmation, a debtor must establish that there exists a reasonable likelihood that it will be commercially viable after emergence.[15] Since investors who purchase claims often become the new owners of a company upon emergence, they have a strong incentive to maximize value and improve the company's overall business performance.[16] Thus, the active involvement of these investors, including their rigorous testing and assessment of the debtor's financial condition and its exit strategy, can benefit the process.

Hedge funds are well equipped for this function. They have both the resources and expertise to carefully scrutinize and analyze management projections and other financial data and, in turn, evaluate whether the debtor's suggested path out of chapter 11 actually represents the best outcome.[17] In a model that is premised upon the give-and-take between management and creditors, and active engagement by creditors in developing a plan, the addition of a sophisticated financial player with the motivation and ability to independently analyze the debtor's financial condition is a positive development.[18]

Recent studies confirm that active involvement by distressed investors in a bankruptcy case increases the company's enterprise value and improves its performance post-reorganization.[19] In other words, hedge fund involvement helps

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[14] *See id.* at 73–76 (summarizing primary benefits offered by claims trading and collecting commentary thereon).

[15] *See* 11 U.S.C. § 1129(a)(11) (requiring the court find "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan"); *see also In re* Texaco Inc., 84 B.R. 893, 910 (Bankr. S.D.N.Y. 1988) (noting feasibility requires "reasonable assurance of commercial viability.").

[16] *See Written Statement of Daniel B. Kamensky*, American Bankruptcy Institute Field Hearing on Chapter 11 Reform (October 17, 2012).

[17] *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1942 (2006).

[18] *See* Eisenberg, *supra* note 11, at 12 (stating "hedge funds, complimented by their innovation and unconventional perspective, will continue to have a positive impact on the bankruptcy process"). More broadly, commentators recognize the role investors can play in disciplining management. *See* Harner & Marincic, *supra* note 5, at 1178 (acknowledging role of investors in disciplining debtor and representing creditor body more evenly in negotiations with debtor and other creditors); Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 401 (1997) (concluding active investors add value through "disciplining managers").

[19] In particular, the recent empirical study by Wei Jiang shows that hedge fund involvement in chapter 11, among other things: (1) increases the likelihood of a successful reorganization; (2) results in higher recoveries for junior classes; (3) creates efficiencies in the process, particularly by curbing management overreaching; and (4) enhances the company's overall value and reduces its leverage upon emergence. *See* Jiang, et al., *supra* note 2, at 514–15. The study also refutes the notion that hedge funds have short-term investment strategies, and instead shows that funds are increasingly focused on loan-to-own strategies where they benefit from the positive long-term prospects of the reorganized company. *See id.* at 515. *See also*

ensure feasibility, which should reduce repeated chapter 11 filings by the same company—so-called "chapter 22s."[20] To reiterate: where hedge funds are actively involved, creditors experience *higher* overall recoveries and companies are more likely to reorganize *successfully*. Even more telling, these results are consistent with recent empirical studies of hedge fund activism outside of bankruptcy as well.[21] This implies that, contrary to certain perceptions, hedge funds are not getting the benefit of higher recoveries at the expense of other unsecured creditors or equity holders. Nor are they creating artificial, short-term value improvements so they can cash out promptly. Instead, hedge funds can help to enhance the value of the surviving enterprise, thereby increasing the "size of the pie" for all parties in interest.[22]

III. EXEMPLAR: PAULSON'S RECENT EXPERIENCES

My own experiences at Paulson underscore many of these themes, and are consistent with the conclusion that hedge funds can play a positive role in bankruptcy. Paulson has been involved in many of the largest bankruptcies of the last credit cycle from 2008-2012. During this time, Paulson has had a positive impact on several companies in bankruptcy.

Paulson has helped companies reduce leverage and emerge from bankruptcy as successful going concerns by accepting equity on account of their debt claims. For example, in the *Delphi Automotive* bankruptcy cases[23] and the *Houghton Mifflin*

Harner, et al., *supra* note 2, at 168 n.2, 179 n.80 (collecting results of other recent and pending empirical studies that show, among other things, that hedge funds improve corporate governance and operating performance of reorganized companies, and that their involvement in chapter 11 is associated with greater deleveraging during the case).

20 *See generally* Edward I. Altman et al., *Post-Chapter 11 Bankruptcy Performance: Avoiding Chapter 22*, 21 J. APPLIED CORP. FIN. 53 (2009) (analyzing recidivism in bankruptcy).

21 *See* Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-term Effects of Activism*, (Colom. Bus. Sch. Research Paper No. 12-66) (July 9, 2013) (manuscript at 3–4) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577 (finding *no evidence* that a business's operating performance declines after fund actions; *no evidence* that stock prices diminish after fund intervention, even after 5 years; and *no evidence* that stock prices diminish once fund ceases to be majority or significant owner, again even 5 years later; therefore, concluding "policymakers and institutional investors should not accept the validity of assertions that interventions by hedge funds are followed by long-term adverse consequences for companies and their long-term shareholders."). *See also* Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. LAW & BUS. R. 459, 482, 489, 508 (2013) (refuting notion that funds are merely interested in short-term investment and finding that aggressive fund strategies, when used, cause stock prices to rise; therefore, concluding that objections to activism are "a myth" and counseling against changes that would combat this trend, citing in particular fact that hedge fund activism can "reshape corporate governance in a manner more conducive to the needs of shareholder value").

22 *See* Jiang et al., *supra* note 2, at 556 (concluding "the favorable outcomes for claims in which hedge funds invest do not come at the expense of other claimholders—they are more likely to result from value creation by alleviating financial constraints and mitigating conflicts among difference classes of claims."). Said differently, fund involvement is associated with efficiency gains, not value extraction. *See* Hotchkiss & Mooradian, *supra* note 18, at 404, 427 (finding distressed debt investments have positive valuation effects on their targets, and thus they "do more than bargain to increase distributions on their own behalf.").

23 *In re* Delphi Corp., No. 05-44481 (Bankr. S.D.N.Y.).

Harcourt bankruptcy cases,[24] Paulson and other existing debtholders converted their debt to equity, which enabled the companies to emerge from bankruptcy with a de-levered capital structure positioned for growth.[25] Notably, in *Delphi*, the hedge funds did so despite the volatile capital markets in 2009 and an uncertain business path, which made traditional financing opportunities scarce.[26]

Paulson has also provided new financing to companies to enable them to exit chapter 11. The *Extended Stay* bankruptcy cases in 2009-2010 are one such example.[27] There, Paulson and its partners were the successful bidders at a contentious section 363 auction for the Extended Stay business.[28] Under the resulting plan, Paulson and its partners acquired the company and capitalized it with hundreds of millions of dollars to enable it to invest in renovations and maintain the business.[29]

Finally, through its position as a large creditor, Paulson has helped facilitate compromises and settlements in contested cases. A prime example is the *Lehman* bankruptcy cases, where Paulson helped achieve a global compromise that was praised by the bankruptcy judge overseeing the proceedings.[30] That compromise was aided by the concentration of significant amounts of debt in the hands of a much smaller group of creditors (namely, hedge funds) through active claims trading in the case.

Notably, Paulson was a long-term investor in each of these companies. Thus, Paulson's experiences help challenge the notion that hedge funds are short-term investors seeking quick turnarounds at the expense of business fundamentals or third parties.[31]

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[24] *In re* Houghton Mifflin Harcourt Publ'g Co., No. 12-15610 (Bankr. D. Mass.).

[25] *See* Nick Bunkley, *After 4 Years, Delphi Exits Bankruptcy With Sale of Assets to Lenders and G.M.*, N.Y. TIMES, Oct. 7, 2009, *available at* http://www.nytimes.com/2009/10/07/business/07delphi.html (explaining company's existing lenders "agreed to forgive about $3.4 billion in debt and invest $900 million into the company" upon emergence); D.C. Denison, *Houghton Mifflin Harcourt Emerges from Bankruptcy*, BOSTON GLOBE, June 23, 2012, *available at* http://www.boston.com/businessupdates/2012/06/22/houghton-mifflin-harcourt-emerges-from-bankruptcy/NO50JzPtIlb3n4RaFjz3oI/story.html (stating company's creditors agreed to exchange their debt for equity, eliminating $3.1 billion in debt).

[26] *See* Bunkley, *supra* note 25.

[27] *In re* Extended Stay Inc., No. 09-13764 (Bankr. S.D.N.Y.).

[28] *See* Nadja Brandt, *Extended Stay Exits Bankruptcy Amid Sale of Company*, BLOOMBERG, Oct. 8, 2010, http://www.bloomberg.com/news/2010-10-08/extended-stay-exits-bankruptcy-amid-sale-of-company-update1-.html.

[29] *See id.*

[30] *See* Transcript of Hearing Held Sept. 19, 2012 at 14:16–19, *In re* Lehman Bros., No. 08-13555 (Bankr. S.D.N.Y.) ("The accomplishments in this bankruptcy case speak for themselves and no one group can take credit for it; it's an interactive process that produced a consensual outcome of remarkable proportions."); *In re* Lehman Bros. Holdings Inc., 487 B.R. 181, 181 (Bankr. S.D.N.Y. 2013) ("These historic bankruptcy cases have been characterized by professional excellence and creative problem solving leading to negotiation, cooperation and the ultimate compromise of conflicting positions.").

[31] *See, e.g.*, Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1662 (2009) (discussing potential for shorter investment horizons to impact firm's reorganization); *but cf.* Jiang et al., *supra* note 2, at 556 (offering empirical evidence to dispute this contention).

IV. THE FUTURE OF CHAPTER 11

Any modifications to the Bankruptcy Code or chapter 11 practice should be considered in light of how those changes will improve or impair the ability of parties to accomplish the rehabilitative and value-maximizing goals of chapter 11 and the negotiating dynamic on which chapter 11 practice is premised. This paper identifies some of the many ways in which hedge funds can contribute positively to improve both the bankruptcy process and the substantive outcome. As such, the Bankruptcy Code and chapter 11 practice should be structured to encourage their continued involvement and participation in the bankruptcy process. This can be accomplished generally by creating consistent and well-defined rules of the road, promoting liquidity and capital investment, increasing transparency, management and board accountability, and improving the flow of information to creditors. More specifically:

First, the increasing use of equitable remedies should be reconsidered. Equitable subordination, vote designation and disallowance[32] should be used solely to curb behavior that is illegal, harms other creditors, or is otherwise antithetical to the goals of chapter 11.[33] To deploy these remedies for anything less extends them beyond their intended equitable goals, while casting uncertainty on hedge funds' ability to participate in the case for strategic purposes. Accordingly, to the extent that cases such as *DBSD North America*—where the bankruptcy court designated the rejecting plan vote of a claims purchaser because the party had purchased claims and voted against the plan in an effort to acquire the debtor's assets for its own strategic purposes—become a trend, this would be a real cause for concern.[34] Courts recognize that parties in bankruptcy frequently have ulterior motives and their decisions in a case are informed by self-interest, and that this alone does not warrant designation or applying other equitable remedies. But it should be remembered that these motivations can, in many cases, actually benefit a case, such as in instances where hedge funds purchase claims in the fulcrum class to gain ownership of the reorganized entity, and thereby enable a debt-for-equity conversion. To penalize secondary market participants for actions (and motivations) that are legal, consistent with the goals of chapter 11, and do not disadvantage or harm other creditors,

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[32] *See* 11 U.S.C. §§ 502(d), 510(c), 1126(e) (2012).

[33] *See, e.g.*, *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 56, 61 (Bankr. S.D.N.Y. 2006) (noting vote designation of a "drastic remedy" that should be "the exception, not the rule" and it is appropriate only "when the voting process is being used as a device with which to accomplish some ulterior purpose, out of keeping with the purpose of the reorganization process itself, and only incidentally related to the creditor's status *qua* creditor") (internal citations omitted); *In re* W.T. Grant Co., 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980), *aff'd* 699 F.2d 599 (2d Cir. 1983) (finding equitable subordination to be "extraordinary remedy" that should be used sparingly).

[34] *See* DISH Network Corp. v. DBSD N. America, Inc. (*In re* DBSD N. America, Inc.), 634 F.3d 79, 104–05 (2d Cir. 2011) (upholding decision to designate votes pursuant to section 1126(e) based on creditor's bad faith).

forecloses the advantages hedge funds can offer.[35] Moreover, such remedies, if indiscriminately applied, may cause capital to flow to other markets with more defined and transparent rules.

Nor should equitable remedies be utilized if they do not actually curb bad behavior. Applying these remedies to disallow claims purchased in the secondary market by good faith, innocent purchasers is one such example, since doing so inappropriately penalizes innocent parties for the actions of others without curbing bad acts.[36] Using these remedies as strategic weapons to gain leverage—the invocation of these remedies by the out-of-the-money equity committee in *WaMu*, for one—is another example.[37] In neither circumstance is the goal of remedying or deterring egregious behavior accomplished; instead, these efforts interject uncertainty into the market and complicate the chapter 11 process. They should not be permitted.

Second, the uncertainty caused by the *WaMu* decision must be addressed, lest it adversely impact the robust negotiating dynamic upon which chapter 11 relies. In the hedge fund world, *WaMu* stands for the proposition that a hedge fund that participates in plan negotiations with a debtor is at risk of becoming a temporary insider, thereby facing allegations of insider trading if it continues to trade the debtor's claims in the secondary market—even if such trading is performed in compliance with a cleansing provision or on the other side of an ethical wall.[38] As Judge Peck observed at this symposium, this has led some funds to determine that the most prudent course of action is to opt out of such negotiations, lest they be deemed an insider.[39] This impairs active negotiation in bankruptcy, since the absence of an often-key and substantial creditor from such negotiations may delay, complicate, and even harm those negotiations. After all, absent a commitment by all large creditor groups to a plan, the debtor cannot be assured of an affirmative

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[35] While it is clear that a creditor cannot use its position to disadvantage similarly situated creditors, *see In re* Allegheny Int'l, Inc., 118 B.R. 282, 289–90 (Bankr. W.D. Pa. 1990), *DBSD* arguably went further, penalizing a creditor interested in a strategic transaction that could have benefited parties in interest. Moreover, favoring original creditors over secondary purchasers is contrary to the basic principle of equal treatment for similarly situated creditors.

[36] *In re* Enron Corp., 379 B.R. 425, 439 n.76, 447 (Bankr. S.D.N.Y. 2007), is instructive in this regard. There, the court concluded that equitable subordination and disallowance resulting from misconduct by a creditor should not be applied to "good faith open market purchasers of claims" where other more appropriate remedies, i.e., lender liability rules, exist to address wrongful behavior. *But cf. In re* KB Toys, Inc., 470 B.R. 331, 343 (Bankr. D. Del. 2012) (reaching contrary decision with respect to trade claims, though refraining from commenting about such remedies for transferred public securities).

[37] *See In re* Wash. Mut., Inc., 461 B.R. 200, 254 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012) ("The Equity Committee has recently filed a motion for authority to prosecute an action to equitably subordinate or disallow the Settlement Noteholders' claims.").

[38] *See id.* at 263 ("The Equity Committee and the TPS Group contend that the Settlement Noteholders became temporary insiders when they were given material non-public information creating a fiduciary duty on their part towards other creditors and shareholders.").

[39] *See* Hon. James M. Peck, *Settlement Talks in Chapter 11 After "WaMu": A Plan Mediator's Perspective*, 22 AM. BANKR. INST. L. REV. 65, 67 (2014) (stating "[m]any distressed hedge funds are opting not to engage in negotiations that might expose them to any incremental threat of potential liability based on insider trading claims").

vote during solicitation. Accordingly, steps must be taken to enable hedge funds to fully engage in confidential plan negotiations—including the receipt of material non-public information with appropriate cleansing mechanisms—without being deemed insiders. In this respect, Judge Peck's recommendation for more *ResCap*-like protective orders is worthy of consideration.[40]

Third, more information about the debtor must be provided to creditors to promote their meaningful participation in negotiations and plan development. Outside of bankruptcy, transparent financial reporting by companies is necessary for the market to function properly. In bankruptcy, this is absolutely essential; without accurate information about the debtor, creditors lack the information necessary to fully assess a debtor's proposed plan.[41] Yet in practice, accurate and useable financial information about the debtor is often unavailable. Though efforts have been made to address this issue (for example, requiring official creditors' committees to "provide access to information"[42]), these efforts have been largely unsuccessful. This is particularly true for monthly operating reports, which include voluminous financial data about the debtor, but little or no analysis. As such, these reports are of little practical utility to a creditor seeking to assess its claims or the debtor's proposed path to emergence.[43] Because adequate information is essential for meaningful creditor participation in chapter 11, increasing the flow of information to creditors would yield a better process.

Preserving management oversight by creditors is similarly important. Productive discussions between management and creditors require an alignment of interests regarding the rehabilitation of the company and the maximization of value. Yet inadequate management oversight and accountability can lead creditors to distrust the debtor's decisions about its future. This is particularly true when creditors will become the future owners of the business by receiving equity under a plan. Therefore, in conjunction with increasing information flow to creditors, consideration should be given to enhancing the ability of creditors to appropriately

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[40] *See* Peck, *supra* note 39, at [8–9] (referring to Order in Aid of Mediation and Settlement, *In re* Res. Cap., LLC (Bankr. S.D.N.Y.) (Case No. 12-12020) [Dkt. No. 4379]. A similar protective order was entered in the *Vitro* bankruptcy cases. *See* Order in Aid of Settlement Negotiations, *In re* Vitro S.A.B. de C.V. (Bankr. N.D. Tex.) (No. 11-33335-hdh-15) [Dkt. No. 311].

[41] *See, e.g.*, Ziad Raymond Azar, *Bankruptcy Policy: A Review and Critique of Bankruptcy Statutes and Practices in Fifty Countries Worldwide*, 16 CARDOZO J. INT'L & COMP. L. 279, 373 (2008) (noting importance of "the continuous flow of information to creditors throughout [the bankruptcy process]").

[42] 11 U.S.C. § 1102(b)(3) (2012).

[43] Compounding this problem is the ability of certain public reporting companies to stop their SEC reporting while in bankruptcy. *See* SEC Staff Legal Bulletin No. 2 (April 15, 1997), *available at* http://www.sec.gov/interps/legal/slbcf2.txt ("Companies in bankruptcy are not relieved of their reporting obligations."). The MFA has made suggestions to correct the shortcomings of the current reporting obligations, such as establishing more consistent rules and guidelines. *See* Letter from Stuart J. Kaswell, Exec. Vice President & Managing Director, General Counsel, Managed Funds Ass'n, to Clifford J. White III, Director, Exec. Office of the U.S. Trustees, U.S. Trustee Program (October 7, 2013), *available at* https://www.managedfunds.org/wp-content/uploads/2013/10/MFA-USTP-Ltr-on-MORs-final-10-7-13.pdf ("We believe that the public would benefit from improved financial disclosure in chapter 11 cases."). The MFA hopes for a prompt resolution of this matter.

monitor management during a chapter 11 case.[44] For example, some have proposed that the role of chief restructuring officers be expanded in chapter 11 to counterbalance the perceived influence of secured creditors. While this suggestion may have merit, chief restructuring officers should also be able to counterbalance any perceived conflict or self-interest of management, when necessary. To accomplish this goal, such individuals would have to be truly independent, selected and appointed through an appropriate process with meaningful input by all creditors.

Finally, the mandate and function of the official creditors' committee should be reexamined. As corporate capital structures continue to evolve and grow ever more complex, certain creditor constituencies are increasingly underrepresented on the official creditors' committee.[45] This underrepresentation is one factor driving the prevalence of *ad hoc* committees in recent years (and all the attendant litigation, including the Rule 2019 debate[46]), where creditors band together outside of the official committee structure to ensure their interests are protected.[47] However, *ad hoc* committees are not perfect substitutes for statutory committees. In particular, they do not enjoy the same protections or benefits.[48] They are imperfect solutions. Structural changes and other steps should be considered to ensure that official committees accurately and appropriately represent the creditor body and those parties with a financial stake in the outcome of the case.

CONCLUSION

Hedge fund involvement in bankruptcy is complex, with many different participants operating with many different goals.[49] Accordingly, in considering whether changes to the Bankruptcy Code or Rules are appropriate or necessary in light of the increase of hedge fund involvement in chapter 11, care must be taken. Statutory changes are blunt instruments, as the 2005 amendments to the Bankruptcy

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[44] *See* Jiang et al., *supra* note 2, at 514 (suggesting hedge funds can help create more "management-neutral" chapter 11 dynamic that appropriately balances competing interests of management and creditors).

[45] *See* Kurt F. Gwynne, *Intra-Committee Conflicts, Multiple Creditors' Committees, Altering Committee Membership and Other Alternatives for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 109, 110 (2006) (noting alleged "competing fiduciary or contractual dut[ies]" of committee members may prevent them from properly representing constituents' interests).

[46] *See In re* Northwest Airlines Corp., 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007) (addressing application of Rule 2019 disclosures to informal, *ad hoc* committees); *see also In re* Wash. Mut., Inc., 419 B.R. 271, 275 (Bankr. D. Del 2009) (concluding *ad hoc* committees "must comply with Rule 2019").

[47] *See* Perechocky, *supra* note 5, at 529–30 ("Often, multiple investors, hedge funds and claims traders will work together in informal, or '*ad hoc*,' groups, sharing resources and cutting administrative costs.").

[48] Nor are they fiduciaries for parties other than themselves. *But see In re* Washington Mut., Inc., 419 B.R. at 278 (finding "the case law . . . suggests that members of a class of creditors may, in fact, owe fiduciary duties to other members of the class"); *see also* Perechocky, *supra* note 5, at 560–61 (analyzing these decisions and arguing that it is inappropriate to impose fiduciary duties on unsecured creditor groups, when similar secured creditor groups (namely, loan syndicates) are not so burdened).

[49] *See, e.g.*, Levitin, *supra* note 8, at 97 (outlining different types of claims traders, which are "comprised of dynamic, multi-motivational, and overlapping sub-markets").

Code made clear, and are often inappropriate tools to correct specific outlying behavior.

It is simplistic to suggest one-size "solutions" for a single "problem," unless the goal is to end hedge fund involvement entirely. Any such goal is entirely inadvisable and is not supported by fact. Recent data, including some of the data introduced at this symposium, clearly refutes certain negative perceptions about hedge fund participation in bankruptcy, and reveal them as misperceptions: beliefs, without factual basis.[50] Professor Harner has suggested that suspicions about hedge fund participation in bankruptcy may be due, in part, to a lack of information.[51] Therefore, more data is needed so that the debate over hedge funds is based on fact, rather than anecdotal evidence where unique and specific cases and actions are used to exemplify the entire arena of hedge fund participation in chapter 11.[52]

This paper is submitted to outline some of the ways in which hedge funds can benefit the chapter 11 process, and to suggest that statutory changes that limit hedge fund involvement in chapter 11 would have broad negative repercussions: that impairing the contributions of hedge funds in chapter 11 would impede the chapter 11 process as a whole.

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[50] *See* Jiang et al., *supra* note 2, at 556 (concluding hedge fund presence in bankruptcy process results in favorable outcomes while creating value and "mitigating conflicts").

[51] *See* Michelle Harner, *Trends in Distressed Debt Investing*, 16 AM. BANKR. INST. L. REV. 69, 71 (2008) ("The lack of transparency in the activities of distressed debt investors creates uncertainty and unease with respect to their involvement in chapter 11 cases.").

[52] For example, the *Tribune* cases are frequently utilized as the poster child of how hedge funds delay and complicate a chapter 11 case. But *Tribune* involved many complexities, including a $2 billion fraudulent conveyance litigation and multiple competing plans, and is far from the norm. Given that an independent third party concluded that colorable claims of fraud and other wrongdoing existed, it should be no surprise that the case was litigious. *See* Report of Kenneth N. Klee, as Examiner, *In re* Tribune Co. (Bankr. D. Del.) (No. 08-13141) [Dkt. Nos. 5247-5250] (concluding colorable fraud and other claims likely existed against Tribune's management related to pre-petition financing transactions).