Living on the [H]edge: Where Distressed Investors Are Taking Modern Bankruptcy Practice

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LIVING ON THE [H]EDGE: WHERE DISTRESSED INVESTORS ARE TAKING MODERN BANKRUPTCY PRACTICE

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* The materials were prepared by Latham & Watkins LLP and do not necessarily reflect the views of any of the other panelists.

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I. INTRODUCTION

Over the last 15 years, as part of their strategy to generate substantial returns on their investments, hedge funds have turned their attention to distressed and bankrupt companies. Indeed, in their quest for profits from distressed situations, hedge funds have poured billions of dollars into troubled companies. In the wake of the Great Recession, many of these hedge funds imploded.[1] However, the successful ones have raised larger funds than ever and are very active in the distressed market. Hedge fund participation in large chapter 11 cases is now more the rule than not. In fact, the growing role of hedge funds in large chapter 11 cases in one of, if not the, most significant developments in bankruptcy practice in the past decade. One study found significant hedge fund involvement in approximately 90 percent of all large chapter 11 cases: (i) as the largest unsecured creditors in 25.1 percent of large Chapter 11 cases; (ii) as the largest shareholders in 48.5 percent of those cases; (iii) as the DIP lenders in 9.1 percent; and (iv) as members of creditors committees in 38.5 percent.[2]

Hedge funds' investment strategies generally entail finding companies that are currently undervalued and that can be profitably restructured. When a hedge fund decides to become involved in a restructuring, it tends to take an extremely active role in the process to achieve the results it desires, including engaging in hard-nosed negotiation and resorting to costly litigation when necessary.

Hedge fund investments in distressed and bankrupt companies have benefited the corporate restructuring process in a number ways, including by providing more competitive financing terms for many companies and increased liquidity in the financial markets on an immediate basis. Interestingly one large statistical analysis found that hedge fund involvement increased the odds of emergence from bankruptcy and that the success of hedge funds in achieving higher returns on their debt and equity investments "does not come at the expense of other claimants, but rather from creating value for the firm as a whole." The study's statistical analysis did not show decreased returns to unsecured creditors, and so the authors posited that hedge funds were creating value, perhaps by overcoming secured creditors' liquidation bias (hence the higher probability of emergence), by confronting underperforming managers (hence the higher CEO turnover rate and higher probability of loss of exclusivity) by retaining key personnel (reflected in the more frequent adoption of KERPs), and by relaxing financial constraints (as part of a loan-to-own strategy).[3]

In addition, it may be that hedge fund involvement in large Chapter 11 cases are one of the factors speeding up the process. Data from the UCLA-LoPucki Bankruptcy Research Database shows the average duration of a non-prepackaged, non-prenegotiated large company bankruptcy (from petition date to final decree) in which a plan was confirmed was 651 days for cases concluded during 2013; in contrast, the mean duration of a bankruptcy for a large public company filed with a prenegotiated plan during 2005-2013 was 247 days.[4]

Anecdotal evidence that prearranged plans have increasingly become the norm have been supplemented by recent studies. One such study concluded that large Chapter 11 cases filed at the end of 2012 were expected to reach resolution 25 percent faster than those that were filed at the beginning of 2008. The decrease was attributed to the increased percentage of preplanned cases, from less than 40 percent of the 2008 cases to over 60 percent of the 2012 cases. Interestingly, however, the study found that typical free-fall cases filed in late 2012 were projected to take approximately 13 percent longer (49 more days) to reach resolution.[5]

However, as described in this article, hedge fund involvement in the restructuring process also creates an array of complex issues for their counsel and other attorneys involved in multi-party restructuring matters. These issues affect not only attorneys representing the hedge funds themselves but they affect attorneys representing debtors-in-possession, official committees and other parties in bankruptcy cases.

II. HEDGE FUNDS GENERALLY, AND THEIR INVOLVEMENT IN BANKRUPTCY CASES

A. What are Hedge Funds?

Hedge funds are large, and ever growing, players in the financial markets. For years, they have been extremely popular investment vehicles for wealthy individuals or institutions who seek to diversify their portfolios. Hedge funds have now seeped into the "mainstream" investment world, several managers of hedge funds have completely successful initial public offerings ("IPOs"). For example, the IPO of Fortress Investment Group LLC (a company that manages hedge funds and private equity funds) offered smaller investors the chance to share in the fortunes of a company that manages money for hedge funds.[6] Moreover, mutual fund companies have unveiled products that mimic the investment strategies of hedge funds and are adding hedge fund-like strategies in traditional mutual funds.[7] In addition, the Blackstone Group, KKR and Apollo (some of the largest private equity firms in the United States) have completely IPOs that value them in the billions of dollars.

What is a "hedge fund"? The term appears nowhere in the federal securities laws. Even industry participants do not agree on a single definition.[8] The term typically is used to describe any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.[9] They are not mutual funds, private equity funds, venture capital funds or commodity pools, which generally have a much higher degree of regulation and long-term investment strategies.[10] Hedge funds typically are exempt from coverage under the Investment Company Act of 1940 either because they have one hundred or fewer beneficial owners and do not offer their securities to the public, or because their investors are only "qualified" high net-worth individuals or institutions.[11] To rely on either exemption from regulation under the Investment Company Act, hedge funds must restrict their offerings so that they can meet the requirements for non-public offerings.

Because hedge funds are not registered with the SEC, they generally are not obligated to comply with disclosure requirements. Thus, a veil of secrecy permits hedge funds not to disclose their investment positions and strategies, and to make investments that mutual funds and other regulated investment advisers cannot make.[12] Hedge funds invest in equity and fixed income securities, currencies, over-the-counter derivatives, futures contracts and even "non-financial" assets such as fine wines. Some hedge funds also may assume substantial leverage, sell securities short and employ certain hedging and arbitrage strategies.[13] In addition, as described in more detail below, hedge funds have become very involved with investing in distressed companies, including debtors in bankruptcy proceedings.

Hedge funds' management structure and the way they compensate their advisers differ from other investment companies. Like other types of investment companies, hedge funds typically are organized by professional investment advisers that manage the funds' assets. However, unlike mutual funds, which must comply with a number or requirements for independent boards of directors and whose shareholders must approve certain actions,[14] hedge funds normally are structured as limited partnerships to achieve separation of ownership and management. Typically, the general partner is responsible for managing the hedge fund, and the limited investors do not participate in management.[15] Hedge fund investment advisers typically receive as compensation a management fee based on the amount of hedge fund assets under management, plus a share of the capital gains or some other allocation based on the fund's investment performance.[16] This fee structure creates incentives for hedge fund advisers to exceed financial return benchmarks, not just to manage a larger asset pool. In addition, hedge fund advisers often invest significant amounts of their own money into the funds that they manage.[17]

Because there is a lack of data concerning the number of hedge funds now operating in the United States and the amount of assets they control, it is difficult to estimate how large the hedge fund industry currently is. In 2006, SEC Chairman Christopher Cox estimated that as of the middle of 2006, there were approximately 8,800 hedge funds managing about $1.2 trillion of assets. If that estimate is accurate, then it would imply a growth in hedge fund assets of almost 3,000% from 1990 to 2006.[18] A recent estimate is that hedge funds currently manage $2.8 trillion.[19] Much of the growth likely is attributable to increased investments in hedge funds by institutions such as investment banks, private and public pension plans, endowments and foundations.[20] For example, Mr. Cox estimated that about two-thirds of endowments invest in hedge funds, and those that do invest in hedge funds allocate an average of 18% of their investment dollars to them.[21] Hedge funds also are extremely active traders. [Although hedge funds control only approximately [5%] of all U.S. assets under management, they account for approximately 30% of all U.S. equity trading volume.] [Find updated cite]

B. The SEC's Attempt to Require Hedge Fund Managers to Register Under the Investment Advisers Act of 1940

One impetus for the SEC's earlier attempts to regulate hedge funds was the collapse nearly ten years ago of Long-Term Capital Management ("LTCM"), a hedge fund that had more than $125 billion in assets under management at its peak.[22] LTCM lost about $4 billion in five weeks in 1998. Federal Reserve Chairman Alan Greenspan stated that, had the Federal Reserve Bank of New York not intervened to organize a $3.6 billion bailout, LTCM's failure "could have potentially impaired the economies of many nations, including our own."[23]

After LTCM's demise, a joint working group of the major U.S. financial regulators produced a report recommending changes to the regulatory scheme concerning hedge funds, and the SEC staff produced another report about the state of hedge fund regulation. In 2004, over the dissent of two of its commissioners, the SEC adopted a rule requiring managers of domestic hedge funds with assets of at least $30 million and at least 15 "clients" to register under the

Investment Advisers Act of 1940 by February 1, 2006.[24] Overseas hedge fund advisers were required to register if they had at least 15 U.S. clients, regardless of the size of their assets. Notably, the rule provided that hedge funds had to count as "clients" the shareholders, limited partners, members or beneficiaries of their funds. In other words, each investor was a "client" of a hedge fund. Previously, most hedge fund advisers managed fewer than 15 funds, so they were exempt from the registration requirement. The SEC's rule had the effect of requiring these hedge fund advisers to register with the SEC.[25] The registration requirement was intended not only to provide the SEC with information about hedge fund advisers, but also to bring them within the SEC's compliance scheme. Registration required advisers to implement programs to prevent, detect and correct compliance violations, required advisers to open their records to the SEC upon request, and provided the SEC the authority to conduct on-site compliance examinations. Moreover, registration had the effect of limiting the types of investors to whom hedge funds are sold, because the Investment Advisers Act prohibits advisers from charging a performance fee unless each investor in the fund is a "qualified client" (*i.e.*, a client with a net worth of at least $1.5 million or at least $750,000 in assets under management with the adviser).[26] Therefore, registration would deter hedge fund sales to retail investors.[27]

In deciding to adopt this rule, the SEC cited three shifts in the hedge fund industry to justify the need for increased regulation. First, hedge fund assets grew by 260 percent from 1999 to 2004. Second, the SEC noticed a trend toward "retailization" of hedge funds that increased the exposure of ordinary investors to these funds. This retailization largely was driven by hedge funds loosening their investment requirements, as well as increased investment in hedge funds by pension funds, universities, endowments, foundations and other charitable organizations. Third, the SEC was concerned about an increase in the number of fraud actions brought against hedge funds.[28]

On June 23, 2006, a panel of the United States Circuit Court of Appeals in Washington D.C. vacated and remanded the SEC's hedge fund rule. In *Goldstein v. S.E.C.*, the court ruled that the SEC's interpretation of the term "client" was arbitrary and capricious, and that the SEC had failed to justify its rule adequately.[29] While it noted that the Investment Advisers Act did not define the term "client,"[30] the court determined (based on its analysis of the legislative history and other provisions of the Act, as well as the SEC's prior interpretation of the Act) that Congress likely did not intend for investors to be counted as "clients" of an investment adviser. Rather, investment company entities were the advisers' clients. The court held that the SEC had failed to establish how the relationship between investors and hedge fund advisers justifies treating the former as clients of the latter. For example, the court noted that an investment adviser owes fiduciary duties to the fund, rather than the fund's investors. Indeed, if an investment adviser were deemed to owe fiduciary duties both to the fund and to investors, conflicts of interest would arise. The court described the following situation:[31]

> "Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation the 'clients' of the corporation's lawyers or accountants. … While the shareholders may benefit from the professionals' counsel indirectly, their individual interests can be drawn into conflict with the interests of the entity. It simply cannot be the case that investment advisers are the servants of two masters in this way."

C. The Current State of Governmental Oversight of Hedge Funds

The SEC did not appeal the *Goldstein* decision. However, Mr. Cox noted that hedge funds still remain subject to SEC regulations and enforcement under the anti-fraud, civil liability and other provisions of the federal securities laws.[32] Hedge funds continue to be a topic of interest to legislative and regulatory bodies in the U.S. and abroad, which have focused on the potential systemic risks posed by the industry. For example, key U.S. lawmakers have expressed interest in holding Congressional hearings to learn more about how the industry operates, though these lawmakers mostly have stopped short of calling for stiff oversight of these funds at this time. In 2006, high-ranking Treasury Department officials held a number of meetings with representatives of prominent hedge funds, investors, lawyers and others to gather information about hedge funds' operations. Presently, U.S. officials believe that the best way to oversee hedge funds is to ensure that banks, which handle billions of dollars of hedge funds' business in loans and trades, are aware of the risks that hedge funds pose.[33] Indeed, in February 2007 the Bush administration stated that there was no need for greater government oversight of the hedge fund industry to protect the U.S. financial system. Instead the administration, in an agreement it reached with regulatory agencies, stated that investors, hedge funds and their lenders can adequately take care of themselves by adhering to a set of non-binding principles. These principles provide in part that investors should not take risks they cannot tolerate and should evaluate the strategies and management skills of hedge fund managers. They also call for hedge funds to make clear and meaningful disclosures to investors.[34] In May 2007, Representative Barney Frank, the chairman of the House Financial Services Committee, issued a letter calling on global leaders to establish a task force to study the effects of the growing role of hedge funds and private equity funds on world markets. In his letter, Mr. Frank stated that governments need a more sophisticated understanding of how hedge funds and private equity funds operate and the consequences of their operations on world economies and financial markets.[35]

Outside the U.S., in February 2007 the Group of Seven announced that it will subject hedge funds to greater scrutiny. These policy makers are concerned that a major hedge fund failure could endanger the stability of international investment banks, in turn creating chaos in major financial markets.[36] In addition, German finance minister Peer Steinbrueck recently remarked that hedge funds could pose systemic risks and create a vicious circle of problems. Government officials in Germany and other European countries have expressed outrage over activist hedge fund managers, noting their involvement in the blocking of Deutsche Borse AG's bid for London Stock Exchange plc.[37] Moreover, a former Danish prime minister declared that hedge funds were immoral and dangerous because they caused economic volatility and disregarded workers' rights.[38] Other government officials have opposed mandatory regulation of hedge funds by the

European Union. However, it is possible that the European Union will set limits on the amount of debt exposure that European banks may have to hedge funds.[39]

D. Hedge Funds' Investment in Distressed and Bankrupt Companies

Over the past decade, distressed companies inside and outside of bankruptcy have become a larger component of basic hedge fund investment strategy.[40] The veil of secrecy under which hedge funds operate makes it difficult for target companies to know whether their hedge fund investors intend to rebuild them into financially stronger entities with higher stock value, or rather intend to force a break-up and sale of their pieces. Thus, hedge funds can interject uncertainty into bankruptcy cases and out-of-court workouts. One thing is certain, however: as the number of hedge funds and the amount of money they attract from investors continue to grow, they undoubtedly will continue to have an enormous influence over the restructuring process for a large number of financially troubled companies.

One principal distinction between hedge funds and more traditional investors in distressed companies is the time horizon of the investments. Investors such as banks and private equity firms frequently become involved early in the restructuring process with a view toward rehabilitating the company and reaping the long-term gains as a result thereof. On the other hand, hedge funds generally are not designed to build value in the long run, and this creates conflicting interests with other creditors and shareholders.[41] While some hedge funds do have long-term investment philosophies, the permissive redemption policies offered by most hedge funds require their advisers to engage in more short-term strategies to maintain sufficient fund liquidity. Hedge funds typically demand a rapid exit strategy when they invest in a company's debt or equity. Some hedge funds seek a "quick flip" of their investments, often in as few as six months and most likely in no more than eighteen months. Other hedge funds engage in a "loan to own" strategy, in which they make loans to a distressed company with the intent to convert that debt to equity after the company defaults on the loans and restructures the debt. In sum, hedge funds are more likely than more traditional investors to seek short-term returns that are not necessarily tied to the debtor's successful reorganization.[42]

Hedge funds can invest in distressed companies inside and outside of bankruptcy in a number of different ways, including (a) as members of lending syndicates holding first-lien and second-lien secured debt, (b) as purchasers of unsecured debt and equity, (c) as DIP lenders and (d) as sponsors of reorganization plans. These investments enable hedge funds to influence these companies' restructuring efforts and to obtain ownership interests in these companies after restructuring.[43] Below is a description of just some of the ways in which hedge funds invest in distressed companies.

1. DIP Loans

Hedge funds have become more active in the DIP lending arena in the past few years. By offering DIP loans, hedge funds can collect significant fees, liens that prime existing pre-petition liens and a super-priority administrative expense claim for repayment. DIP lenders also gain access to confidential information concerning the debtor, as well as the ability to influence the course of the debtor's reorganization. In addition, DIP financing terms generally include financial and other covenants that may be difficult to achieve. Any time a waiver of the covenants is required, the DIP lender would have a significant advantage in negotiations with the debtor.[44] It has been noted that the opportunity to turn a restructuring in their favor is a major reason why hedge funds have been increasingly active in the DIP lending arena. As one investment banker stated, "[h]edge funds are interested in the opportunity because they don't just see an opportunity to earn prime plus two. They are interested in positioning themselves for loaning to own."[45]

2. Pre-Petition Secured Loans

Secured lenders sit atop a distressed company's pre-petition capital structure, and have ample clout in a bankruptcy case, beginning with the post-petition DIP loan the company may require immediately following the bankruptcy. As secured creditors, hedge funds have a number of rights in a company's chapter 11 case, including the right to adequate protection of their collateral interests, cash collateral leverage, credit bidding opportunities and significant leverage in the company's restructuring process.[46] Hedge funds have been particularly active recently in the second lien loan market. By making these loans, hedge funds enjoy the preferred status of a secured creditor, seizing the right to collateral value beyond the amount of the company's outstanding first lien loan, while receiving an interest rate higher than the first lien lenders receive.

3. Pre-Petition Unsecured Debt

Hedge funds have been very active in purchasing bankrupt companies' unsecured debt. Such purchases are a multi-billion dollar a year industry that provides tremendous liquidity to the markets. It also promises significant opportunity to those parties that are sophisticated enough to understand the restructuring process and with sufficient access to information to take appropriate risks. Because there are relatively few buyers of unsecured debt in the market, and because smaller and less sophisticated creditors often require liquidity and will accept an offer to sell their claims early in a bankruptcy case, hedge funds can purchase unsecured debt at a very significant discount. In addition, banks and other professional investors generally are constrained to limit exposure and not carry large defaulted loans that must be marked to market. To achieve liquidity and limit losses, banks often will trade the debt they hold.[47]

Prior to 1991, creditors had greater access to information that enabled them to make more informed decisions about whether they should sell their claims to distressed debt traders.[48] In 1991, Bankruptcy Rule 3001(e) was amended to no longer require disclosure to the bankruptcy court of the terms of the transfer and the consideration therefor. These disclosure requirements were viewed as frustrating the goal of creating a liquid market for the sale of claims.[49] As a result of the amendment to Bankruptcy Rule 3001(e), claims trading largely is unregulated by bankruptcy courts. For example, one court denied a debtor's motion to invalidate a transfer of claims "[b]ecause Rule 3001(e), which governs the assignment of bankruptcy claims, does not confer standing on the Debtor to object to the assignment" and because the intent of the 1991 amendments was to "curtail judicial oversight of the claim assignment process."[50] Courts also have refused to invalidate claims transfers, even where claims purchasers had distributed misleading information to sellers.[51]

Buyers of distressed debt typically will invest if they determine that: (a) the reorganization will yield a higher return than the cost of the claim; and (b) the reorganization plan will be confirmed and consummated before the investor's cost of carrying the investment consumes the profit it makes on the discount.[52] In making investments in unsecured debt, hedge funds take advantage of investment professionals who specialize in bankruptcy and in researching distressed companies to understand their true value. Hedge funds can capitalize on their knowledge and on the flexibility and patience that other creditors lack. Hedge funds can also profit simply on account of their sophisticated analysis of appropriate discounts for unsecured claims. Depending on the amount of debt acquired, they also may gain control over a class of creditors or a creditors' committee, and therefore obtain considerable influence over the debtor's reorganization.[53]

The restructuring of Barney's is one of the many examples of hedge funds profiting handsomely from their investment in a company's unsecured claims. Barney's was a healthy company that had over-borrowed and needed to reduce its debt. Trade creditors sold their claims to hedge funds and other distressed debt buyers for pennies on the dollar. After restructuring, Barney's was able to distribute a significant sum to the holders of unsecured claims, which resulted in a substantial gain for the buyers of the debt. Hedge funds have been extremely active in purchasing unsecured debt in other large chapter 11 debtors, such as Washington Mutual, Rescap, Tribune Company, and Calpine Corporation among many others.

4. Equity

Investment in the stock of distressed companies is similar to investment in debt, but with lower priority and higher risk. When a bankrupt company is insolvent, shareholders are not legally entitled to receive any distribution under a plan on account of their equity interest. However, hedge funds may buy stock in a debtor after a chapter 11 case begins, betting that the shareholders actually will receive a distribution under a reorganization plan. One example of a hedge fund profiting from an investment in a distressed company's equity is Foamex International Inc. Prior to its bankruptcy, Foamex's stock had traded at levels as low as 15 cents. After the bankruptcy filing, one hedge fund bought a total over 2 million shares of Foamex (representing approximately 10% of the company's equity) in a number of different transactions on the open market. The hedge fund made its first purchase at approximately 24 cents per share. By the time the hedge fund had made its last purchase, the stock was trading at $1.31 per share. The shares later almost reached $5.00 per share, generating a gain of over 650% for the hedge fund.[54] On February 12, 2007, Foamex exited chapter 11 protection pursuant to a reorganization plan in which shareholders retained their interests in the company.

Hedge funds also obtain equity interests in troubled companies before a bankruptcy case is filed. For example, as of March 2007, more than 55% of the equity of Bally Total Fitness Holding Corp. was owned by hedge funds. These hedge funds have taken an active role in the company, forcing out its chief executive in 2006. In purchasing Bally's equity interest, the hedge funds have bet that the company will fare well in its restructuring negotiations with bondholders, which would have a positive impact on the company's share price.

5. *Other Investments*

Hedge funds also may make more complex, sophisticated investments in distressed companies. For example, prior to the debtor's petition date, hedge funds could sell short the company's unsecured debt and buy long the secured facilities. When the company's secured facilities require covenant or other waivers, the hedge funds would be in a position to extract steep concessions from the company. If the company has to file a bankruptcy petition, the unsecured notes may decline in value, resulting in a gain for the hedge fund's short position.[55]

In addition, many hedge funds engage in credit default swaps. The credit default swap market originally was formed to provide banks with the means to transfer credit exposure and free up regulatory capital. While banks still may be the largest buyers and sellers of credit default swaps, hedge funds and other investment management firms are major participants in this market. Credit default swaps are two-party contracts in which one party "buys" protection from credit risk and the counterparty "sells" that protection. The protection buyer (which tends to own the underlying credit asset) pays a periodic fee to the protection seller. In return, the protection seller agrees to pay the protection buyer a stated amount if there is a credit event. Typical credit events include bankruptcy with respect to the reference entity and failure to pay with respect to its direct or guaranteed bond or loan debt. Credit default swaps differ from loan syndications in terms of control rights. When a bank syndicates loans, it also sells all of the applicable control rights in connection with the loans that are syndicated. However, when a bank lender purchases credit risk protection, that bank lender still retains the control rights that accompany the loan.

The presence of credit default swaps may fundamentally change the economic interest of lenders. When they purchase credit risk protection, lenders will not have as much to lose if the debtor defaults. Indeed, if a lender purchases enough credit protection, it may even benefit the lender for the loan to go into default. In addition, credit default swaps are private transactions, so there would be no way to ascertain the financial incentives of any party. For example, a hedge fund that holds a substantial long position in a loan may actually have a net short position in that loan as a result of credit default swaps. However, the public would be unaware of that short position.

Issues regarding credit default swaps in the "subprime" mortgage-backed securities market caused tensions between the investment banks that bundle and resell mortgage loans made to borrowers with marginal credit ratings and the hedge funds that insure the transactions by entering into credit default swaps. Hedge funds asserted that some methods now being used to restructure subprime mortgage loans reduces the value of their credit default swaps. Specifically, in renegotiating loan terms, lenders may remove mortgage loans from the loan pool in a security and thus reduce the likelihood of default.[56] Companies that service troubled subprime loans were under pressure to renegotiate, extend or otherwise modify the terms of the loans to allow borrowers to remain in their homes. Under many security agreements, loan servicers could modify a mortgage loan in a portfolio if they determine that the loss from modification would be lower than the loss from foreclosure. Hedge funds complained that some lenders' practice of removing troubled loans from securitized loan portfolios to avoid paying losses on credit default swaps may erode the value of the swaps in the marketplace.[57]

Hedge fund's investment in credit default swaps is significant because it allows such funds to greatly magnify bets on troubled companies. Hedge funds are increasingly combining credit default swap investments with activism in a distressed company.[58] Since holdings of credit default swaps is not required to be disclosed, it is difficult to discern the motives of the holders who are also active in distressed cases.[59] Recent examples of this phenomenon include Forest Oil Corp., J.C. Penney, Radio Shack and Caesars Entertainment Operating Co.

E. Hedge Funds Can Invest in Multiple Segments of a Distressed Company's Capital Structure

Hedge funds sometimes invest in multiple segments of a single company's capital structure. For instance, they can invest in both first lien and second lien secured debt, in both secured bank debt and unsecured debt, or in both unsecured debt and equity. These investment strategies differ from those of more traditional investors, which tend to focus on only one segment of a company's capital structure. These varied holdings present different strategic alternatives that put their interests at odds with those of more traditional creditors. For example, assume that a hedge fund had invested in a distressed company's secured bank debt, purchased unsecured claims from trade creditors at a discount and sold short the company's common stock. The company's other secured bank creditors would have an incentive to preserve the company's long-term going concern value to ensure a continued stream of interest payments. In contrast, the hedge fund may seek to force a sale of the company's underlying assets to realize quick gains on the unsecured debt that it had purchased at a discount.[60] Similarly, the hedge fund would not share the incentives of the company's other trade creditors, who seek to engage in future business with the company. In addition, because of its short position, the hedge fund's interests would be directly adverse to those of the company's shareholders.[61] The best result for this hedge fund would be for the company to be able to pay off its secured and unsecured debt in full, but for shareholders to receive nothing. Thus, unlike a traditional creditor that would be indifferent to the fate of shareholders, the hedge fund generates the most profits if shareholders receive nothing.[62]

F. Potential Effects of Hedge Fund Involvement in Bankruptcy Cases

Hedge funds have been, and likely will continue to be, extremely pervasive and activist participants in restructurings both inside and outside of bankruptcy. Investment and participation by hedge funds can create benefits for companies, creditors and shareholders alike. For example, they are a source of capital when more traditional lenders are unwilling to lend. Investments by hedge funds may enable a troubled company to correct its problems and avoid bankruptcy altogether. DIP financing from hedge funds may be critical to a successful chapter 11 case if bankruptcy is necessary.[63] In addition, hedge fund purchases of secured and unsecured debt permit creditors to invest their money in other transactions that are better suited to their own goals and needs.[64]

However, hedge fund involvement in chapter 11 cases can create a number of problems for debtors, creditors and shareholders. Partly as a result of hedge funds' short-term investment horizon and investments in multiple segments of a company's capital structure, hedge funds' interests are not always aligned with debtors or other creditors and shareholders. The focus by hedge funds on the maximization of relatively short-term returns often has caused tensions among the parties to a restructuring, and may conflict with the Bankruptcy Code's emphasis on the rehabilitation of debtors. A prominent bankruptcy expert stated that in the early days of the Bankruptcy Code, there was a more symbiotic relationship between debtors and creditors than there tends to be today. Generally, creditors were interested in the ultimate emergence of a viable entity and the preservation of a good customer, and financial institutions maintained and supported long-established relationships with distressed companies.[65] However, distressed debt trading and changes in bankruptcy relationships have frayed the symbiotic relationship between debtors and creditors. Creditors who purchase debt at substantial discounts are likely to be interested in the return on their investment, rather than the debtors' long-term viability.[66]

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provides hedge funds and other significant creditors additional leverage over debtors. For example, BAPCPA amended section 1121(d) of the Bankruptcy Code to provide that the exclusive period during which only the debtor can propose a plan of reorganization cannot be extended beyond eighteen months following the petition date. In large, complex bankruptcy cases, a debtor may need more than eighteen months to negotiate and formulate a restructuring plan. The new eighteen-month limit on exclusivity may reduce hedge funds' incentives to reach consensus with the debtor and other creditors, because they would be able to propose their own plans after the exclusivity period expires.[67]

Hedge funds can and do engage in a number of different strategies to gain leverage in the restructuring process. Below is a brief description of some of the strategies.

1. Forming or Taking Control of Official Committees

Hedge funds may seek to have a separate official committee formed to advocate for their interests. There are a number of benefits that hedge funds can derive from this strategy. First, the fees of official committee professionals are paid by the debtor's estate. Second, members of official committees are in a position to exert substantial influence over the debtor's reorganization path. Third, members of official committees are privy to confidential information concerning the debtor. Cognizant of these facts, hedge funds and other parties owning common stock of companies in bankruptcy have sought the appointment of official equity committees in cases such as Delphi Corporation, Northwest Airlines Corporation, Kmart Corporation, Solutia Inc. and Granite Broadcasting Corporation. Hedge funds also may try to obtain seats on an existing official committee by acquiring substantial claims or equity interests after the petition date, and requesting the United States Trustee to appoint them to that committee (and may request the bankruptcy court to do so, if the United States Trustee refuses).

Members of official committees owe fiduciary duties to their constituents. As such, official unsecured creditors' committees owe fiduciary duties to the debtor's general unsecured creditors, and official equity committees owe fiduciary duties to the debtor's existing shareholders.[68] These fiduciary duties should serve as a check to hedge fund committee members acting solely in their own interests, though hedge funds' views of what is best for the debtor's estate may differ from the views of other creditors and shareholders.

One obstacle to hedge funds becoming members of official committees is the potential restriction on the trading of the debtor's securities. Because they receive substantial confidential information about the debtor and its bankruptcy case, members of official committees typically are prohibited from buying and selling the debtor's securities. Such trading would contravene committee members' fiduciary duties, as well as violate applicable securities laws. However, in an effort to serve on official committees while continuing to trade in the applicable securities, committees (or individual members thereof) often request court approval of "screening walls" and other procedures. Courts commonly grant requests for such screening walls, as long as the proposed walls are appropriate. Such screening procedures are designed to ensure that non-public information obtained by committee members is not shared with the committee members' securities trading personnel. Court orders approving screening walls typically provide that if the procedures set forth in the order are followed, then committee members would not, by their trading activity, *per se* be in violation of their fiduciary duties and their claims or equity interests would not *per se* be subject to adverse treatment on that basis.[69] With court-approved screening walls in place, this obstacle to hedge funds' membership on official committees is removed.

2. *Controlling a Class of Creditors or Interest Holders*

Hedge funds can buy enough debt or equity in an impaired class of creditors or interest holders, such that they effectively control that class and the class' vote on any reorganization plan. At least one-third of the amount of allowed claims or interests in a given class is required to control that class.[70] Controlling a class enables a hedge fund to exert enormous pressure on debtors and may force a plan of reorganization that is favorable to the hedge fund's own interests. A hedge fund gains leverage over the plan in this way because of the possibility of a contested confirmation hearing if the debtor cannot reach an agreement with the hedge fund.[71]

3. *Joining With Other Investors to Form Ad Hoc Committees*

A hedge fund that is not a member of an official committee and that does not hold enough claims or equity to control a class can still obtain substantial bargaining leverage by forming an unofficial *ad hoc* committee with other investors. *Ad hoc* committees provide similarly-situated creditors and shareholders the chance to bargain with the debtor and other creditors as a single unit. Members of these committees can also demand and receive confidential information regarding the debtor and its restructuring. Though *ad hoc* committees lack the statutory benefits of official committees, such as payment of professionals' fees, members of *ad hoc* committees are not hindered by fiduciary duties to a broader constituency and thus may pursue their own parochial interests. If the bankruptcy case is particularly complex with multiple layers of debt of differing structural and legal priorities, a number of *ad hoc* committees could be formed to share legal costs and advance common agendas.[72]

4. *Improper Trading by Official Committee Members*

Members of official committees are privy to a mountain of confidential information regarding the debtor and its reorganization efforts. As such, there is a danger that a committee member will abuse its fiduciary duties and improperly trade on the information it obtains while serving on the official committee. Counsel for official committees should be aware of any suspicious trades by members and be prepared to take action, if necessary.

In the Galey & Lord chapter 11 case, the official unsecured creditors' committee commenced an adversary proceeding a former member of the committee, alleging that while in possession of confidential information gained while serving on the committee, the former committee member purchased up to $20 million of the debtor's outstanding secured bank debt without the knowledge or consent of the creditors' committee.[73] The committee asserted that the former committee member purchased this debt in violation of its fiduciary duties to unsecured creditors and in contravention of the committee's bylaws (which required committee members disclose conflicts of interest to the committee, and prohibited the use of confidential information for any purpose that is inconsistent with the majority decision or the intent of the committee).[74]

In its complaint, the committee sought to (a) equitably subordinate all of the former committee member's claims to the claims of all other unsecured creditors pursuant to section 510(c) of the Bankruptcy Code, (b) recover all consideration paid or payable to the former committee member on account of its claims and (c) obtain damages or disgorgement of all illicit profits from the former committee member based in its breach of its fiduciary duties.[75] The United States Trustee filed a motion to intervene in the adversary proceeding, stating that it intended to seek injunctive relief to require the former committee member to (a) institute internal protective measures to prevent the misuse of confidential information, (b) certify to the United States Trustee that it was in compliance with its internal protective measures, (c) use such internal protective measures in all cases in which it serves on an official committee and (d) refrain from future use of any confidential information for its own pecuniary interest.[76] In its answer to the committee's complaint, the former committee member denied the committee's allegations.[77] Subsequently, the parties settled the adversary proceeding. The settlement agreement provided, among other things, that the former committee member would pay $2,079,000 to unsecured creditors (which amount represented the approximate market value of the former committee member's secured claim against the debtor). In executing the settlement agreement, the former committee member did not admit any wrongdoing.

5. *Insider Trading Issues*

With their increasing involvement in distressed debt investments, hedge funds need to be aware of restrictions created by insider trading laws and the interplay of those restrictions with their investment strategies. Set forth below is a brief description of insider trading laws and a description of the seminal bankruptcy insider trading case (WaMu).

Section 10(b) of the Exchange Act of 1934 prohibits the use of any "manipulative or deceptive device ... in connection with the purchase or sale of any security." 15 U.S.C. § 78(b). SEC Rule 10b-5 makes it unlawful for any person, in connection with the sale of any security, to: (i) employ any device, scheme, or artifice to defraud; (ii) make a misstatement or omission of a material fact; or (iii) engage in any act or practice which operates as fraud or deceit.

Rule 10b5-1(a) defines insider trading as the purchase or sale of a security on the basis of material nonpublic information ("MNPI") in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issues of that security or the shareholders of that issuer, or to any person who is the source of the material nonpublic information. Courts also require a showing of scienter, a mental state embracing an intent to deceive, manipulate or defraud. A duty of trust or confidence can arise in two ways: (1) a fiduciary duty to the issuer; or; (2) misappropriation.

The traditional theory of fiduciary duty is that a corporate insider trading on the basis of material nonpublic information is in violation of a fiduciary duty to shareholders. Insiders includes includes "temporary insiders" such as underwriters, accountants, lawyers, or consultants. People who trade on MNPI received from an insider ("tippees") violate insider trading law if they knew or should have known that the insider was violating his fiduciary or fiduciary-like duty.

A corporate outsider who trades on "confidential information ... in breach of a duty owed to the source of the information." The duty arises when the outsider agrees to maintain MNPI in confidence, either explicitly or implicitly based on past practices,_ (e.g., an attorney who receives MNPI from a partner who represents a company bidding on an issuer). The attorney owes a duty of confidentiality to the partnership's client. Some cases suggest that a mere duty of confidentiality is not enough, but it should be assumed that liability will attach if a duty of confidentiality can be proven.

Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. In other words, if it would be "viewed by a reasonable investor as having significantly altered the 'total mix' of information" available about a security. Information is nonpublic if it has not been disseminated broadly to investors. SEC commentary suggests that public information is that which has been announced in securities filings (e.g., an 8-K) or discussed in media sources of widespread circulation. Following adequate disclosure, the market must have time to absorb the information and reflect it in prices.

Investors may acquire MNPI through their participation in distressed debt investments, restructuring transactions and insolvency proceedings. MNPI can be communicated in a variety of non-intuitive ways. MNPI may include, among other things, information about a company's businesses and/or financial performance, contemplated restructuring transactions, potential creditor recoveries, prospective business plans, and the prospective disposition of a debtors' assets. Parties may assert that investors have violated insider trading laws based, in part, on their asserted receipt of MNPI during negotiations associated with transactions or restructurings.

Participants in bankruptcy proceedings often from joint committees and *ad hoc* groups to maximize bargaining power and lower the costs of participation. Each member of a committee or group, however, may be required to report its broadly-defined "<u>disclosable economic interests</u>" under Rule 2019 of the Federal Rules of Bankruptcy Procedure. Members of a committee or group may also be required to update their disclosures upon trading disclosable economic interests. Under certain circumstances, a member of a committee or group may be required to disclose the date and time of the acquisition of its disclosable economic interests and the price paid.

Trading is permissible after MNPI is publicly-aired or "cleansed." Participants should establish procedures to confirm that a debtor has disclosed any MNPI prior to trading. Prior to trading, participants may seek a statement from the debtor and/or a legal opinion from counsel that MNPI has been adequately disclosed, that sufficient period of time has passed, and that trading is unrestricted. Before trading, participants should create a record that demonstrates that they are not restricted.

Participants that sit at the negotiation table in bankruptcy proceedings may use third parties (such as financial advisors or lawyers) to limit the information they receive to preserve their ability to trade. This allows the participant to choose to either; (1) receive the information deemed MNPI and become "restricted", or (2) refuse receipt of the information and continue trading. However, the receipt of MNPI may still be actionable even if it comes in the form of "secondary source" analysis rather than through direct transmission.

Whether or not information is public requires a fact-specific analysis. But in this case, the information that lawyers are working long hours on a restructuring is both material and almost certainly nonpublic. Once a trader is aware of MNPI, securities regulators assume his/her trades are on the basis of MNPI, even if he/she conducted an independent analysis or traded for other reasons.

Much has been written[78] about the famous or infamous (depending on your viewpoint) September 13, 2011 Washington Mutual Inc. ("WaMu") bankruptcy opinion written by Delaware Bankruptcy Judge Mary F. Walrath. In her opinion, Judge Walrath granted a motion by the equity committee for authority to pursue equitable subordination and disallowance claims against four hedge funds for allegedly trading on inside information regarding settlement talks among WaMu, J.P. Morgan & Co. and the Federal Deposit Insurance Corp.[79] Judge Walrath's opinion stated that "creditors who want to participate in settlement discussions in which the receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case."[80]

Even though Judge Walrath agreed to strike the language in the opinion regarding insider trading in connection with the ultimate confirmation of the plan of reorganization, the opinion sent shockwaves into the community of distressed investors. Former U.S. Bankruptcy Judge James Peck has even referred to the "WaMu effect" referencing investors post-WaMu desire to get "comfort orders" to protect themselves from insider trading liability.[81]

Comfort orders seem to be becoming a trend. In *In re Vitro*, the bankruptcy court entered an order providing that (i) settlement proposals shall not constitute material nonpublic information; (ii) no party participating in the settlement negotiations shall (a) be or become an insider or fiduciary of the debtor, (b) undertake any duty to any party in interest, or (c) be limited in its ability to trade any security, regardless of whether a confidentiality agreement exists.[82] The order further provided that no party in interest shall have any claim, defense, objection or cause of action of any nature, including but not limited to any objection to a claim or any other basis to withhold, subordinate or disallow a claim.[83] The order makes clear, however, that it is not binding on a governmental entity with jurisdiction to enforce securities laws.[84] Similarly, in *In re Residential Capital ("ResCap")*, the bankruptcy court entered an order providing that no mediation party shall (i) be or become a temporary insider or fiduciary of any debtor or their affiliates, (ii) be deemed to owe any duty to any of the debtors, and (iii) undertake any duty to any party in interest.[85] The order further stated that no party in interest "shall have any claim, defense, objection or cause of action of any nature against any [m]ediation [p]arty or any other basis to withhold, subordinate or disallow" a claim on account of a claim based on such mediation party's trading in the debtor's securities and participating in settlement discussions.[86] Further, according to the order, the mediation party shall have no duty of confidentiality or otherwise with respect to material nonpublic information except as set forth in a confidentiality agreement.[87] Like the *Vitro* order, this order makes clear that it is not binding on a governmental entity seeking to enforce securities laws.[88] However, unlike the *Vitro* order, the order in *ResCap* does not expressly permit a participating party to trade in any security, including securities of the debtor.

It seems that WaMu-style insider trading allegations and related comfort orders are probably here to stay.

IV. CONCLUSION

Hedge funds appear to be here to stay in bankruptcy cases. Attorneys, financial advisors and other restructuring advisors will have to adapt to the myriad of issues that the highly liquid, action-oriented and quick-paced hedge fund world brings. A look at recent bankruptcy case headlines suggests that hedge funds are driving many of the cutting edge restructuring issues today.

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[1] S*ee* cover page of hf-implode.com ("Since late 2006 at lease 117 major funds have imploded").

[2] Wei Jiang, Kai Li, and Wei Wang "Hedge Funds and Chapter 11," *Journal of Finance*, Volume 67, Issue 2 (Apr 2012).

[3] Id.

[4] UCLA - LoPucki Bankruptcy Research Database (reproduced by permission); Altman, Edward I., "The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations," published in the Winter 2014 *ABI Law Review* (Vol. 22:75).

[5] Dennis A. Meloro, Randall G. Reese and Travis K. Vandell, "The Fast and Laborious Chapter 11 Case Trends," *ABI Journal,* March 2014 (discussing a study conducted by UpShot Services and Chapter 11 Dockets of voluntary Chapter 11 filings from Jan. 1, 2008, to Dec. 31, 2012, of companies with assets of over $250 million).

[6] *See* Eleanor Laise, *Hedge Funds Beckon Small Investors*, Wall Street Journal, at D1 (Feb. 14, 2007).

[7] *See id.*

[8] *See Goldstein v. S.E.C.*, 451 F.3d 873, 874-75 (D.C. Cir. 2006) (noting that fourteen different definitions are found in government and industry publications).

[9] *See id.* at 875.

[10] *See* Stephen M. Gross *et al.*, *Auto Cases: Where is This Road Going?*, 061506 ABI-CLE 281 (June 2006).

[11] *See* 15 U.S.C. § 80a-3(c).

[12] *See Goldstein*, *supra* note 8, at 875 (noting that the Investment Company Act places significant restrictions on the types of transactions in which registered investment companies may engage).

[13] *See* Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission, at viii (2003) (hereinafter, "SEC Staff Report").

[14] *See* 15 U.S.C. § 80a-10.

[15] *See Goldstein*, *supra* note 8, at 876, citing SEC Staff Report.

[16] Indeed, top hedge fund managers are compensated extremely well. In 2006, each of the top 25 managers made at least $240 million, and earned $14 billion collectively. (Each of the top three managers took home more than $1 billion in 2006). The average compensation for the top 25 hedge fund managers increased 57% from 2005 and 127% from 2004. *See* Walter Hamilton, *Top 25 Hedge-Fund Chiefs Earn $14 Billion*, Los Angeles Times, at C1 (Apr. 25, 2007).

[17] *See* SEC Staff Report, *supra* note 13, at ix.

[18] *See* SEC Chairman Christopher Cox's Testimony Concerning the Regulation of Hedge Funds Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 25, 2006), available at www.sec.gov/news/testimony/2006/ts072506cc.htm (last viewed on June 15, 2007) (hereinafter, "Christopher Cox Testimony").

[19] *See* W. Wainewright and Linsay Fortado, *Hedge Fund Manager Compensation Rises 8% to $2.4 Million*, Bloomberg (November 6, 2014*). See also 2014 Preqin Global Hedge Fund Report* (estimating hedge fund assets under management at $2.66 trillion.

[20] *See id.*

[21] *See id.*

[22] *See Goldstein*, *supra* note 8, at 877.

[23] *See* Christopher Cox Testimony, *supra* note 18.

[24] The SEC states that the Investment Advisers Act of 1940 requires that firms or sole practitioners compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors. *See* www.sec.gov/about/laws.shtml#invcoact1940 (last viewed on June 15, 2007).

[25] *See Goldstein*, *supra* note 8, at 877.

[26] *See* Gareth T. Evans, *SEC Goes Back to the Drawing Board Following Invalidation of Hedge Fund Rule*, Wallstreetlawyer.com: Securities in the Electronic Age (August 2006).

[27] *See Goldstein*, *supra* note 8, at 877.

[28] *See id*.

[29] The court stated that the SEC's rule might have been more understandable if the advisory relationship between hedge fund advisers and investors had changed over the years. The SEC did cite a rise in the amount of hedge fund assets, an indication that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds to justify the rule. However, the court stated that there was a disconnect between the factors the SEC cited and the rule it promulgated, because there was no evidence that the role of fund advisers had undergone a transformation. *See id.* at 882.

[30] *See id.* at 878.

[31] *Id.* at 881 (internal citations omitted).

[32] *See* Christopher Cox Testimony, *supra* note 18.

[33] *See* Carrie Johnson & Jeffrey Birnbaum, *Hedge Funds Begin to Show Up on Regulators' Radar*, Washington Post, at D1 (Feb. 9, 2007).

[34] *See* Stephen Labaton, *Officials Reject More Oversight of Hedge Funds*, New York Times, at A1 (Feb. 23, 2007).

[35] *See* Siobhan Hughes, *Rep. Frank Calls for Review of Hedge Funds, Private Equity*, Daily Bankruptcy Review (June 6, 2007).

[36] *See* Carter Dougherty, *Economic Powers to Study Growing Influence of Hedge Funds*, New York Times, at A21 (Feb. 11, 2007).

[37] *See* Ron Orol, *Hedging on Hedges*, The Daily Deal, 2007 WLNR 5062563 (Mar. 19, 2007).

[38] *See* Siobhan Hughes, *Rep. Frank Calls for Review of Hedge Funds, Private Equity*, Daily Bankruptcy Review (June 6, 2007).

[39] *See id.*

[40] Hedge funds also will invest in companies *after* they exit bankruptcy, with the expectation that the reorganized companies will pay generous dividends to shareholders, buy back stock, or be acquired. For example, hedge funds invested heavily in Mirant Corporation after its exit from bankruptcy.

[41] However, some hedge funds recently have hired turnaround specialists to help them restructure the distressed companies that they acquire. This is a departure from hedge funds' typical practice, which traditionally involve buying and selling distressed companies, not restructuring them. *See* Erika Lovley, *Hedge Funds Try a New Trick: Running a Troubled Business*, Daily Bankruptcy Review (Apr. 19, 2007).

[42] *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, American Bankruptcy Institute Journal 24 (Dec./Jan. 2007).

[43] *See* Peter M. Gilhuly *et al.*, *Changing Roles in Commercial Cases: The Impact of Hedge Funds on the Restructuring Landscape*, 060907 ABI-CLE 65, at 4 (Sept. 2006).

[44] *See id.* at 4-5.

[45] *See* Avital L. Hahn, *More Hedge Funds Get Into the DIP Game*, Bank Loan Report (April 17, 2006).

[46] *See* Gilhuly, *supra* note 43, at 5.

[47] *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 Vand. L. Rev. 1987, 2014-15 (2002).

[48] *See id.* at 2015, citing Andrew P Logan III, *Claims Trading: he Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, Am. Bankr. Inst. L. Rev. 495, 495 & n. 3 (1994); *see also In re Revere Copper & Brass, Inc.*, 58 B.R. 1, 2 (Bankr S.D.N.Y. 1985) (noting that "[o]ne of the evils attendant upon a solicitation of assignment of claims for a cash payment such as is being made by [the distressed debt trader] is that solicited creditors may be unaware of their rights and options and fall prey to the belief that bankruptcy inevitably will result in their receiving the proverbial 10 cents on the dollar or worse. Creditors may not be aware of the difference

between a straight bankruptcy case under Chapter 7 and a reorganization case under Chapter 11 of the Bankruptcy Code.")

[49] *See* Miller, *supra* note 47, at 2015-16. Bankruptcy Rule 3001(e) currently provides as follows:

> (1) *Transfer of claim other than for security before proof filed.* If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.
>
> (2) *Transfer of claim other than for security after proof filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If the alleged transferor files a timely objection and the court finds, after notice and a hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.
>
> (3) *Transfer of claim for security before proof filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer. If either the transferor or the transferee files a proof of claim, the clerk shall immediately notify the other by mail of the right to join in the filed claim. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.
>
> (4) *Transfer of claim for security after proof filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security after the proof of claim has been filed, evidence of the terms of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If a timely objection is filed by the alleged transferor, the court, after notice and a hearing, shall determine whether the claim has been transferred for security. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.
>
> (5) *Service of objection or motion; notice of hearing.* A copy of an objection filed pursuant to paragraph (2) or (4) or a motion filed pursuant to paragraph (3) or (4) of this subdivision together with a notice of a hearing shall be mailed or otherwise delivered to the transferor or transferee, whichever is appropriate, at least 30 days prior to the hearing.
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> Fed. R. Bankr. P. 3001(e).

[50] *See*, *e.g.*, *In re Lynn*, 285 B.R. 858, 859, 861 (Bankr. S.D.N.Y. 2002); *see also* Thomas C. Daniels *et al.*, An Overview of Legal Risks for Distressed Claims Traders (Nov. 2006), available at http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=d09b7339-5cb6-43f7-a044-00f05caf101f&RSS=true (last viewed on June 15, 2007).

[51] *See Viking Assocs., L.L.C. v. Drewes (In re Olson)*, 120 F.3d 98, 101-02 (8th Cir. 1997).

[52] *See* Miller, *supra* note 47, at 2015, citing Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 Cardozo L. Rev. 1, 13 (1990).

[53] *See* Gilhuly, *supra* note 43, at 5.

[54] *See* Christopher Byron, *The Big Bounce – Funds Reap Huge Returns on a Bankrupt Foam Maker*, New York Post 35 (June 12, 2006).

[55] *See id.*

[56] *See* Steven D. Jones, *Hedge Funds Fret Over Erosion in Credit Default Swaps Value*, Daily Bankruptcy Review (June 11, 2007).

[57] *See id*.

[58] *See* M. Wirz, M. Jarzemsky and T. McGinty, *Credit-Default Swaps Get Activist Look*, Wall Street Journal (December 23, 2014)

[59] *See* id.

[60] *See* Fisher & Buck, *supra* note 42.

[61] *See id.*

[62] *See id.*

[63] *See* Gilhuly, *supra* note 43, at 8.

[64] *See id*.

[65] *See* Miller, *supra* note 47, at 2014.

[66] *See id.* at 2014-15.

[67] *See* Gross, *supra* note 10.

[68] *See, e.g.*, *Johns-Manville Sales Corp. v. Doan (In re Johns-Manville Corp.)*, 26 B.R. 919, 924 (Bankr. S.D.N.Y. 1983), citing *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262 (1941); *In re Realty Associates Securities Corp.*, 56 F. Supp. 1008, 1009 (E.D.N.Y. 1944).

[69] *See* Honorable Theodore C. Albert *et al.*, *Navigating the Minefields of Representing Chapter 11 Committees – Getting Employed, Managing Inter-Committee Conflicts & Complying With BAPCPA*, 060907 ABI-CLE 189 (Sept. 2006).

[70] Section 1126(c) of the Bankruptcy Code provides that a class of claims accepts a plan if it was accepted by creditors holding at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors that have voted to accept or reject the plan. *See* 11 U.S.C. § 1126(c). Section 1126(d) of the Bankruptcy Code provides that a class of interests accepts a plan if it was accepted by holders of at least two-thirds in amount and more than one-half in number of the allowed interests of such class held by holders of such interests that have voted to accept or reject the plan. *See* 11 U.S.C. § 1126(d).

[71] *See* Gilhuly, *supra* note 43, at 9.

[72] *See* Fisher & Buck, *supra* note 42.

[73] *See Official Committee of Unsecured Creditors of Galey & Lord, Inc. v. Barclays Bank PLC*, Adv. Pro. No. 03-92683 (Bankr. S.D.N.Y.), Docket No. 1, at 9-11.

[74] *See id.* at 5-6.

[75] *See id.* at 2-3, 12-15.

[76] *See Official Committee of Unsecured Creditors of Galey & Lord, Inc. v. Barclays Bank PLC*, Adv. Pro. No. 03-92683 (Bankr. S.D.N.Y.), Docket No. 6, at 3.

[77] *See Official Committee of Unsecured Creditors of Galey & Lord, Inc. v. Barclays Bank PLC*, Adv. Pro. No. 03-92683 (Bankr. S.D.N.Y.), Docket No. 4.

[78] *See, e.g.*, Eric B. Fisher and Katie L. Weinstein, *The Aftermath of "WAMU": A Problem Still in Search of a Solution*, ABI Law Review (22:153) (2014).

[79] *See* In re Washington Mutual, Inc., 461 B.R. 200 (Bankr. D. Del. 2011).

[80] *Id*. at 266.

[81] *See* Tiffany Kary, *Hedge Funds Seek to Trade in Comfort as Bankruptcy Insiders* Bloomberg (October 18, 2013).

[82] Order in Aid of Settlement Discussions at 2, *In re Vitro*, S.A.B. de C.V., 473 B.R. 117 (Bankr. N.D. Tex. 2012)(No. 11-33335-hdh-15).

[83] *Id*. at 4.

[84] *Id.*

[85] Order in Aid of Mediation and Settlement at 2, In re Residential Capital, LLC, 2013 WL 1618327 (2013) (No. 12-12020).

[86] *Id*. at 3.

[87] *Id*. at 2.

[88] *Id*. at 5.