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Are Hedge Funds and Private-Equity Firms Different than Other Case Parties?

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Overview

Hedge Funds

- Hedge funds are investment funds that take capital from institutional and accredited investors
- In general, hedge funds are less regulated than other types of investment vehicles (e.g., mutual funds)
- Structures and investment philosophies vary widely, but hedge funds typically pursue more aggressive strategies and higher target rates of return than traditional asset managers

Investing Strategies

- Funds operating special situations, distressed investing and activist investing strategies are frequent actors in restructurings
- Many special situations/distressed funds are able to invest throughout the capital structure and in derivative instruments (e.g., credit default swaps), not just bonds and loans, leading to complex layered investments structures
- Other common hedge fund strategies include long/short equity, global macro and high-frequency trading, but investors operating these and other strategies are less frequently seen taking active roles in restructurings
- Investment time horizon varies widely based on investor base

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Hedge Funds and Private Equity Firms (cont'd)

Private Equity Firms

- Like hedge funds, private equity firms typically take capital from institutional and accredited investors and pursue aggressive investing strategies seeking high rates of return
- Although strategies also vary, private equity funds are typically mandated to focus primarily or exclusively on private equity investments, often through leverage buyouts
  - Some private equity platforms are also able to invest in senior and/or mezzanine debt to support equity investments
- Private equity funds are typically structured differently from hedge funds, with investors' capital locked up for several years in order to realize long-term investments
- Private equity firms may appear in restructurings as the incumbent equity sponsors of distressed businesses, as new-money equity investors or purchasers of distressed assets
  - Prevalence of highly leveraged buyouts has led to more frequent bankruptcies of portfolio companies, and private equity sponsors have become increasingly prominent repeat players in the bankruptcy process

Diversified Asset Managers

- The demarcation line between firms that operate hedge funds, private equity firms and other types of investment firms is increasingly blurry
- Large asset managers frequently sponsor various types of investment platforms, including hedge funds, private equity funds and retail investment vehicles (e.g., mutual funds, REITs, business development companies) under one umbrella
  - Many of the best known private equity firms, including KKR, Blackstone, Apollo and Bain have expansive debt investment platforms and invest in special situations

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Common Hedge Fund Strategies in Bankruptcies and Out of Court Restructurings

While hedge fund investing strategies vary considerably from fund to fund and case to case, some common approaches include:

- Distressed for control (i.e., "loan to own") investing
  - Investors acquire "fulcrum" debt, typically at discount, expecting to convert to equity through a restructuring process
  - Assumes that post-reorganization equity will eventually (or immediately) be worth significantly more than the cost of the initial debt investment
  - Often requires investors to take an active role in negotiating and sponsoring the restructuring with additional capital investment, which can take the form of equity contributions, new-money exit loans and/or DIP financing
  - Requires tolerance for process complication, value fluctuation risk and opposition from other constituencies
- Litigation-driven activism
  - Broadly, this strategy involves acquiring debt or other claims and then pursuing particular litigation to improve recoveries
  - Litigation may take the form of plan or sale objections, claims brought in adversary proceedings or pre-bankruptcy civil suits
  - Potential issues in dispute may include valuation, structural or legal priorities among creditors (e.g., objecting to a plan that provides for substantive consolidation), pursuit of avoidance actions and allegation of defaults
  - Litigation can generate "hold-up" value in situations where other stakeholders are willing to give additional consideration to resolve claims or objections as a means to speeding up restructuring process
  - Strategy can backfire if legal arguments are unsuccessful, other participants have the capacity to withstand extensive litigation, or if debtors and other stakeholders are able to structure around the legal issues raised

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Common Hedge Fund Strategies in Bankruptcies and Out of Court Restructurings (cont'd)

- "Rescue" Financing
  - Distressed investors can sometimes find lucrative investment opportunities by extending credit to distressed borrowers unable to access traditional credit and capital markets
    - Debt may have attractive interest rates, liens on collateral, structural priority and/or and other lender-friendly terms
    - Parties providing such financing may be existing stakeholders or strangers to the borrower
  - Growth of "direct-lending" funds has fueled a rise in rescue financing
  - Borrower/sponsor appetite for aggressive liability management has created increased opportunity for out-of-court financing
  - Financings that exploit covenant baskets and other obscure features of debt documents may engender controversy and draw challenge from existing creditors arguing that they are improperly diluted as a result of the new debt
  - Participants in such financings may face fraudulent transfer claims and other legal challenges
  - So-called rescue loans may also be insufficient to address a company's fundamental financial and operational distress, and lenders may still be subject to a bankruptcy process (which they may or may not expect at the time of the transaction)
- Passive Distressed Trading
  - While each of the foregoing strategies depends on the investor's active involvement in the bankruptcy or restructuring process, distressed debt focused hedge funds may also make more passive investments, buying securities, loans, derivatives or other instruments based on an expectation as to how such instruments may recover in a restructuring, a belief that they are fundamentally mispriced and/or to tag along and benefit from another investor's activist strategy

Private Equity Sponsors in Bankruptcies and Restructurings

- Private equity sponsors may be motivated by a number of considerations when portfolio companies face distress
  - Preservation of equity value and liquidity (including efforts to stave off bankruptcy)
  - Fiduciary duties and governance concerns
  - Mitigation of avoidance and other litigation risk in bankruptcy
    - Controlling shareholders are subject to the Bankruptcy Code's one-year lookback period for preferences as well as heightened scrutiny with respect to fraudulent transfer, equitable subordination, and recharacterization claims
    - LBOs, dividend recapitalizations, payment of management fees and other shareholder transactions may all be subject to avoidance
  - Mitigation of employee-related liabilities (e.g., pension costs and WARN Act fines) that under some circumstances can be assessed on shareholders
  - Other relationships with the debtor
    - Sponsors may be creditors in addition to equityholders and may also have bona fide commercial relationships with their portfolio companies, either directly or through other portfolio companies (e.g., a sponsor may own two separate businesses that make complementary products)
  - Releases of third-party litigation claims
- These considerations can be in direct tension with one another, as strategies to preserve value for shareholders may conflict with fiduciary duties owed to the enterprise and/or create added litigation exposure in bankruptcy
- Sponsors typically have greater control over the restructuring process prior to bankruptcy
  - Appointment of independent directors during or on the eve of bankruptcy is increasingly common
  - Judicial scrutiny of the debtor and the risk of trustee and examiner appointment also lessen the influence of equity sponsors

Hedge Funds and Private Equity Firms vs Other Types of Creditors

Hedge funds are often opportunistic rather than captive creditors

- Whereas other key stakeholders (e.g., employees, trade creditors) engage in the restructuring process to protect pre-existing relationships with the debtor, distressed hedge funds may be drawn to the company *because* of the restructuring
- One critique: depending on its investment strategy, a hedge fund's interest in the debtor may begin and end with the restructuring process, and hedge funds may have little natural incentive to leave the company as a sustainable going concern after realizing their investments
- "*[F]inancial investors are involved, workers are committed. This difference is best illustrated when you have a breakfast of bacon and eggs. The chicken is involved, the pig is committed.*" - Labor leader Ron Bloom
  - [Remarks to: INSOL International Annual Regional Conference, May 21, 2006.]
- Distressed investor funds are also distinct from other financial creditors (e.g., banks, CLOs, mutual funds) that are likely to have invested principally as par holders of debt

Both hedge funds and private equity firms often have considerable financial resources to pursue their interests in bankruptcy and can also benefit from increased process sophistication relative to other parties

- Hedge funds and private equity firms are typically repeat players in the restructuring process
- For distressed investors and equity sponsors, successfully navigating bankruptcy (and even turning it to tactical advantage) is often a central objective for which there are considerable financial stakes and an incentive to devote considerable resources

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Effects of Hedge Fund and Private Equity Involvement in the Restructuring Process

Ownership Concentration

- Private equity sponsors typically own portfolio companies outright or in small groups, and can negotiate from a position of equity and board control
  - C.f. public companies that may have widely-held stock and board members with disparate interests
  - Because of their concentrated ownership and control, private equity sponsors can be more effective at negotiating for equity (and for their institutions more broadly) than are shareholders in public companies
- Hedge funds are also able to consolidate positions, either individually or through the formation of ad hoc groups
  - Ad hoc groups often determine membership not only on the basis of the instrument held, but also based on the strategic objectives and institutional compatibility of the members (e.g., hedge fund term lenders may organize separately from revolving lender banks; distressed funds may organize separately from par holders)
  - Unlike official committees that have fiduciary duties to their class or steering committees organized by an agent, ad hoc groups are responsible only to themselves
  - Plan features such as rights offerings and backstop fees can be used to divert value that would otherwise go to the entire class toward a select group (i.e., the ad hoc group members present at the negotiating table), and debtors have become increasingly sophisticated at solving for a majority group rather than solving for the class as a whole
- Consolidation and collective action can reduce costs and delay associated with the restructuring process, and more easily and efficiently foster compromise
- Organization can lend disparate creditors bargaining leverage they otherwise may not have due to the ability to block proposed plans or transactions

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Effects of Hedge Fund and Private Equity Involvement in the Restructuring Process (cont'd)

"Empty Creditor" Dynamic

- Many hedge funds have flexibility to invest throughout the capital structure and have become increasingly sophisticated about doing so
- Private equity firms and their affiliated debt funds may also have significant debt holdings to go along with equity positions in their portfolio companies
- Presence of significant cross-holdings may create subtle and not-so-subtle incentives for creditors holding a particular class of claims to vote and act in a manor not necessarily most favorable to the "pure" interests of that class
  - E.g., holders of first and second lien debt voting first lien claims in favor of a plan that steers value to their second lien positions
- Plan confirmation requirements set forth in section 1129 of the Bankruptcy Code, disclosure requirements under Bankruptcy Rule 2019, insider voting restrictions and potential for vote designation create at least potential checks against "empty creditor" abuses
  - While these may be helpful tools once a debtor is in bankruptcy, they have more limited effect on the pre-bankruptcy negotiation process, which is increasingly the forum where restructuring transactions are agreed
- Less visible investments, such as credit default swaps, may also have a considerable impact on the restructuring process
  - Recent litigation involving Hovnanian Enterprises and Windstream are prominent examples of cases where key creditors' behavior appears to have been driven by their CDS positions

Effects of Hedge Fund and Private Equity Involvement in the Restructuring Process (cont'd)

Prepacks, Out of Court Restructurings and the Increased Focus on Non-Bankruptcy Negotiations

- Hedge funds and private equity firms have contributed to the rise in prepackaged bankruptcies
  - Prepacks are typically pure balance sheet restructurings, effective at reducing a company's leverage, which is a frequent reason for the need to restructure private equity portfolio companies
  - Prepacks may also appeal to investors because they offer relatively predictable timelines and cabined costs as compared to open-ended bankruptcies
- Prepacks typically do not involve efforts to compromise claims of trade creditors or modify employee or retiree benefits, as such they can be attractive to these constituencies
- A key feature of prepackaged and prearranged bankruptcies is that the central terms of their resolutions are negotiated and agreed out-of-court, allowing private equity sponsors and hedge funds with controlling positions to manage the input of other parties and control negotiations in ways they would likely be unable to during a bankruptcy
- Private equity-backed companies may also be more inclined to pursue out-of-court liability management strategies than their public counterparts
  - Private equity owners may be less receptive to bankruptcy or full equitization of debt than are directors and senior managers of public companies
  - Further, because private equity-owned companies do not have public stock, they can engage in full recapitalizations without a need to use the bankruptcy process to cancel or dilute pre-restructuring equity

Effects of Hedge Fund and Private Equity Involvement in the Restructuring Process (cont'd)

Unequal Treatment

- Debtors, investors and ad hoc groups have become increasingly sophisticated at structuring chapter 11 plans and out-of-court transactions that concentrate value among those at the negotiating table rather than pro rata across a broader class
- Ad hoc groups can be aggressive about negotiating fees and minimum allocation of attractively priced new investment opportunities to themselves in exchange for backstop commitments
  - For example, in the *Expro Resources* bankruptcy in 2017-18, backstop parties received an exclusive allocation of 25% of all rights in the rights offering (over and above their pro rata share of the remainder) <u>and</u> an additional 5% backstop fee payable in equity
- Restructuring support agreements can be an effective tool at quieting potential dissent to these transactions by giving "outside" creditors limited economic benefits (e.g., participation in new-money equity investments or DIP financings at a reduced ratio to that of the backstop parties) only on the condition that such creditors agree to sign RSAs and forgo their objection rights
  - RSAs may also include short sign-up deadlines to limit non-backstop creditors' ability to scrutinize the terms of the agreements or attempt to organize amongst themselves
- Unequal treatment also sometimes manifests in amendments to debt documents and other out-of-court transactions, particularly those involving modifications to waterfall and pro rata sharing provisions and "covenant stripping" imposed on creditors that refuse to participate
  - These transactions may be negotiated by the borrower, its private equity sponsor and an ad hoc creditor group, with effectively no opportunity for other affected creditors to object or have input on terms

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Key Policy Questions

How do underlying policy interests of the bankruptcy system apply to distressed investors?

- The American bankruptcy system is typified by two competing primary policy interests: (1) efficient reorganization and the "fresh start" and (2) fairness to, and equitable treatment of, creditors
- There are opportunities and risks for hedge fund investors in both of these policy interests, and investors may make decisions based on predictions about which of those concerns will prevail in a particular situation
- Hedge funds may also facilitate a court's pursuit of both policy goals by, for example, providing new investment to bring a company out of bankruptcy or actively litigating in favor of particular rights of creditors where parties without the same financial incentives and resources would not do so
- Distressed investors can also offer liquidity to creditors that would prefer a quick exit to protracted involvement

Are the interests of distressed investors misaligned with those other creditors?

- Hedge funds and private equity firms are economic actors and fundamentally self-interested. At times, their interests will inevitably be intension with those of other parties in a bankruptcy process where allocation of a fixed pot of value is at issue, but all parties are self-interested – trade creditors have an interest in keeping their customers alive, employees have an interest in retaining jobs and benefits and customers want to retain their suppliers
- Trends toward prepackaged and out-of-court restructurings also reduce the likelihood that non-financial creditors will be directly impacted by the restructuring
  - Creditors could be significantly *indirectly* impacted, through layoffs, contract renegotiations and events that take place on the front or back end of a balance sheet restructuring

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Key Policy Questions (cont'd)

Should distressed investors be classified separately from other creditors?

- Separate classification may protect other creditors (especially non-financial creditors) from being dragged along with potentially aggressive or unpalatable strategies pursued by hedge funds
- Separate classification could also protect the ability of other creditors to have their votes counted and not effectively drowned out by hedge funds able to consolidate bankruptcy majorities of claims at discounted prices
- Conversely, separate classification could result in another avenue for gamesmanship, with less favorable treatment for a class of non-financial creditors
- Attempting to codify distinctions between hedge funds and other creditors holding similar claims could lead to line-drawing problems – should all financial creditors be grouped together and separate from non-financial creditors? Should further distinctions be made between distressed hedge funds and conventional asset managers, banks, etc.?

Is Additional Disclosure a Solution?

- Some commentators have advocated for enhanced disclosure requirements that would require investors to report both the face amount of the claims they hold and their cost basis in such claims
  - Most courts have required disclosure only of the face amount of claims held by creditors acting in concert and required to disclose holdings under Rule 2019
- Basis disclosure could potentially provide additional clarity to the court and other stakeholders about certain investors' motivations, but could also create a tacit expectation that creditors will recover only on the amounts paid for their claims rather than the face amount of the claims acquired