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Hedge Funds:

The New Players at the Chapter 11 Table

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ARE HEDGE FUNDS DIFFERENT FROM OTHER CREDITORS?

Size matters: hedge funds manage over $1 trillion.

Focus is on ROI. Winning demands more than just getting your money back.

This time it's personal: individual fund managers have a personal economic state in the outcome of the reorganization.

IS THIS A GOOD THING?

A bigger stake means a more active, involved player.

This means more accountability, better corporate decision making.

More liquidity in the market means more options for the distressed debtor, and thus less distress. Borrowers are able to refinance problems and thus often buy time to address them.

Hedge funds are willing to provide rescue financing on more aggressive terms in exchange for upside reward.

> *E.g., Aloha Airlines – hedge fund lenders received an exclusive right to propose an emergence transaction and obtain exit "success" fees, in exchange for DIP financing.*

An ROI focus creates a heightened appetite for equity and thus more flexibility for debtors. Rights offerings, driven by hedge fund money, are now an important source of exit financing.

> *E.g., Owens Corning's $2.2 billion exit financing – a rights offering syndicated to hedge funds.*

ON THE OTHER HAND, IS THIS A BAD THING?

Do funds really have a long term view, or is it just about generating trading profits?

Can they acknowledge and deal constructively with restructuring setbacks, or are they wedded to maintaining the illusion of success? Will more debtors be forced to exit chapter 11 before they are ready?

Will hedge funds force more sales of entire business in order to achieve higher returns?

What impact might this have on vendors, employees, managers?

Will the emphasis on ROI conflict with the traditional goals of compromise in chapter 11?

Will we see a greater misalignment between investment positions (e.g., short positions) and reorganization objectives?

HAVE HEDGE FUNDS ALREADY CHANGED THE PROCESS?

Multiple holdings, derivative exposure, short positions, do we even know with whom we're negotiating?

"Because the long position in one proprietary account was offset by a short position in another proprietary account, Blue River had only a $6.5 million face value claim against WorldCom. Had the U.S. Trustee know that the Blue River's claim was $6.5 million and not $400 million, it is unlikely that Blue River would have been appointed to WorldCom's creditors' committee."
SEC Release No. 52744/Nov. 7, 2005.

Will Section 1102(b)(3) lead to selective disclosure of material information?

Will it cause non fiduciary Ad Hoc Committees to proliferate?

Will greater access to information give non fiduciary distressed investors an unfair edge in the marketplace?

Bank debt trading and inside information. Should anyone care?

"In early March, executives from Movie Gallery, a big movie chain, held a private conference call for their lenders to talk about how disastrous 2005 had been....Most of the roughly 200 lenders were not bankers, but hedge funds. And what they heard was supposed to be confidential....During the next two days, though, [Movie Gallery's] stock plummeted 25 percent". **New York Times, Oct 16, 2006**

LITIGATION AS AN INVESTMENT STRATEGY

With more money looking for distressed investments, and an increasing number of sophisticated investors, there are few, if any, easy wins.

As a result, more than ever, litigation has become an essential investment tool for boosting ROI.

WHAT SHOULD WE EXPECT?

Inter Debtor Conflicts: Will multi debtor cases require separate fiduciaries? (*See* Adelphia at p. 14 below)

Valuation Disputes: Will the assault on management's credibility continue? (*See* Exide at p. 15 below)

Vote Designation: Will creditors with multiple holdings be subject to attack? (*See* Adelphia at p. 16 below)

Exclusivity Battles: Will holdouts force more companies for sale?

Lender Liability: Will we continue to see new theories? (*See* Radnor at p. 17 below)

First Lien/Second Lien: What is a "subordination agreement"? (*See* Dura at p. 18 below)

Buyer v. Seller: Is the Buyer liable for the Seller's sins? (*See* Enron at p. 21 below)

CAN LITIGATION BE CONTROLLED?

Should courts begin to exercise greater control over derivative actions?

Should they put creditor parties to the burden of showing some probability of success before asserting estate claims? (*See* G-I Holdings; Baltimore Emerging Services at p. 19 below)

Should they curtail the rights of intervenor parties in disputes, or should everyone allowed to "appear and be heard" also be allowed to fully litigate? (*See* Adelphia at p. 20 below)

Should there be expanded 2019 disclosure of all holdings (*e.g.*, short positions) in bankruptcy?

What will be the ground rules when exclusivity terminates? Who will get to go first?

CASE SUMMARIES

INTER DEBTORS CONFLICTS

In re Adelphia Communications Corp., 336 BR 610 (Bankr. SDNY, 2006), aff'd 342 BR 122 (SDNY, 2006).

An ad hoc bondholders' committee moved for the appointment of a trustee for certain debtors, recusal of such debtors with respect to certain inter debtor disputes, the appointment of non statutory fiduciaries with separate counsel for such debtors, the disqualification of debtors' counsel with respect to the disputes, and the termination of exclusivity. Court denied the motion but grants the motion for recusal and disqualification. Debtors and their counsel were directed to stay out of inter debtor disputes, leaving the issue to be litigated by non fiduciaries.

VALUATION DISPUTES

In re Exide Technologies, 303 BR 48 (Bankr. D. Del. 2003).

Case concerned a contested confirmation hearing which resulted in the denial of plan confirmation. A key issue in the dispute was over valuation. The debtors had valued the enterprise in the range of $950 million to $1.05 billion. The creditors' committee, opposing confirmation, argued for a valuation of $1.5 billion to $1.7 billion. The Court adopted a valuation of $1.4 billion to $1.6 billion. It also took note of the Committee's argument that "plans providing management and/or senior creditors with the majority of stock or options in the reorganized company is a strong indicator that the company is being undervalued, resulting in a windfall for management and the senior creditors". The *Exide* court's observation of possible management bias was echoed by the court in *In re Coram Healthcare,* 315 BR 321, 339 (Bankr. D. Del. 2004)

VOTE DESIGNATION

In re Adelphia Communications Corp., 2006 WL 3609959 (Bankr. SDNY, 2007).

An ad hoc committee of parent bondholders moved to designate the votes of certain other holders. The targeted holders held bonds against the parent debtor and also against other debtors involved in an inter debtor dispute with the parent debtor. The court denied the motion. "If, under section 1126 (e) ... creditors who hold claims of multiple debtors are to be denied the right to vote all of their claims, in all of the debtors in which they hold debt - even assuming, once again, that the individual debtors have interests contrary to each other, and that the recoveries of one debtor come at the expense of another - that is a matter for Congress to decide."

LENDER LIABILITY

In re Radnor Holdings Corporation, 2006 WL 3346191 (Bankr. D. Del. 2006).

TCP, a hedge fund and a secured lender to the debtor sought to credit bid its lien and buy the debtor out of chapter 11. The creditors' committee objected and sued, alleging claims for recharacterization, breach of fiduciary duty, fraudulent transfers and preferences, among other claims. In connection with the action the creditors' committee accused TCP of having entered into the loans with no expectation of Radnor being able to repay them, but rather as a way to acquire Radnor, a so-called "loan to own" strategy. The case went to trial and TCP prevailed on all counts.

FIRST LIEN/SECOND LIEN

In re Dura Automotive Systems, Case No. 06-11202 (D. Del).

A first lien/second lien intercreditor agreement imposed severe limitations on the second lienholders' ability to oppose a priming dip financing and seek adequate protection. One key dispute, yet to be adjudicated, is whether a dip financing that takes out the first lien position can succeed to the first lienholders' rights under the intercreditor agreement and continue to enforce its terms against the second lienholders. In their objection (docket # 202) the second lienholders state: "While the Debtors are also included as nominal parties, the "rights" are extremely limited under the [intercreditor agreement] and under no circumstances do such rights allow the Debtors to impose the DIP Financing or the proposed

STANDING TO ASSERT ESTATE CLAIMS

In re G-I Holdings, Inc., 2006 US Dist. Lexis 45510, (D. N.J. 2006).

On cross appeal, the district court reversed the bankruptcy court's decision to give the creditors' committee standing to pursue certain avoidance actions. Relying heavily on the Second Circuit's *STN* decision, the court remanded to the bankruptcy court with instructions to "explicitly" conduct a cost-benefit analysis of the proposed litigation with "detailed factual findings". The district court made it clear that in order to obtain standing to sue, the committee needed to do more that file a complaint sufficient to survive a Rule 12 (b)(6). It needed to provide the bankruptcy court with the evidence required for a cost-benefit analysis justifying the suit, including by sufficiently demonstrating, among other things, factors relevant to "the probabilities of legal success in the event the action is pursued." *See also*, *In re Baltimore Emergency Services II, Corporation*, 432 F. 3d 557 (4th Cir. 2005) (reversing an order granting standing to creditors' to pursue estate claims in the absence of evidence "that allowing the suit would be beneficial to the estate and necessary to the fair and efficient resolution of the bankruptcy proceedings").

CURTAILING INTERVENOR RIGHTS

In re Adelphia Communications Corp., **285 BR 848 (Bankr. SDNY 2002).**

The creditors and equity holders' committees sought to intervene in an adversary proceeding commenced by the debtors. The court recognized the committees' intervention rights under Section 1109 (b), but it drew a distinction between the right to intervene and the right to fully litigate the dispute in issue. "[T]he Court believes that it does not necessarily follow that once having intervened, intervenors have the right to litigate as the possessors of causes of action do, or to act wholly free of the limitations imposed by the Court in the interests of orderly procedure". Among the potential limits the court said it had the power to impose were limits on an intervenor's rights to take discovery.

BUYER'S LIABILITY

In re Enron Corp., 333 BR 205 (Bankr. SDNY 2005).

The debtors sought to equitably subordinate claims held by claims buyers based upon the sellers' prepetition misconduct. The claimants moved to dismiss and lost. The court stated "a claim in the hands of a transferee…who received that claim from a transferor found to have engaged in inequitable conduct is subject to the same equitable relief as if such claim were still held by the transferor." *See also, In re Enron* 340 BR 180 (Bankr. SDNY 2006) (transferee's claim disallowed under Section 502(d) because its transferor failed to return avoidable transfers).