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Anti-Bankruptcy: Hedge Fund Activity in Corporate Reorganizations

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When the next wave of corporate bankruptcies crests, corporate reorganization law will be put under new stress.[1] Since the last round of large Chapter 11s, financial markets have undergone a revolution. Financial innovation has allowed investors to slice and dice cash flow rights and control rights into smaller and smaller pieces. Those charged with shepherding the business through the reorganization face a daunting challenge in trying to bring together the various stakeholders and accommodate the interests of each.

The players in the next round of reorganizations will be sophisticated distressed debt investors, each of whom holds novel and competing long and short positions, positions that are constantly shifting throughout the course of the case. Unsecured debt may exist in many flavors or be entirely irrelevant. The relative positions of the parties cannot be reconciled with the traditional neatly hierarchical capital structure, nor do the parties know the position of the other players. Those with a voice in the reorganization may have no economic stake, and those with a stake may have no voice. The strength of the desire of one to work towards a successful reorganization cannot be gleaned from knowing into which class their claim falls. Various investors may or may not participate in the reorganization process, may or may not want to act in concert with others, and may or may not care if the reorganization succeeds.

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[1] The last few years have seen a dramatic decline in the number of large companies that file for bankruptcy. In 2006 there were only 14 filings of large, publicly held companies, while in 2002 there were 120. Some of this downturn is cyclical. Hence, we can expect the number of cases to increase if credit markets dry up and distressed firms cannot find refinancing as easily as they can today. Nevertheless, the long-term trend is decidedly away from the traditional reorganization. For reasons as to why this is so, see Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy,* 55 Stan. L. Rev. 751 (2002).

The challenge the legal system faces is much like assembling a city block that has been broken up into many parcels. This is quite at odds with the standard account of corporate reorganizations—that it deals with a tragedy of the commons, a world in which general creditors share dispersed, but otherwise similar interests. Instead, we face an anti-commons problem, a world in which ownership interests are fragmented and conflicting.[2] Senior creditors used to press for a sale; now they often favor a reorganization. Junior parties who used to fear sales now see it as way to protect their interests. In the past, creditors wanted a prominent seat at the bargaining table; now many large players want to stay in the shadows. Bankruptcy has become anti-bankruptcy. In this article, we take stock of the recent changes and show how they will come to the fore when reorganization activity increases.

Our conclusions are twofold. First, recent financial innovations are likely to bring significant benefits over the long run. They allow the diversification of risk and better-tuned allocations of cashflow and control rights. Firms are less likely to encounter financial distress as they are able to hedge more risks and tap into more liquid credit markets. Once they are working effectively, they will join the other forces that, over the long terms, signal the end of bankruptcy.[3] But these financial innovations are still new and untested. Many emerged after the last large wave of Chapter 11s, the one that came in the wake of the dot.com and telecommunications meltdown in the first part of this decade. It is unrealistic to think all the new financial innovations will work as planned. Much of the business—or at least the interesting business—of sorting through the next round of large Chapter 11 cases will arise from the disequilibrium that these new tools are likely to bring with them.

The primary source of this disequilibrium—the Achilles heel of the recent financial innovations—stems from the emphasis placed in the first instance on risk and the allocation of cash flow rights. The effects new instruments will have on control rights was not front and center for the high-tech investment bankers who designed the new financial instruments. Consider, for example, credit default swaps. A lender can buy a credit derivative that guarantees it will be paid in full even if its debtor defaults. While spreading risk brings undoubted

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[2] On too small property rights creating an anticommons problem, see Michael Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 Harv. L. Rev. 621 (1998).

[3] See Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673 (2003).

benefits (the lender might otherwise be under-diversified), with the credit derivative comes a moral hazard problem.

Ordinary lenders are often willing to waive loan covenants and otherwise work with their debtors to forestall a default that might disrupt the debtor's business and reduce its ability to repay what it owes. But a lender with a credit derivative possesses a rather different set of incentives. Rather than wanting to engage in work-out negotiations that enhance the value of the business, the lender may refuse and thereby induce a "credit event." It triggers the payment obligation on the part of the person that sold it the credit protection.[4] By allowing the credit event, it is sure to be paid in full. If it waits, the credit derivative may expire and leave it unprotected.

Those who designed these credit derivatives (the notional amount of which now exceeds $45 trillion) are not stupid people. They were, of course, aware of the moral hazard problem, but navigating such problems is hard. It depends upon knowing both how control rights are set out explicitly in loan documents and what practices and norms are associated with them that further affect the behavior of the parties. An old-line bank holding a loan with a particular set of covenants behaves differently from a newly arrived hedge fund holding the same instrument. The bank and the hedge fund will behave more differently still if the bank and the hedge fund have, in addition, bought a credit derivative. One should expect that the problem of coordinating cashflow and control rights requires some trial and error, and mistakes will be made before then. Controversy is likely to emerge when some of these mistakes surface.

It is always hard to give useful advice about problems whose exact contours remain unknown. Nevertheless, as we suggest below, it is sensible to focus first on the idea that we are devising rules for situations that the parties perhaps could not and in any event did not anticipate. Of course, one wants to vindicate the ex ante bargain whenever one can, but finding that bargain (or hypothesizing what it would have been had the parties thought about it) is a hazardous business. In such instances, it may make sense to default to rules that, regardless of whether parties anticipated them, are easiest to navigate around prospectively.

We set out this idea at greater length below, but the basic idea is straightforward enough. For example, holding everything else equal, a

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[4] For a description of credit derivatives and a discussion of their possible effects on Chapter 11, see Stephen J. Lubben, Credit Derivatives & the Future of Chapter 11 (Seton Hall Public Law Research Paper No. 906613) (July 17, 2007) (available at SSRN: http://ssrn.com/abstract=906613).

bankruptcy judge's exercise of her discretion to disqualify an investors' vote on a plan for engaging in strategic behavior is inherently more problematic than a rule that mandates disclosure of information on the part of investors who participate in the reorganization process. While both decisions might in principle curb misbehavior, the first breeds uncertainty and makes the design of finely tuned financial instruments in the future hard. The second may dampen some kinds of trading, but is much more susceptible to being incorporated as a rule of the road. Those who design financial instruments and those who trade them can know exactly where they stand.

I. The New World of Chapter 11

Large Chapter 11s no longer play the role they once did.[5] Relatively fewer financially distressed firms need a collective bankruptcy proceeding to overcome a collective action problem among diverse creditors preserve going concern value. Firms depend far less on assets that are firm-specific. Shutting down businesses that lack dedicated assets is less costly than shutting down one that has them. (A motion picture production company can be reassembled in a way that a railroad cannot, and firms today are more like motion picture production companies than a railroad.) Firms are built with capital structures that lack the crazy-quilt character of the 19th Century railroads and other first efforts at large corporate form. Finally, in modern capital markets sales even of the largest firms are completely feasible. These changes put the traditional accounts of large Chapter 11s under considerable pressure. Changes in the financial market transforms the face of Chapter 11 further still.

A. The Decline of the Traditional Bank

Perhaps there is no more stock character in the discussion of bankruptcy policy than the senior bank. The bank has made a large loan to the company and has a security interest in most, if not all, of the company's assets. The financial interest of the bank is relatively straightforward. If it can realize the value of its collateral, it will be paid in full. As such, the lender has an incentive to turn its collateral into cash via some form of sale. The senior lender would seek to sell the discrete asset in which it had a security interest, and this would lead to the closure of the business. The lender is biased toward liquidation. Because it does not share in the upside should the debtor's fortunes improved, it does not take such possibilities into account. Rather, if it can force a liquidation today, it can be paid in full. It sees no need to risk continuation that can only reduce its return.

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[5] We have told this story elsewhere. See Baird & Rasmussen, supra note 1;

Even if the company is to be sold, the bank cannot be trusted if it is owed less than the company is worth. In this situation, the bank may not seek top dollar. It will only look for a sale that pays it in full. Given these incentives, the bank should not have its hand on the levers of control.[6]

Two changes in bank lending practice render this account obsolete. The first is the rise of the syndicated loan. Single banks no longer make loans to large businesses. Given the amount of these loans, any bank that funded the loan itself would be tying up a hefty portion of its capital with a single borrower. To take a simple example, assume that we have ten banks and ten borrowers. Each borrower wants to borrow $200 million, and there is a 10% chance that any given borrower will default during the term of the loan. In a world where loans were funded by a single bank, any bank loaning $200 million would have a 10% risk that a large portion of its capital would end up in default.

Syndication allows the banks to reduce this risk. By parceling out each loan among a consortium of banks, each bank can lessen its default risk. In our example, if each bank signed up to fund 10% of each borrower, it would have mitigated its risk. To be sure, by participating in more loans it is more likely that some debtor in its portfolio will default. Each bank expects to have to deal with a default on a $20 million commitment. It is much easier, however, for each bank to handle a $20 million default rather than a $200 million default. In exchange for taking on a greater risk that it will have to deal with some default, each bank has greatly reduced the risk that it will have a default that would threaten the viability of the bank.

Syndication has been with us for two decades.[7] It initially had little effect on bankruptcy practice. The lending agreement contained various covenants. If the borrower tripped up a covenant, it would have to procure a waiver. The contract governing the syndicate did not grant the lead bank the unilateral right to grant a waiver; rather, the waiver had to be approved by syndicate members holding a specified percentage of the loan. By and large, however, syndicated members would follow the recommendation of the lead bank. The reason was that members of the syndicate generally had the same economic interests and instincts. Many were banks and, while at some level they were competitors, they

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[6] See Thomas H. Jackson, The Logic and Limits of Bankruptcy 181-89 (1986) (secured creditors should receive the value of their rights, but the decision as to the fate of the corporation should be left to the general creditors).

[7] Syndication in its current form arose in response to Continental Illinois' failure due to its loan to Penn Square, a small bank in the oil fields in the 1970s.

also were repeat players. Any bank that reached an agreement with a borrower to fund a new loan would have to shop the loan to its brethren. Other frequent participants in these syndicates were pension funds looking for a safe return on their assets. These funds did not have the assessment capabilities of banks, and hence were even more likely to defer to the recommendation of the lead bank that arranged the syndicate. The general norm that developed was that, when decisions had to be made regarding the administration of the loan, there was a heavy presumption that the members of the syndicate would follow the recommendation of the lead bank. The lead bank, in essence, served as the monitor of the loan for the rest of the syndicate. Befitting the lead bank's status as the leader of the syndicate, the expectation developed that the lead bank would hold a portion of the loan that was larger than any other member.

The lead bank, in turn, would in effect demonstrate its commitment to performing its monitoring activities faithfully by holding onto the single biggest piece of the loan itself. By holding a share that was disproportionate to that of the other members of the syndicate, the lead bank would take a bigger economic hit should it fail to maximize the value of the loan. Making such a commitment made the loan easier to sell to other lenders.

The composition of lending syndicates, however, has changed recently. Membership is no longer limited to bank and pension funds. Hedge funds can participate in the syndication stage. To be sure, they do not have unfettered access to all syndicated loans. Some hedge funds, as discussed below, have reputations for being problematic, at least from the perspective of the borrowers. The current norm seems to be that borrowers can negotiate with the lead bank over excluding some hedge funds from being part of the lending syndicate.

The second development, however, makes these efforts to keep hedge funds out of the syndicate potentially futile. In recent years there has developed a secondary market in syndicated loans. The advantage of this market to those lenders participating in the syndicate is readily apparent. Any member of the syndicate, including the lead bank, now has an exit option. It can sell its portion of the loan to a willing buyer.[8] These buyers, however, now include hedge funds. Given the desire of lending institutions to be able to exit a situation with which they are no longer comfortable, the loan syndicates by and large place no

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[8] The options provided to banks by the secondary loan market are in many ways similar to the options that claims trading in bankruptcy provides to the holders of claims.

restrictions on the ability of all members of the syndicate, including the lead bank, from selling its interest in the loan in the secondary market.

Thus, when a borrower trips up covenants in its loan or files for bankruptcy, it will not necessarily be the case that all it has to do is to come to an understanding with the bank that has funded its senior debt. Today hedge funds can often purchase enough of the loan in the secondary market so that they have the power to block any waiver of default, proposed amendment to the credit facility, or plan of reorganization that does not meet with their approval.

A hedge fund that holds a position identical to the one held by a bank at an earlier time may view bad states of the world radically differently. It may have bought the loan with the view that, in the event of default, it would be left with the business and, given the amount at which it purchased the notes, it would not be a bad price at which to acquire it even if it were in financial distress. Banks want their money bank; hedge funds loan to own. Far from having a liquidation bias, a hedge fund may affirmatively want to advance a reorganization plan in which it ends up with the equity of the business. Rather than push for a market sale, it prefers a judicial process that it can control. Not only can it push for a low valuation, but the managers of the business, people whose options will be reset upon emergence from Chapter 11, will push for a low valuation as well. In short, the senior lender in the identical place in the capital structure is doing exactly the opposite of its traditional counterpart: Instead of fleeing from the Chapter 11 process, it embraces it. Rather than terminating its relationship with the business, it wants to run it. Rather than fighting the managers, it allies itself with them.

B. The Rise of New Investment Types

Bankruptcy law developed in a world of what today would appear as having limited financial instruments. Secured debt (generally held by banks), unsecured debt (generally held by banks), public investors and trade creditors, and stock (either closely held by those running the business or publicly held by dispersed individuals) exhausted the types of investments that comprised the capital structure of most businesses. In addition, investors tended to hold a single type of investment in the company. Shareholders held shares; creditors held debt, with banks holding secured debt. In this world, it was relatively simple to ascertain the incentives of any investor. Standard accounts of Chapter 11 assume the existence of a relatively limited type of investments in the debtor: secured debt, unsecured debt, and equity. The Code itself provides for secured claims,

unsecured claims, and interests, and pretty much nothing else.[9] When we think back to when the Code was drafted in the 1970s, these were the basic investments in a company. One could of course find some additional securities, but these were pretty much the exception. Put differently, the roots of the Bankruptcy Code predate Black-Scholes.[10]

The drafters of the Bankruptcy Code assumed that secured creditors, principally banks, could be trusted to look out for themselves. The banks tended to have a relationship with the debtor that it could exploit to glean information from the company. The lending agreement between the lender and debtor made sure that the bank would have access to the information that it needed in order to safeguard its own interests. By contrast, the unsecured creditors had two hurdles to overcome. One was that they were dispersed. Whereas the secured debt was concentrated in the hands of a single institution, various parties had held unsecured debt. These parties could include holders of public debt, trade creditors, land lords, tort creditors, and creditors who claimed that the debtor had breached its contract.

The problem was one of collective action. As a group the unsecured creditors may be better off by taking concerted action, but no one creditor is willing to take the laboring oar. The costs of participation fall on those who participate, but the benefits are distributed to all creditors. While for creditors as a group the best course of action may be to actively participate in the reorganization discussions, for each individual creditor the rational thing to do is stay passive. The nonbankruptcy rights are insufficiently tailored to allow them to act in a way that is mutually beneficial. Just as the agency issuing fishing licenses or regulating drilling in an oil field attempts to maximize value, those charged with overseeing the reorganization again take steps to preserve the value of the estate

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[9] See 11 U.S.C. 506 (distinguishing between secured claims and unsecured claims) & 11 U.S.C. 501(a) (allowing equity security holders to file an interest). See also 11 US.C. 1129(b) (defining cram down procedure for secured claims, unsecured claims and interests). The one exception is the Code acknowledges, but steers a wide course around, certain derivative transactions. As to why these transactions have been left unaffected by Chapter 11, and why it may be an error to do so, see Edward R. Morrison

[10] See Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637, 649–54 (1973); Robert C. Merton, Theory of Rational Option Pricing, 4 Bell J. Econ. & Mgmt. Sci. 141, 141–42 (1973). For an accessible discussion of how financial innovation alters our perception of capital structures, see Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 465–70 (1993);

on behalf of general creditors who are presumptively similarly situated and entitled to equal treatment.[11]

In addition to the incentive towards passivity, unsecured creditors also lack the information necessary to participate in the reorganization. A central, perhaps the central, issue in any reorganization effort is valuation. What would the company be worth if liquidated, and what would it be worth if kept together. While creditors could, perhaps, piece together information on liquidation values from publicly available sources, putting a price on the company as a going concern is a more difficult endeavor. One has to know the future plans for the company, and what the plausible projections are for the future revenue stream. These both require information that the company has but that outsiders do not. Indeed, the creditors have no legal entitlement to such information.

The answer to these problems was the committee structure. A committee would be formed representing the interests of the unsecured creditors. The committee would be staffed with creditors holding the six largest claims against the debtor. The existence of the committee provided a mechanism by which private information could be shared with the creditors. The committee would negotiate on behalf of the unsecured creditors as a group. Moreover, the committee would be able to collect the information that it needed in order to make an informed judgment. It could hire accountants to investigate the books of the company. It could hire investment bankers to assess what options the company had. It is invested with the broad power to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case."[12] Also, to overcome the financial disincentives, the Code required that the expense of the committee be paid for by the debtor. The court would approve the law firms that the committee hired. Moreover, the debtor would pay for all of the committee professionals, such as investment bankers and accountants.

The creditors on the committee had both a fiduciary and economic interest to represent the group of unsecured creditors as a whole. The case law established that those on the committee had to represent the interests of the unsecured creditors as a group. By and large, this duty corresponded with the economic interest of the creditors. Absent complicating factors and bribes, a creditor would

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[11] See Jackson, supra note 6, at 10-19.

[12] 11 U.S.C. §1103(c)(2).

maximize the value of its own claim by maximizing the value distributed to the unsecured creditors as a group.

The final check on the committee process was voting. The committee had no power to bind all of the class members. Rather, a plan of reorganization was put up for a vote by all class members. A class of unsecured creditors would only be deemed to accept the plan if two requirements were met. The first is that at least half of the creditors in the class vote in favor of the plan. The second is that those voting in favor of the plan hold at least two-thirds of the total amount of debt in the class. Subjecting the work of the committee to voting by those with the same economic interest as the committee members allows for the creditor community to police the committee's efforts.

This approach—one that assumes common interests among creditors—fits awkwardly with types of investment instruments in use today. Stakeholders in distressed businesses are neither distant nor uninformed nor similarly situated. Far from being dispersed investors, each is a holder of a fragmented interested in fiercely determined to profit by taking strategic advantage of her position. Investors today exploit the lessons of put-call parity,[13] and they devise investment contracts narrowly tailored to their needs with various types of derivatives. Terms such as senior secured debt, junior secured debt, senior subordinated debt and junior subordinated debt are both common and carry little fixed meaning. Figuring out precisely what cash flow rights come with a certain investment often requires careful reading of a contract running for many pages. Far from having a relatively undefined right to the debtor's assets, these investors have particular and highly defined rights. The ownership interest is hardly as simple as holding a piece of senior or junior debt. Any particular investor holds a package of claims and derivatives.

To again return to the real estate analogy, the problem is not dispersed owners of a common asset, but a city block that has been divided many ways. There are easements, leasehold and reversionary interests, air rights, and many other sticks in the Hofeldian bundle that are held by sophisticated claimants. There is no easy way to decide how much weight to be given to any one. Someone who is the record owner of a particular type of bond may also be a credit protection seller and his total position may be short. Far from wanting the

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[13] See Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 465–70 (1993); Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637, 649–54 (1973); Robert C. Merton, Theory of Rational Option Pricing, 4 Bell J. Econ. & Mgmt. Sci. 141, 141–42 (1973).

company to reorganize successfully, he may be better off if the business blows up. In addition to voting against plans of reorganization, he has an incentive to derail the reorganization process.

C. Claims Trading

Any creditor, no matter how large or small, that decides it no longer wants to maintain its relationship with the debtor now has an easy way out. There will be someone (usually a hedge fund) willing to buy its claims. This is a lightly regulated process where folks trade repeatedly even though both may have information that neither has disclosed to the other. Those on the outside have difficulty ascertaining precisely who is buying what. The one thing of which we can be confident, however, is that the players consist almost exclusively of professional investors who specialize in distressed businesses who are there by choice.[14] These are not people trying to cut their losses; these are investors looking to make a profit.

The ability to trade in claims against a Chapter 11 debtor has existed for over twenty years.[15] The increased presence and financial wherewithal of hedge funds, however, has increased the importance of this aspect of reorganization practice.[16] The basic notion of claims trading is quite simple. Chapter 11 cases can

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[14] See David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 Cardozo L. Rev. 1905 (2004).

[15] See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11,* 12 Cardozo L. Rev. 1 (1990); Robert K. Rasmussen & David A. Skeel, Jr. *The Economic Analysis of Corporate Bankruptcy Law,* 3 Am. Bankr. Inst. L. Rev. 85, 101-04 (1995).

[16] 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, 181 (2004) (noting that "distressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act"); Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy*, 11 Am. Bankr. Inst. L. Rev. 177, 177 (2003) ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims. . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader . . . ."). See generally Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 Colum. Bus. L. Rev. 191 (2005) (discussing the growing importance of role distressed debt investors play in Chapter 11).

be long and drawn out affairs.[17] The holder of a claim may not wish to wait until the end of the proceeding for payment. For example, a trade creditor rarely expects to be a long-term investor in the enterprise. When a debtor files for Chapter 11, however, the debtor is prohibited from paying pre-petition debt.[18] All payments on such obligations, even if they are to be paid in full, must await the end of the case.[19] The trade creditor, however, is not set up to participate in the Chapter 11 proceeding. It has little knowledge of the ins and outs of bankruptcy practice. Perhaps even more importantly, its business model is not built around tying up its capital in bankruptcy proceedings. It depends on cash flow from the goods that it sells to run its own operations. Even if the trade creditor still wants an on-going relationship with the debtor, it is eager to monetize its claim for prepetition goods.

Those with money to invest can make a profit here. An investor with more knowledge about the likely outcome of the case and a longer time horizon can make a positive return. One way is simply by providing liquidity. Some claimants, such as the holders of trade debt, may be relatively impatient. Similarly, an individual may have bought a bond because she sought the regular interest payments that it provided. All things being equal, she would prefer to reinvest the value of her bond in a company that is still providing regular payments. To the extent that a bankruptcy filing changes the cash-flow characteristics of an investment, the holders of that investment may want out. Claims-trading allows such investors to turn their bankruptcy claim against the debtor into cash.

The new investors who come onto the scene after a Chapter 11 has been filed may also profit from their ability to negotiate the bankruptcy process. They may be better able to assess how much the debtor will ultimately be able to pay on its claims. Moreover, the investor may be able to find overlooked value in the instruments that the debtor has issued. Either way, the investor may be able to

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[17] For example, of the 57 companies that were public at the time they filed for bankruptcy and confirmed reorganization plans in 2005, 26 were in bankruptcy for over a year, and one was in bankruptcy for almost seven years. See NEW GENERATIONS RESEARCH, THE 2006 BANKRUPTCY YEARBOOK AND ALMANAC 46-47.

[18] 11 U.S.C. 362(a).

[19] This requirement that payments be made only at the end of the case was a main reason as to why the Seventh Circuit cast a skeptical eye on critical vendor orders. See In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

use its knowledge of reorganization process to generate a higher return than could the party that owned the claim when the debtor filed for bankruptcy.

To be sure, we should worry about the sophisticated fleecing the innocent. We do not expect trade creditors and individual bondholders to have any idea as to what they can expect to receive at the end of the bankruptcy case. They also do not necessarily understand all of the rights they may have against the debtor. Yet once we have a robust market for claims, competition will carry much of the load. When, say, three entities are bidding for claims, the holder of the debt needs only to compare their relative offers; she does not have to make an independent investigation of the likely outcome of the process. Here as elsewhere markets excel at providing pricing information.

The trading of claims in advance of bankruptcy itself eases the pressures that lead to Chapter 11 in the first place. By the time for Chapter 11 to become a seriously possibility, most of its debt may be in the hands of perhaps only a few dozen distressed debt investors. The deficiencies in new financial instruments may lead to tough bargaining, but bargaining that takes place outside of bankruptcy. A Chapter 11, like any other corporate restructuring or control transaction is expensive. It will likely consume 10% of the business's assets. Even professionals with dramatically opposing interests will work hard together to incur such an expense unnecessarily. Because they are no longer widely dispersed, the cost of Coasean bargaining among them is not high.

Forging an agreement among several dozen people, however sophisticated, is far from surefire. But these individuals are powerfully inclined neither to incur the costs of bankruptcy nor to lose the control that might come with it. Indeed, instead of arising because dispersed creditors cannot work together, modern Chapter 11s often arise because the distressed debt professionals have decided to enter Chapter 11 because it gives them a substantive benefit they could not find outside bankruptcy. They may well have agreed on a plan to deal with the debt of an airline, and use Chapter 11 to escape a collective bargaining unit; a retailer uses it to escape undesirable leases. The investors that took a firm through an unsuccessful LBO agree to restructure the debt, but must use Chapter 11 in order to step around the Trust Indenture Act.[20] The investors in a rent-a-car company agree that a sale is in their mutual interest and enter Chapter 11 merely to consummate a sale to a buyer according to terms already negotiated. As a matter of first principle, having these different substantive rules in bankruptcy is a bad idea (independent of what they are). Nevertheless, such cases accounted for

[20] Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232 (1987).

something like ninety percent of the large reorganizations in the last round of Chapter 11s.[21] Put selling the assets, implementing a prenegotiated plan, and rejecting collective bargaining agreements and leases to one side, and you eliminate all but a handful of cases.

While trading of claims in the shadow of bankruptcy reduces the need for Chapter 11 altogether, the existence of claims trading inside of bankruptcy changes its dynamics when it does take place. Hedge funds (and other private investors) often buy claims in Chapter 11 for control rights that accompanying the claims that they purchase. The Bankruptcy Code provides certain rights to holders of claims. For example, claim holders may sit on the creditors committee. The creditors committee is a portal into the bankruptcy process. Whereas any individual creditor has to pay its own costs should it seek to participate in the reorganization proceeding, the creditors committee can hire counsel and advisors and have these fees reimbursed by the estate as an administrative expense. Also, the creditors committee can press the debtors for concessions. It purports to speak for the creditors. As such, the debtor has reason to listen to its concerns.

Having a seat on the creditors committee can provide an investor with a good deal of input into the way in which a bankruptcy case proceeds. At the same time, however, someone on the creditors' committee is supposed to attend to the interests of the general creditors as a whole. Reconciling the traditional committee structure with the new type of player requires forcing disclosures from the investor and limiting her range of action, especially with respect to trading. Whether this can be done in a way that keeps the largest players at the bargaining table has proved hard. In an environment in which sitting at the bargaining table requires representing others' interests as well as one's own, the most important players may stay away from the negotiations altogether. Again, there has been an inversion of the traditional process, one in which creditors wanted to be on the creditors' committee, rather than stay away from it.

The changing dynamic of who wants to be on creditors' committees illustrates the way in which trading changes the nature of the Chapter 11 process. Once claims trade freely and find themselves in the hands of comparatively few professionals, we are no longer in a world in which the players sit around the table and negotiate, but rather a conventional take-over contest outside of bankruptcy. The most notable example of the use of buying

[21] Indeed, sales and prenegotiated plans counted for eighty-five percent. See Baird & Rasmussen, supra note 3.

claims to get control of a company in bankruptcy is the Kmart reorganization. ESL, a well-heeled hedge fund, bought up $400 million of Kmart's debt. No other investor could confirm a plan of reorganization with ESL's support. Eventually, ESL put agreed to invest an addition $100 million after the case emerged from Chapter 11.[22] The reorganization plan gave ESL the right to appoint four directors. Edward Lampert, the head of ESL Investments, appointed himself, two of his employees, and a major investor in ESL.

II. The Dark Side of Financial Innovation

Even as the professionalism of today's holders of distressed debt makes Chapter 11 less necessary, another force is pushing in the opposite direction, at least over the short term, to make it harder to pull off successfully. As rights against in the debtor become parsed more and more finely, and as the number of differing configurations of financial interests increase, the transaction costs of putting them back together increases. The incentive of individual investors to hold discrete pieces of the business (a short position in stock; a long position in a particular type of bond) may run contrary to the interests of all the investors as a group. Also, many make bets today based on the assumption that the current liquidity will persist. When money becomes less plentiful, hedge funds will find it increasingly difficult to exit a situation. The costs of fragmentation will increase and present problems that have not been fully anticipated. In this part, we review the types of problems that might arise.

A. The Second-lien Loan

Most debtors that file for bankruptcy tend to have a senior secured creditor. That creditor (or, more precisely, that lending syndicate) will have a security interest in virtually all of the assets of the company.[23] When the loan is made, however, it often will not be made to the limit of what the lender believes what

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[22] See Edward S. Lampert Appointed Chairman of the Board, Kmart Holding Corp., PR NEWSWIRE, May 6, 2003; Karen Dybis, Kmart adds financial control, DETROIT NEWS, Sept. 9, 2003, at 1C.

[23] There may be some assets here and there to which the creditor's lien does not extend. It may not be worth the effort to get the lien noted on the certificate of title of the debtor's used cars. For tax reasons, it may be that foreign subsidiaries do not guarantee the loan. It may not be feasible to have a security interest in all intellectual property as it is created. In the main, however, the debtor's bank is unlikely to leave substantial assets on the table. Not only does the bank wish to protect its loan as much as possible, but it does not want to have to deal with another lender should financial distress arise.

the business is worth. Bankers term this "enterprise value." The lender when making the loan leaves a cushion between its assessment of enterprise value and the amount that it is willing to loan. The reason for acting in this manner is that the lender does not want to begin the life of the loan on the knife's edge. If the business begins to falter, it does not want this misstep to immediately imperil its chance for full recovery. Moreover, the lender knows that valuation is more of an art than a science, and it wants to protect itself in case it has been unduly optimistic in assessing the debtor's enterprise value.

Debtors thus would have the large part of their financing from the senior lender, but there would be value in the company which exceeded the debt owed to this lender. Borrowers seeking funds would at times seek to access the remaining value in the business. In years past, the debtor would access this additional value through mezzanine financing on an unsecured basis. In the 1980s, this financing was provided by savings-and-loan associations and insurance companies. These were relatively passive investors who had little ability to affect the operation of the company. To the extent that any investor was monitoring the debtor, it was the lead bank in the lending syndicate.

Today, however, we see a new trend in the capital markets. The debtor accesses the difference between the senior loan and full enterprise value through a second-lien loan. The lenders take a security interest in the same assets as does the first lender. Their right to payment by and large is not subordinated to the senior debt. Maturity schedules are set so that the borrower is required to make payments on both loans. The second-lien lenders can seek to be repaid at the same time as the senior lender is being repaid. Moreover, unlike subordinated debt, they do not have to pay any monies that they collect to the senior debt. Rather, they are second only in terms of their claim on the collateral package. Only when collateral is sold is it the cash that the senior lender has first dibs. The second-lien loan market has exploded in the past five years. In 2001, according to Standard and Poor's, the total amount of second-lien loans was $65 million. By 2005, the market had grown to more than $16 billion. As with syndicated first lien loans, there is a robust secondary market for second-lien loans.

The second lender only comes onto the scene with the blessing of the first lender. This necessity for consent arises because the loan documents surrounding the senior loan typically restrict the ability of the borrower to grant a competing security interest in the company's assets. Few lenders would make a loan that would give the borrower the unfettered ability to pledge the collateral it is relying on to another lending group. Thus, to the extent that the borrower wants

to obtain financing based on a second lien, it needs the consent of its primary lender.

The primary lender may have a financial interest in agreeing to the second-lien loan. After all, the second loan benefits the first lender in that it puts more money into the business. This money can be used to generate additional revenues, some of which will be used to make payments to the senior lender. Yet the senior lender obviously wants some assurances that the new lender – which as with the senior loan is usually a group of lenders – will not cause it undue hardship. Granting a lien has consequences, both outside of bankruptcy and inside of bankruptcy. A second-lien holder, by virtue of its lien, can grab its collateral. After a bankruptcy petition has been filed, it can object to the use of its collateral and seek adequate protection of its interest. The second-lien lenders are sophisticated financial institutions who are well versed in pushing to the limit whatever legal rights they may have. Hedge funds are primary purchasers of second-lien debt.

The lynchpin of second-lien financing is the intercreditor agreement.[24] This contract specifies the relationship between the parties. It addresses in detail their respective rights should the borrower file for bankruptcy. For example, the intercreditor agreement often grants the senior lender the right to sell the collateral without the consent of the second-lien lender. The intercreditor agreement also gives the senior lender the right to finance the debtor post-petition and provides that this financing will have priority over the loan of the second-lien lender. This provision means that although the second-lien lender can ascertain how much the first lien lender is owed today, this amount could increase should there be a bankruptcy filing.

The intercreditor agreement may also provide that the second-lien lender will consent to any cash collateral order to which the senior lender has also agreed. Cash collateral, as its name implies, is cash in which the creditor has a security interest. In the case of second-lien lending, it will often be the case that both the first lien and the second lien cover these funds. The Bankruptcy Code places restrictions on the debtor's use of cash, as opposed to other, collateral, and it is common practice for debtors to attempt to seek the secured creditor's consent to cash collateral orders. Should the senior lender allow the debtor to use cash collateral, it may well be that should the debtor lose money in its operations, this money will come first out of the collateral that would have otherwise gone to the

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[24] See C. Edward Dobbs, *Negotiating Points in Second-lien Financing Transactions*, 4 DePaul Bus. & Comm. L.J. 189 (2006).

second-lien holder. In sum, the senior lender wants to make sure that it will "drive the bus" should the debtor file for bankruptcy.[25] Indeed, one often hears the phrase "silent" second liens. The word "silent" describes how the second-lien holder should act if the debtor files for bankruptcy.

To prevent the second-lien holders from interfering with the ability of the senior lending group to control the case, some intercreditor agreements provide that if the second-lien holder buys some of the first lien debt on the secondary market, the second-lien holder cannot participate in the decisionmaking process of the first lien group. While the loan that it buys allows it to vote on major decision involving the loan, the intercreditor agreement disenfranchises the second-lien holder from voting its first lien interest. One common way for the second-lien holder to protect itself is to insist on a provision in the intercreditor agreement with allows it to buy out the first lien once the loan is in default.

The effect of second liens has yet to be felt. Indeed, as Standard & Poors has noted, "[t]here is insufficient insolvency experience to confidently anticipate how either the judicial process or the relationship between first- and second-lien lenders may impact ultimate recovery." By and large, the last few years have been relatively quiet. Yet we can hazard some predictions. The first is that many cases will enter bankruptcy administratively insolvent. Under the Code, secured creditors receive the value of their collateral first. After that, the administrative costs of bankruptcy are paid. A case is said to be administratively insolvent when there is insufficient funds to pay off the administrative expenses.

Who will fund the case? Common practice is for the secured creditor to agree to a so-called "carve out" of its lien. Basically, the secured lender devotes part of the value of its collateral to fund the costs running the proceeding. The question is going to be the extent of the carve-out. To sure, secured creditors benefit from the basic operation of bankruptcy law. It cashes out the shareholders without a liquidation of the company and provides clean title. They will not, however, be willing to fund other activities. They have no interest in supporting a creditors committee. Similarly, they do not want to use the assets in which they have a security interest to investigate the validity of that interest.[26]

Once the case is funded, we need to think about the effect of the intercreditor agreement. These contacts by and large tend to be clear, but they have yet to be

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[25] This desire is a manifestation of the power that senior creditors exert in modern reorganization proceedings.

[26] For an excellent discussion of the issues surrounding carve outs, see Richard Levin, *Almost All You Ever Wanted to Know about Carveout*, 76 Am. Bankr. L.J. 445 (2002).

tested in bankruptcy court. For example, in the *Maxim Crane* case, the senior lender gave up its rights to insist on absolute priority. It did this not because there was anything facially wrong with the intercreditor agreement, but rather because it "bought off" the rights of the junior secured lenders. While the first lien holders thought that their loan was a tad more than the company was worth, by agreeing to funnel 9% of the equity of the reorganized company down the priority ladder they were able to avoid a valuation hearing. While the plan thus not does comport with absolute priority, this may be the result of a good faith valuation dispute.[27]

The principal doubts with respect to second-lien financing revolve around the extent to which the traditional idea that bankruptcy is for the benefit of unsecured creditors exercises gravitational pull. Some academics—and perhaps some judges—think that a Chapter 11 reorganization done for the benefit of secured creditors is simply illegitimate.[28] A group of first- and second-lienholders should not be able to use Chapter 11 to effect a sale of the distressed business, but rather should rely instead on their nonbankruptcy foreclosure remedies. Whether these views will find traction in the bankruptcy courts is not clear. Our suspicion is that, in the principal courts that oversee large reorganizations (the bankruptcy courts in Delaware and the Southern District of New York), judges will resist such arguments. As a matter of history, Chapter 11 emerged out of the old equity receiverships of the 19th Century railroad, and in those cases virtually all the debt was secured and the entire process revolved around sorting out the

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[27] The case is thus an illustration of the argument advanced by one of us (with Don Bernstein) that we would expect to see relative priority plans in a world committed to absolute priority. See Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930 (2006).

[28] See George W. Kuney, Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, 24-25 (2004) ("secured creditors capitalizing upon agency problems to gain the help of insiders and insolvency professionals [have] effectively take[n] over – or 'hijack[ed]' – the chapter 11 process and essentially create[d] a federal unified foreclosure process"); Stephen J. Lubben, The "New and Improved" Chapter 11, 93 Ky. L.J. 839, 841-42 (2004-2005) ("[I]t is not clear that this development promotes social welfare. Rather, lender control may only benefit lenders."); Harvey R. Miller & Shai Y. Waisman, The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases, 21 Bankr. Strategist 1, 2 (2003) ("The excuse ... of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower"); Jay Lawrence Westbrook, The Control of Wealth in Bankruptcy, 82 Tex. L. Rev. 795, 799 (2004) ("[W]idespread adoption of a privatized system depending upon dominant security interests is as undesirable as it is unlikely").

conflicts between secured creditors. Hence, the idea that a Chapter 11 run for the benefit of secured creditors is hardly without precedent. If in the view of those whose money is at stake, a Chapter 11 is the process most likely to put the assets to their highest use, bankruptcy judges may find it unobjectionable. Nevertheless, in these cases, the pursuit in bankruptcy of substantive benefits (such as rejection of collective bargaining agreements) not to be found elsewhere may encounter more resistance.

B. Credit Default Swaps

We generally analyze the economic incentives of a given creditor based on the type of claim it has against the debtor. We tend to believe that once we understand which financial instrument an investor holds we can ascertain its economic interest. Shareholders look for gains and worry little about losses. Debt holders seek to protect their principal and give little thought to foregone opportunities. The more senior the debt, the more the holder will favor conservative actions over aggressive ones.

Ascertaining economic interests is crucial to assessing bankruptcy policy. Investments come with both cash flow rights and control rights. Shareholders can vote for the board of directors. Creditors can invoke the machinery of the state to collect their debts. More importantly, credit contracts often give lenders the ability to affect the business in various ways. In the extreme case, the rights that a senior creditor has by virtue of its lending agreement give it the power to engineer a change in the corner office.[29] As a general matter, cash flow rights and control right work in tandem. It is the investor's cash flow rights that give it the incentive to exercise its control rights in a certain manner. We normally assume that an investor exercising a control right granted by a financial instrument that the debtor has issued is acting so as to maximize the value of that instrument.

Credit default swaps have rendered this assumption obsolete. A credit default swap is a two-party contract under which one—the protection buyer—promises the other side – the protection seller – that, upon default of a certain loan, it will make a payment to the counter party in exchange for the interest of the first party.[30] For example, a holder of a GM bond may enter into a credit

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[29] See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209 (2006).

[30] For a discussion of some of the ways in which credit default swaps are changing bankruptcy practice, see Frank Partnoy and David Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. Cinn. L. Rev. 1019 (2007).

default swap that provides that, if GM defaults on the bond, the holder can give the bond to its counter party in exchange for the face amount of the bond. In essence, the parties have "swapped" the risk of default. The extent of this market is quite large. There is no requirement that one actually own the underlying credit instrument in order to purchase a credit default swap. Indeed, the nominal value of credit default swaps is $45 trillion, or twice the size of the United States economy.

At first blush, this can be seen as another way for a lender to reduce its risk exposure, just as lenders do with the syndication process. Just as a bank faces less risk when it only has a piece of a $200 million loan than when it funds the entire loan itself, a bank that buys a credit default swap reduces its exposure to an even greater degree. Indeed, the advocates for credit default swaps argue that they promise to bring stability to the banking system. Banks by and large remain the originators of large loans. Private institutions such as hedge funds simply do not (at least yet) have the back office operations necessary to service a large loan. Credit default swaps allow the banks to off load some the risk of default outside the banking system. By removing risk from the banking system, this should bolster the banks' position should the economy hit a downturn.[31]

Buying a credit default swap differs from syndication in terms of control rights. When a lead bank sells part of the loan, it bundles with that loan any applicable control rights. Any waiver of an event of default needs to be agreed to by the syndicate. The agent may be able to cajole syndicate members to follow its recommendation, but it is still the case that those who own the loan have to make the decision. Sell the loan, lose your ability to have an input on any decisions that the syndicate has to make.

When a lender purchases a credit default swap, however, it retains the control rights that accompany the loan. If a waiver of an event of default is needed, the holder of the loan is free to vote as it sees fit. But now its economic interest has changed. In the extreme case, if the lender has purchased more credit default swaps than it has at risk in terms of the loan itself, it may be the case that it will be to its financial advantage if the loan goes into default. While such a default and subsequent bankruptcy case may provide a lower return on its debt

[31] Indeed, the proponents of credit default swaps have touted their ability to reduce the risk to the banking system.

instrument than it would have received had the debtor procured a waiver, it may more than make up for this by collecting on its credit default swap contract.[32]

Moreover, there is no public record of who has purchased a credit default swap. In the bankruptcy proceeding, all holders of claims and interests have to file their claims and interests with the bankruptcy court. While it sometimes becomes unclear exactly who owns what, there is some information as to who holds the debtor's financial instruments. But since credit default swaps are private transactions, there is no way to know what the true financial incentives of any one is. A hedge fund that holds a large loan position that it has acquired in the secondary market may in fact be net short.

Credit default swaps, however, create a moral hazard problem only before the Chapter 11 begins and then in its immediate aftermath. A Chapter 11 case is a "credit event" that terminates the swap. The accounts are settled up and the control of the claim against the debtor soon is again placed in the hands of the person who holds the economic interest in it. Credit default swaps may seriously complicate (and potentially even distort) workouts that take place before a "credit event," but they are likely to matter in Chapter 11 only if crucial decisions are made at the start of the case and no one else is minding the store. But even if problems with credit derivatives are absent in the typical large Chapter 11, there may be cases in which it matters enormously. Much of the action in a large case takes place on the first day. Many issues—from the approval of the dip financing to the composition of the creditors' committee—and resolved in the first month. In some cases, the entire case is effectively wrapped up within 60 days. The case can arise in which closing out all the positions takes place while the major controversies in the Chapter 11 are being resolved and those who will be left holding the bag are left out of the process. Credit derivatives may trade multiple times, but a credit derivative is only as good as the counterparty that issues it. If there are enough credit events across enough different firms, sorting out who ultimately takes the fall when some counterparties prove insolvent may need to be done at the same time that various Chapter 11s are already in motion.

C. Total Return Swaps

The total return swap allows an investor (typically an SIV that is buying a portfolio of loans) to enjoy the economic rights associated without the control

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[32] Part of the standard credit default sway requires that the protection buyer deliver the underlying loan to the protection seller. The protection seller will now have the incentive, all else being equal, of maximizing the value of the loan. By this point, however, the borrower may be in bankruptcy.

rights. In these cases, the contracts are not settled in the event of default. These are cases in which the owner of record is not the person with the economic interest and the holder of the economic interest is hidden from the rest of the world. The potential abuses of empty voting and hidden ownership are kept in check by the absence of any incentive on the part of the party that holds the economic interest in the claim to exercise it in a way that runs contrary to the interests of its counterparty. Again, this party will likely be a bank. It is a repeat player that has transferred a portfolio of loans to the special purpose entity. It is not a strategic investor who has another agenda. It faces a reputational penalty if it does something other than its counterparty's bidding. The risk here is not so much that the bank will vote contrary to its counterparty's interest, but rather that those with the economic interest to exercise controls right in the process that leads up to the plan and the vote will not have the knowledge or the expertise and that the bank will not have the incentive.

Over time, this problem may prove self-correcting. Those in charge of the SIV typically have the ability to sell the swap and those who value it most highly are likely to be the distressed debt professionals who will have both the expertise and the incentive to be active in the case. They too, of course, must rely on the willingness of the record owner to act as they wish, but in the typical case the record owner will have no reason not to do so and, to the extent that the tension exists, there will again be incentives for parties to recombine the control and formal ownership. Winners and losers, however, may appear while this is being sorted out.

D. Wearing Multiple Hats

A change that is perhaps as large as anyone of those discussed lies in the ability of individual investors to assemble together their own investment positions with the different instruments that are available. The proliferation of these various instruments allows particular investors to be long and short in different tranches of the debtor and to have portfolios (perhaps with other firms in the same industry) that give them returns from different decisions that are dramatically different from those of other investors.

Hedge funds transform this schematic. Not only can a hedge fund buy into any part of a company's capital structure, but it can buy into multiple parts of the capital structure. Again, one can tell a good story and a bad story. The good story would be that the hedge fund could acquire a position so that its economic interest was coextensive with the interest of the corporation. By holding slices throughout the capital structure, the hedge fund could focus on maximizing enterprise value rather than only maximizing the value of its investment. To be

sure, one way an investor can maximize the value of its investment is through maximizing the value of the business. Still, when an investor only holds a slice we worry that it will attempt to increase its slice by reducing the return to others.

Yet one can tell a bad story as well. For example, consider a company that files for bankruptcy. A hedge could, on the quiet, buy up a large portion of the unsecured debt. At the time, the equity is trading for trivial amounts. The hedge fund then buys up a large portion of the equity and makes this purchase public. Other investors, thinking that the hedge fund believes that there is value in the equity, reacts by bidding up the price of the unsecured debt. Surely if the smart money thinks that equity is the place to be, the unsecured debt must be a relatively safe investment.

Still, it may be the case that the hedge fund saw no value in the equity. The purchase of the equity was simply a loss leader. It can easily recover the money spent on the equity through the increase in the prices of its bonds. Indeed, no one may ever know that the fund ever held the bonds. It can both buy and sell the bonds in anonymity.

Other problems can exist as well. Chapter 11 is designed to be a bargaining process. As we have seen, hedge funds can pretermit this process to the extent that they can gain control over the company. But other times they cannot. Here, parties are assigned rights based on the investment they hold. But again the Code assumes that the investor's economic interest is directly related to the claim that she holds. One person on the creditor committee could actually be net short. She could then take an aggressive stand in the guise of promoting her investment, but in truth be seeking to ensure that no agreement is ever reached.

What if the hedge fund has a big investment in a competitor of the debtor? The competitor may benefit from the debtor's demise. The hedge fund could use its rights under the Bankruptcy Code to slow down and perhaps ultimately undermine the reorganization. We tend to assign control rights and cash flow rights together. Yet the incredible liquidity and secrecy that hedge funds bring to the process undermine these assumptions. Cash flow rights and control rights are parceled out in an infinite variety of ways. Many of the hedge funds are seeking to gain any advantage that they can.[33] To be sure, there often is more to

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[33] Of course this is not limited to bankruptcy or even financial distress. Bernie Black and Henry Hu have demonstrated "empty voting," which is another manifestation of the same problem. See Henry T.C. Hu & Bernard S. Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 Business Lawyer 1011 (2006). Recently, they too have recognized that the same problem extends to all types of

be made by increasing the value of the pie rather than reallocating its slices. To the extent that a hedge fund can get a big enough interest, it may be good. But in some cases it may not be possible to rearrange the interests. The cash flow rights and the control rights may have been scattered in such a way that the transaction costs of putting them back together exceeds any gains that could be had.

This is an anti-commons problem. To return to the analogy of assembling the city block, even after one goes through the land records and figures out who holds what sort of interest, the interests are not homogenous. The person who holds a lease that expires in five years is in a completely different position from a landlord who owns the reversion.

Chapter 11 was created under the assumption that one could sensibly decide the fate of a firm by organizing claims against the firm into discrete classes. To solve the collective action problem, it provides that a supermajority vote binds dissident minority shareholders. As investors, the interests of all the claimholders in a particular class are presumptively aligned. An opportunity for strategic behavior does arise. A creditor who controls one class of claims can promote a plan that favors one class and disadvantages another by buying enough votes in the other class to ensure that other class approves the plan.

The opportunities for profiting from such activity in the traditional context is comparatively modest. To obtain the consent of the disadvantaged class, one needs to buy two-thirds of it. The amount it costs to buy out the two-thirds majority (and receive comparatively little for these claims under a plan that favors another class at the expense of this one) is likely to exceed whatever benefit it gets by squeezing out the minority interest. Indeed, the common case in which we see one class buying up a controlling interest in a junior class are ones in which the old equityholders are still in control and want to put in place a plan that favors them but is inefficient. The equityholders want to roll the dice by taking a rental apartment building condo. The senior creditors are severely disadvantage by this plan. To prevent its adoption, the seniors buy up all the claims in the junior class of creditors for 100 cents on the dollar. The seniors are

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investments. Henry T.C. Hu & Bernard S. Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions (University of Texas Working Paper) (Nov. 4, 2007) (available at SSRN: http://ssrn.com/abstract=1030721). The hedge fund buying the right to vote the shares has an economic interest that runs directly counter to those who hold the economic interest in the shares.

indeed acting strategically, but only to counteract out-of-the-money investors' ability to undercompensate them.[34]

The ability to separate ownership and control right, as well as the ability to short, increases the possibility of strategic behavior, however. By obtaining a blocking position in one class, an investor can thwarts a reorganization and drive down the value of the debt. By shorting enough debt, such a strategy could in principle be profitable. Similarly, an investor in control of one class could acquire voting rights (but not the economic interest) of a class that is made worse off by the plan. Financial innovation has made naked shorting of debt possible. Similarly, total return swaps and other transactions make it possible to acquire the ability to vote on plans without holding the underlying economic stake.

In equilibrium in a well-functioning market, of course, such strategic behavior should not happen. The counterparty to the naked short would take steps to prevent such misbehavior or refuse to enter into the transaction altogether. Similarly, the person holding the economic interest would ensure that the person holding the vote did not engage in misbehavior. In addition, the bankruptcy judge possesses the ability to prevent such advantage-taking by disqualifying (or "designating") votes cast in bad faith or even equitably subordinating claims. There is relatively little law here, but it seems possible that judges will become more willing to exercise this power if they discover creditors amass complicated positions and use the rights they acquire to vote strategically. Investors are especially likely to encounter trouble if they sit on a committee, sit on the board, or otherwise are found to have fiduciary duties.[35] Indeed, there is some chance that the largest problem will not arise from actual strategic misbehavior itself, but from false positives—cases in which parties argue that another has manipulated the Chapter 11 process and should on that account have its vote designated.[36]

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[34] See Figter, Ltd. v. Teachers Insurance & Annuity Association, 118 F.3d 635 (9th Cir. 1997).

[35] See Citicorp Venture Capital, Ltd v. Committee of Creditors Holding Unsecured Claims (In re Papercraft), 323 F.3d 228 (3d Cir 2003). For an excellent discussion of these dynamics, see Daniel Sullivan, Big Boys and Chinese Walls, 75 U. Chi. L. Rev. --- (2008).

[36] A possible example is *Allegheny*, a case in which an outsider acquired control by buying up shares in much the fashion of a corporate raider outside of bankruptcy. See In re Allegheny International, Inc., 118 Bank. 282 (Bankr. W.D. Pa. 1990). This case arose in the 1980s and may no longer reflect current practice, at least when the investor acts at arm's length and owes neither the debtor nor the creditors' committee a fiduciary duty.

III. Information and Control

Swirling around all of these developments are questions of information. One question goes to who owns what. A single hedge fund can buy any or all of the products spawned in today's financial marketplace. While there is a public record of who owns a debtor's stock, it is often less clear as to which institutions actually own loans or claims. The original holder of the claim has to file a proof of claim in the bankruptcy proceeding unless the debtor lists the creditor on its schedule. As these claims trade hands, however, it often becomes quite murky as to who the players actually are. Hedge funds often do not announce that they are seeking to purchase claims. Such an announcement would simply drive up the price of the claims that they wish to purchase. To guard their anonymity, buyers of claims often establish a new entity. The only task of this entity is to buy claims in a given bankruptcy case. The name of the entity gives no clue as to who the ultimate owner is.

A recent skirmish in the bankruptcy case of Northwest Airlines illustrates the extent to which the players in the new world of bankruptcy wish to keep their actions as private as possible.[37] A group of hedge funds who were buying the shares of Northwest formed an ad hoc equity committee. They formed the committee in order to coordinate their actions, but they decided not to seek official status from the bankruptcy court. They eschewed such status even though official status would allow them to seek reimbursement for their expenses, including professional fees. The reason is that they did not wish to disclose their holding.

In that case, the bankruptcy court held that Bankruptcy Rule 2019 required the members of the ad hoc committee to disclose their holdings, when they acquired them, and what they had paid for them. It was precisely to evade this requirement that the hedge funds had not sought official status. Both the hedge funds themselves and two trade groups dominated by hedge funds appealed this ruling, arguing that this ruling presents hedge funds with the draconian choice of either disclosing what they view as proprietary information or not participating in the bankruptcy. While the matter remains in litigation, the fervor with which the hedge fund community has opposed this order indicates the value that hedge funds attached to keep the details of their transactions quiet.

This quest for opaqueness makes it somewhere between difficult and impossible to assess a party's true economic interest. First, a hedge fund can buy into multiple parts of the capital structure. Investors seek to promote the interests

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[37] In re Northwest Airlines Corp, 363 Bankr. 701, 704 (Bankr. S.D.N.Y. 2007).

of the investment that they hold. But when a hedge holds multiple investments, it only seeks to promote its total return; it cares little about how that return is allocated among its various investments. In some situations, it may be beneficial for the hedge fund to press for a lower return on one of its investments in order to secure a higher return on another one. Indeed, it may have bought the one investment precisely in order to gain leverage so that it could increase the return on a different instrument.

Finally there is the question of private information about the debtor. Covenants in credit agreements often provide private lenders with access to greater information than is otherwise publicly available.[38] The debtor is generally required to provide information when the lender requests it. This access to information is generally thought to be necessary for the lender to monitor the debtor effectively.

Difficulties arise, however, when the debtor becomes financially distressed. In workout negotiations, the banks and other large investors are supplied with large amounts of information about the debtor and its business. They retain, with the debtor's agreement and at its expense, legal and financial advisors to help them evaluate the information and alternative restructuring plans. The lender may have the right under the lending contract to talk with any member of the management team or any employee of the company, and the debtor provides the creditor groups and their advisors with direct access to its books, records, and employees for the purposes of permitting them to evaluate the company and its restructuring proposals. The managers, with the assistance of their own financial advisor, accounting firm, and turnaround experts, develops a long-range plan for the business, which includes detailed projected cash flows and estimates of debt capacity.

Once the debtor files for bankruptcy and creditors committees are formed, these committees also receive nonpublic information. The debtor is trying to secure their consent to its reorganization efforts, and in doing so is offering its own financial projections that are not otherwise publicly available. Indeed, it is the duty of the committee to promote the interests of the creditors it represents, and the most effective way to discharge this duty is to aggressively gather information about the debtor's prospects.

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[38] A recent paper suggests that institutional investors can use information gleaned from a loan to trade profitably in equity of other companies whose returns are correlated with that of the company whose loan it holds. See Victoria Ivashina & Zheng Sun, Institutional Investors and Loan Market Information Spill Over, Feb. 2007 draft.

The challenge is that institutions such as hedge funds may be both privy to private information and actively engaged in trading claims. Some devices have been developed to attempt to mitigate the potential for abuse. In terms of bank loans, when a party buys a piece of a bank loan, it can now choose whether its investment is on the public side or the private side. The lead bank will establish a virtual room where it places the information that it has about the borrower that it makes available to syndicate members. The information that any loan owner can access will depend on whether it is on the private side or the public side. To the extent that an institution is actively trading in the securities of the company, the expectation is that it will limit itself to the public information.

A similar situation exists in bankruptcy. The court will often issue an order requiring that, if a hedge fund is serving on the creditors committee, there has to be a wall between those with private information that they obtain by virtue of their committee service and those who are engaged in the trading.

The question, of course, is who polices these mechanisms. To the extent the hedge funds assiduously buy only on the public side when they want to trade in the debtor's securities, and to the extent that they ensure that no information seeps from those on the creditors committee to those trading in the debtor's securities, we would worry less about potentials for abuse. We have little data, however, on how scrupulously all of the participants in the new environment hew to these requirements.

The differing levels of information in today's bankruptcy environment have led to the creation of so-called "Big Boy" letters.[39] Just as the five-year-old seeking new responsibilities attests that he is a "big boy," so too an investor can give up any right he might have to complain that he was taken advantage of by signing a letter to the effect that he is acquiring a claim where his trading opposite has private information and he is willing to accept whatever risks come with nondisclosure.[40] A Big Boy letter basically acknowledges that the person

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[39] See Sullivan, supra note 35.

[40] Section 29(a) of the '34 Act prohibits the waiver of rights, but Big Boy letters might prevent those wishing to bring a 10b-5 from asserting the reliance that is an essential element of the claim. See Harsco Corp v. Segui, 91 F.3d 337, 341–48 (2d Cir. 1996); Jensen v Kimble, 1 F.3d 1073, 1074 (10th Cir. 1993). But see AES Corp. v. Dow Chemical Co., 325 F3d 174, 180 (3d Cir 2003). For a discussion, see M. Todd Henderson, *Deconstructing* Duff and Phelps, 74 U. Chi. L. Rev. ●●● (forthcoming 2007). Whether the claims transferred in bankruptcy are "securities" within the meaning the '34 Act is unclear. See Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 Am. Bankr. Inst. L. Rev. 569, 569 n.1 (Winter 2002). Also unclear is the

buying the claim understands that the seller may have private information about the company that the seller is not disclosing. The buyer, however, is a "big boy" and promises that he will not sue based on this potential informational disparity. This big boy language has become so ubiquitous in trading claims and bank debt that its inclusion accompanying a trade does not necessarily signal that the seller in fact has private information.

IV. The New Dynamics of Chapter 11

The mismatch between the Code's structure and modern realities can be glimpsed in the FiberMark bankruptcy. Much that goes on in today's bankruptcy environment cannot be seen by an outside observer. Hedge funds often keep their strategy and even their existence a secret. *FiberMark* is an unusual case in that the machinations among competing groups were forced above water.

FiberMark was a specialty producer of paper products based in Vermont. The company had been formed in 1989 by a management led buyout of a division of Boise Cascade.[41] The capital structure of the company was relatively simple. It had a secured credit facility of $85 million. Throughout the events surrounding FiberMark's financial distress, it was clear that the company had more than sufficient assets to pay off the facility in full, and the secured lender, GE Capital, did not play a role in the ultimate fight that erupted. The bulk of the rest of FiberMark's financing was through public bonds. These bonds had a face amount of $350 million. The remaining unsecured debt was roughly $17 million. In light of this capital structure, it was clear that whoever controlled the bond debt would control the outcome of the case. It was the fulcrum security.

While GE Capital may have had the ability to oust current management if it chose to do so, it had no economic reason to seek a change of control. The value of the business was sufficiently large and that the debtor even in bankruptcy would likely have been able to find a lender willing to lend enough to pay off GE Capital and take its place, albeit perhaps under different and less favorable terms. The value of the assets was such that there was little threat that the senior

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bankruptcy court's equitable power to fashion regulations inside of bankruptcy analogous to Rule 10b-5.

[41] Almost half of the company's revenues came from overseas. FiberMark's foreign subsidiaries, however, remained outside of insolvency proceedings. To finance the foreign operations, the foreign subsidiaries obtained direct loans from a foreign bank and, as part of the debtor-in-possession financing package, FiberMark guaranteed the loan. This pattern of handling the financial distress of a transnational enterprise in a single court is quite common.

loan would not be repaid in full. The holders of the public debt, however, did not have the ability wrest control of the company away from its existing management team.

Looking at this capital structure, there was thus a concentrated interest at the senior level. Moreover, the equity interest was closely held as well. To the extent that there may have been a large number of investors, they would have been found in the public debt. Yet, as we will see shortly, this public debt became closely held as well, with over eighty percent of the bonds held by just three investors, all of which were hedge funds.

An optimist viewing this situation may have believed that things would have gone smoothly. The company had a very simple capital structure as these things go, and the unsecured debt came to be held by a small number of hedge funds. Surely the smart money could find the solution that promised the largest gain at the smallest costs. Indeed, at the end of the proceeding, the company was bought by a hedge fund, Silver Point Capital, a well-respected hedge fund which specializes in distressed debt and has over $4 billion under management.[42]

A search for outside buyers for the company early in the proceeding failed to produce any acceptable bids.[43] The company then reorganized, though in essence the plan of reorganization was a sale of the business to Silver Point. As part of the plan of reorganization, the senior credit facility and DIP financing were paid in full, and bond holders (other than the warring hedge funds) received 70 cents on the dollar. Silver Point paid a tad less than $100 million to both purchase the claims of two rival hedge funds and to fund the payment to the remaining unsecured creditors. The old equity holders received no distribution. The old board of directors resigned, and Silver Point was granted the power to appoint all seven members of the new board. Three of the new directors were members of Silver Point.[44]

FiberMark thus emerged as a private company held by Silver Point. Silver Point and GECC provided the exit financing, with Silver Point funding the term portion of the loan and GECC funding the revolving credit facility. Viewed from

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[42] Silver Point describes itself as a "multi-strategy credit opportunity fund that specializes in credit analysis and credit-related investments."

[43] Sales of companies as a going concern in Chapter 11 are commonplace these days.

[44] The replacement of the old board of directors with a new board appointed by the former creditors of the company is a common pattern in today's reorganization practice. See Baird & Rasmussen, supra note 21, at 697-99.

afar, the case appears to be another example of the way in which bankruptcy can be used by hedge funds to buy a company. The company was not torn apart, and Silver Point seems well-positioned to maximize the value of the assets. Moreover, the presence of other hedge funds suggests that the bidding for the company was competitive.

When we look more closely, however, things were not so smooth. The company filed for bankruptcy in March 2004, and the company emerged over a year and a half later in November 2005. What took so long with what should have been a relatively straightforward process? The answer is that the reorganization proceeding eventually became brutal fight among three hedge funds that was only settled after the bankruptcy court appointed an examiner to look matters.

Two of the hedge funds, AIG Global Investment Corporation and Post Advisory Group, acquired FiberMark bonds well in advance of bankruptcy. At the time that the bankruptcy petition was filed, AIG had about 19% of the outstanding notes and Post held another 15% of the notes. Neither acquired any more notes during the case. They thus had over a third of the outstanding notes at the time the case began (which meant that their would not be a consensual reorganization plan without their approval), and both were appointed to serve on the creditors committee. The indenture trustee for the notes and a trade creditor holding a $50,000 claim were also appointed to the committee.[45]

Because the other creditors were not active, Post and especially AIG believed that they could control FiberMark and its reorganization. The representative of AIG dominated the creditors' committee. He took an active role in the case, worried about the amount of money being spent and tried to direct the actions of the managers on the theory that the public debt holders were the residual claimants. At the beginning of the proceeding, he favored a quick plan that basically wiped out the equity and converted the debt to equity. Such a course of action would have left AIG as the largest shareholder and firmly in control of the business. He made it clear that he had no confidence in the CEO.

AIG and Post were surprised to learn in the summer of 2004 that Silver Point had begun acquiring notes shortly before the case began and continued to do so while the case proceeded and already had acquired 35% of the bonds. (This ability to acquire such a significant stake in the company without attracting the

[45] The trade creditor eventually sold its claim to Silver Point. As part of the sale, the trade creditor agreed to remain on the creditors' committee as an agent of Silver Point. Report at 10.

attention of other major investors illustrates how opaque the claims trading market can be, even to those who participate in it on a regular basis.) Silver Point was then asked to join the creditors committee.

As part of its appointing Silver Point to the committee, the bankruptcy court entered a trading order in the case. This order allowed members of the creditors committee to continue to trade in the debtor's securities so long as they established an internal screening wall to insure that private information that came to the creditors' committee was not shared with those buying and selling the debtor's securities. Silver Point established a screening wall so that its traders on the "public side" did not have the information available to those on the "private side" who were serving on the creditors' committee. While those on the private side received daily updates on the securities and claims that the public side was purchasing, the receipt of this information did not violate the terms of the court's trading order.[46]

The debtor put forth a plan of reorganization in November 2004. The drama of the case consisted largely of the negotiations among the three hedge funds on a corporate governance agreement as to how the company was to be run after bankruptcy. Silver Point's arrival drastically altered the expectations of AIG and Post. Before they knew of Silver Point's investments in FiberMark, they believed that they would end up with de facto control of the reorganized company. Silver Point's large stake and intent to continue purchasing bonds made it clear that Silver Point would be the controlling shareholder of any reorganized company. Once AIG and Post saw the changed landscape, they focused on minimizing the power that Silver Point would have as the controlling shareholder of the reorganized FiberMark. (Indeed, it appears the Silver Point eventually acquired more than 50% of the outstanding bonds. The three hedge funds by the end of the case held well over 80% of the unsecured debt.[47])

When Silver Point came into the picture, the prospects for a quick reorganization evaporated. Basically, the three hedge funds could never reach agreement among themselves as to the respective rights of the three running the company post petition. Silver Point was quite comfortable with the default corporate governance provisions provided by Delaware corporate law. From its

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[46] Silver Point's trading activities are clearly private information, but it is Silver Point's private information. It is not private information from the debtor.

[47] Much of the remainder of the debt appears to have been held by hedge funds as well. Four hedge funds that held over 10% of the notes objected to the plan, but the court overruled these objections.

perspective, its position was no different from (and hence it should enjoy the same rights as) a shareholder who acquired a similar stake in a business under nonbankruptcy law. A controlling position in the debt of an insolvent company is no different from a controlling interest in the equity of a solvent one. Indeed, the purpose of a reorganization is to transform such debt into equity. AIG, with the backing of Post, pressed for a corporate governance agreement that would provide the minority with greater rights than they would have had under Delaware law.

Much of the problem stemmed from a clash of personalities between the representative of AIG and the bankruptcy attorney hired by Silver Point. What had been a corporate reorganization transformed itself into an ugly take-over battle in which AIG and Post, like entrenched board members, used their position on the creditors' committee to further their own interests rather than to advance the interest of the creditors as a group.[48] In short, they pressed for corporate governance provisions that would be of little value to the other creditors but of great value to them. The Code assumes that the members of the creditors committee will act in the best interests of all of the creditors. In days past, this had been a fairly safe assumption. Here, however, it did not hold. The hedge funds were in the company for the long haul. The rests of the creditors were more than likely to not end with an equity interest.

The parties reached agreement only after a blistering report issued by the court-appointed examiner. To be sure, the parties involved took issue with many of the findings of the report, but it does seem that the highly public report helped push the parties towards an agreement under which Silver Point bought out the interests of the other hedge funds as well as the notes held by other investors.

FiberMark illustrates both the potential and perils of hedge funds. By the middle of the case, any investors who did not want to participate in the reorganization had left. The only people in the game were hedge funds well versed in bankruptcy proceedings. In the end, Silver Point was able to buy the entire company. The company emerged with a rational capital structure.

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[48] The dealings among the three hedge funds became so acrimonious that the bankruptcy court appointed an examiner to investigate the situation. The impetus for the appointment was that AIG alleged that Silver Point had violated the court's trading order. The court selected Harvey Miller, perhaps the most noted bankruptcy attorney in the country to investigate the matter. Miller's report provides unique insight to some of the problems likely to arise in the new environment in which Chapter 11 now finds itself.

While the ultimate result of the case is hard to quarrel with, the process was not the most efficient. The fight among the three hedge funds cost $60 million over seven months. AIG was able to use the device of the creditors committee to hold things up as it sought better terms for itself as a future minority shareholder. In the end, the costs of these problems were felt exclusively by the three hedge funds. The secured creditor was paid in full, and the three hedge funds kicked in some cash to ensure that the unsecured creditors received precisely what they would have received had the first plan of reorganization been confirmed.

In the end, *FiberMark* was ugly but it was not a disaster. AIG and Post may have used the committee structure for questionable ends, and the process should have been shorter. The proceeding cost more in legal fees than it should have, but there is no reason to believe that the value of the company itself was lessened. One could chalk up much of the problems to a clash of personalities. While these frictions may have been costly, it is difficult to quarrel with the outcome. The company was aggressively shopped to potential purchasers, and when there was not a buyer that offered an adequate price, the company was taken private by a hedge fund that was left in complete control. Indeed, had the three hedge funds been able to cooperate, the case would have gone off without a hitch.

The case does, however, illustrate how the provisions of the Code can be used in today's environment to ends not foreseen by the Code's drafters. FiberMark by no means exhausts the way in which hedge funds can affect reorganization practice. To see another way in which a hedge fund can alter reorganization practice, consider the recent bankruptcy case of Radnor, a California-based maker of foam cups. Prior to its relationship with the hedge fund that would become its major investor, Radnor had a revolving credit facility funded by a lending syndicate, $70 million in senior secured notes and $120 million in unsecured notes. In 2005, at a time when it was looking for fresh capital to expand its operations, Radnor obtained an additional $120 million from Tennenbaum Capital Partners. Tennenbaum enjoyed no special access to Radnor; the relationship between them began when Radnor's investment bank approached 40 potential investors seeking to infuse fresh cash into the business.

The majority of these funds – $95 million – were in the form of a secured loan. The collateral package consisted of substantially all of Radnor's assets. The majority of this loan – $70 million – was used to redeem senior secured notes that the company had issued in the past. (Originally, Radnor had hoped that the senior note holders would consent to the pledging of their collateral to back up

the infusion of funds from Tennenbaum; they did not, and the transaction was restructured in order to pay off the senior secured notes in full.) Of the remaining $25 million, these funds were devoted to paying down equipment loans, reducing the company's revolving credit facility, and increasing working capital.

The remaining $25 million of Tennenbaum's investment in Radnor was in exchange for preferred stock which had the potential of giving Tennenbaum a bit more than 15% of Radnor's equity. As part of this latter investment, Tennenbaum and Radnor entered into a contract that gave the hedge fund the right to appoint one member of Radnor's four person board of directors.

Radnor did not perform as well as expected, and in April 2006 Radnor approached the hedge fund seeking an additional infusion of capital. Tennenbaum declined to make an additional equity investment, but did agree to loan an additional $23.5 million on a secured basis, bringing the total loan from Tennenbaum to Radnor to almost $120 million. The later loan was personally guaranteed by Radnor's largest shareholder, who was also CEO of the company and had appointed the other three members of the board. At the same time, under pressure from its bank lending group that was funding Radnor's revolving credit facility and with the agreement of Tennenbaum, Radnor appointed a Chief Operating Officer from Alverz & Marsal, one of the country's preeminent turnaround firms.[49] The combination of its seat on the board of directors and the personal guarantee by the largest shareholder provided Tennenbaum with a good deal of input into the future of the company.

The new infusion of funds failed to turn the business around. Radnor filed for Chapter 11 in late August 2006. As part of the filing, it procured debtor-in-possession financing from Silver Point (yes, that Silver Point). The financing package was in the amount of $103 million, of which $64 million of this went to pay off the prepetition revolving secured credit facility. The effect of this financing was to leave the DIP lender as the only other secured lender in the picture with Tennenbaum. The funds not used to pay off the prepetition revolver were enough to enable the company to survive until it could sell its assets, but they were not enough to continue operations should the company seek to reorganize in Chapter 11. In accepting this DIP financing, Radnor's fate was sealed. It would be sold to the highest bidder.

Radnor then put its assets up for sale. The unsecured creditors objected, seeking to block Tennenbaum from asserting its secured claim on a number of

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[49] The firm's web site is http://www.alvarezandmarsal.com.

theories. After a trial on the merits, the Delaware bankruptcy court rejected each theory advanced by the creditors' committee. With this objection out of the way, the assets of Radnor were auctioned off. Tennenbaum bid $225 million, of which $120 million was a credit bid. The new money was enough to pay off the DIP loan in full, but not much more. In the end, all of the prepetition secured creditors were paid, the unsecured creditors received little, the equity holders nothing and Tennenbaum was the sole owner of the company.

Radnor went more smoothly than did FiberMark, but at some level it may be more problematic. Tennenbaum protested vigorously that this was not a loan-to-own transaction, and court agreed. Putting the motivation to one side, however, one sees the same problem that plagues loan-to-own situations. By the time that the company decided to sell itself, Tennenbaum had a strategic advantage over all other potential bidders. To the extent that the CEO added value to the company, his interests were aligned with Tennenbaum as he had personally guaranteed the last loan that the hedge fund had made to Radnor. Also, by virtue of its rights under the lending agreement and its seat on the Board of Directors, Tennenbaum had information about the company that no other bidder could match.

It is possible, of course, that the hedge fund paid any less than top dollar. We do not have access to the company's financial information, and we would not presume to tout our abilities at assessing enterprise value. Still, it is noteworthy that the winning bid in Radnor put just enough cash on the table to pay off the only other investors in the company that would have had the financial wherewithal to mount a challenge. While the sale in Radnor may well have been done perfectly, the systemic effect here should give one pause.[50]

V. Conclusion

The most immediate problem that we face is not in the Bankruptcy Code itself or any particular requirement. Through a wide variety of devices—from the discretion to approve a sale under §363 to the ability to designate votes under §1126, the bankruptcy judge has the power to curb abuse and prevent

[50] Of course, given that it was credit bidding, Tennenbaum had no reason not to bid the full amount of its secured claim. It is likely that the DIP financing agreement put that claim ahead of Tennenbaum's, so once Tennenbaum concluded that the assets were worth more than what was owed to the DIP lender, its best strategy would be to bid in its full claim, even if it privately assessed the value of Radnor's assets at less than $225 million.

misbehavior. The difficulty is that there is not yet a clear understanding as to what counts as misbehavior and one can doubt that the bankruptcy judge is going to be well-positioned to identify it. But today's bankruptcy judges are a new breed. They do not assume they know what is fair and just in a corporate reorganization. They are more comfortable with the idea that, subject to the specific substantive rules placed in the Bankruptcy Code and elsewhere, their job is to vindicate the ex parte bargain among investors.

Judges are quite likely to follow the lead of professional investors when they present a united front, but the issue is likely to come before the judge precisely because the parties do not agree. Modern judges are likely to enforce intercreditor agreements as written, but in a world in which the financial instruments are new, the agreements are likely incomplete and some recourse to gap-filling is necessary. While things will sort themselves out eventually, life is not going to be easy during the interim. Perhaps the most important thing that courts can do in fashioning rules is ensuring that whatever is put is place gives clear benchmarks that future investors can use to navigate their way. The current disequilibrium is the result of instruments that have already been written. Investment going forward will use different and improved ones. What may matter most is the ability of different investors to write new ones, learning from past mistakes and being able to predict how judges will respond to new provisions.

If past is prologue, the uncertainties that financial innovation brings with it are likely to be resolved satisfactorily, even if not immediately. We do not believe that this anti-commons problem will be an enduring feature of corporate finance, only that the next round of Chapter 11 will have revolve around these problems precisely because they are new. Our experience with large corporations competing in a market economy is only about a century and a half old. Capitalism is still very much a work in progress and the science of corporate finance in an early stage.