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Riding the Fulcrum Seesaw

How Hedge Funds Will Change the Dynamics of Future Bankruptcies

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Due in large part to prolific liquidity in the marketplace and historically low interest rates, corporate bankruptcy filings are at record lows. Although recent events indicate that liquidity may be beginning to dry up, distressed companies have gorged on this easy credit with the hopes that throwing more money at problems will improve results. Troubled businesses also may have turned to the distressed debt market instead of filing for bankruptcy protection due to recent changes to the Bankruptcy Code, which made bankruptcy a more complicated, expensive and uncertain alternative. As a result, when the next wave of Chapter 11 filings comes, hedge funds and other distressed debt investors will act to protect their unique interests and strategies, which will bring new dynamics to bankruptcy cases.

THE FULCRUM INVESTMENT STRATEGY

In recent years, the growing distressed debt market has provided desperately needed cash to troubled companies, permitting them to restructure their balance sheets. Distressed debt investors are willing to accept junior positions, or even equity, in the capital structures of companies. In this way, although motivated to achieve high returns, hedge funds may help distressed companies by infusing money to allow a company a chance to turn around its financial problems.

There are, however, costs to this easy money: One cost comes in the form of higher interest rates and other charges; another cost comes in the form of pressure that aggressive investors can bring to bear to expedite turnarounds of a business. After all, many investors in the distressed debt market, unlike traditional lenders, like influencing restructurings almost as much as they like making money.

Hedge funds often advance their strategies by finding and acquiring so-called "fulcrum" positions in capital structures. The "fulcrum" is the point of a company's capital structure at which its liabilities exceed its assets. By acquiring the fulcrum position in a corporate capital structure, hedge funds seek an opportunity to have some measure of control or influence over a company's turnaround or bankruptcy. Exerting such power over a distressed situation provides some protection against a potential impairment of value. In addition, owning positions around the fulcrum increases the potential upside for distressed investors. If a fund obtains a position in the fulcrum, it increases the likelihood that its debt positions ultimately will be converted into potentially lucrative new equity.

The location of the fulcrum, however, is not always clear and varies from company to company. Thus, it is common to see distressed debt investors taking multiple positions in a company's capital structure. For example, many distressed debt traders will purchase debt higher in the capital structure as a hedge against their potential unsecured debt or equity investment. Once a company is in bankruptcy, traders also look to augment their position by buying trade claims. If the strategy plays out successfully, the distressed trader generates solid returns by recovering either proceeds from a sale or refinancing, or a significant equi-

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ty position. On the downside, the investor ultimately may be left with worthless debt.

Unlike the situation in the late '80s and '90s, when loans were auctioned off at bargain-basement prices, there is strong competition today to purchase distressed debt. There are thousands of funds in the distressed market competing for a relatively small pool of assets. As a result, hedge funds today often must pay closer to par to acquire distressed debt.

In this climate, traditional lenders are more willing to sell troubled senior secured loans into the distressed debt market. Similarly, when a company becomes stressed or distressed, traditional investors holding high yield debt, such as junk bonds or subordinated notes, are more apt to sell, thereby limiting downside risk and guaranteeing a recovery.

The Proliferation of Second-Lien Loans

In addition to acquiring existing debt, hedge funds also make new loans as a means of acquiring a fulcrum position. Although some loans are made on an unsecured basis, second-lien loans have become a common vehicle. Second liens are placed into the capital structure below the senior secured debt and usually above (but sometimes below) bonds and subordinated notes.

As new money seeks to enter a company's capital structure, second lien lenders must negotiate with senior secured lenders and holders of other debt. Senior lenders will negotiate vigorously to limit second lien lenders' inter-creditor rights and push borrowers to extract such concessions. In many instances, loan documents for second liens have so few loan covenants that they are often referred to as "covenant lite" loans. Moreover, senior secured creditors typically require second-lien lenders to waive rights and submit to restrictive covenants in inter-creditor, standstill, subordination, and other agreements governing the respective creditor's rights.

Due to the paucity of business bankruptcy filings over the last several years, there have been few reported cases in which inter-creditor agreements have been interpreted and enforced. In one recent case, *Aerosol Packaging, LLC*, Case No. 06-67096-MHM, U.S. Bankruptcy Court for the Northern District of Georgia, the court enforced a pre-bankruptcy assignment of voting rights from a second-lien lender to the first lien holder. In other cases, such as *New World Pasta Company*, Case No. 1-04-02817 (MDF), U.S. Bankruptcy Court for the Middle District of Pennsylvania, and *Meridian Automotive*, Case No. 05-11168-MFW, U.S. Bankruptcy Court for the District of Delaware, where investors were litigating over the enforceability of inter-creditor second lien waivers, the matters settled without a court ruling.

Not surprisingly, such heated litigation has lead to inter-creditor agreements placing even more restrictions on the rights of second lien holders. Borrowers are sometimes put in a position of taking affirmative acts to eliminate or reduce the secured position of junior lien holders. *See, e.g.*, *Wilmington Trust Co. v. Solutia, Inc. (In re Solutia, Inc.)*, No. 05-01843, 2007 WL 1302609 (Bankr. S.D.N.Y. May 1, 2007) (Beatty, J.) (court finding, after a trial, that noteholders were properly desecuritized under the terms of their indenture by a new loan agreement ten weeks before the bankruptcy filing). The goal seems to be to further reduce the ability of second liens from having a meaningful voice in restructurings.

To date, second lien holders have been willing to enter into these agreements to get a valuable break in spreads. And some traders may be too busy trading to read the fine print. Regardless, it is highly likely that heated negotiations and fierce litigation will ensue as second lien lenders attempt to reclaim and assert their rights in bankruptcy proceedings. Well-financed investors holding so-called "silent seconds" may not remain silent. Given the slim spreads in distressed debt acquisition markets, hedge funds will have little choice but to operate aggressively to preserve returns.

The New Dynamics of the Next Bankruptcy Wave

Although the recent number of business bankruptcy filings has increased marginally, a surge in business bankruptcy filings is expected by certain market commentators as soon as the end of 2007. Recent events, such as the subprime mortgage crisis and the failure of few leveraged hedge funds, may signify the approach of the next phase of the business cycle. A rise in Chapter 11 activity will be inevitable when traditional credit tightens, the distressed debt market cools, and repeated infusions of debt are not enough to fix underlying business problems. When the next wave comes, distressed businesses and their professionals will look upon a new landscape.

Chapter 11 bankruptcy proceedings have become more complicated as a result of certain amendments to the Bankruptcy Code. For example, the new 18-month outside limit on exclusivity, the 120-day deadline for assuming non-residential real estate leases, and the restrictions on executive compensation will require a debtor and its professionals to quickly focus on key aspects of the business plan.

Previously, bankruptcy reorganizations were largely influenced by traditional financial institutions, which had a vested interest in restructuring their customer's affairs and having them remain in business. The goals of hedge funds, however, diverge from those of conventional lenders. Instead of restructuring or refinancing troubled loans, distressed investors holding senior lien positions may seek more immediate recoveries through asset sales. Similarly, unlike traditional bond holders or junior lenders with subordinate lien positions, today's second lien holders are not necessarily concerned with repayment, but are comfortable converting their debt into equity.

In addition, the complexities of the new forms of capital structures will make Chapter 11 reorganizations more challenging. There will be litigation concerning the competing rights within the capital structure. Moreover, instead of dealing with a few representatives of key constituencies, such as an administrative agent for lenders and members of official committees, a debtor will have to navigate the varied interests and unique strategies of diverse groups of claim holders.

If a debtor's capital structure is not controlled by an investor or a coordinated group before the bankruptcy filing, the quest for control through trading will likely result in entities holding a variety of levels of claims to achieve their goals. In fact, traders may purchase unsecured debt and trade claims in bankruptcy to boost their fulcrum strategy. One of the by-products of this trading dynamic may be that it could become more difficult to find creditors willing to be bound by the duties and strictures that govern creditors' committees. Another by-product may be that committee professionals could be asked by distressed investors to take positions that drive trading values. These dynamics likely will make it more difficult to run a complex Chapter 11 case.

The case of *Interstate Bakeries Corp.*, Case No. 04-45814-JWV, U.S. Bankruptcy Court for the Western District of Missouri, is a recent example of a case where the composition of both the creditors committee and equity committee changed radically during the course of the case. As a result of certain equity traders amassing shares, the equity committee members were required to erect ethical walls within their organizations to separate those participating in the traditional committee representation from those participating in the trading side. To protect against the improper use of inside information, such trading procedures orders have become commonplace in cases with active trading.

The Quick and the Dead

In order to effect speedy and profitable recoveries, hedge funds are proving to be quite aggressive in utilizing litigation to gain a place at the negotiating table. Litigation, of course, has always been part of the game of creating leverage in Chapter 11 proceedings. But hedge funds are more proactive in executing their strategies. Thus, in addition to battling with a corporate Chapter 11 debtor, the various creditor constituencies in the next wave likely will be battling among themselves. As a result, Chapter 11 proceedings could become mired in a higher level of aggressive litigation, which would increase both the costs attendant to filing for bankruptcy and the risks of a failure to reorganize.

Ultimately, a distressed debtor may succumb to the burdens of the additional costs and delays occasioned by inter-creditor litigation. For example, in the case of *American Remanu-facturers, Inc.*, Case No. 05-20022-PJW, U.S. Bankruptcy Court for the District of Delaware, creditor lien disputes forced the debtor into Chapter 7. On the tenth day of that case, the court granted the debtor's motion to convert the case because the senior (and DIP) lender and second lien holder failed to reach an agreement as to the terms of DIP financing and inter-creditor issues. Although this extreme result may be an aberration, it demonstrates the potential ramifications of the complex capital structures of future debtors.

To be sure, high-stakes litigation will continue to play a critical role in Chapter 11, particularly in the first days of a case. As the struggle to acquire a fulcrum position becomes a driving force, valuation issues will likely arise much sooner in a case. In addition, the enforceability of the current generation of inter-creditor agreements will be tested. Many second lien positions will be the subject of challenges from both above and below in the capital structure, as the different constituents compete to realize value. Debtors, too, may fight requests for current payments or replacement liens for second liens, which could result in decreased liquidity in bankruptcy cases. Strategic DIP financing terms, such as pricing, cross-collateralization and the priority of post-petition liens, will be vigorously contested.

Conclusion

Once the business cycle turns, the arrival of this new breed of constituents in an evolving, far more complicated capital structure will operate to change the dynamics of Chapter 11 cases and out-of-court restructurings. Negotiations and litigation will be fierce. As the Goliaths of Greenwich help shake out the unprecedented leverage placed on distressed assets, there necessarily will be some collateral damage. But, guided as they are by profit, these archetypal capitalists have the resources to devise ways, such as the outbreak of rights offerings as part of exit financings, to salvage recoveries as they fight to realize value.