MORE PHOENIX THAN VULTURE: THE CASE FOR DISTRESSED INVESTOR PRESENCE IN THE BANKRUPTCY REORGANIZATION PROCESS

Paul M. Goldschmid*

* J.D. Candidate 2006, Columbia University School of Law; M.B.A. Candidate 2006, Columbia Business School; A.B. Government 2000, Harvard College. The author thanks Professor Edward R. Morrison and the many financial and legal practitioners who provided invaluable advice, guidance and information on this note.

I. INTRODUCTION

Firms in Chapter 11 bankruptcy are presumed to have going-concern value, with operational efficiencies, even though they are usually technically insolvent.[1] A primary objective of Chapter 11 bankruptcy proceedings, therefore, is to protect such going-concern value from the potentially inefficient and destructive behavior of competing and self-motivated creditors. Commentators have often described the challenges of Chapter 11 proceedings as the "residual actor problem." When the firm is solvent, shareholders, as the residual owners, know that their wealth, often reflected by a publicly traded stock value, is closely tied to firm value, and hence to the success of managerial decision-making. Consequently, it is in shareholders' interests to champion strategies for long-run profit maximization.

By contrast, when the firm is insolvent and in Chapter 11, shareholders' claims are, by definition, negligible, and creditors cannot be relied upon to maximize an insolvent firm's value.[2] Senior creditor classes, whose debt may be fully secured or "above water," will presumably favor risk-averse strategies that maximize the probability of recovering the full value of their loans. Junior creditors, who face low probabilities of appreciable recovery, will prefer high-risk strategies because there is little to lose and potentially something to gain by "swinging for the fences." The unfortunate result in many bankruptcies is discord between two groups of potential decision makers: overly risk-averse creditors holding claims that are close to or are "above water," and overly risk-tolerant creditors with claims that

---

[1] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) (from a purely economic view, firms without going-concern value should be liquidated as long as the liquidation will preserve the highest value for the firm's investors) [hereinafter EASTERBROOK & FISCHEL]

[2] *See id.* at 68-69.

are far "below water."[3] The dynamic is "a basic form of the prisoner's dilemma: the aggregation of individualistic, albeit rational, decisions leading to an inferior collective result."[4] An appropriate goal for Chapter 11 proceedings, therefore, is the effective provision of a collective forum for the re-creation of an efficient residual claimant class by creating a new "above-water" equity actor whose self-interest is aligned with the long-run value maximization of the firm.[5]

This study examines how the increased presence of distressed-debt investors[6] in bankruptcy proceedings has greatly affected the residual actor problem. The thesis of this paper is that distressed-debt investors generally have a salutary impact on the residual actor problem of bankruptcy by expediting business reorganizations and protecting going-concern enterprise values. The argument proceeds in seven steps: Part II restates the theoretical residual actor problem in Chapter 11 bankruptcy reorganizations; Part III analyzes the dramatic growth of distressed-debt investing in recent years and the increased presence and control of distressed investors in bankruptcy proceedings; Part IV explains how distressed-debt investors have driven other important and desirable bankruptcy trends: faster reorganizations, increased liquidity in the markets for debtor assets, greater flexibility in creditor-debtor negotiations under Delaware law, and improved focus on enterprise strategies that maximize long-term enterprise value; Part V is an extended examination and subsequent refutation of the alternative hypothesis, advanced by Douglas Baird and Robert

---

[3] Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1496 (1993).

[4] Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 544 (1983).

[5] Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 735 (1993).

[6] The qualifier "distressed-debt" in the term "distressed-debt investors" does not imply an exclusive investment in distressed debt. Rather, it refers to a class of investors who purchase the assets or claims of firms once their debt or operations become "distressed."

Rasmussen, that these salutary recent changes in bankruptcy proceedings have occurred, not as a result of the increased influence of distressed-debt funds, but rather as a consequence of significant changes in pre- and post-petition debt contracting by senior bank creditors. According to Baird and Rasmussen, such "dynamic debt contracting" has enabled these traditional fixed-income claimants to re-establish wealth maximization as the principal goal of bankruptcy;[7] Part VI explains why distressed-debt funds are better incentivized and positioned than senior creditors to effectively perform the residual actor role in Chapter 11 reorganizations; Part VII evaluates the principal public policy criticism of distressed-debt funds: they may cause higher bankruptcy recidivism rates if companies emerge from Chapter 11 either too highly leveraged or before they are operationally sound and secure. Finally, Part VIII offers some concluding thoughts about the public policy implications[8] of this study for bankruptcy reorganizations.

---

[7] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 786 (2002) [hereinafter Baird & Rasmussen, *End of Bankruptcy*] While the authors do not specifically mention the increased presence of distressed investors in the reorganization process, Baird and Rasmussen point specifically to capital markets improvements as having a significant influence on the recent trends in bankruptcy. The authors point out that capital market improvements have made it much easier for large corporations to sell assets or the entire firm during bankruptcy. *See also* Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons From Enron*, 55 VAND. L. REV. 1787, 1808-09 (2002) (explaining that modern capital markets can easily deal with the sale of a diverse set of corporate assets, making it no longer necessary to preserve the firm as a going concern to avoid losing significant value in a sale, as was once the case with bankrupt companies such as railroads).

[8] It is rare to find anything positive written about distressed-debt investors. Most often, they are referred to by the derogatory title of "vultures." Hilary Rosenberg is one of the only authors to actually take an in-depth look at these investors, their motivations and activities. In her 1992 book The Vulture Investors, Rosenberg examined the actions of distressed investors by focusing on their investments in a number of the corporate bankruptcies in the 80's and early 90's. But Rosenberg does little to quell the investors' image as circling scavengers who pick apart

Following the 2001-2002 period in which corporate-debt default rates reached all-time highs, a number of the most fragile U.S. industries have been turned around and consolidated by long-term, operationally minded distressed-debt investors. The trading of claims from the hands of inflexible, fixed-income oriented banks to the hands of operations-minded, equity-oriented distressed investors has been instrumental in reviving dozens, if not hundreds, of corporations. While some have called for further regulating the trading of distressed claims because they fear that the interests of distressed-debt "vulture" funds are insufficiently aligned with those of shareholders, this paper argues that such fears are unfounded.[9] Likewise, the paper counters the argument that distressed-debt investors are too quick to push the firm out of Chapter 11, and that they exacerbate bankruptcy recidivism rates, with empirical evidence to the contrary.[10]

---

the carcasses of dead or dying businesses. While Rosenberg is clearly fascinated by the so-called vultures' strategy and their power in modern bankruptcies, she never specifically finds that their presence had a net salutary affect on any of the reorganization processes she examines. Moreover, constant allusions to the investors' vulture-like strategies, predilection for devouring dying businesses, and "cold opportunism" only reinforce their reputation as "rapacious speculators." HILARY ROSENBERG, THE VULTURE INVESTORS, 20 (1992).

[9] *See* Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1749 (1996) (calling for a "trading injunction" after an initial period following a bankruptcy filing. This injunction, Tung believes, would prevent the delay and disruptions to the negotiation caused when claims are traded during the reorganization process.).

[10] The question of whether distressed debt investors should be treated as a friend or foe of the reorganizing firm reached an unprecedented level as Worldcom emerged from Chapter 11. Worldcom's two largest investors, distressed investors MatlinPatterson and Silver Lake Partners, were forced into a decision not to take positions on the emerging company's board (the two firms, along with Cerberus Capital, had all initially been granted one seat each on the 11 member board). Richard Breeden, former Chairman of the SEC and corporate monitor in the Worldcom case, warned that these firms' self-interests may be severely at odds with best interests of the corporation, making it improper to elect those firms' representatives as board members. Said Breeden: "there's no guarantee that these people

II. THE RESIDUAL ACTOR PROBLEM IN BANKRUPTCY REORGANIZATIONS

The residual actor of economic theory is the party whose investment will reap the marginal dollar of the firm's gain or suffer the marginal dollar of its losses.[11] The residual actor is the "frequently-invoked hero of economic theory,"[12] because the residual actor's rational, self-motivated decision-making is so directly tied to the best interests of the firm as a whole that its self-motivated actions will also maximize that firm's overall wealth.[13] In a solvent corporation, shareholders are the residual actors because they suffer the marginal gain and loss of managerial decision-making through the value of their publicly traded stock.[14] Shareholders seek to maximize the market value of their equity, which is almost tantamount to firm value. Therefore, as appropriately incentivized decision-makers, shareholders are given the right to certain decision-making authority, including the right to vote at corporate meetings.[15] By contrast, the corporation's creditors have fixed claims, usually involving coupon payments and a principal amount. Because creditors of a solvent company do

---

are going to be holding securities six months after you emerge from bankruptcy." Breeden therefore rebuffed the original reorganization plan which would have given the distressed investors control of a majority of the seats on the new board, proposing instead that, if the funds want to sit on the board, they must publicize their future trading plans, an unprecedented proposal for corporate directors. Mitchell Paccelle & Shawn Young, *As MCI Tries for a Second Act, 'Vultures' Add to Drama*, WALL ST. J., Apr. 16, 2004, at A1.

[11] Lynn M. LoPucki, *The Nature of The Bankrupt Firm: A Reply to Baird and Rasmussen's The End Of Bankruptcy*, 56 STAN. L. REV. 645, 661 (2003).

[12] Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, No. 3-11, at *4 (2003) (unpublished manuscript, on file at The Social Science Research Network Electronic Paper Collection) [hereinafter, LoPucki, *Myth of the Residual Owner*].

[13] *Id.*

[14] Marcia L. Goldstein & Scott E. Cohen, *Fiduciary Duties of Directors of an Insolvent Corporation*, SG 108 ALI-ABA 193, 200-203 (2002) (commenting on the definition of "balance sheet insolvency.").

[15] EASTERBROOK & FISCHEL, *supra* note 1, at 68.

not benefit from increases in corporate value beyond their individual claims, they are not incentivized to increase the total value of the firm.[16] Their interest in the firm is fixed at their claims' par, or "face," value and their rights protected by contract. As long as the value of their claims does not drop below par, creditors lack incentive to favor business strategies that would further increase the total value of the firm.

As long as the company remains solvent, self-motivated shareholder decision-making aligns perfectly with the welfare of the firm as a whole, but the efficiently organized corporate form begins to break down as a firm enters the "vicinity of insolvency."[17] Once a firm is insolvent, shareholders' claims are, by definition, negligible.[18] The claims of junior creditors and unsecured suppliers likewise may be worth only pennies on the dollar. When insolvency occurs, investors across the company's capital structure stop thinking about their claims as "equity" or "fixed" returns, and begin to evaluate their claims in terms of their "recovery value." While senior or secured debt holders may estimate an expected recovery close to full face value, those holding junior priorities may estimate a recovery of next to nothing after all senior classes are paid. Obviously, those investors holding claims whose expected recovery is close to 100% have very little upside potential, but tremendous downside risk; while those with almost no expected recovery at the start of a Chapter 11 process have almost no downside risk, but tremendous upside potential if the firm can get back on track.

The asymmetrical risks of creditors and shareholders are the source of the residual actor problem in Chapter 11 bankruptcy proceedings. The self-interest of the senior

---

[16] Harvey Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1477-78 (1993).

[17] *See* Credit Lyonnais Bank Nederland N.V. v. Pathe Comm. Co., 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

[18] Lin, *supra* note 3, at 1490.

classes favors risk-averse, conservative strategies that ensure recovery of fixed claims; while the self-interest of junior classes and equity is the opposite: high risk/high reward activities.[19] These interests are likely to clash in the first and most important decision of bankruptcy: whether the firm should seek reorganization in Chapter 11 or liquidation in Chapter 7. A *financially* distressed firm with operational efficiencies and profitable opportunities ought to be restructured in Chapter 11 to protect its going-concern value while debt pressures are relieved. On the other hand, an *economically* distressed firm lacking profitable prospects ought to be liquidated immediately in Chapter 7 before its market value deteriorates any further. A bona fide residual actor would be capable of making this basic decision in a balanced manner that would satisfy the public policy interest in economic efficiency. But not all of the creditors in bankruptcy proceedings are likely to be bona fide residual actors. While the fundamental bias of senior creditors is toward Chapter 7 liquidations, that of junior creditors and shareholders is toward Chapter 11 reorganization. And, if Chapter 11 is the chosen course, these biases will continue to affect other critical operational and strategic decisions: Should management be replaced; should certain assets be sold; should the firm take on post-petition debt; and what should the capital structure of the reorganized firm look like? When a firm is insolvent, there is often no party whose self-interested decisions can be relied on to maximize economic value.

Legal scholars have recommended theoretical solutions to the residual actor problem of bankruptcy. For example, according to Thomas Jackson and Robert Scott, the potential biases and economic inefficiencies of bankruptcy might be overcome if decision-making authority were conferred on a

[19] Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganziation of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 787 (1993).

single residual claimant[20] whose wealth, when a firm's balance sheet's assets are worth less than its liabilities,[21] directly increases or decreases from any movement upwards or downwards in the company's value.[22] The ideal candidate, therefore, would be a creditor holding a claim whose current reorganization value is 50% of its face value. Therefore, this claim holder would have relatively equal upside and downside potential from decisions that the corporation makes, and a dollar earned or lost at the corporate level would directly affect the recovery on the investor's claim.

The practical problem, of course, is that the real world is far less tidy than the world of theoretical scholarship, and there is no easy way to identify and then shift decision-making authority to some putative residual claimant. The empirical research of Lynn LoPucki, for example, finds that the "paradigm financial structure"—the three-level structure scholars often refer to of equity, unsecured and secured debt —is simply not the way that modern firms are structured.[23] Instead, modern firms have complex credit covenants that create secured and unsecured classes with many different seniority and structural levels.[24] In LoPucki's research of large, public bankruptcies, 62% of firms had a capital structure in which there was more than one creditor class, often across multiple priority levels, that might qualify as the ideal residual owner with claims directly affected by marginal gains and losses in firm value.[25] Even by the time that a large corporate reorganization is nearly complete, the identity of an individual class of residual claimants is often far from certain.[26] LoPucki concludes bluntly that "any

[20] *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 159 (1989).

[21] Goldstein & Cohen, *supra* note 14, at 200-03 (commenting on the definition of "balance sheet insolvency").

[22] EASTERBROOK & FISCHEL, *supra* note 1, at 69.

[23] LoPucki, *Myth of the Residual Owner*, *supra* note 12, at 15.

[24] *Id.*

[25] *Id.* at 18.

[26] *Id.* at 8.

bankruptcy governance scheme that depends on identification of the residual owner [is] unworkable."[27]

It is also significant that bankruptcy claims are rarely, if ever, consolidated in the hands of an investor with enough at stake to take significant interest and control in the debtor. If claims are trade claims, they are likely to be spread across hundreds or even thousands of suppliers or customers. If they are high-yield notes, they may be held by thousands of different investors. It is usually difficult to find creditors with enough at stake to dedicate the resources, absorb the administrative expenses, and bear the opportunity costs of a Chapter 11 proceeding.[28] Substantial administrative and opportunity costs result from a lengthy reorganization process. Claimholders without a great deal at stake lack the financial leverage and patience to even make decisions that may be in their own best interest. Instead, these claimholders may support the easiest, most liquid reorganization plan. Therefore, even if a residual claimant class could be identified, it might lack sufficient motivation or inclination to take control of the firm and steer it in an economically efficient, value maximizing direction.

III. THE DRAMATIC GROWTH OF DISTRESSED DEBT INVESTING IN RECENT YEARS

When the executives of Adelphia Communications, which filed for bankruptcy in June 2002, sat down for the first time at the Chapter 11 bargaining table to begin negotiations with its six largest bondholders, three of those bondholders were completely expected: Fidelity Investments, Oppenheimer Funds, and Alliance Capital. As three of the largest institutional investors in the world, it was natural that Fidelity, Oppenheimer, and Alliance would have acquired hundreds of millions of dollars worth of Adelphia's bonds at par value during the bonds' primary syndication into the

[27] *Id.* at 19.

[28] Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 6-7 (1990).

debt market.[29] Less foreseeable was the presence of distressed debt investors, Oaktree Capital Management, Och-Ziff Capital, and Angelo, Gordon & Co., as the three other leading creditors at the bankruptcy proceeding. As Adelphia had spiraled into bankruptcy, each of these distressed debt funds had purchased their claims on Adephia in the secondary market for pennies on the dollar.[30] The Adelphia bankruptcy is not unique. When Enron filed for bankruptcy, distressed investors Angelo, Gordon & Co., and the Baupost Group numbered among its three largest claimholders, with each having purchased approximately $1 billion (face value) worth of Enron's corporate notes as the company was sliding towards bankruptcy.[31] In the bankruptcy of Worldcom (now MCI), distressed investors MatlinPatterson, Silver Lake Capital, and Bain Capital purchased approximately 25% of the company's outstanding debt for more than a billion dollars.[32] In fact, Worldcom had more distressed debt investors than financial institutions on its creditors' committee with distressed investors Cerberus Partners and Blue River acting as co-chairs of the committee.[33] Kmart Corporation, which emerged from bankruptcy in May of 2003, is now controlled by ESL Investments, a hedge fund that purchased $1.16 billion worth of Kmart's publicly traded bonds and $600 million face value worth of Kmart's bank debt, all after the company had already filed for bankruptcy.[34] ESL now owns 49% of the

---

[29] Peter Lauria, *Adelphia off to Chapter 11*, DAILY DEAL, June 22, 2002.

[30] *Id.*

[31] Henry Sender, *Enron Bets May Bite 'Vulture' Firms*, WALL ST. J., May 23, 2002, at C1.

[32] Gregory Zuckerman, *MCI Bondholders Get Distressed*, WALL ST. J., July 29, 2003, at C1.

[33] Bankruptcy Datasource, 12/1/02, Worldcom's creditors committee includes ESL Investments, Cerberus Capital Management, GSC Partners, Elliott Management and Blue River LLC *available at* http://bankrupt.com/TCREUR_Public/020801.mbx.

[34] Mitchell Pacelle & Amy Merrick, *Salvage Operation: Behind Kmart Exit from Chapter 11*, WALL ST. J., May 6, 2003, at A1.

reorganized company's shares, and has nominated four of the company's nine directors.[35] The creditors' committee of the Mirant Corporation, which filed for bankruptcy in July 2003 with $11.6 billion in liabilities, is chaired by Appaloosa Management, a multi-billion dollar hedge fund and distressed debt investor.[36] Veteran San Francisco bankruptcy lawyer Pat Murphy concedes that times have drastically changed; when a company gets in trouble, it no longer faces familiar bankers across the negotiating table. Instead, it faces distressed debt investors having no prior relationship with the company.[37] Professor Edward Altman, one of the nation's leading experts on distressed securities, calls distressed debt the "hottest alternative investment area."[38] According to Altman's research, there was at least $65 billion dedicated solely to distressed debt investing in 2003[39] compared to only about $6 billion as recently as 1991.[40]

Oaktree Capital Management, one of the world's largest distressed debt investors, controls more than $25 billion and has been found among the largest claim holders in dozens of recent bankruptcies.[41] Cerberus Capital Management, a distressed debt hedge fund, controls more than $10 billion in capital and is among the top five largest hedge funds in the

---

[35] *Id.*

[36] Gregory Zuckerman, *Heard on the Street: Appaloosa: Galloping 'Vulture,'* WALL ST. J., Aug. 19, 2003, at C1.

[37] John E. Morris, *Bankrupt: Times are Changing*, DAILY DEAL, June 20, 2002.

[38] Matt Miller, *Disciple of Doom*, DAILY DEAL, June 5, 2003.

[39] *Id.*

[40] Edward Altman et al., *The Link Between Default and Recovery Rates: Theory, Empirical Evidence and Implications* (Apr. 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=314719 (noting that there is clearly more than $65 billion if you include hedge funds and private equity firms willing to invest in distressed securities and assets as opposed to dollars solely dedicated to such purposes).

[41] Vyvyan Tenorio, *Oaktree to Close $1B Fund*, DAILY DEAL, Feb. 20, 2004. Oaktree does not dedicate the entire $25 billion to distressed investing. The firm has significant investment funds dedicated to real estate, emerging markets, high yield and convertible investments, as well.

world.[42] During just the last few years, Cerberus has succeeded in taking controlling positions in sportswear group Fila for about $350 million, bottling company Anchor Glass for $380 million, Conseco's lending business in a partnership with Fortress Investments for $850 million, and the major assets of ANC Rental, a car rental group that includes Alamo and National, for $230 million. Cerberus controls Teleglobe Canada, and owns countertop manufacturer Formica Corporation through a joint venture with distressed investor Oaktree Capital Management. In 2004, Cerberus became Air Canada's largest shareholder after investing $183 million in the bankrupt company, purchased troubled department store Mervyn's in a $1.2 billion deal,[43] and owns a significant stake and has a board seat in MCI (formerly Worldcom).[44] Without actually purchasing a controlling position, Cerberus has also acquired significant stakes in numerous other major bankruptcies in the past few years, gaining seats on the creditors' committees of many large corporate debtors.

The table below documents the extent of distressed debt investor presence in the largest Chapter 11 bankruptcies of 2001 and 2002.[45] In almost every case, the distressed investors have held significant or controlling debt postitions. Often, these investors have been major players in asset sales or have even made a bid for the entire corporation.

---

[42] Louis Forster, portfolio manager at Cerberus Capital Management, Aozora Bank: The Contest Over the Future Begins, Remarks at The Program on Alternative Investments, Center on Japanese Economy and Business at Columbia Business School in New York, NY (Sept. 24, 2003).

[43] David Carey, *PE Firms Snag Mervyn's*, DAILY DEAL, Aug. 2, 2004.

[44] Peter Smith et al., *A Three-headed Dog with a Fearsome Reputation Tries to Prove it can Really be a Loyal, Tame Animal...*, FIN. TIMES, Oct. 20, 2003 at 19 (Cerberus is a member of Worldcom's Creditors' Committee).

[45] The list includes the largest domestic Chapter 11 bankruptcies from 2001 and 2002 which have now emerged according to Lynn LoPucki's bankruptcy database located at http://lopucki.law.ucla.edu.

Table 1: GROWTH OF DISTRESSED DEBT INVESTOR PRESENCE IN LARGE CORPORATE BANKRUPTCIES, 2001—2002[46]

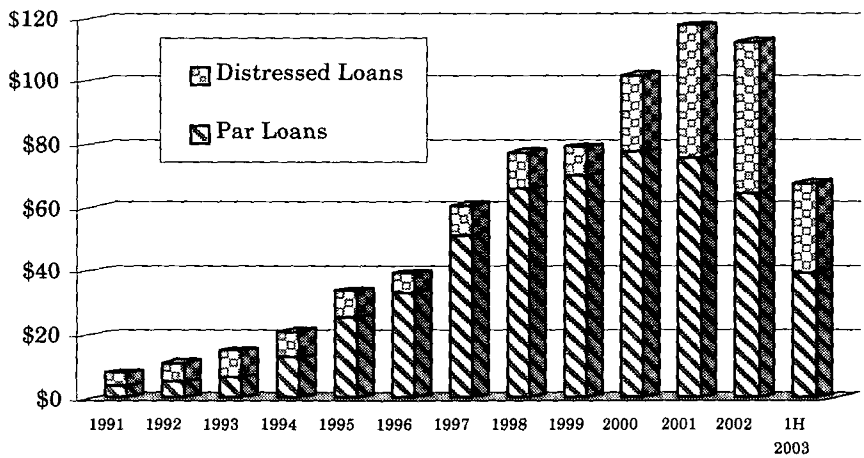
($ in millions)

			Distressed Debt Investor Involvement		
Company Name	**Year**	**Assets**	**Controlling Stake**	**Board Seats**	**Significant Stake**
Global Crossing	2002	$30,185	N/A	N/A	Carl Icahn, Cerberus Capital Management
NTL Inc.	2002	$16,581	N/A	WR Huff Fund (2), Apollo Management (1), Oaktree Capital (1), Appaloosa Partners (1)	Franklin Advisors, WR Huff, Oaktree Capital, Appaloosa Partners, Angelo Gordon
Kmart	2002	$14,832	ESL owns approximately 50% of the company's equity	ESL (3), Third Avenue Fund (1)	Third Avenue Fund
US Airways	2002	$7,865	Alabama State Pension Fund	N/A	Texas Pacific Group
XO Communications	2002	$7,807	Carl Icahn	Carl Icahn (4)	Appaloosa Management, Carlson Capital
WilTel Communications (Formerly Williams Communications)	2002	$5,902	Leucadia National Corp.	Leucadia National Corp. (3), Q Investments (1)	Q Investments
McCleod USA	2002	$4,755	Forstmann Little & Co.	Apollo Management (1)	Apollo Management
Sunbeam	2001	$3,155	Oaktree Capital Management controls the company along with Morgan Stanley and Bank of America	Bank of America, Morgan Stanley, Oaktree Capital Management	Elliott Management, KS Capital Partners
Spectrasite Holdings	2002	$3,128	N/A	Apollo Management (1), Oaktree Capital (1)	Apollo Management, Oaktree Capital, Franklin Mutual Advisors
Hayes Lemmerz International	2001	$2,817	N/A	Apollo Management (2)	Apollo Management
Warnaco	2001	$2,331	N/A	N/A	TWC Management (6%), Chilton Investments (5%)
Arch Wireless	2001	$2,306	N/A	N/A	Franklin Advisors (10%), Tudor Investments
Loews Cineplex	2001	$1,921	Partnership between Onex and Oaktree Capital Management	Onex (3), Oaktree Capital Management (1)	N/A
AMF Bowling	2001	$1,730	Partnership between Farallon Capital Management, Oaktree Capital and Satellite Asset Management (92.5%)	Farallon Capital Management (1), Oaktree Capital (1) and Satellite Asset Management (1)	N/A
Nations Rent	2001	$1,724	Baupost and Island (through portfolio company Phoenix Rental Partners) control the firm	Baupost Group (1), Island Partners (2)	Apollo Management, Seneca Capital Management
Covad Communications	2001	$1,509	N/A	N/A	Oaktree Capital, Fir Tree Partners
Chiquita Brands International, Inc.	2001	$1,496	N/A	Apollo Management (1)	Apollo Management
APW	2002	$1,284	Oaktree Capital Management	Oaktree Capital Management, Greenwich Street Capital	Greenwich Street Capital
Teligent Inc.	2002	$1,205	N/A	N/A	Goldman Sachs Credit Partners
Washington Group International	2002	$1,192	N/A	N/A	N/A
Lodgian Inc.	2002	$1,167	Oaktree Capital Management (22.5%)	Oaktree Capital Management (2)	Third Avenue Fund (6%)
Metals USA	2002	$1,106	Citadel Investment Group (23%)	Citadel Investment Group (2)	MatlinPatterson, Triton Partners
Link Energy (formerly EOTT Energy)	2002	$1,075	Farallon Capital Management (21%), Lehman Brothers Energy Fund (20%)	Lehman Brothers Energy Fund (1)	N/A
Pinnacle Holdings	2002	$1,018	Greenhill Capital and Fortress Investment control the company through a JV investment	Greenhill Capital (1), Fortress Investment (2)	N/A

[46] Lynn LoPucki's Bankruptcy Database, *available at* http://lopucki.law.ucla.edu (containing companies that emerged from Chapter 11, based on asset size and using shareholder, creditors' committee, and board data from SEC filings and bankruptcy court filings found on Lexis–Nexis' Bankruptcy DataSource).

The recent dramatic growth in distressed debt investing is surely linked to the similarly dramatic growth in the issuance of high-yield bonds and highly leveraged bank loans, as well as the increased ease with which they have been traded in the secondary loan market. The issuance of high-yield bonds and leveraged loans has grown tremendously over the past decade, with high yield bonds peaking in 1998 at $145 billion in issuances, and leveraged loans peaking in 1999 with $320 billion.[47] As the chart below demonstrates, there has also been a dramatic increase in the size of the secondary markets for senior bank loans. In 1991, a total of only $8 billion (face value) of bank loans traded in the secondary market. By 2002, secondary volume grew to a total of $118 billion (face value) with the greatest growth attributable to distressed loans.[48]

Table 2: U.S. SECONDARY LOAN MARKET VOLUME (1991-1H 2003)



[47] Keven S. Buehler et al., *The Allure of Distressed Debt*, McKINSEY QUARTERLY, APR. 14, 2003.

[48] Loan Pricing Data Corporation, *available at* http://www.loanpricing.com.

A 1990 amendment to the Federal Bankruptcy Code also stimulated the growth of distressed debt investing. The amended language of Rule 3001(e)(2) vastly reduced court interference with the transfer of bankruptcy claims by making it clear that only the transferor has standing to object to a transfer, and by eliminating the need for a court hearing and court order to effect a transfer.[49] This amendment paved the way for the growth of distressed debt funds by lowering both the transaction costs of claims trading and diminishing the uncertainty over the legitimacy of claims acquired after bankruptcy filing.[50]

As the supply of distressed and defaulted debt has grown, the demand for these claims has risen apace. Distressed debt investors, like all other investors, seek to buy low and sell high. Buying opportunities arise when the market value of debtors' claims falls below what these investors consider to be the "true" value, often due to the shock of an unexpected bankruptcy filing or uncertainty about the capacity of the firm to restructure successfully. Distressed investors offer liquidity, albeit often at a steep discount, for owners of nearly every kind of claim, including publicly traded debt, bank loans, trade claims, tort claims, and rejected executory contract claims.[51] Often, sellers may be willing to "sell low" to unload these claims to avoid the administrative hassle and costs of bankruptcy proceedings. The seller may seek to establish a tax loss on his investment.[52] The seller may face regulatory requirements, including Basel Accord capital requirements, auditing rules for balance sheet asset write-offs or mark-to-market accounting requirements for securities.[53] If they do not have a large enough financial

---

[49] Tung, *supra* note 9, at 1704.

[50] It should be noted that Rule 3001(e)(2) does not apply to publicly traded securities. Because all classes of debt are much more widely securitized today than they were in 1990, the percentage of claims trading falling under Rule 3001(e)(2)'s "proof of claim" requirements has decreased significantly over the past fourteen years.

[51] Fortgang & Mayer, *supra* note 28, at 4.

[52] *Id.*

[53] *Id.*

stake in the debtor to warrant bearing the expense and delay of a bankruptcy proceeding, sellers may also choose to "sell low." The seller may be a mutual fund whose covenants do not allow the fund to carry defaulted bonds. The seller may have purchased the claims on margin and owe debts of its own and, therefore, needs to sell the claim to provide its own creditors with cash. Alternatively, the seller may be a supplier or customer who values its long-term relationship with the debtor and does not want to get involved in an acrimonious bankruptcy proceeding.[54]

The purchase of various claims in a bankruptcy proceeding does not directly give the distressed debt investor any legal standing beyond that provided by the explicit contractual agreement. But there are indirect means to gain strategic and operative influence. Statutorily, the distressed debt investor will have the right to move to lift the automatic stay, move to lift the debtor's exclusive right to file a plan, raise objections to operating decisions made outside the ordinary course of business, and vote against the debtor's plan of reorganization—potentially forcing a difficult and time consuming "cram down" under Section 1129(b)(2). A distressed investor, because of its proportionally large presence among claimholders, may be appointed to the debtor's creditors' committee[55] where the distressed debt investor may threaten or move for the court appointment of a trustee.[56] The threat of management's losing control to a trustee may be enough for the creditors' committee to gain significant input into firm decision making.[57]

[54] *Id.*

[55] Note that distressed investors may prefer not to join the creditors' committee. Often this decision is made based on the committee's occasional access to inside information and the distressed investor's desire to remain legally able to trade in and out of its position in the company.

[56] LoPucki & Whitford, *supra* note 19, at 699.

[57] That said, appointment of a trustee is thought to be an extraordinary measure in Chapter 11, often reserved for cases of bad faith or fraud. In fact, research on large corporate bankruptcies conducted by Lynn LoPucki and William Whitford found that a trustee was appointed in only two of the forty-three major corporate bankruptcies examined. *Id.*

Much more common is a significant creditor gaining leverage through an informal understanding that: 1) the debtor will need the creditor's approval of its reorganization plan (especially if the creditor holds a blocking position—33% of value or 50% of claims—in its particular class), or 2) the creditor is likely to become a major shareholder of the reorganized entity, potentially having the power to nominate a director or sway management choices in the future. In this manner, there is often a tremendous amount of indirect control that creditors' committees have in the day-to-day operations of the debtor. As Harvey Miller explains, the creditors' committee can oppose anything that happens in the case; it simply comes down to an issue of how far the bankruptcy court will support the creditors and their demands.[58]

The creditors' committees, thinking of themselves more as the Board of Directors than as claimholders, will often argue that that they should be involved in every decision and negotiation.[59] Understandably, the fact that creditors may end up being the controlling shareholders of the restructured company has a tendency to provide the creditors' committee with a great deal of authority, even with ordinary course, day-to-day decision making of the debtor. Irwin Gold, senior managing director of Houlihan, Lokey, Howard & Zukin, and former financial advisor to the creditors of MCI, points out that the creditors' committee played an active role in many important management decisions, including the selection of Mr. Capellas as the company's new CEO. Mr. Gold points out that the creditors developed a close relationship with Mr. Capellas, often stressing the importance of emerging from bankruptcy as quickly as possible.[60] Especially in situations where the creditors' committee includes a single creditor who is likely to have control of the restructured company's equity,

---

[58] Interview with Harvey Miller, Senior Partner, Greenhill & Co., in New York, NY (Mar. 2, 2004).

[59] *Id.*

[60] Rebecca Blumenstein & Shawn Young, *Worldcom Creditors Back Plan to Reorganize in Bankruptcy*, WALL ST. J., Apr. 14, 2003, at A1.

Harvey Miller points out that it is natural for the debtor's management to give the creditors' committee significant input in strategic decision making.[61] One distressed investor remarked that his firm often gains the ear of the debtor's management because of its willingness to discuss management retention plans, potential post-emergence bonuses, and future strategic directions.[62]

IV. RECENT TRENDS IN BANKRUPTCY PROCEEDINGS AND THE DISTRESSED DEBT INVESTOR

The significant presence of distressed debt investors on creditors' committees has transformed the dynamics of bankruptcy. A decade or two ago, a bankruptcy filing created a relationship-based, communitarian process in which the creditors and the debtor worked together to rehabilitate and preserve the going-concern value of a corporation. Today, a bankruptcy filing effectively puts a "for sale" sign on the debtor; it communicates to the financial world, and especially to distressed debt investors, that it is time to evaluate the debtor's assets for potential Section 363 purchases.[63] Miller maintains that:

> the ability of third parties, such as private equity firms and hedge funds, to gain access to $1 billion or more in capital is adding to the thrust toward liquidation . . . [t]he effect of that access to capital has been to dramatically change the nature of Chapter 11 from rehabilitation of the debtor to a potential auction sale.[64]

---

[61] Interview with Harvey Miller, *supra* note 58.

[62] Interview with portfolio manager at New York-based multi-billion dollar hedge fund, in New York, NY (June 22, 2004).

[63] Section 363 asset purchases are those made "outside the ordinary course of business" under Section 363(b)(1).

[64] Terry Brennan, *Miller: Liquidations Set to Rise*, DAILY DEAL, Dec. 3, 2003.

Protecting the debtor's going-concern value through court-monitored rehabilitation might have been appropriate in the thinly traded "lemons" markets that dominated bankruptcies of a decade or more ago. An empirical study of large bankruptcy asset sales, published by Hotchkiss and Mooradian in 1998, found the "lemons problem" to be the prevalent pattern for firms acquired while in Chapter 11 between 1983-1992. During that period, out of the fifty-five sales the authors examined, only eighteen had multiple bidders.[65] When there are few potential buyers in an imperfect market, an appropriate goal for the bankruptcy process may be to protect the debtor from asset liquidations at depressed "fire-sale" valuations.[66] Today, the "lemons-market" case is hard to make. A senior managing director at a large New York-based distressed investment fund points out that the number of buyers for distressed assets has grown dramatically since the period studied by Hotchkiss and Mooradian. The director specifically identifies two driving factors behind this increased activity: first, the significant investment returns of distressed investors in the late 1980's and early 1990's brought more competitors to the marketplace and demonstrated that there was significant investment opportunity; and second, the tremendous growth of the high-yield market over the last decade has helped investors become more comfortable and familiar with distressed investing and the bankruptcy process.[67]

With a well-capitalized group of distressed debt funds seemingly eager to bid on assets, there is more reason for bankruptcy courts to push the debtor towards speedy asset

[65] Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. FIN. INTERMEDIATION 240, 243 (1998), *available at* http://www.sciencedirect.com/science?_ob=MImg &_imagekey=B6WJD-45K19MC-3-1&_cdi=6876&_user=18704&_orig= browse&_coverDate=07%2F31%2F1998&_sk=999929996&view=c&wchp= dGLbVzb-zSkWA&md5=7fc456b4b5a4ecf9f675ae0d22dd3888&ie =/sdarticle.pdf [hereinafter Hotchkiss & Mooradian, *Acquisitions*].

[66] *Id.* at 244

[67] Interview with Senior Managing Director of New York-based distressed investor, in New York, NY (Apr. 13, 2004).

sales or M&A events. Miller notes that courts have decreased the amount of time during which debtors are given "plan exclusivity"—the exclusive right to file and solicit acceptance of a reorganization plan—as debtors' assets have become more liquid. Miller cites the lackadaisical pace of the 1982 Johns Manville bankruptcy, in which the debtor was granted plan exclusivity through court extensions for more than four and a half years, as treatment of a bygone era. Likewise, he regards the repeated extensions of plan exclusivity in Eastern Airlines' Chapter 11 proceedings, which led to the erosion of the firm's asset values and a 93% loss of bondholders' original open market claim value, as largely a preventable, and now a probably unlikely, court error.[68] With large distressed debt investors standing ready to purchase assets, a firm in Chapter 11 can no longer count on exclusivity extensions.[69]

As debtor firms increasingly turn to distressed debt funds to expedite their reorganizations, the average time in bankruptcy has declined. According to Lynn LoPucki's bankruptcy database, the mean number of days a company spends under bankruptcy protection has decreased from 741 in 1990 to 367 in 2002.[70] Baird and Rasmussen point out that, during the 1980's, 88% of the large businesses entered Chapter 11 without a clear reorganization plan; but by 2002, that ratio had fallen to 24%.[71] The figure demonstrates that debtors are no longer "protected" by a Chapter 11 filing. Modern bankruptcy courts are no longer willing to allow the

---

[68] Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines*, 48 J. FIN. ECON. 55, at *22 (1998), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=60064.

[69] Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2013 (2002) [hereinafter Miller, *Delaware Myth*].

[70] Alix Nyberg, *Second Acts: After Bankruptcy, Companies Often Teeter Between Encore and Final Curtain Call*, CFO MAG., June 1, 2003, at 40.

[71] Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 674 (2003) [hereinafter Baird & Rasmussen, *Chapter 11 at Twilight*].

debtor a great deal of time to proceed without creditor approval. Harvey Miller concurs, adding that courts have become much more responsive to creditors' liquidation demands over the last decade.[72]

Shorter times in bankruptcy reorganization are driven by the financial incentives and the distinctive business culture of distressed debt investors. Distressed investors are usually private investment funds whose principals' fees and bonuses rise dramatically when the fund's rate of return exceeds a "hurdle rate," which is significantly above that expected by fixed-income investors.[73] As Fred Hodara, a partner at Akin, Gump, Strauss & Feld, explains, "[t]hese funds aren't looking to get principal and interest back on their loans, they want equity-style returns."[74] Distressed investors commonly purchase relatively low-yielding bank loans and bonds with a high probability of eventually being converted into equity positions that can provide much higher rates of return *if* the bankruptcy reorganization is successful and *if* the company emerges from bankruptcy with revitalized earnings power.

It follows that the distressed debt investor's bet is extremely time sensitive; in order to attain high required rates of return, funds cannot tolerate delayed or inefficient bankruptcy proceedings. When a distressed debt fund invests in post-petition claims, it believes, by implication, that the plan of reorganization will be confirmed and consummated before the high opportunity cost of carrying the investment destroys any net profit that the investor might be able to book.[75] The funds report their results to

[72] Interview with Harvey Miller, *supra* note 58.

[73] A majority of the fund managers whom I interviewed said that they are looking for about a 20% internal rate of return on invested funds.

[74] Shanon D. Murray, *Bankrupt: Letter From Delaware*, DAILY DEAL, Sept. 25, 2003. (The difference between debt and equity returns is substantial. Since 1946, stocks have had average annual returns of 7.5% and bonds 1%, after adjusting for inflation.).

[75] Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 407, at *5 (1997), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1883.

their investors on a quarterly, or sometimes even a monthly basis; consequently there is constant pressure to achieve high expected rates of return with liquid positions which can be "marked to market" in companies that have emerged from bankruptcy.[76] Hedge funds, most of which face redemptions from their investors at any time, are particularly prone to be "battling against the clock from an IRR [internal rate of return] perspective."[77] While economic theory might suggest near equivalency between the time value of money to a pre-petition fixed-income investor and its value to a post-petition distressed debt investor, in practice, as Chaim Fortgang and Thomas Mayer observe, "[t]here is a real world difference between the attitude of the longtime creditor and an investor who has just invested its money."[78] According to Harvey Miller, exit strategies are paramount to the managers of distressed debt funds:

> All they're concerned about is, how can I get this company to a point where I can either do an IPO or I can sell. . . . The distressed traders will call up [the debtor] in the first three months and say: "alright, we're converting debt to equity, we don't want to hear anything else, we want you out of Chapter 11."[79]

When the IPO [initial public offering] market is "hot," distressed investors will be pushing especially hard to get debtors out of bankruptcy; "they are thinking, 'the market time is now, if we wait, we may not be able to do IPO.'"[80]

The incentives and culture of distressed debt funds also favor Delaware for Chapter 11 bankruptcy proceedings because Delaware courts are often believed to be faster, more knowledgeable, and more predictable than other jurisdictions. Delaware courts are said to understand the

---

[76] Telephone Interview with founder of distressed debt investing hedge fund (Mar. 31, 2004).

[77] Telephone Interview with principal at multi-billion dollar distressed investment fund (Apr. 2, 2004).

[78] Fortgang & Mayer, *supra* note 28, at 4.

[79] Interview with Harvey Miller, *supra* note 58.

[80] *Id.*

importance of "first day motions" which allow a debtor to carry on its business as usual by approving DIP financing, the payment of wages, and critical vendor orders.[81] Delaware courts are also more likely to accept pre-packaged plans between the debtor and the creditors, and are generally faster in approving such plans (on average taking less than fifty-two days).[82] Harvey Miller notes how Delaware judges routinely make themselves available at almost any time during the initial phase of filing, and emergency hearings can be scheduled quickly.[83] The characteristic expertise of Delaware judges in corporate law also allows them to get through issues more quickly and with a greater understanding of financial and corporate issues.[84] Lynn LoPucki sums up the available evidence by suggesting that Delaware courts offer more latitude or "laissez faire" to enable the quick negotiation of asset sales or reorganization plans.[85] One common argument is that large creditors (often commercial banks and mutual funds) pressure the debtor to file in Delaware in order to increase the value of their post-petition claims, knowing that the distressed investors prefer a Delaware jurisdiction.[86] Research data support the professional observations: Theodore Eisenberg and Lynn LoPucki, examining 284 public company bankruptcies with more than $100 million in assets between 1980-1997, conclude that there has been a shift in forum shopping from New York courts to Delaware courts and that a major factor behind this shift has been a significant difference in case processing time.[87]

[81] Miller, *Delaware Myth*, *supra* note 69, at 1992-93.

[82] David Marcus, *Destination Delaware*, DAILY DEAL, May 5, 2001.

[83] Miller, *Delaware Myth*, *supra* note 69, at 1993.

[84] *Id.* at 1992-93.

[85] Marcus, *supra* note 82.

[86] *Id.*

[87] *See* Theodore Eisenberg & Lynn M. LoPucki, *Shopping For Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 987-92 (1999). While the authors point out that the Delaware Court's perceived processing time is a major explanation for this trend, they argue that Delaware is only faster

By reducing the time spent in bankruptcy, distressed debt investors are helping to mitigate the tremendous transaction costs that usually accompany a Chapter 11 proceeding. For years, scholars have argued that the transaction costs of the bankruptcy process are inefficiently high.[88] Transaction costs of the Chapter 11 process can usually be broken down into direct costs and indirect costs.[89] Direct costs are those costs that come directly out of the debtor's pocket because of the filing. These costs include all of the costs of administering the Chapter 11 process, and negotiating a reorganization plan including fees paid to investment bankers, commercial bankers, lawyers, and accountants. In fact, the direct costs of bankruptcy, in the form of legal fees and administrative expenses, can range from 3 to 25% of debtor's total value.[90] As far back as 1986, Baird argued that the transaction costs of Chapter 11 were too high and that all cases should immediately be converted to Chapter 7, regardless of going-concern value.[91]

While scholars usually concentrate on direct and easily quantifiable transaction costs, the indirect costs of a Chapter

---

because of its large proportion of pre-packaged cases. The authors point out that Delaware is statistically faster than New York, but not necessarily faster than other jurisdictions.

[88] *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV 439, 463-64 (1992). *See also* LoPucki & Whitford, *supra* note 18, at 776 n.339, 788. In their 1991 study of large corporate bankruptcies, LoPucki and Whitford found that in thirty-four of forty-three cases studied (79%), exclusivity was granted throughout the entire reorganization. The authors suggest two reforms: first, a "preemptive cram down" in which, early in the case, after providing fair hearing, the court would eliminate the interests of the equity holders if it could be shown that the company was clearly insolvent. This method could also be used, at the discretion of the court to eliminate particular creditor interests. Second, the authors suggest that there should be specific statutory limitations for plan exclusivity, perhaps a bright line rule requiring greater review of court extensions.

[89] *See* Adler, *supra* note 88, at 465-67.

[90] *See* Adler, *supra* note 88, at 465.

[91] Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 139 (1986).

11 filing, while not easily quantifiable, are likely to be greater still. These indirect costs are mostly the "uncertainty costs" which surround a debtor.[92] Doubts about whether a firm will survive reorganization cause critical employees to leave, trading partners to curtail potentially profitable dealings, and a company's brand name to be degraded.[93] Each additional day in bankruptcy proceedings increases these costs of uncertainty. A complicated and public bankruptcy will also create significant opportunity costs for the debtor. A drawn-out Chapter 11 process is a significant distraction to managers, consuming their valuable time and negatively affecting their ability to concentrate on the day-to-day operations and long-term strategy of the firm. Moreover, the bankruptcy process often forces managers to sacrifice profitable long-term ventures in pursuit of short-term projects with high free cash flow that can satisfy creditors' immediate property interests.[94]

By trying to expedite the bankruptcy process, distressed debt funds mitigate both the direct and indirect costs of bankruptcy. In the 2002 Kmart Chapter 11 filing, for example, before distressed investor ESL stepped in and purchased a controlling stake in the company's debt, the company was paying lawyers, advisors, and investment bankers $10-12 million per month.[95] Focused on its own internal rate of return, ESL was eager to trim these fees by ensuring that Kmart management could no longer delay the negotiation of a reorganization plan. Toward this end, ESL forced Kmart CEO James Adamson to resign and replaced him with a former Sears executive (ESL also owns approximately 9% of Sears).[96] ESL also focused on curbing the damage from the high-profile bankruptcy on Kmart's brand image and supplier relations. The fund provided

---

[92] Adler, *supra* note 88, at 465-66.

[93] *Id.*

[94] *Id.*

[95] Mitchell Pacelle & Amy Merrick, *Salvage Operation: Behind Kmart Exit from Chapter 11*, WALL ST. J., May 6, 2003, at A1.

[96] *Id.*

Kmart with a significant exit debt financing package, but based the attractive financing terms on Kmart's ability to quickly emerge from Chapter 11—threatening to rescind the financing if a quick exit were not achieved.[97] In a similar move, rather than risk the possibility of further delay and legal costs, ESL quickly struck a financial settlement with large unsecured trade creditor, Capitol Factors, who had threatened to hold-up the plan confirmation.[98]

A senior managing director at a New York-based distressed investor told me that his firm relies on Chapter 11 to help the debtor rehabilitate its operations and balance sheet. That said, he believes that distressed investors, often faced with significant investment return responsibilities to their own limited partners ("LPs"), are in a good position to tightly monitor the fees and expenses of a Chapter 11 filing, which he deems "out of control."[99] A portfolio manager at a NY-based distressed hedge fund remarked that the most important advantage of private distressed investors is their flexibility in negotiations. He said that his fund is able to "get deals done quickly and efficiently" because the fund is willing to own any part of the company's capital structure or accept any kind of corporate security—something other creditors are often unwilling or unable to do.[100] Distressed funds are appropriately incentivized to find a proper balance between Chapter 11's rehabilitation benefits and the direct and indirect costs of an overly extended Chapter 11 reorganization. In this manner, distressed debt investors can lower the transaction costs of a Chapter 11 filing and

---

[97] Laura Heller, *Kmart to Emerge After 15 Months in Chapter 11*, DSN RETAILING TODAY, May 5, 2003, at 1, 38.

[98] *Id.*

[99] Interview with a senior managing director of New York-based distressed investor, in New York, NY (Apr. 13, 2004). Specifically, the investor points out that restructuring advisors are often monetarily incentivized to convince the debtor to stay in Chapter 11 because the advisors want to continue to collect monthly retainer fees and asset sale success fees. *Id.*

[100] Interview with a portfolio manager at New York-based multi-billion dollar hedge fund, *supra* note 62.

thereby improve the economic efficiency of large corporate bankruptcies.

V. THE ALTERNATIVE HYPOTHESIS OF BAIRD AND RASMUSSEN

In *The End of Bankruptcy* and other articles, Douglas Baird and Robert Rasmussen have noted that the "traditional" bankruptcies, in which the bankruptcy court provides a collective forum for the debtor-in-possession to control the firm's rehabilitation and emergence as a going concern, have all but come to an end.[101] Baird and Rasmussen were early in recognizing what is now widely acknowledged—that the principal players (in bankruptcy proceedings) understand that a Chapter 11 filing has the effect of putting the company on the auction block.[102] Likewise, Baird and Rasmussen were early in both recognizing and documenting the trends toward faster reorganizations and more M&A events in bankruptcy proceedings, along with the migration of legal filings from New York to Delaware. What is surprising is that Baird and Rasmussen virtually ignore the influence of distressed debt investors in driving these trends. Instead, they largely credit the "end of bankruptcy" to the modern process of "dynamic contracting," in which senior bank creditors gain control over debtors, without a change in bankruptcy laws, by exercising rights contained in covenants to both pre-petition revolving credit agreements and post-petition debtor-in-possession (DIP) loans.

Baird and Rasmussen's basic argument is that modern senior creditors have learned to structure their debt covenants so that control rights begin to shift to the firm's creditors at the first sign of financial distress, even before the bankruptcy petition, and continue to shift through post-petition financing. The principal vehicles of encroaching creditor control are the revolving credit facility (pre-petition)

[101] Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 71, at 674.
[102] *Id.*

and the post-petition debtor-in-possession (DIP) financing. According to Baird and Rasmussen, when serious signs of financial distress first arise, multiple institutional creditors respond by morphing into a single revolving credit facility[103] with a first-priority lien over all of the firm's property and the power to declare the firm in default. In the words of Baird and Rasmussen, "[t]he power to declare defaults can give them the de facto power to hire and fire the managers and the ability to review decisions the managers make about how assets are to be used."[104] Even before the bankruptcy petition is filed, creditors are said to have the wherewithal to "turn off the cash," to monitor and approve every decision "out of the ordinary course," and often to appoint a chief restructuring officer.[105]

In the ineluctable cycle of "dynamic contracting," it is post-petition, DIP financing that finalizes the shift of enterprise control to senior creditors. Baird and Rasmussen describe how debtors have little alternative to the draconian demands of the DIP creditors. Moreover, faced with the risk that the enterprise will lose critical suppliers or customer security if DIP financing is not immediately forthcoming, bankruptcy courts are prone to approve highly restrictive contracting terms.[106] In his *Creditor's Ball* article, David Skeel reiterates Baird and Rasmussen's theory. "The magical provision is section 364 . . . it authorizes the bankruptcy court to roll out the red carpet for a lender that is willing to make a new loan to the debtor."[107] Skeel, Baird and Rasmussen agree that the DIP contract characteristically specifies the fate of every asset and every division in the company, completely transferring control to

---

[103] *Id.* at 696.

[104] *See* Baird & Rasmussen, *End of Bankruptcy, supra* note 7, at 782.

[105] Douglas G. Baird & Robert K. Rasmussen, *Controlling the Agents of Enterprise* (Oct. 2002) (unpublished manuscript on file with author) [hereinafter Baird & Rasmussen, *Agents of Enterprise*].

[106] *Id.*

[107] David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 924 (2003).

the post-petition lender. Harvey Miller agrees: "Increasingly sophisticated DIP lenders are succeeding in subjecting all the company's assets to liens and security interests at the very start of a filing, when the debtor is in its most fragile state."[108] As Baird and Rasmussen explain, once the DIP is in place, the debtor's Board of Directors and management have lost the ability to make decisions against the wishes of their DIP lenders.[109] Often, the DIP covenants require certain assets to be sold, certain financial milestones to be met, and the reorganization plan to be completed by a certain date. Skeel acknowledges, "it is not an overstatement to say that the terms of the debtor's post-petition financing regularly set the course, and even the outcome, of the Chapter 11 case."[110]

Critics of the Chapter 11 bankruptcy process often argue that the DIP financer and secured pre-petition lender are often fully protected under their financing agreements and may thus be indifferent to the fate of the firm as a whole. Residual actor theorists argue that creditor control in Chapter 11 may even encourage the pursuit of negative net-present-value strategies as long as these strategies create sufficient cash flow to permit senior claims to be accommodated. Baird and Rasmussen's most important argument is that this process of shifting control to senior lenders is economically efficient; as long as control rights are sensibly allocated, control will always rest with those best able to make strategic decisions with the firm's best interests in mind.[111] Baird and Rasmussen never explicitly say that modern "dynamic contracting" by senior creditors has eliminated the residual actor problem in Chapter 11 proceedings, but their discussion of the incentives of senior creditors suggests as much. Because large creditors have so much at stake, they are said to have ample incentive to

[108] Cheryl Meyer, *Provell Declares Bankruptcy*, DAILY DEAL, May 11, 2002.

[109] Baird & Rasmussen, *End of Bankruptcy*, *supra* note 7, at 785.

[110] Skeel, *supra* note 107, at 927.

[111] Baird & Rasmussen, *End of Bankruptcy*, *supra* note 7, at 778.

revitalize the debtor as a going concern. Baird and Rasmussen conclude that better incentives create a better outcome: as senior creditors seek to maximize the firm value, all of the debtor's claimants are better off, including junior bondholders and even equity.[112]

In this manner, Baird and Rasmussen describe a process that largely solves the classic residual actor problem—the economic efficiency problem—of Chapter 11 bankruptcy proceedings. Baird and Rasmussen maintain that in the process of obtaining total control over strategic and tactical firm decisions, senior creditors also begin to act like equity owners in that they seek to maximize total firm value through efficiency improvements.[113] With their power solidified over both strategic and tactical decisions, and with their debt capital providing essentially all of the bankrupt firm's financing, senior creditors are said to be adequately incentivized to maximize the total value of the firm, rather than just enough value to repay fixed obligations.[114] As Baird explains, "remember, if you lend a little money to someone, you're a creditor. If you lend a lot of money to someone, you're a partner."[115]

While Baird and Rasmussen's thesis has great logical appeal, it does not fully describe the realities of modern bankruptcy proceedings. Contracting appearances can be deceptive; recent capital market innovations enable large senior creditors to "lend a lot of money" without incurring a

---

[112] Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

[113] *See* Baird & Rasmussen, *End of Bankruptcy*, *supra* note 7, at 784-85; *see also* Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

[114] Douglas G. Baird & Martin Bienenstock, *Panel 5: Debtor-In Possession Financing (Pre-Petition & Lock-up Agreements)* 1 DEPAUL BUS. & COMM. L.J. 589, 592 (2003). Empirical research adds credence to Baird and Rasmussen's efficiency argument. Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 270-76 (2003) examined Chapter 11 cases between 1988-1997, finding DIP financed firms more likely to emerge successfully from bankruptcy, and that their time spent in the reorganization period is shorter than that of the non-DIP financed firms.

[115] *See* Baird & Bienenstock, *supra* note 114, at 592.

lot of financial risk. Although consortiums of large banks may indeed be the first to originate substantial commercial loans for financially distressed companies, they are seldom doing so in a manner that establishes a long-term or "partnering" relationship with the creditor. Instead, senior debtors typically off-load these loans to others through syndications, collateralized loan obligations (CLOs), and collaterized bond obligations (CBOs), often leaving them with "little money" in true credit exposure.[116] In addition, commercial banks have reduced their default-risk exposure by buying credit insurance in the form of credit default swaps, which effectively transfer credit risk and, hence, the incentive to "partner" to default swap sellers. And finally, much of what commercial banks contract to loan in post-petition DIP financing is in the form of contingent or revolving credit loans, which are typically more cosmetic than real, and seldom confer enterprise control because debtors seldom tap them anywhere close to stated capacity. In short, Baird and Rasmussen wrongly focus their research on initial contractual relationships with large commercial banks rather than eventual economic realities with distressed debt investors. Although they proclaim the importance of dynamic contracting in bankruptcy proceedings, Baird and Rasmussen largely neglect second-order contracting dynamics that enable activist-minded distressed debt investors to have more "skin in the game" than senior commercial bank creditors. Over the last twenty years, commercial banks have increasingly de-emphasized the "classic" creditor-debtor relationship and built a "modern" service-oriented and less-risky relationship in which bank income depends more on fees for services provided and less on interest for credit extended. The principal dynamic of modern large corporate bankruptcy proceedings is the transfer of claims and financial risks from the hands of short-term oriented financial institutions to

[116] Baird and Rasmussen also fail to point out that the revolving credit facilities themselves are widely syndicated, at times to more than 100 financial institutions.

long-term, operations-minded third-party investors. This transfer has created a new class of residual actors—distressed debt funds—that are sufficiently motivated and positioned to re-establish long-run profit maximization as the principal goal of firms being reorganized under Chapter 11 proceedings.

A. Revolving Credit Facilities

Baird and Rasmussen err by using Warnaco as the prototypical example of how a company facing bankruptcy is likely to refinance. As Warnaco became distressed, it consolidated 97% of its debt into a $1.7 billion secured revolving credit facility—precisely the kind of pre-petition financing vehicle that Baird and Rasmussen describe as modern "dynamic contracting."[117] A few commercial banks accounted for the bulk of debt in this revolving credit facility: JP Morgan, Citigroup, Société Générale, Bank of Nova Scotia, and Commerzbank AG.[118] Since Warnaco was clearly insolvent, and because 97% of its debt was consolidated in its revolving credit facility, these pre-petition secured claims were "under water." Any loss in Warnaco's firm value produced a loss for these creditors; likewise, marginal gains redounded equally to the creditors.[119] For the leading commercial lenders, therefore, there was little practical difference between their own economic prospects and Warnaco's total market value, and there was much reason to pursue enterprise strategies that would maximize this total market value. As Baird and Rasmussen point out, these commercial banking lenders had so much at stake that they had become Warnaco's "partner" in essence, if not in name.

Warnaco turns out to be a significant exception to prevalent patterns in pre-petition U.S. debt financings. Data

[117] Warnaco Group, 2002 10-K (July 31, 2002).

[118] *Id.*

[119] Of course, the revolving credit facility creditors' gains were capped by the par value of their claims. Had Warnaco gone through a remarkable operating turnaround in Chapter 11, stockholders might have shared in the gains.

from the twenty largest bankruptcy filings of both 2001 and 2002 reveal that Warnaco's capital structure was far from the norm. Warnaco had 97% of its pre-petition debt in secured revolving credit; the weighted average for the 20 largest 2001-2002 filings was only 16.8%. As shown in the table below, in three cases, the debtor did not have any pre-petition revolving credit. For most of the companies listed, the majority of their pre-petition debt was held in publicly tradable notes; instead of being concentrated in the hands of a few commercial lending "partners," it was widely dispersed among thousands of largely anonymous institutional and private investors. For instance, 100% of Adelphia Communications', 98% of United Airlines', 97% of Metromedia International's, 95% of ANC Rental's, 88% of Exodus Communications', and 83% of XO Communications' pre-petition debt was in the form of underwritten notes and bonds.

Table 3: REVOLVING CREDIT FACILITY DEBT 2001-2002[120]

($ in millions)

Company	Credit Facility Debt	Total Debt	Credit Facility as % of Total
Enron	$3,336	$16,855	20.0%
Comdisco	$1,068	$5,059	21.1%
ANC Rental	$40	$4,260	0.9%
Bethlehem Steel	$354	$1,174	30.1%
Exodus Communications	$224	$2,841	7.9%
Winstar Communications	$697	$2,330	29.9%
Hayes Lemmerz International	$808	$1,708	47.3%
PSInet	$0	$3,700	0.0%
Finova Group	$4,691	$10,998	42.7%
Worldcom	$2,650	$36,000	7.4%
Conseco	$2,001	$6,616	30.2%
Global Crossing	$2,211	$6,641	33.3%
United Air Lines	$133	$8,032	1.7%
Adelphia Communications	$0	$14,850	0.0%
NTL Inc.	$4,195	$14,206	29.5%
Kmart Corp.	$1,069	$3,348	31.9%
US Airways Group	$369	$3,218	11.5%
XO Communications	$1,000	$6,008	16.6%
Metromedia International	$0	$217	0.0%
WilTel Communications Group	$1,011	$5,911	17.1%
Weighted Average	$25,887	$153,972	16.8%
Warnaco Group	*$1,777*	*$1,839*	*96.6%*

Furthermore, when debt is consolidated in a revolving credit facility, it is almost always syndicated, with one "agent" bank creditor typically leading restructuring

[120] List of largest bankruptcies compiled from Lynn LoPucki's Bankruptcy Database, *available at* http://lopucki.law.ucla.edu. Financial information from: Enron 10-Q (Sept. 30, 2001), Comdisco 10-K (Sept. 30, 2001), ANC Rental 10-K (Dec. 31, 2001), Bethlehem Steel 10-K (Dec. 30, 2001), Exodus Communications 10-K (Dec. 31, 2001), Winstar Communications 8-K (Nov. 7, 2000), Hayes Lemmerz International 10-K (Jan. 31, 2001), PSInet 10-K (Dec. 31, 2000), Finova Group 10-K (Dec. 31, 2000), Conseco 10-K (Dec. 31, 2001), Global Crossing 10-K (Dec. 31, 2002), United Air Lines 10-K (Dec. 31, 2001), Adelphia Communications 10-Q (Sept. 30, 2001), NTL, Inc., 10-K/A (Dec. 31, 2002), Kmart 10-K (Jan. 31, 2002), US Airways Group 10-K (Dec. 31, 2002), XO Communications 10-K (Dec. 31, 2001), Metromedia International 10-K (Dec. 31, 2002), WilTel Communications Group 10-K/A (Dec. 31, 2002), Warnaco Group 10-K (Jan. 5, 2002), Chris Nolter, *Creditors Soon to Meet With Worldcom*, DAILY DEAL, Aug. 3, 2002.

negotiations for about ten to twenty syndicates. In most cases, the "agent" creditor will account for a relatively small amount of the total debt: approximately 10% is typical.[121] Since 10% is hardly a compelling "partnership" share, there is a natural inclination for the creditor with negotiating power to think more about recovering its own relatively limited fixed claim than maximizing total firm value. Even in the Warnaco example, in which the revolving credit facility represented claims totaling close to total firm value, the agent who represents this facility is likely to have a much narrower perspective.

In decades past, it was more common to have revolving credit facilities with only a few principal lenders. Today, preferring the reduced risks and servicing fees of syndicated loan agreements or public debt underwriting, banks often refuse to take such a significant stake in an individual debtor. The world of commercial banking has changed, and Baird and Rasmussen's analysis does not account for this change. Baird and Rasmussen see the commercial banking environment as it might have been years ago. Gregory Schweb, partner at Loeb & Loeb LLP, explains that, in the past "the same banker who put the loan out did the workout," and when debtors ran into trouble, the banks, riding out the downturn while paying careful attention to the debtor's operations, would keep the loans on their books.[122] Harvey Miller adds that lenders tended to negotiate in unison; while the largest lender might syndicate the debtor's credit facility, it would continue to hold sway over the entire syndicate.[123] Miller believes that, "relationship banking is dead. . . . [D]ebt has become a commodity and it has created an entirely different environment."[124] Moreover, as banks expose themselves less to the risk of direct commercial lending, there is reduced reason to demand onerous contract

[121] Interview with Bankruptcy Partner at Major New York Corporate Law Firm, at Columbia Law School in New York, N.Y. (Apr. 7, 2004).

[122] Morris, *supra* note 37.

[123] *Id.*

[124] Interview with Harvey Miller, *supra* note 58.

covenants. As one hedge fund manager put it, "If anything, there are less strict covenants in today's bank loans [than there were a decade ago]. There's less security, little margin, and no banks want to hold onto their loans."[125]

Twenty years ago, financial institutions were usually judged and ranked according to "asset base," measured by the amount of commercial loans on their balance sheets.[126] Today, "return on capital" and other profitability ratios have become the principal metrics of success,[127] and so-called "[b]alance sheet obesity" has given way to the art of removing risk from the balance sheet.[128] Many experts cite the sovereign debt crisis of 1982, involving Mexico and several other developing countries, as a major shifting point in commercial banking strategy. The efforts of regulators to reassess the adequacy of capital reserves led to the Basle Concordat of 1983, which created minimum capital requirements at eight percent of risk-weighted assets.[129] In response, banks began to focus more on removing from their balance sheets heavily weighted risks, such as commercial loans, and thereby freed up capital for more profitable reinvestment. Loan origination became less of an effort to establish a long-term lending relationship with clients and more of an effort to earn a steady stream of servicing fees by syndicating or monetizing the loan. Most banks have found that it is more profitable to get fees from arranging a loan than from collecting interest.[130] Raymond Minella, a senior partner at Berenson Minella, sums up the situation thus: "[commercial banks] really have an eye when they originate

---

[125] Telephone Interview with Founder of Distressed Debt Investing Hedge Fund (Mar. 31, 2004).

[126] Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP & INT'L L. 541 (2002).

[127] *Id.* at 545.

[128] *Id.* at 542.

[129] *Id.* at 544.

[130] Morris, *supra* note 37.

the loan on how you get out the back door rather than on what you put on your books."[131]

The wave of consolidation between commercial and investment banks in the 1990's has elevated the importance of servicing fees and related capital-market servicing capabilities over the prior focus on loan portfolios.[132] Some commentators explain that banks increasingly analyze their relationship with a debtor based on their "return on relationship"—in which the relationship is judged primarily on the bank's return from servicing fees, rather than direct interest payments on loans.[133] But the "supply-push" of changing profitability considerations has been paralleled by the "demand-pull" of altered customer preferences. According to numerous commentators, institutional investors are eagerly buying what banks increasingly wish to sell.[134] Risk-averse institutional investors often prefer commercial bank loans, which tend to involve extensive covenants, but are relatively easy to amend, to bond instruments, which often feature more permissive covenants and are rarely restructured outside of a bankruptcy process.[135] The 2003 bankruptcy of energy company NRG provides a case in point. NRG's debt had been so widely syndicated that there were 105 different banks involved in the talks, and the largest stake in bank debt was actually held by distressed debt investor MatlinPatterson who had purchased the claims in the secondary market.[136] Veteran San Francisco bankruptcy lawyer Pat Murphy remembers the "good old days" in the 1980's when banks and insurance companies would keep their commercial loans on their balance sheets. Today, when a company gets in trouble, debtors rarely see the familiar

---

[131] *Id.*

[132] Stephen A. Lumpkin, *The Integration of the Corporate Bond and Commercial Loan Markets*, FIN. MKT. TRENDS, Oct. 1, 2003, at 51.

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] Soma Biswas, *NRG Energy May Seek Prepack*, DAILY DEAL, Mar. 27, 2003.

faces of commercial lenders across the table; instead, with most of their debt syndicated, anonymous institutional investors, and especially distressed debt investors, are the most common sight.[137]

B. Bank Loan Syndication

In the former world of relationship banking, commercial banks feared that syndicating bank loans would jeopardize their long-term relationships with debtors. The syndication of a loan was seen as an indication that the bank believed the debtor to be a risk.[138] Today, syndication of bank loans is the norm, accounting for just over half of all new corporate financings.[139] Recent data from *International Finance Review* placed the number of 2002 syndicated loans in the United States at 2,756, with a face value of $969 billion, versus only $137 billion in 1987.[140]

The syndication agreement between the lead bank and the syndicate is often structured as an "assignment," providing the purchaser of the loan with the rights to payments but not providing the purchaser with a direct claim on the borrower's assets.[141] The lead bank/arranger of the syndication will then continue to structure and manage the banking relationship, even though the bank will have far less financial risk at stake.[142] In situations where the debtor is highly leveraged or distressed, it is even more likely that the loans will be widely syndicated as debtors tend to have far less leverage to prevent assignment or refuse to waive assignment fees.[143]

---

[137] Morris, *supra* note 37.
[138] Lumpkin, *supra* note 132, at 51.
[139] *Id.*
[140] *Id.*
[141] *Id.*
[142] *Id.*
[143] *Id.*

C. Credit Default Swaps

Credit default swaps are a method by which a bank or an investor who buys a syndicated loan or bond may reduce default-risk exposure by buying credit insurance for the debt.[144] The seller of the insurance is usually an insurance company or hedge fund that guarantees against a "negative credit event" such as default or bankruptcy.[145] Credit default swaps are traded on an annual payment basis. For instance, if a credit default swap is traded at five percent it means that the seller of the insurance must be paid five percent of the insured debt's face value each year in order to provide insurance against default.[146] Once a "credit event" occurs—usually meaning a default—the parties to the swap will enter into their pre-arranged "cash" or "physical" settlement. Most credit default swaps have "physically settled arrangements," meaning that the underlying debt will be transferred from the buyer of the swap to the seller of the swap, in exchange for a payment equal to the par value of the debt.[147] When a credit swap is a "cash" settlement, there is a prescribed valuation to determine the "market price" (recovery price) for the underlying loan. Once the price is determined, the seller of the insurance will pay the commercial bank the difference between the par value of the loan and the new market price.[148]

Credit default swaps are particularly popular for the type of lender Baird and Rasmussen cite as having so much control in modern bankruptcies—banks who have lent to "relationship clients," whom they are reluctant to offend by

---

[144] Charles Batchelor, *Credit Default Swaps Take Off*, FIN. TIMES, Sept. 30, 2003, at 49.

[145] *Id.*

[146] *See Gone too Far? The Dangers of Credit-Risk Transfer*, ECONOMIST, Aug. 16, 2003.

[147] Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, COLUM. BUS. L. REV. 677, 708-09 (2002).

[148] E-mail from Managing Director, Fitch Credit Ratings, to author, (Feb. 25, 2004) (on file with author).

selling their exposure in primary markets.[149] "Default swaps allow banks to hedge their risk without the client being any wiser."[150] Swaps allow a bank to originate more loans, and to keep the loans on its balance sheets, even though the credit risk and actual "ownership" of the loans have largely been shifted to third party default swap sellers.[151] According to the International Swaps and Derivatives Association Market Survey, the value of credit default swaps outstanding has gone from $631 billion in the first half of 2001, to $2.7 trillion in the first half of 2003. Indeed, the credit default swap market has doubled in size, on average, every year since 1997.[152] For 2003, the global commercial banking industry as a whole used credit derivatives to reduce the risk of their commercial bank loans by a "net" $229 billion. The "gross" amount of risk transferred off of bank balance sheets was $1.34 trillion. However, the vast bulk of it was from one commercial bank to another; and hence the net amount of risk reduction for the banking industry as a whole was far smaller. Moreover, sixty-three percent of the "gross" sold position was attributable to ten international commercial banks: JP Morgan, Merrill Lynch, Deutsche Bank, Morgan Stanley, CSFB, Goldman Sachs, UBS, Lehman Brothers, Citigroup and Commerzbank.[153]

During JP Morgan's fourth quarter 2003 earnings conference call, the company offered one example of how banks have used these financial instruments to reduce their bank loan risk. Since the end of 2001, JP Morgan reported that its total commercial credit exposure declined by $60 billion, with the addition of $35 billion in single name (single company) credit default swaps. Morgan has also sold into

---

[149] Batchelor, *supra* note 144.

[150] *Id.*

[151] Hilary Rosenberg, *Compromising Positions*, CFO MAG., Sept. 1, 2003.

[152] *See* Dave Watts, *Editor's Letter*, CREDIT, Apr. 1, 2003, *at* http://db.riskwaters.com/public/showPage.html?page=11369.

[153] *Global Credit Derivatives: A Qualified Success*, FITCH RATINGS, Sept. 24, 2003, at 6 (on file with author).

secondary markets what it calls "higher risk loans and commitments" and is actively reducing its "single name concentration."[154]

Credit default swaps enabled commercial banks to weather the 2001-2002 onslaught of corporate defaults by greatly reducing their credit exposure.[155] In stark contrast to Baird and Rasmussen, Charles Batchelor of the *Financial Times* worries that, with so little financial risk at stake, banks are likely to neglect the operational concerns of debtors and be far less rigorous in their initial assessments of a borrower's financial wherewithal.[156] Ian Powell, head of business recovery services at PriceWaterhouseCoopers, explains that what you end up having in some situations is, "a creditor with [£100 million] at stake who is relaxed about what happens [in financial restructuring] because he has laid off all his debt exposure through credit derivatives..."[157] Ruth Trougott, managing director and head of restructuring at JP Morgan, understands that credit derivatives "may change a bank's behavior because it feels it has less skin in the game."[158]

The *Wall Street Journal* reported in 2003 that Mirant Corp.'s commercial banking lenders (especially Citigroup) may have been unwilling to restructure the company's debt out of bankruptcy court because they had insured most of their liability on the credit default market.[159] The *Journal* estimated that commercial lenders purchased between $500-600 million of protection against Mirant's default and concluded that :

---

[154] JP Morgan 2003 Fourth Quarter Earnings Conference Call (Jan. 24, 2004).

[155] Bill Shepherd, *Behind the Mask: The Booming Credit Derivatives Market Harbors Unseen Risks*, INV. DEALERS' DIG., June 9, 2003.

[156] Batchelor, *supra* note 144.

[157] Charles Batchelor, *Credit Default Swaps Join Booming Derivatives Line-Up*, FIN. TIMES, Feb. 11, 2004, at 44.

[158] Geraldine Lambe, *Investment Banking: Complexity Muddies Restructuring Process*, BANKER, May 1, 2003.

[159] *See* Henry Sender, *Mirant Reveals New Reality for Lenders to Ailing Firms,* WALL ST. J., Feb. 3, 2004, at C1.

> [U]p until the past few years, banks usually worked together to try and keep ailing companies from collapsing into bankruptcy in order to protect their own interests . . . but new financial markets, especially markets that provide lenders with 'insurance' against loan defaults, have created a world where banks no longer find themselves holding common interests.[160]

D. Collateralized Debt/Loan Obligations

After credit default swaps, the fastest growing credit derivatives are portfolio securitizations, CLOs and CBOs. CLOs emerged into the global capital markets in 1996 when National Westminster Bank sponsored a $5 billion CLO security.[161] CLOs enable banks to sell large portfolios of commercial loans, or the credit risk associated with such loans, directly into the international capital markets. In a CLO structure, a "sponsor" commercial bank transfers (often through a sale) a portion of its multi-corporation loan portfolio to a special purpose vehicle ("SPV"), which, in turn, issues CLO securities to the capital markets that are backed by its diversified collection of bank loans. These CLO securities usually consist of one of more classes ("tranches") of rated debt securities, typically having different interest

---

[160] *See id.* It should be noted that credit derivatives swaps have been primarily provided for the debt of companies with "investment grade" credit. While a market for credit default swaps in non-investment grade loans is developing, the bulk of these contracts are still made on investment grade loans. That said, over the past few years, there has been a dramatic rise of "fallen angel" bankruptcies of companies that once had investment grade debt. In 2002, $55 billion of the $163 billion of defaulted corporate bonds was in investment grade firms. Lambe, *supra* note 158. It is likely that there were significant credit default swap contracts written for these companies. One principal at a distressed investment firm told me that he expects the further development of the credit default market to "revolutionize" the way that commercial bank credit risk is treated.

[161] Kenneth Kohler, *Collateralized Loan Obligations: A Powerful New Portfolio Management Tool For Banks* (1998), *at* http://www.mayerbrownrowe.com/cdo/news/newport.asp.

rates and credit ratings.[162] They are normally purchased by a wide variety of financial institutions, pension funds, and individual investors. A portfolio manager, often a bank employee, is appointed to service and manage the loans on behalf of the SPV.[163]

CLOs have several advantages. By using CLOs to remove higher-risk commercial loans from their balance sheets, commercial banks can lower their Basel Accord capital requirements, and use the freed-up capital for new investments.[164] This alternative investment income, plus the fees earned from managing the CLOs, is expected to more than offset the interest income lost from the offloading of loans, thereby boosting net bank income, on average. In addition, CLOs are less likely to damage customer relationships than syndications. Often, the debtor does not even know that the loan has been transferred to a CLO.[165]

In the 2002 Survey of Credit Portfolio Management Practices, encompassing 41 leading financial institutions, more than two thirds of respondents indicated that they had issued a CLO to transfer credit risk from the institution.[166] CSFB and Merrill Lynch recently estimated that CLOs represent between 13.5% to 25% of the bank debt market.[167] It is to be expected, therefore, that CLOs are a part of modern bankruptcy filings. When Worldcom filed for bankruptcy, for example, $211 million of its debt was

---

[162] *Id.* (the most common tranche formula is a "waterfall" structure in which the junior level securities—often called the "equity"—will absorb the first losses from any credit defaults on the underlying debt. Once the equity level is "insolvent," the next lowest seniority level will suffer credit default losses until the highest rated "senior" level CLO security is reached. The CLO securities' interest rates will be priced according to their seniority and the credit ratings of the underlying securities).

[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] Charles Smithson, et al., *2002 Survey of Credit Portfolio Management Practices* (2002), *available at* http://www.isda.org/c_and_a/pdf/2002-cpm-survey.pdf.

[167] Morris, *supra* note 37.

controlled by such vehicles. Likewise, CLOs accounted for an estimated $135 million worth of Enron's debt upon its filing; $90 million of Comdisco debt, and $84 million of NRG debt.[168]

The use of CLOs has also made it easier for this debt to end up in the hands of distressed investors. Often, the CLOs face severe contractual restrictions with the purchasers of their securities, and when loans go bad, the CLO manager is forced to sell the debt, establishing its recovery value.[169] Many CLO funds are also leveraged and need cash-generating securities to cover their own interest obligations. If there is a credit default, and interest payments are no longer forthcoming, the CLO manager may be forced to immediately sell the underlying debt to obtain the needed liquidity to satisfy its own obligations.[170] Many CDO and CLO funds are contractually forbidden to hold equity shares, which means that they can't agree to debt-for-equity swaps.[171] It follows that, when companies get into trouble, even before bankruptcy proceedings begin, CLO funds are usually eagerly selling the underlying debt of these companies to equally-eager distressed debt investors in what appears to be a win-win situation for both parties.[172]

E. DIP Financing

Baird and Rasmussen consider DIP lending to be the last phase in the "dynamic contracting" that shifts enterprise control from the debtor to the senior commercial creditors.[173] Using Warnaco as the compelling example of this shift, Baird and Rasmussen emphasize how Warnaco had to turn to its pre-petition lenders—JP Morgan, Bank of Nova Scotia and

---

[168] *Credit Events in Global Synthetic CDOs: 2000-2003*, FITCH RATINGS, May 12, 2003. (It should be noted that these CLO figures represent a very small percent of the debtor's total pre-petition claims).

[169] Morris, *supra* note 37.

[170] *Id.*

[171] *Id.*

[172] *Id.*

[173] Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

Citigroup—for DIP lending due to a dearth of alternatives.[174] Baird and Rasmussen use the Warnaco DIP (along with United Airlines' DIP) as their primary examples of the immense control that the DIP lenders wield. Warnaco's DIP lenders were able to create and appoint a corporate Chief Restructuring Officer "CRO" who was later appointed as the company's CEO. The DIP covenants included requirements for: 1) $200 million in asset sales in the first ninety days, 2) an additional $275 million in asset sales in the first six months, and 3) the filing of a reorganization plan within six months.[175] Warnaco's DIP lenders even gained the power of attorney over the company.[176] When Warnaco emerged from bankruptcy, its bank lenders got ninety-six percent of its new equity, $104 million in cash, and $200 million in new bonds. Common shareholders of the pre-petition company were completely wiped out.[177]

The Warnaco example demonstrates the power that the DIP lenders can wield. As Baird and Rasmussen point out, DIP covenants are typically extensive and strict, and if a debtor is forced to rely heavily on the DIP loan (by drawing down a significant percent of the facility), these covenants may shift significant control to the originators of these facilities. But again, Baird and Rasmussen focus their attention too much on the contract itself, rather than the owners of the debt. By focusing on the contract, Baird and Rasmussen fail to point out that in most cases, DIP financing is provided for "cosmetic" purposes; it is rarely drawn down completely, and it is usually as attractive to creditors as it is to debtors. After filing for bankruptcy, debtors characteristically rely on DIP financing as part of their "first day orders" to reassure suppliers and customers that their enterprise is not about to go out of business by demonstrating that there is ample credit available to pay for goods and services.

---

[174] *Id.*

[175] *Id.*

[176] *Id.*

[177] Soma Biswas, *Warnaco Set to Emerge*, DAILY DEAL, Jan. 17, 2003.

James Connolly, President and CEO of DIP financer Fleet Capital Corporation, explains: "just as important as cash is confidence. Many suppliers get nervous when they hear a company is filing Chapter 11 because they mistake a reorganization for a liquidation . . . a key value of DIP financing is to reassure trade creditors and keep goods and services coming."[178] Robert S. Rosenberg, a partner at Latham and Watkins in New York, similarly describes DIP as serving a "public relations function. . . . The DIP has become an announcement to the world that the debtor is here to stay and that it's safe to do business with it."[179]

Debtors seem willing to accept hefty fees and interest rates in order to gain this security. In Comdisco's DIP press release, following its 2001 bankruptcy, its CEO explained the value of its $450 million DIP package, for which it paid a $9 million fee, even though it never drew down a penny of the credit made available:

> The final approval granted to Comdisco by the court for $450 million in DIP financing, along with significant cash reserves, should give all of our customers, employees and business partners added reassurance that we have sufficient financial resources to continue to run our businesses as usual and meet our commitments without disruptions.[180]

Martin Bienenstock, a partner in Weil Gotshal's bankruptcy practice, explains why agreeing to DIP financing in the first-day hearing is so important: "Frequently you have to, because you have to assure the public—the people that you do business with—that you have financing, otherwise you can't do business the next day."[181] There's also

---

[178] James G. Connolly, *DIP Financing: New Life for Ailing Companies*, FIN. EXECUTIVE, May 1, 2003, at 33.

[179] Anthony Baldo, *Hard Times for Those Needing DIP Financing*, DAILY DEAL, July 6, 2001.

[180] Press Release, Comdisco, Comdisco Receives Court Approval of Debtor-In-Possession (DIP) Financing (Aug. 24, 2001), *available at* http://www.comdisco.com/press_release.asp?pressreleaseid=42.

[181] *See* Baird & Bienenstock, *supra* note 114.

an element of "capital markets discipline" in the DIP agreements and the covenants attached to it. It's an assurance to suppliers, customers, and even other creditors that the debtor will be careful with its money, and that it has an experienced DIP financier to oversee its operations and financial wherewithal.[182]

Given these cosmetic objectives, the debtor seldom taps DIP financing anywhere close to capacity. Indeed, if the debtor actually needed the money, it might not be able to get it. In almost every major Chapter 11 bankruptcy, the firm needs to demonstrate positive operating cash flow before senior creditors are willing to extend DIP financing. In theory, most companies in Chapter 11 should be cash flow positive once they are allowed to suspend their interest payments.[183] Therefore, there is often plenty of cash to pay the DIP interest and still maintain a cash cushion. The credit quality of DIP borrowers is often better than many of their solvent competitors; some will even have investment grade credit ratings.[184] In fact, there is only one major DIP loan that has ever gone bad—Winstar's 2001 DIP in which the lender underestimated the eventual collapse of the telecom market.[185]

Since bankrupt companies get DIP financing when they don't need it, it follows that they seldom use it.[186] The financial reports of the top thirty bankrupt debtors (who

---

[182] *See id.*

[183] The basis for this assumption is that Chapter 11 is supposed to preserve the going-concern value of financially distressed companies. If a company were economically distressed—unable to generate cash flow on an un-leveraged basis—the company should be in Chapter 7 liquidation because it has no going-concern value. A principal at a distressed investment fund also pointed out that "most" bankrupt companies that restructure Chapter 11 are cash flow positive (post-petition). Telephone interview, *supra* note 77.

[184] Robert Manor, *Lending to Bankrupt Firms is Not as Crazy as it Sounds*, ORLANDO SENTINEL TRIB., Jan. 12, 2003, at H1.

[185] *Id.* (as this article goes to press, it appears that United Airlines' DIP may become a second).

[186] Telephone interview, *supra* note 77.

obtained post-petition financing) between 2001-2003 reveals a stark contrast between Warnaco and what is the typical minimal use of DIP financing.

Table 4: PERCENTAGE OF DIP FACILITY DRAWN DOWN 2001-2003:[187]

Debtor's Name	Year	Assets ($ in millions)	Lending Institutions (Agents)	DIP Amount	Amount Drawn	% Drawn
Worldcom	2002	$102,183	Citigroup, JP Morgan, GE Capital	Originally $2 billion, subsequently reduced to $1.1billion	Nominal, immediately repaid	0%

[187] Top thirty bankruptcies between 2001-2003 based on asset size and found on Lynn LoPucki's Bankruptcy Database, *at* http://lopucki.law.ucla.edu. For the largest 2003 bankruptcies, the database on bankrupt.com was used. Financial information found in Jonathan Berke, *DIP Dimensions: WorldCom Inc.*, DAILY DEAL, July 25, 2002; Jonathan Berke, *GE Capital is MIA in United's DIP*, DAILY DEAL, Dec. 11, 2002; UAL Corp. Form 10-Q, filed Oct. 30, 2003; Adelphia Comm. Corp. Form 8-K, filed Oct. 27, 2003; Mirant Corp. Form 10-Q, filed Dec. 22, 2003; NTL Inc. Form 10-Q, filed Nov. 14, 2003; Kmart Holding Corp. Form 10-Q, filed Dec. 5, 2003; Kmart Corp. Form 10-K, filed Mar. 24, 2003; NRG Energy Inc. Form 10-Q, filed Nov. 13, 2003; Federal-Mogul Corp. Form 10-Q, filed Nov. 5, 2003; Comdisco Holding Co. Inc. Form 10-K, filed Dec. 23, 2003; Bethlehem Steel Corp. Form 10-K, filed Feb. 4, 2002; Budget Group Inc. Form 10-Q, filed Nov. 14, 2002; Exds Inc. Form 8-K, filed May 3, 2002; Amerco Form 10-Q, filed Nov. 14, 2003; Fleming Companies Inc. Form 8-K, filed Dec. 15, 2003; Solutia Inc. Form 10-K, filed Mar. 15, 2004; Jonathan Berke, *DIP Dimensions: Solutia Inc.*, DAILY DEAL, Feb. 12, 2004; Jonathan Berke, *Solutia Rounds Up New DIP*, DAILY DEAL, Jan. 21, 2004; Sunbeam Corp. Form 10-Q, filed Nov. 19, 2001; Robert Manor, *Lending to Bankrupt Firms is not as Crazy as it Sounds*, ORLANDO SENTINEL TRIB., Jan. 12, 2003, at H1; Hayes Lemmerz International Inc. Form 10-K, filed Apr. 2, 2003; Kaiser Aluminum Corp. Form 10-Q, art. 154, filed Nov. 14, 2003; Farmland Industries Inc. Form 10-Q, filed July 15, 2003; Warnaco Group Inc. Form 10-K, filed Apr. 4, 2003; Arch Wireless Inc. Form 10-Q, art. 153, filed May 15, 2002; National Steel Corp. Form 10-K, filed Mar. 31, 2003; Jonathan Berke, *DIP Dimensions: National Steel Corp.*, DAILY DEAL, Mar. 14, 2002; Exide Technologies Form 10-Q, filed Nov. 14, 2003; Primary PDC Inc. Form 8-K, filed Jan. 17, 2003; Spiegel Inc. Forms 8-K, filed Nov. 26, 2003, and Sept. 22, 2003; NationsRent Inc. Form 10-K, art. 157, filed Mar. 31, 2003.

Enron Corp.	2001	$65,651	JP Morgan, Citigroup	$1.5 billion, later reduced to $250 million	None	0%
Conseco	2002	$60,102	Fortress Investment Group, JC Flowers & Co., Cerberus Capital Management	$125 million	$121.8 million	97%
UAL Corp.	2002	$24,668	Bank One, JP Morgan, CIT Group	$1.5 billion	$727 million	48%
Adelphia Communications	2002	$21,164	JP Morgan, Citigroup	$1.5 billion	$220 million	15%
Mirant Corp.	2003	$19,415	GE Capital	$500 million	None	0%
NTL Inc.	2002	$16,581	Angelo & Gordon, Appaloosa Investment, and Franklin Resources	$500 million	$229 million	46%
Kmart	2002	$14,832	JP Morgan Chase, Fleet Finance, GE Capital, CSFB	$2 billion	$300 million drawn in 2001, fully repaid in 2002	15%
NRG Energy	2003	$10,884	GE Capital	$250 million	None	0%
Federal-Mogul Corp.	2001	$10,220	JP Morgan	$675 million, subsequently reduced to $600 million	$310 million	46%
Comdisco Holding Co.	2001	$8,734	Citigroup, Chase Manhattan Bank, Heller Financial	$450 million	None	0%
US Airways	2002	$7,865	The Retirement System of Alabama	$500 million	$369 million	74%
Bethlehem Steel	2001	$5,449	GE Capital	$450 million	$280.7 million	62%
Budget Group Inc.	2002	$4,396	GE Capital	$100 million primary tranche	None	0%
Exodus Communications	2001	$3,868	GE Capital	$200 million	None	0%
Amerco	2003	$3,773	Wells Fargo Foothill	$300 million	None	0%
Flemming Companies	2003	$3,654	Deutsche Bank Trust, JP Morgan, Citigroup	$150 million	None	0%
Solutia Inc.	2003	$3,342	Citigroup, Citadel Investment Group, Perry Strategic Capital, Satellite Asset Management	$515 million	$425 million	83%
USG Corp.	2001	$3,198	JP Morgan	Originally $350 million, later reduced to $100 million, terminated in June 2003	None	0%
Sunbeam Corp.	2001	$3,155	Wachovia, Morgan Stanley, Bank of America	$285 million, later reduced to $160 million	$42 million	15%

Winstar Communications	2001	$3,068	Bank of New York, Salomon Smith Barney, CIBC, JP Morgan, CSFB	$175 million	$175 million	100%
Hayes Lemmerz	2001	$2,817	CIBC World Markets, Bank of America, Citigroup	$200 million	$55 million	28%
Kaiser Aluminum	2002	$2,733	Bank of America	Initial facility of $300 million, reduced to $285 million	None	0%
Farmland Industries	2002	$2,696	Deutsche Bank Trust	Originally provided with $306 million DIP facility, amount reduced under amendments twice to $72.5 million	None	0%
Encompass Services Group	2002	$2,345	Bank of America, GE Capital, JP Morgan Chase	$60 million	$24.8 million	41%
Warnaco	2001	$2,331	Citgroup, Bank of America, Bank of Nova Scotia	$600 million	$203.4 million	34%
Arch Wireless	2001	$2,306	Toronto Dominion Securities	$50 million	None	0%
National Steel Corp.	2002	$2,286	Citigroup	$450 million	$128.5 million	29%
Exide Technologies	2002	$2,264	Citigroup	$250 million	$166 million	66%

When debtors actually use DIP loans, they characteristically repay them quickly because of their high interest rates. These high rates, along with substantial up-front fees, strict covenants, and significant protection from downside risks make DIP loans a relatively attractive business. For instance, by agreeing to provide a DIP loan to WorldCom, which was never even drawn down,[188] Citigroup, JPM, and GE Capital received a $30 million arrangement fee, a $15 million closing fee, and $500,000 annual monitoring and agent fees.[189] For Enron's DIP commitment of $1.5 billion, which was also never drawn down, JP Morgan and Citigroup split $5.25 million as soon as usage was

[188] WorldCom drew down a minimal amount of the DIP in the first few weeks of its bankruptcy, immediately repaying the debt. Telephone interview with principal at restructuring firm involved with case (Nov. 12, 2003).

[189] Savita Iyer, *WorldCom Loans Come Back to Bite*, BANK LOAN REP., July 29, 2002.

granted on the first $250 million of the DIP, along with annual fees of $250,000, regardless of whether the DIP was ever drawn down.[190] Michael Druker, head of CIT Group specialty finance, says that DIP fees generally run between two to five percent of the total DIP commitment (as opposed to just the amount drawn down), and these payments are almost always upfront and in cash.[191] That said, these fees can run as high as six or seven percent. The Washington Group, for example, paid six percent upfront on its $350 million DIP led by CSFB.[192] Recently, during Mirant Corp.'s bankruptcy, GE Capital received a $1 million penalty fee from the debtor when the DIP financing was delayed for two weeks because of one investor group's objections to the DIP. Mirant had more than $1 billion in cash on its balance sheet at the time of filing, but felt that its suppliers would react favorably and its trading partners would feel more secure if it acquired an extra $500 million of DIP as a "backstop" for energy trading operations.[193] Adelphia Communications paid its upfront DIP fee before the loan was even approved, and without approval being a contingency.[194]

The table below provides the DIP fees (where available) of the top thirty debtors with DIP loans between 2001-2003. These fees are often upfront, cash payments before the DIP is even approved by the court, and without a dollar ever needing to be drawn down.

[190] Jonathan Berke, *DIP Dimensions: Kmart Corp.*, DAILY DEAL, Jan. 31, 2002.

[191] Baldo, *supra* note 179.

[192] *Id.*

[193] Jonathan Berke, *GE Capital Gets Fee to Delay Mirant DIP*, DAILY DEAL, Oct. 2, 2003.

[194] Berke, *supra* note 190.

Table 5: DIP LENDING FEES: 2001-2003[195]

Debtor's Name	Year	Assets ($ in millions)	Interest Rate	Banking Fees
Worldcom	2002	$102,183	Libor + 350 basis points	Letter of credit fee of 3.5%, $30 million arrangement fee, $250,000 agent fee, $250,000 collateral fee, unused commitment fee of between 0.25% and 1%
Enron Corp.	2001	$65,651	Libor + 350 basis points	Banks received $5.25 million each (1%) as soon as DIP was granted, regardless of if it was ever used. Additionally, banks receive $500,000 administration fee whether or not DIP is used
Conseco	2002	$60,102	Minimum 10% rate	Commitment fees of up to $3.75 million, service fee of $50,000 per month
UAL Corp.	2002	$24,668	Libor + 450 basis points	The DIP syndicate shares between $4 million and $8 million upfront fees on the primary DIP of $800 million. When UAL uses the $300 million secondary DIP, there are another $15 million in fees. Letter of credit fee of 4.5% on the primary DIP ($800 million)
Adelphia Communications Corp.	2002	$21,164	Libor + 350 basis points	$10 million in commitment fees, $1 million upfront "work fee," 2.5% underwriting fee ($37.5 million), annual administration fee to JP Morgan and Citigroup of $500,000
Mirant Corp.	2003	$19,415	Libor + 350 basis points	Issuance fee of .25% per annum, letter of credit fee of 3.5% per annum, unused portion fee of .75% per annum
NTL Inc.	2002	$16,581	11% initial rate increasing by 1% for every month in bankruptcy	In May, NTL paid commitment fee of 2% of amount committed ($10 million). Two months later, the company paid a "closing fee" of 2%, an additional $10 million. There is also an unused commitment fee of 0.5% per annum
Kmart	2002	$14,832	Libor + 350 basis points	Unused commitment fee between 1% and 0.5% per annum depending percent of DIP drawn
NRG Energy	2003	$10,884	Libor + 350 basis points	Facility fee of $900,000, unused commitment fee between 1% and 0.5% per annum
Federal-Mogul Corp.	2001	$10,220	Libor + 350 basis points	Underwriting fee of 2.25%, agency fee of $350,000 annually, undrawn commitment fee of 0.5% per annum
Comdisco Holding Co.	2001	$8,734	N/A	Arrangement and structuring fee of 2%, or $9 million, 0.5% unused line fee
US Airways	2002	$7,865	Libor + 400 basis points	N/A
Bethlehem Steel	2001	$5,449	Libor + 350 basis points	$8 million in fees from the facility
Budget Group Inc.	2002	$4,396	Average Libor + 325 basis points	Letter of credit fee up to 3.5%, unused facility fee of up to 0.75%, commitment fees of $300,000
Exodus Communications	2001	$3,868	N/A	Company paid total of $2.2 million in DIP financing fees without draw down
Amerco	2003	$3,773	Libor + 350 basis points	0.5% unused line fee per annum, 3.5% letter of credit fees, $850 / day per analyst "field examination fees"

[195] *See supra* note 187, where information was unavailable in SEC Filings, marked "N/A."

Flemming Companies	2003	$3,654	Prime + 200 basis points (represents rate on bridge DIP provided by JP Morgan)	Paid $750,000 bridge financing fee
Solutia Inc.	2003	$3,342	Term loan carries Prime + 400 basis points, Revolver carries Libor + 300 basis points	$5 million closing fee to first DIP providers (Ableco). 0.25% commitment fee
USG Corp.	2001	$3,198	Libor + 200 basis points on first $200 million drawn	N/A
Sunbeam Corp.	2001	$3,155	Libor + 350 basis points	A facility fee of 2%, commitment fee of 0.5%, letter of credit fee of 3.5%, annual administration fee of $200,000, $3 million fee in the event of default
Winstar Communications	2001	$3,068	Libor + 400 basis points	N/A
Hayes Lemmerz	2001	$2,817	Libor + 350 basis points	$5 million facility fee. Unused commitment fee of 0.75%, administrative and collateral agent fee of 0.75%. Total booked cash costs of $7.2 million for fiscal year 2002
Kaiser Aluminum	2002	$2,733	Libor + 325 basis points	Arrangement fee of $1.5 million, closing fee for all members of syndicate of $6 million. Recorded total financing costs of $12.1 million
Farmland Industries	2002	$2,696	Prime + 250 basis points	Unused commitment fee of up to 1% on $25 million "tranche A" commitment
Encompass Services Group	2002	$2,345	Libor + 340 basis points	N/A
Warnaco	2001	$2,331	Libor + 275 basis points	Commitment fee of 0.5% on first $200 million
Arch Wireless	2001	$2,306	Libor + 325 basis points on first $25 million, Libor + 400 basis points on second $25 million	$875,000 upon closing, $500,000 if more than $25 million drawn down, 0.5% fee on unused amount per year
National Steel Corp.	2002	$2,286	Libor + 350 basis points	$4.5 million in closing fees, 0.5% unused commitment fee per annum, administrative and collateral monitoring fees of $300,000 deferred fee of $550,000
Exide Technologies	2002	$2,264	Libor + 375 basis points	N/A
Polaroid Corp.	2001	$2,036	Libor + 325 basis points for first 6 months, Libor + 375 basis points subsequently	$500,000 advisory and structuring fee, $750,000 facility fee, 0.75% undrawn commitment fee per annum

DIP lending is very profitable business for commercial lenders. Interest rates range up to three hundred basis points more than traditional leveraged loans for BB and B rated companies, and interest plus fees from the loan can range from ten to twenty percent.[196] Many lenders charge exit fees, unused line fees, and monthly or quarterly monitoring fees, and the debtor is expected to pay the lenders' due diligence and documentation costs. Lenders willing to take higher risks may require warrants or other equity-type "kickers" in the reorganized firm. Any draw-downs of the DIP credit line will trigger onerous budgeting and performance requirements (e.g., EBITDA margins, minimum cash balances, etc.). The lender will generally receive a first-priority lien over all of the estate's assets. If the DIP lender is also a pre-petition secured creditor, it is not unusual for the lender, as part of a DIP loan, to ask for waivers from the debtor covering possible lender liability issues as well as preferences, fraudulent transfers or equitable subordination actions.[197] Below are some sample DIP covenants for the top thirty bankruptcies between 2001-2003.

Table 6: DIP FINANCING COVENANTS 2001-2003:[198]

Debtor's Name	Year	Assets ($ in millions)	Collateral	Covenants
Worldcom	2002	$102,183	First priority liens on all unencumbered assets, with exception of foreign subsidiaries, lien on 65% of foreign subsidiaries' voting stock	N/A
Conseco	2002	$60,102	Secured by Conseco's private-label credit card operations	N/A
UAL Corp.	2002	$24,668	Secured by first priority on all unencumbered present and future assets of the debtor and by junior liens on all other assets	DIP financing requires company to meet monthly financial requirements based on EBITDA and restricts additional capital expenditures and borrowing. $700 million of the DIP is only made available once certain financial results are met. Covenants also include substantial labor savings from employees which forced the company to impose immediate wage reductions

[196] Baldo, *supra* note 179.

[197] Connolly, *supra* note 178.

[198] *See supra* note 187, where information was unavailable in SEC Filings, marked "N/A."

Adelphia Communic ations	2002	$21,164	First priority liens on all unencumbered assets, priming first priority lien on all assets securing pre-petition bank debt, junior lien on all other assets	The DIP facility contains certain restrictive covenants, which include limitation on the incurrence of additional guarantees, liens and indebtedness, the sale of assets, and the funding of capital expenditures. The DIP facility also requires that the Company meet certain financial covenants, which became effective for periods beginning May 1, 2003
Mirant Corp.	2003	$19,415	Secured by substantially all the debtor's assets	Will provide updated weekly cash flows, restrictions concerning ability to merge or acquire assets, incur new debt, make changes to business objectives, and make capital expenditures. Required to maintain $50 million in liquidity at all times.
Kmart	2002	$14,832	First priority liens on all unencumbered assets. Of the net cash proceeds received from any asset sale greater than $150 million, 50% must go to reduction of indebtedness. Capital expenditures restricted, required to maintain certain level of EBITDA	Required to maintain minimum levels of EBITDA and indebtedness. Restricts capital expenditures and sale of assets.
NRG Energy	2003	$10,884	First priority liens on all unencumbered assets	Covenants restrict mergers or acquisitions, incurrence of additional debt, sale of assets and capital expenditures
Federal-Mogul Corp.	2001	$10,220	N/A	Maintain certain levels of EBITDA, limitations on capital expenditures, limitations on early retirement of debt, additional borrowings, sale of assets
US Airways	2002	$7,865	First priority liens on all unencumbered assets	Debtor must satisfy certain financial requirements including operating results, cash receipts, liquidity, and additional indebtedness
Bethlehem Steel	2001	$5,449	Senior lien on all of debtor's assets, junior lien on all inventory and other assets previously subject to a lien	N/A
Amerco	2003	$3,773	Debtor must have $40 million available cash or credit at all times, quarterly EBITDA requirements	Covenants requiring minimum level of EBITDA, limitation on capital expenditures
Fleming Companie s	2003	$3,654	Secured by virtually all debtor's assets on a super priority basis	N/A
Solutia Inc.	2003	$3,342	Lien on substantially all debtor's domestic assets, and 65% of outstanding stock of certain foreign subsidiaries	DIP facility requires minimum EBITDA targets, The DIP limits the incurrence of additional debt, aggregate capital expenditures, issuance of guarantees, liens, investments, asset sales, dividends, certain payments, acquisitions, mergers, consolidations and dissolutions, change of business, and transactions with affiliates
USG Corp.	2001	$3,198	N/A	Limits capital spending to $175 million per year
Sunbeam Corp.	2001	$3,155	First liens on debtor's unencumbered property, including 100% of the stock of first-tier subsidiaries. Priming liens on all collateral securing the pre-petition credit facility. Junior liens on all property	N/A

Hayes Lemmerz	2001	$2,817	Perfected first priority lien on majority of company's assets, Junior lien on other assets	Requires compliance with monthly EBITDA tests, and limits on capital expenditures
Kaiser Aluminum	2002	$2,733	DIP lenders must approve any substantial sale of assets	Restrictions on ability to incur debt, make investments, sell assets, and make capital expenditures
Farmland Industries	2002	$2,696	First priority lien on all assets	Restrictions on incurring additional debt, making investments
Warnaco	2001	$2,331	Secured by substantially all the domestic assets of the company	Required to maintain minimum EBITDA, limited capital expenditures and incurrence of material additional indebtedness, power of attorney
Arch Wireless	2001	$2,306	Perfected first priority priming lien on all of company's assets	N/A
National Steel Corp.	2002	$2,286	Secured by lien on all of debtor's assets, required liquidity reserve of $35 million	As part of DIP facility, portion of cash account is applied to outstanding DIP amount
Exide Technologies	2002	$2,264	Senior secured by all assets	N/A
Polaroid Corp.	2001	$2,036	First priority priming lien under 364(d)(1) on all property of the debtor that is subject to priming liens	Waiver from asserting a claim under section 506(c) for any expenses incurred with the preservation of secured assets. Debtor will provide weekly use of proceeds budget. DIP availability will decrease with time.
Spiegel Inc.	2003	$1,817	Senior secured asset-based facility tied to inventory, receivables, and other collateral	Restrictions on ability to incur or create indebtedness or liens, sell assets, enter in to certain transactions
Nations Rent	2001	$1,724	Priming lien on all corporate assets	Maintain minimum EBITDA levels, spending restrictions

With a prospectively high risk-reward ratio, the DIP loan market has invited a surge of entry. Historically, asset-based lenders provided most DIP financing, but over the last fifteen years, distressed debt funds, institutional investors, hedge funds, and commercial banks have crowded into the market.[199] Cerberus Capital Management and Angelo, Gordon & Co., two of the largest distressed debt hedge funds, for example, have built their own DIP lending organizations.[200] Other hedge funds and pension funds have followed their lead. For instance, when Solutia, a herbicide products maker with over $3 billion in assets, filed for bankruptcy in late 2003, Ableco, Cerberus' DIP financing arm, provided its initial $500 million DIP. Only three weeks later, the DIP was replaced by a second DIP, led by Citigroup

[199] Connolly, *supra* note 178.

[200] Cerberus' Ableco Finance unit has consistently ranked in the top DIP lenders over the last few years. *Bankrupt DIP Lender Portfolios*, DAILY DEAL, Sept. 27, 2002.

but co-lent by major hedge funds Citadel Investment Group, Perry Strategic Capital, and Satellite Asset Management.[201] For hedge funds and institutional investors, DIP lending provides a relatively safe way to make a "fast" return on their investment.[202] "Lending institutions are falling all over each other trying to get DIP financing," says Joel Getzler, president of Getzler & Co., a restructuring firm.[203]

As competition has grown, debtors have gained significantly more leverage in this competitive process than Baird and Rasmussen indicate.[204] When Adelphia Communications filed for bankruptcy in 2002, the company is said to have been inundated with lenders pitching their DIP business.[205] Oakwood Homes' 2002 bankruptcy included a battle between Warren Buffett and Wilbur Ross (chairman of unsecured creditors) for control of the company, but just as important was the battle for control of the DIP financing. Wilbur Ross favored DIP financing of $140 million to come from GE Capital and Chicago distressed investor Citadel Investment Group. Buffett preferred financing the DIP himself, along with the help of Greenwich Capital Management.[206] Most observers consider Mirant Corp.'s choice of GE Capital for its $500 million DIP to be a "punishment" for the company's pre-petition lenders'

---

[201] Jonathan Berke, *Solutia Rounds Up New DIP*, DAILY DEAL, Jan. 21, 2004.

[202] Jonathan Berke, *DIP Dimensions: International Wire Co.*, DAILY DEAL, Apr. 8, 2004 (explaining why Highbridge, a $4 billion hedge fund based in New York that typically uses a convertible arbitrage investment strategy, has recently entered the DIP financing business).

[203] Heke Wipperfurth, *Lending Frenzy: Bankruptcy Financing Soars; Competitors Rush In*, CRAIN'S N.Y. BUS., June 3, 2002.

[204] Baird and Rasmussen attribute much of the DIP financer's ability to control the Chapter 11 case to the debtor's inability to obtain alternate financing. Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

[205] Wipperfurth, *supra* note 203 (Kevin Genda, head of Ableco Finance, is quoted as saying, "It's huge . . . everyone is starting to surround it, call up the company, call up the advisers, see how they can offer them something to help them out.").

[206] Jonathan Berke, *Oakwood DIP Sparks Tug-of-war*, DAILY DEAL, Dec. 21, 2002.

unwillingness to restructure Mirant's pre-petition debt (forcing Mirant into bankruptcy). Instead of inviting its two biggest pre-petition lenders, Citigroup and CSFB, to participate in DIP financing and produce millions in upfront fees, Mirant offered the business to GE Capital.[207] When aluminum maker Ormet Corp. filed for bankruptcy in February, 2004, the firm received five different proposals for its $210 million DIP financing needs. The firm eventually chose a proposal by GE Capital and distressed debt investor MatlinPatterson over a more expensive offer from its pre-petition bank loan agent, Fleet Boston Financial.[208] DIP financing for Sun World International (fruit producer) actually led to a court-monitored DIP auction between Ableco and Black Diamond Capital, with Black Diamond eventually winning the $40 million DIP business.[209] Most recently, Mississippi Chemical went through three separate consensual DIPs, each with better terms than the previous agreement, and without the company drawing down a dollar for most of the Chapter 11 case.[210]

F. Distressed Debt Funds as DIP Lenders

The previous arguments should not be taken to imply that DIP loans never cause the type of shifts in enterprise control that Baird and Rasmussen attribute to them. When commercial lenders are unwilling to provide DIP financing, distressed investors may indeed take control of the debtor through the use of carefully constructed DIP covenants. Commercial lenders are prone to withhold DIP financing from companies with insufficient unsecuritized assets, or the inability to produce operating cash flow, absent new loans.

[207] Soma Biswas, *GE Capital to Provide Mirant DIP*, DAILY DEAL, July 17, 2003.

[208] Jonathan Berke, *DIP Dimensions: Ormet Corp.*, DAILY DEAL, Feb. 26, 2004.

[209] Jonathan Berke, *DIP Dimensions: Sun World International*, DAILY DEAL, Mar. 20, 2003.

[210] Beard Group Distressed Investing Conference, Mississippi Chemical Round-table, The Plaza Hotel, New York, NY (Nov. 29, 2004).

In such cases, DIP financing is not "cosmetic," rather, it is essential for the debtor's survival and is often fully drawn down. Moreover, a distressed debt investor in these circumstances will structure DIP financing to maximize its ability to acquire the debtor as a going concern, or to acquire particular assets of the debtor, while at the same time increasing the costs of acquisition to other potential purchasers. For example, it is not uncommon to see a distressed investor provide the DIP as part of a stalking horse bid for the entire company. The DIP terms may state that, if the distressed investor is the successful bidder, the DIP debt may convert into equity or may be allowed to be repaid out over time post-confirmation, while if their bid is not accepted, the DIP will require 100% pay off at the effective date.[211]

For example, after filing for bankruptcy, it was commonly believed among financial critics that Arthur D. Little, a 116-year-old, Boston-based technology consulting firm, would not be able to obtain DIP financing, and would therefore have to cease operations. While DIP financing is almost always provided with a lien on hard assets, Little's only major asset was its human capital.[212] As the company's largest claims holder with $63 million in pre-petition claims, Cerberus Capital Management came forward, providing Little with $68 million in DIP financing through its Ableco unit, and at the same time making a $71 million stalking horse offer for the entire company.[213] Ableco included significant fees, timing requirements, and high interest rates on the DIP, forcing Little to proceed quickly and efficiently. When Little did get better offers in individual asset sales (the company completed asset sales to five different companies in just two

[211] That said, hedge funds and private equity funds are developing their DIP lending businesses on a pure returns basis as well. Due to the significant upfront fees and high interest rates, DIP loans may provide private equity funds with "equity-type" returns. Interview *supra* note 62.

[212] Jonathan Berke, *DIP Dimensions: Arthur D. Little, Inc.*, DAILY DEAL, Feb. 14, 2002.

[213] Jonathan Berke, *Sale of ADL Units Approved*, DAILY DEAL, Apr. 9, 2002.

months), Little used the $96.5 million it received in the sales to pay off the Cerberus DIP and its significant financing fees.[214]

When distressed investor W.L. Ross signed an agreement, subject to court approval, to buy textile maker Cone Mills Corp. out of bankruptcy, the firm also agreed to assume Cone Mills' DIP financing of approximately $40 million.[215] The same day that Carl Icahn made a stalking horse bid to acquire Philip Services out of bankruptcy, his subsidiary, High River Ventures, provided the company with $35 million in DIP financing.[216] When healthcare finance company DVI was unable to get pre-petition bank lender Fleet Boston to provide DIP financing, the company turned to distressed investors, ultimately getting $20 million in DIP financing from Ableco and Goldman Sachs' distressed debt investment firm, Goldman Sachs Credit Partners. Many believe that Ableco and Goldman will be willing to forego the DIP repayment in order to get equity in the reorganized entity.[217]

When SLI Inc., a lighting fixtures manufacturer, went bankrupt in September 2002, Ableco provided the company with $8.89 million of its $35 million DIP. (Meanwhile DDJ Capital management, another distressed debt firm, also provided part of the DIP.) With Ableco's parent, Cerberus Capital Management, owning twenty percent of SLI's $366 million in pre-petition debt, Ableco wanted the firm in and out of bankruptcy as quickly as possible—giving the company only eight months to pay off the DIP.[218] Using a similar strategy, Ableco created an "exploding DIP" when Sunterra went into bankruptcy, providing that the DIP's interest rate would double each month, basically tying the

214 *Id.*

215 Jonathon Berke, *Cone Mills Seen in the Clear*, DAILY DEAL Feb. 26, 2004.

216 Greg Johnson, *Icahn Bids for Philip Services*, DAILY DEAL, Aug. 7, 2003.

217 Jonathan Berke, *DIP Dimensions: DVI Inc.*, DAILY DEAL, Oct. 16, 2003.

218 Jonathan Berke, *DIP Dimensions: SLI Inc.*, DAILY DEAL, Sept. 19, 2002.

company's hands to either quickly reorganize or sell its assets.[219] When catalog company Provell went bankrupt, Cerberus, holding $8 million of the company's secured claims, used Ableco to join another provider in a $21 million DIP financing, but gave the company only three months to either find a buyer or agree to a reorganization plan.[220] In Ableco's $25 million DIP to the Buffalo Sabres, the loan's interest rate jumped one hundred basis points every forty-five days.[221] The table below demonstrates the extent of recent DIP loan financings provided by distressed debt investors. The table also suggests that the distressed investors are often providing the DIP as part of a larger plan to take over control of the company.

Table 7: DISTRESSED DEBT INVESTOR PRESENCE IN DIP FINANCING:

Company	Distressed Debt Investor Presence	DIP Amount	Long Term Investment?
AMF Bowling	Farallon Capital Management part of syndicate	$75 million	AMF emerged from Chapter 11 in 2002 with Farallon part of partnership group that acquired controlling 92.5% stake
Conseco	$150 million DIP facility led by distressed debt investors Fortress Investment Group and Cerberus Capital Management, along with private equity firm J.C. Flowers & Co.	$150 million	DIP part of stalking horse bid, and eventual purchase, of Conseco Finance Company for $1 billion
DVI Inc.	Ableco and Goldman Sachs Credit Partners (distressed debt investment vehicle of Goldman Sachs)	$148 million	Ableco and Goldman Sachs Credit Partners stepped in to provide DIP when lead creditor Fleet Bank backed away because of fear from accounting irregularities. Ableco and Goldman recovered 100% of their loan, and also provided exit financing, while the remaining creditors received close to zero recovery
NTL Inc.	Appalossa Investment, Angelo Gordon & Co. and Franklin Resources	$500 million	The three distressed debt funds were major debt holders of NTL, and all three remain major shareholders of the reorganized company

[219] Jonathan Berke, *No Vacation For You*, DAILY DEAL, Aug. 15, 2002.

[220] Jonathan Berke, *DIP Dimensions: Provell Inc.*, DAILY DEAL, June 13, 2002.

[221] Jonathan Berke, *Sabres Get 'Exploding' DIP*, DAILY DEAL, Jan. 15, 2003.

Philip Services Co.	Carl Icahn's High River LP	$35 million	Provided DIP as part of stalking horse offer for the assets of the bankrupt recycler. At same time, offered exit financing of $160 million, fee of 5% of stock of reorganized company
LTV Corp.	Ableco Finance, a unit of Cerberus Capital Management	$100 million	LTV's assets eventually sold to distressed investor W.L. Ross
Oakwood Homes	Berkshire Hathaway, part of DIP syndicate (led by Greenwich Capital Markets) for Oakwood's $215 million DIP (Nov. 2002)	$215 million	Signed stalking horse offer for Oakwood Homes one year after providing DIP financing. Observers believe that offer was held up by Berkshire's quest to take over fellow manufactured home company Clayton Homes
American Plumbing and Management	Ableco Finance, a unit of Cerberus Capital Managment	$25 million	Under reorganization, Harbert Management Corp. and Ableco Finance LLC will receive preferred shares convertible into 49% of the equity
General Media Inc.	Madeleine Capital, a unit of Cerberus Capital Management	$5 million	DIP agreement included 60 day term to complete reorganization
Gingiss Group Inc.	Distressed investor Antares Capital Corp. along with pre-petition lender GE Capital	$4 million	DIP agreement includes covenant giving company less than two months to find a buyer
Arthur D. Little	Ableco Finance, a unit of Cerberus Capital Management	$69 million	Cerberus, the company's largest debt holder, made stalking horse bid for the entire company, but lost auction to higher bidders.
Advanced Lighting Technologies	Ableco Finance, a unit of Cerberus Capital Managment	$37 million	Ableco supplanted the original DIP lender when the debtor could not find a buyer by a required date under the original DIP. Company found a buyer, private equity firm Saratoga Partners, five months later.
Washington Group International	Ableco Finance, a unit of Cerberus Capital Management, along with M.D. Sass (distressed debt hedge fund) and Citadel Investment (Chicago hedge fund)	$20 million	None
E.spire Communication	Ableco Finance, a unit of Cerberus Capital Management	$85 million	Cerberus provided the acquisition financing when Xspedius Management Co. (a private equity firm) acquired E.spire's assets through a 363 sale
International Wire Group	Distressed debt investing hedge fund Highbridge/Zwirn	$140 million	$82 million of DIP will be used to pay off pre-petition secured notes. Highbridge Fund is one of the largest holders of the secured notes
Lernout & Houspie	Ableco Finance, a unit of Cerberus Capital Management	$60 million	None
Formica	Angelo & Gordon and Cerberus (Ableco)	$10 million each ($78 million in total DIP financing)	Cerberus gained control of the company in a joint venture with Oaktree Capital Management
Anchor Glass	Ableco Finance, a unit of Cerberus Capital Management	$100 million	DIP provided as part of pre-packaged bankruptcy in which Cerberus Capital Management provided $100 million investment to take control of the company

Oxford Automotive	MatlinPatterson Fund	$50 million	Fund already owned 80% of bonds ($200 million in unsecured notes). MatlinPatterson's counsel, Ronald Rose of Dykema Gossett, said that MatlinPatterson used the DIP to further its investment position, eventually taking control of the company when it exited
Railworks	MatlinPatterson Fund	$55 million	MatlinPatterson took control of the company
APW	Oaktree Managment	$22 million	DIP included warrants giving Oaktree opportunity to exchange them for 20% of the company's reorganized equity. Oaktree Capital Management ended taking control of the company
ICG Communications	Ableco Finance, a unit of Cerberus Capital Management	$20 million	Welsh, Carson, Anderson & Stowe, a private equity fund, acquired $150 million face value of the company's senior notes and have a controlling stake in the company (now merged with another Welsh portfolio company).

By focusing on the actual DIP or credit facility contract, Baird and Rasmussen fail to see that it is the holder of these contracts that matters. Without a significant financial stake in the debtor firm, the economic efficiency of Baird and Rasmussen's "control shift" breaks down. As a general matter, unless they have an enormous financial stake in the firm, commercial lenders generally should not be making the strategic decisions of the company. The reasoning goes back to the classic residual actor problems in bankruptcy: control should only be placed in the hands of the investors whose interests are identical with those of the firm as a whole. If the senior lenders do not have enough at stake, their interests may run counter to the interests of the firm as a whole.[222]

As explained earlier, the classic problem with shifting control to senior lenders is that these lenders are often excessively risk-averse. They are overly prone to pursue suboptimal, low-risk strategies: to sell the debtor's assets prematurely for cash and to engage in "low-beta" transactions with expected net present values that are

[222] *See* Lynn M. LoPucki, *The Nature of The Bankrupt Firm: A Response to Baird and Rasmussen's 'The End Of Bankruptcy'*, 56 STAN. L. REV. 645, 661-62 (2003) (questioning whether Baird and Rasmussen's single residual actor exists).

sometimes negative.[223] Especially if DIP financing is fully protected, or if the senior lenders do not have a substantial amount of pre-petition loans at stake, a risk-averse senior creditor is likely to be indifferent to the long-run going-concern prospects of the firm.[224] In very few instances beyond Warnaco can senior creditors be expected to offer the kind of balanced, long-term wealth maximization that Baird and Rasmussen admire.

On the other hand, when distressed investors provide DIP financing, they are generally motivated as true residual actors. Because distressed investors often have a great deal at stake in the reorganizing firm, they are efficiently motivated to deploy DIP loans to maximize firm wealth. Evidence of this is the willingness of distressed investors to convert DIP loans to post-emergence equity, thereby aligning their interests as the future equity holders with firm wealth maximization. When distressed investors gain practical control of the firm through their DIP loans, it is reasonable to expect management strategies that maximize the long-run profits of the firm.

VI. WHY DISTRESSED DEBT INVESTORS MAKE BETTER RESIDUAL ACTORS THAN SENIOR CREDITORS

Financial institutions are very imperfect enterprise owners for three principal reasons: one, strategic; one, regulatory; and the last based on social psychology and group dynamics. Strategically, financial institutions seldom see their "mission" as the use of short-term financing to maximize the firm's long-run market value. Rather, bankers typically have little reason to take interest in speculative, long-term business plans; they are primarily interested in a debtor's ability to produce cash in the short term to pay the

---

[223] David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 937 (2003).

[224] *Id.* at 939.

coupon and repay the principal.[225] As one observer put it, "the senior lender's goal is to be repaid in full in cash, or failing that, to get a renegotiated, well collateralized senior debt instrument with a short timetable for repayment."[226]

Within the negotiating room of a Chapter 11, the self-interest of senior bank creditors will be to keep as much debt as possible on the bankrupt firm since they see little to be gained and, potentially, much to be lost by providing the debtor with financial flexibility.[227] Bank lenders may regard the behavioral constraints of a highly leveraged capital structure as an effective way to keep the debtor from dissipating cash flow in unproven ventures. Distressed debt funds, by contrast, tend to favor increased financial flexibility for debtors in Chapter 11. Bankruptcy negotiations, therefore, often involve disagreements between distressed debt investors who want to reduce debt and raise equity, and senior creditors who resist such change.[228] According to one distressed investor, bank work-out groups are generally "highly professional," but they fail to take the time to understand the problems of the debtor; they just want the problem "off their plate."[229] Distressed investors, by contrast, "will spend a great deal of time in the plants and with the management team."[230] For this reason, the relationship between major distressed debt investors and the debtor's management can be quite harmonious. Both parties want the debtor out of bankruptcy as quickly as possible to

[225] John Mueller, *The Business Dynamics of Bankruptcy*, 16 AM. BANKR. INST. J. 28, 28-29 (Feb. 1997).

[226] *Id.*

[227] Telephone interview, *supra* note 77.

[228] *Id.*

[229] *Id.* This said, during another interview with a distressed investment portfolio manager, I learned that the agent bank of the original loan will often remain an integral part of the restructuring process, even if the bank no longer has an economic stake. The portfolio manager explained that the agent bank often feels a sense of responsibility for the investors in the loan and wants to uphold its longer term reputation with the syndicate. Interview, *supra* note 67.

[230] Telephone interview, *supra* note 77.

minimize the tremendous direct and indirect costs of the filing. Both parties want a "safe, sane capital structure" to ensure that the company does not fall back into financial distress. And both parties want a viable long-term growth plan to ensure the profitability of the company's future operations.[231]

Some of the negotiating intransigence (and financial myopia) of senior bank creditors in Chapter 11 proceedings can be traced to regulatory concerns. Debt crises in the past, especially the sovereign debt crisis of 1982, prompted significant new bank reporting and capital requirements that limit a bank's options when faced with a defaulting debtor.[232] Foremost among these is the requirement that securities be revalued ("mark-to-market") on the balance sheet when a "credit event" such as bankruptcy occurs.[233] Because the write-down of loan values is not required at the first signs of financial distress, a debtor's default may precipitate an unwelcome jolt to bank asset values.[234] To exacerbate matters, auditing requirements often mandate that banks write down the value of these loans to a level *below* potential recovery value.[235] When the resulting book asset value of the loan falls below its realistic liquidation value, banks naturally become eager to sell the claim.[236] As long as the cash generated from the sale is greater than the

[231] Interview, *supra* note 67.

[232] Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivitive Technology For Credit Transfer*, 12 DUKE J. COMP. & INT'L L. 541, 544 (2002).

[233] J. A. McQuown, *Managing Corporate Credit Risk: Catalytic Effects of Basel II*, 86 RISK MGMT. ASS'N J. 94 (2003).

[234] *Id.*

[235] Fortgang & Mayer, *supra* note 28, at 4.

[236] *Id.* Banks will be eager to sell the claim because, just as the firm had to book an income statement loss when it initially wrote down the value of the asset on its balance sheet, it will be able to book a one-time gain to its income statement if the sale of the debt results in a value higher than the recently reduced balance sheet value.

markdown value on the books, there will be a one-time gain on the bank's income statement.[237]

The Bank Holding Act of 1956 poses another regulatory hurdle for institutional creditors. The Act generally prohibits bank holding companies from owning shares of non-banking companies, but provides an exception for shares acquired in satisfaction of debt previously contracted, provided such shares are disposed of within two years.[238] If the number of shares is substantial, the required disposal, or even the expectation of such disposal, can depress market prices. Carter Pate, U.S. Managing Partner of PriceWaterhouseCoopers, adds that when debtors emerge as new entities, and pre-petition claimants have taken stock in lieu of debt, they don't behave like normal investors; "instead of thinking capital appreciation, they're looking at capital retrieval."[239]

Psychological factors also impede senior creditors' ability to effectively manage debtor assets. It is common for pre-petition lenders to enter the Chapter 11 process feeling bitter and angry about their financial losses and the alleged deception of debtor's management. As Chaim Fortgang and Thomas Mayer explain, the pre- and post-bankruptcy negotiations with the old debtors may have created a very hostile environment in which it is difficult to work together and come to a compromise. They point out, "[i]n most

[237] Jonathan Berke, *Bankrupt: Fool's Gold*, DAILY DEAL, March 27, 2003.

[238] 12 U.S.C. § 1843(c)(2) (2000).

[239] Nyberg, *supra* note 70. There is abundant evidence that the financial flexibility endorsed by distressed debt investors tends to produce less highly leveraged companies emerging from bankruptcy. Two recent examples: in WorldCom's (MCI) bankruptcy, 90% of the creditors (many of them distressed debt investors) approved a reorganization plan that left the company with only \$4.5 to \$5.5 billion in debt, down from \$36 billion upon filing. Rebecca Blumenstein & Shawn Young, *WorldCom Creditors Back Plan to Reorganize in Bankruptcy*, WALL ST. J., Apr. 14, 2003. Likewise, in Mirant's Chapter 11, experts believe the creditors' committee, chaired by distressed debt investor Appaloosa Management, to be more interested in Mirant's post-Chapter 11 equity than in a senior fixed income notes. Murray, *supra* note 74.

traditional [C]hapter 11 cases, claims and interests are held by parties who are losing money."[240] One reorganization expert recently commented that the last thing he wants to see when he begins bankruptcy negotiations is a pre-petition, par investor "stuck in the headlights" from the default of his debt.[241]

The arrival of distressed debt investors can add new, positive energy to the reorganization process. The distressed debt investor may find it easier to facilitate a reorganization agreement with the debtor and the other creditors simply because the new investor is not "encumbered by the hostilities of a prior relationship."[242] Distressed investing also changes the nature and outlook of those who are negotiating in bankruptcy; claimholders who have lost a tremendous amount of money through the debtor's operations sell their claims to new investors who treat the Chapter 11 process as their opportunity for profit.[243] Barry Ridings, co-head of the restructuring group at Lazard, remarks: "I would rather deal with a distressed debt investor who paid fifty cents on the dollar than a dozen bankers who all made the original loan. The bankers signed onto the original business plan that failed, and they want their money back."[244] Stephen Lubben adds that a forty percent rise in the value of debt means significantly different things in the hands of a distressed investor than in the hands of the par investor.[245] The holders that bought at par will treat anything less than full repayment or reinstitution of the same claim as a loss, making negotiations significantly more difficult with pre-petition par investors.[246]

---

[240] Fortgang & Mayer, *supra* note 28, at 114.

[241] Lambe, *supra* note 158.

[242] Fortgang & Mayer, *supra* note 28, at 7.

[243] *Id.* at 54.

[244] Ian Springsteel, *Vultures of the New Economy*, WASH. POST, Sept. 9, 2001.

[245] Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 301 (2001).

[246] *Id.*

In 1983, Professor Mark Roe argued that, once a corporation files for bankruptcy, there should be a complete debt-to-equity swap.[247] By converting all credit claims to equity, the holders of these claims would no longer be able to base their self-motivated decisions on debt "recovery value" and instead would become residual actors in a reorganized, debt-free firm.[248] In a less dramatic suggestion, Barry Adler has argued that, upon default, the lowest level of common stock should automatically be cancelled and the next lowest-level claim should become the common shareholders.[249] Even though the plans of Roe and Adler are impractical because of huge barriers to legal implementation, their theoretical appeal is undeniable. The solution to the residual claimant problem in bankruptcy is to get creditor classes to think like shareholders in a financially solvent firm. The thesis of this study is that the emergence of distressed debt investors has largely accomplished informally what Roe and Adler proposed for government regulation. Distressed debtors think more like shareholders than bondholders in Chapter 11 proceedings.

The investors often take significant or even controlling stakes in the debtor, hoping to profit once the company emerges with a restructured balance sheet and potentially a new strategic plan. One restructuring expert recently commented that Cerberus Capital Management, the largest and most active distressed debt investor, "doesn't buy things because [they think] they'll be worth more in three months. They think three to five years out."[250] A principal at one of the largest distressed investment funds in the world remarked that their limited partners ("LPs") are told that

[247] Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 530 (1983).

[248] *Id.* at 542-43.

[249] Lubben, *supra* note 245, at 285.

[250] David Carey, *Cerberus Breaks Out*, DAILY DEAL, Sept. 15, 2003.

they should not be surprised if they have to wait at least ten years for full investment returns.[251]

Modern distressed investors often aggressively seek to take control positions.[252] The same principal explained that they almost exclusively purchase distressed debt where they believe that it will lead to significant equity stakes in the reorganized company, and significant control within the reorganization process—optimally a thirty-four percent blocking position in a particular class of claims. Moreover, the fund tries to develop a long-term strategic plan with the debtor's management and outside consultants soon after a position is taken so that implementation can begin shortly after the company emerges.[253]

Cerberus Capital Management relies on an in-house staff of about forty financial and operations experts—most of them former CFOs, CEOs, and CIOs—to help Cerberus plan its long-term turnaround investments in the diligence phase of the process and again once control is secured. For example, Cerberus appointed Edward Harshfield, ex-CEO of California Federal Bank, as chief executive of Aozora Bank in Japan and Liam Strong, former head of MCI's international operations, as CEO of Teleglobe.[254]

In a 1997 study, Edith Hotchkiss and Robert Mooradian examined 288 firms who filed for bankruptcy between 1980 and 1993, including 172 firms that had some evidence of "vulture" activity in their debt. The study indicated that, even in this fairly "infant" period of distressed debt investing, investors joined the boards of 27.8% (of total sample) of the post-bankruptcy reorganized firms, appointed the chairman or CEO in 9.4% (of total sample) of the cases,

---

[251] A portfolio manager at a New York-based distressed hedge fund told me that his fund's distressed investments are typically held for two to three years. Interview, *supra* note 67.

[252] Telephone interview, *supra* note 77.

[253] *Id.*

[254] Carey, *supra* note 250.

and became the controlling shareholder of 16.3% of firms (of the total sample).[255]

The 2003 restructuring of Vantico, a European chemical maker, is an interesting case in which two distressed debt investors had to compete against each other for equity control. After distressed debt investor MatlinPatterson acquired a majority of Vantico's publicly traded bonds, it sought to exchange the bonds for a controlling equity position in the restructured entity. MatlinPatterson favored a reorganization plan that would leave the senior bank debt (which they did not own) in place, while converting their debt to equity. Sensing an opportunity, Apollo Management, a competing distressed debt fund, purchased a blocking position (greater than thirty-three percent) in the senior bank debt, and announced that it would only vote for a reorganization plan which would convert their own senior debt into a controlling equity position, while leaving the MatlinPatterson debt in place. This particular example ended with MatlinPatterson purchasing Apollo's senior debt at a premium, and converting its entire position into a controlling equity stake, while marketing new high yield bonds.[256] Likewise, in Exide Technologies' bankruptcy, four distressed debt hedge funds purchased seventy percent of the senior bank debt.[257] These investors supported Exide's reorganization plan, which sought to convert the senior bank debt into ninety-nine percent of the post-Chapter 11 equity.[258] Twenty years ago, a debt-to-equity strategy might have meant getting involved in only the junior, or unsecured levels of the capital structure where debt was typically converted to equity (while the senior levels of debt remained in place). Today, however, every level of debt could potentially be converted into equity.[259]

---

[255] Hotchkiss & Mooradian, *supra* note 75, at 4-5.

[256] Nicola Hobday, *Fight to the Debt*, DAILY DEAL, Aug. 7, 2003.

[257] Murray, *supra* note 74.

[258] *Id.*

[259] Hobday, *supra* note 256.

As residual actors in bankruptcy, distressed debtors appear to be superior to senior creditors, but are they also superior to bankruptcy judges? Is there reason to prefer the reasoned judgment of a bankruptcy court official in Chapter 11 proceedings? Economic logic and legal reasoning would suggest not. Markets tend to make decisions as to the proper allocation of assets, or the proper valuation of the firm, better than individual actors or the courts.[260] Giving a judge the power, under Section 363, to approve decisions made outside the "ordinary course" endorses the misconception that judges are more capable than private parties of making the proper decisions. Moreover, there is justified concern about judicially endorsed "asset stripping."[261] Weiss and Wruck, for example, contend that judges habitually favor maintaining the debtor as a going concern, regardless of its economic distress.[262] The classic "bad example" is the Eastern Airlines case, in which bondholders lost almost all of their investment as the judge continued to extend the exclusivity period and prevented important asset sales from taking place.[263]

By creating a market for distressed debt, claims are valued on a liquid market, rather than behind a judicial bench. More importantly, strategic decisions are placed in the hands of those in the market for corporate control: individuals who are willing to "put their money where their mouth is."[264] When distressed debt investors purchase claims from pre-petition creditors, presumably at a premium over what the claim is worth in the pre-petition owner's hands, the market signals value creation. As Easterbrook and Fischel explain, "self-interest assures us that changes of

---

[260] Robert K. Rasmussen & David A. Skeel, *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85 (1995).

[261] Weiss & Wruck, *supra* note 68, at 4.

[262] *Id.* at 26-27.

[263] *Id.* at 21.

[264] *Id.* at 5.

corporate control, like other voluntary exchanges, move assets to higher valued uses."[265]

The distressed debt investment is an informed wager that the company is worth more if taken out of the control of widely syndicated debt holders, potentially given new management, and run by operations-minded strategic investors. Empirical research has documented the superior economic performance of such takeovers. Professors Hotchkiss and Mooradian's research on acquisitions consummated during bankruptcies that occurred between 1979 and 1992 found significant evidence of improvements in operational efficiency and profitability of the bankrupt target, largely due to decreases in operating expenses and employment costs.[266] In sixty-five percent of the cases examined, the takeover could be considered, from an operational standpoint, either "clearly successful" or "marginally successful," leading the authors to conclude that takeovers in bankruptcy facilitate the efficient redeployment of the bankrupt firm's assets.[267]

Later research by Hotchkiss and Mooradian further supports the idea that aggregating claims in the hands of distressed debt investors maximizes firm value. In evaluating their data on 288 large firms that had filed for bankruptcy between 1980 and 1993, the authors concluded that firms with the presence of distressed investors were operationally stronger than those firms without "vulture" presence, especially for firms in which vultures purchased controlling equity positions or where the vulture gained a board seat or the CEO position.[268] In firms where the vulture investor emerged as CEO or chairman, only 4.8% had negative operating income in their first year out of bankruptcy, and their average operating income margin was 12.9%. By comparison, in reorganized firms where vultures were not active, 15.5% had negative operating income in

[265] EASTERBROOK & FISCHEL, *supra* note 1, at 113.

[266] Hotchkiss & Mooradian, *Acquisitions*, *supra* note 65, at 6.

[267] *Id.* at 20-21.

[268] Hotchkiss & Mooradian, *supra* note 75, at 6-7.

their first year out, while operating margins only averaged 5.3% in year one.[269] Similar differences were apparent in operating income. For all non-vulture firms, there was no improvement, on average, in operating margins after firms emerged from bankruptcy; for firms with vulture involvement, however, operating margin improvement was significant—up nineteen percent on average.[270] And firms in which distressed debt investors took an active role as Chairman or CEO registered an impressive sixty percent improvement, on average, in their operating margins upon exit from bankruptcy. In summarizing their findings, Hotchkiss and Mooradian conclude, "[t]he positive valuation effects, together with evidence on the frequency of vulture management and control activity, suggest that vultures do more than bargain to increase distributions on their own behalf."[271]

Hotchkiss and Mooradian's findings are not surprising. As the residual actors of large corporation bankruptcies, the distressed debt investors *mitigate transaction costs*, aggregate control, and make decisions that are better aligned with the long-term value of the firm.

VII. THE DARK SIDE OF DISTRESSED DEBT INVESTING

Harvey Miller is, perhaps, the most renowned critic of distressed debt investors.[272] His criticisms about the potential "dark side" of distressed debt investing strategies deserve careful review. Miller's principal concern is recidivism; he believes that distressed investors' success in achieving faster restructurings and less time in expensive reorganization proceedings may also result in debtors

---

[269] *Id.* at table 6.

[270] *Id.* at table 7 (note that operating margins are used for the analysis because operating margins are *before* interest expense and are therefore independent of the leverage (debt) in the firm's capital structure).

[271] *Id.* at 6.

[272] *See* Miller, *Delaware Myth*, *supra* note 69 (Miller reiterated these points during my interview with him on March 2, 2004).

emerging from Chapter 11 before they are fully rehabilitated. The unfortunate consequence, says Miller, is a high probability that debtors will relapse into bankruptcy a second or third time.[273] Miller argues that the distressed investor's focus on returns in the short run may run counter to the long-term needs of the debtor, and may force the debtor back into bankruptcy months or years later.[274] "Often, it's the creditors forcing companies out of bankruptcy. The motto is, we'll fix your balance sheet, and you can fix the operational problems when you get out."[275]

Miller believes that distressed debt investors are only interested in getting the debtor out of Chapter 11 and towards an IPO or M&A event in which the funds can liquidate their investments. He argues that distressed debt investors will rehabilitate a company only to the minimum degree necessary to make it attractive to potential buyers. Miller believes that the "pushing" of the debtor to leave Chapter 11 can, at times, reach a level of "commercial bribery."[276] Miller describes the typical scenario of a debtor's management needing more time to figure out its operational problems, while the distressed investor is restless, arguing that the "market is hot," and that if the company waits, it may not be able to do an IPO.[277] Eventually, according to Miller, the negotiations come to point where the controlling distressed investors tell the CEO, "if you want to be CEO of the company, don't fight us—because if you fight and we win, you're dead."[278] According to Miller, some management teams will eventually give in, often after the distressed

[273] Terry Brennan, *Miller: Liquidations Set to Rise*, DAILY DEAL, Dec. 3, 2003.

[274] Morris, *supra* note 37.

[275] Marcus, *supra* note 82.

[276] Interview with Harvey Miller, *supra* note 58.

[277] *Id.*

[278] *Id.*

investors have agreed to provide them with post-emergence employment contracts.[279]

Without saying so explicitly, Miller leaves the impression that distressed debt investors are "window dressers" who neglect the kind of fundamental reform needed for long-term business durability.[280] In this manner, Miller questions the long-term restorative benefit of distressed investors as residual actors. He contends that distressed investors are more interested in the "quick flip" than in the slow process of corporate recovery. He bluntly suggests that, "distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investment."[281]

VIII. REPLY TO HARVEY MILLER AND POLICY IMPLICATIONS OF FINDINGS

Clearly, not all distressed debt investors are ideal long-term equity holders who faithfully perform the role of residual actor in bankruptcy proceedings. The relevant public policy concern, however, is not whether perfection reigns in the distressed debt world—it does not—but whether the imperfections are both systemic, and economically and legally injurious. If flipping is legally wrong, then it is deserving of regulations to curb it; if flipping creates economic distortions and inefficiencies, there is additional reason to impose restrictions. But if flipping in the market for distressed debt is akin to short-term trading in other property markets, there may not be a problem.

---

[279] *Id.* One principal at a distressed investment fund whom I interviewed acknowledged that such discussions take place, but argued that, instead of being damaging, such discussions in fact serve several useful purposes. First, they adequately incentivize management during a period in which all other incentives (equity, options) may be below water; and second, they can create a healthy relationship between the management and the future shareholders. Telephone interview, *supra* note 77.

[280] Miller, *supra* note 69, at 2014-15.

[281] *Id.* at 2016.

Instead, the flipping may simply be providing beneficial market liquidity.

These are, of course, difficult issues to address. On the empirical question of the prevalence of flipping, the data are limited but somewhat reassuring. Evidence demonstrates that the major distressed debt investors do not usually sell their holdings soon after a company has emerged from bankruptcy, and for good reason: post-emergence SEC filings demonstrate that these stakes are usually too large (and thus illiquid) to sell en masse without significant price reduction. A quick examination of some of the largest bankruptcies of the past couple of years reveals that distressed investors are still holding their significant stakes in the restructured debtors. ESL Fund continues to hold a controlling stake in Kmart, while Martin Whitman's Third Avenue Management fund owns over $400 million dollars of Kmart's equity.[282] As Conseco's largest post-emergence shareholder, Appaloosa Management continues to hold almost $200 million of the company's reorganized equity, with Angelo, Gordon & Co., and Cerberus Management still owning significant stakes, as well.[283] Distressed investor WR Huff continues to be NTL's largest shareholder, with Oaktree Capital and Franklin Resources owning close to $500 million of the company's reorganized equity.[284] Carl Icahn continues to own more than 60.7% of XO Communications' restructured equity.[285] Before merging into Mittal Steel in late October of 2004, WL Ross & Co. still owned more than thirty percent of International Steel Group, the holding company of both LTV Steel and Bethlehem Steel, years after those companies' bankruptcy filings and almost a year after

[282] Kmart Holding Co. Form DEF 14A, filed Apr. 8, 2004.

[283] Conseco Inc. Form SC 13G, filed Sept. 22, 2003; and Form 3, filed Sept. 10, 2003.

[284] NTL Inc. Form 4, filed Dec. 29, 2003, and Form 10K, filed Mar. 11, 2004 (as of March 10, 2004, WR Huff owned approximately 12.9% of the company's common stock and Oaktree owned 7.1%).

[285] XO Communications Form 10Q, filed Nov. 9, 2004.

Ross took the company public.[286] Even at Warnaco, distressed investor TCW and hedge fund Chilton Investments own over $110 million of the company's post emergence equity.[287] One hedge fund manager told me that, for every case where a distressed investor might try to pull a firm out of bankruptcy before it is operationally sound, there are ten other cases where the company is much better off because of the attention it gets from a major distressed investor.[288]

That said, even long-term investors are financially motivated to receive the highest return on their invested capital, and if they feel that the greatest value can be had from a short-term "flip" of their investment, they will do so. A Senior Managing Director at a New York-based distressed investor concedes that, while his fund has typically purchased debt and assets in bankruptcy with a long-term operational interest, he also has an obligation to his own investors. If he owns debt and sees that he can get an "easy twenty percent return" rather than wait out a potentially long Chapter 11 process, he is likely to trade out of his position.[289]

In addition there will always be certain investors, often hedge funds, who come in and buy up relatively small amounts of claims with the hope that a short-term event or a particular kind of leverage will increase the trading value of

---

[286] International Steel Group Inc. Form 10K, filed Mar. 11, 2004, and Form 425, filed Oct. 25, 2004 (on October 25, 2004 ISG agreed to merge into Mittal Steel, and Wilber Ross will become a board member of Mittal).

[287] Warnaco Group Inc. Major Holders, Yahoo Finance, *at* http://www.finance.yahoo.com/q/mh?s=WRNC.

[288] Telephone interview with founder of distressed debt investing hedge fund (Mar. 31, 2004). That said, Miller's "flipping" theory seems to have a great deal of advocates. During Worldcom's emergence from Chapter 11, its two largest shareholders, MatlinPatterson and Silver Lake Partners, decided not to take positions on the company's board (the two firms, along with Cerberus Capital, had all initially been granted one seat on the eleven-member board). Richard Breeden, former Chairman of the SEC and corporate monitor in the Worldcom case, seems to share Harvey Miller's "flipping" fears. *See supra* note 10.

[289] Interview, *supra* note 67.

this claim. The funds may sell the positions days, weeks, or months later for a short-term trading gain. The funds are not unwilling to own equity in the reorganized firm—in fact, they often do—but the funds usually prefer significantly smaller stakes in the reorganized company. These short-term "trading oriented" funds often face redemptions from their LP investors and therefore don't want to be caught holding illiquid controlling equity positions.[290] There is a significant presence of these trading funds, and they often get the wrath of debtor-oriented literature lamenting that the funds' only interest is to "flip" their investment, capitalizing on a short term gain, at the debtor's expense.[291]

But, these "traders" are really no different than the trade creditors or banks from whom they may buy their claims; they will always favor corporate decisions that will increase the value of their individual claims (often at the expense of maximizing firm wealth). The short-term "flip" investors would really be no different in their motivations than the commercial banks or institutional investors from whom they purchased their claim. All of these investors are interested in a short term, cash return on their claim. In a worst-case scenario, we can expect that their self-motivated actions would mimic the actions of classic claimholders (too risk-averse when holding senior debt, too risk-loving when holding junior positions). In the best-case scenario, we can expect these holders to be far superior to the classic par holders. Even if these investors only want the company to trade well when it emerges, they will still want to make sure

[290] Telephone interview, *supra* note 77.

[291] Brennan, *supra* note 273. It should also be noted that, as recently as the mid 1990's, many of the major distressed debt investors—Cerberus Capital Management, Oaktree Capital Management, Angelo, Gordon & Co., DE Shaw, WR Huff, GSC Partners, Elliott Associates—did not have the capital resources necessary to take the type of controlling positions that they routinely take in today's market. Therefore, a decade ago, most of these funds' primary investment strategy was to profit from shorter-term trading gains in distressed debt. It should also be noted that, even as their invested capital has increased, these funds continue to profit from short-term trading of distressed securities.

that the management team is impressive and the capital structure is sound.[292]

In his writing on the subject, Miller fails to make a clear distinction between these short-term, trader-oriented distressed investors and the more recent trend of longer term, operations-oriented, distressed investors whom I believe create the greatest efficiency gains in Chapter 11.[293]

The problem with Miller's argument is two-fold. First, Miller erroneously attributes to short-term "flip" traders the ability of long-term distressed-debt investors to control the reorganization process. Short-term traders, however, rarely purchase the substantial stakes that larger distressed investors do, and they rarely end up on a creditors' committee, in the courtroom, or at the negotiating table. While they provide a great deal of liquidity to distressed-debt markets, they rarely take on vocal or activist positions with the company. Short-term traders simply do not control the reorganization process. They are incapable of forcing debtors out of bankruptcy before they are ready.

The second, more fundamental concern is that Miller's reasoning is counter-intuitive. Distressed investors would not rationally risk the long-term viability of the debtor in order to get the company out of Chapter 11. This paper has

---

[292] *See* email from Portfolio Manager at New York-based hedge fund (Dec. 12, 2004) (on file with author).

[293] Miller does acknowledge this distinction. While the pure traders may be only making a calculation about how long the Chapter 11 is going to take, the presence of distressed investors taking much larger stakes has "grown enormously" and Miller acknowledges that their strategies have changed "from being short term traders to the investor side." These larger distressed investors look to value the assets of the debtor and aim to be a "major stockholder" in the emerged company and hold their stake for a while—only exiting through an eventual sale or IPO. Interview with Harvey Miller, *supra* note 58. Hilary Rosenberg may have been the first to point out this important difference between distressed investors. In *The Vulture Investors*, she classifies "vultures" as either "migratory birds," the speculator/traders; or "nest builders," who "throw their fate in with a company for the long term." Rosenberg does not, however, imply that either group has a salutary affect on reorganizations. ROSENBERG, *supra* note 8, at 26.

recounted example after example of distressed investors' preference for equity—the debtor's most risky post-emergence currency—over fixed-income securities. Bankruptcy recidivism, should it occur, harms equity holders far more than fixed-income creditors.[294] It follows that distressed investors, as the most junior residual claimholders in the reorganized company, ought to be the most concerned about premature emergence from Chapter 11's protective shell. If distressed investors were concerned about the viability of the restructured company, they would require a significantly safer currency—perhaps senior secured debt. Instead, we see the funds going out of their way to demand new equity.[295]

What Miller and other critics of distressed-claim trading seem to miss are the bygone days when a Chapter 11 filing meant that creditors and the debtor would work together in a collective environment to rehabilitate the operations of the debtor and help it emerge as a healthy company.[296] In 1996, Frederick Tung argued that claims trading has the tendency to destroy the traditional "community" that a Chapter 11 filing is meant to facilitate. Tung argued that claims trading takes the claims out of the hands of those parties who have long-term relationships with the debtor—its commercial bankers, its suppliers and customers—and inserts self-centered players into the Chapter 11 who will only be concerned about the debtor's eventual rehabilitation if it increases the value of their own claims.[297]

The days of "community" based Chapter 11 negotiations are history, if they ever existed. They are a remnant of the

---

[294] *See* David A. Skeel Jr., *What's so Bad About Delaware?*, 54 VAND. L. REV. 309, 318 (2001). Naturally, equity holders are likely to have no financial recovery in a bankruptcy while fixed-income creditors, depending on priority, may have a significant recovery.

[295] This is true for both long- and short-term distressed investors. Both usually operate in the riskiest level of the bankrupt firm's capital structure and seek profit from operational turnarounds.

[296] *See* Tung, *supra* note 9 (similar arguments are made by Harvey Miller in article by Brennan, *supra* note 273).

[297] *See* Brennan, *supra* note 273.

days when commercial banks cared more about their long-term client relationships and loan asset base than their debt syndications and servicing fees. Today, defaulted bank loans are immediately transferred to the bank's "work-out group" at the first sign of distress,[298] and trade creditors are rarely willing to hold their claims through the entire Chapter 11.[299] Instead of longing for the days of the past, we should tentatively applaud the way that distressed-debt investors have brought enterprises closer toward an efficient communitarian relationship. Where distressed claims of the 1980s and early 1990s may have traded hands from one inefficient owner to the next, today, these claims are being aggregated in the hands of what often turn out to be long-term residual owners. The bankruptcy code and the courts should generally facilitate such transfers. This may involve amending the still onerous "proof of claim" requirements for privately owned claims under Rule 3001.[300] It may involve an amendment to the Section 1126(e) "good faith" requirement, or at least an interpretation by courts that would encourage the aggregation of claims in the hands of a distressed investor, even if they contemplate a hostile takeover of the company.[301] It may mean that the code should be amended to

[298] Lambe, *supra* note 158. Carsten Brink, Head of European Restructuring at UBS Warburg, says "Once the debt goes into default, then it generally passes to another part of the bank. The recovery bankers will typically look at the debt in a different way. Their priority will be to manage the credit exposure, and the overall relationship with the borrower will be of secondary relevance. In a restructuring, the power moves from the relationship manager to the workout specialist." *Id.*

[299] A modern trade creditor in a major Chapter 11 will typically get multiple solicitations from distressed investors for their trade claims. Interview, *supra* note 67.

[300] *Contra* W. Andrew P. Logan III, Note, *Claims Trading: The Need For Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495 (1994) (arguing that Rule 3001 should actually be amended to require a greater burdens of disclosure for purchasing claims in bankruptcy).

[301] *See, e.g., In re* Allegheny, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990) (wherein the court designated the votes of Japonica, a distressed debt investor, because the judge found that Japonica had acted with bad faith

make the selection of an unsecured creditors' committee members a more dynamic process, with required adjustments to its membership as debt becomes aggregated in the hands of a few distressed investors during the course of the case.[302]

In the end, there is reason to be optimistic. Distressed-debt investing, while "vulture-like" to many, is better described as a phoenix. Rising from the ashes of bankruptcy are revitalized firms, thanks to the determination of investors who immolate short-run destructive behaviors in favor of long-run value maximization.

and "in aid of an interest other than an interest as a creditor." Japonica's "other interest" was its desire to take hostile control of Allegheny. The judge found that Japonica's acquisition of claims and its voting record were based solely on their desire to take control. *Id.* at 290).

[302] It may be that the creditors committee should also be given greater statutory power to affect corporate decision making and board membership.