Hedge Funds and Distressed Debt Investing Program
Trends in the Marketplace

In framing the discussion, Mr. Rose noted that the distressed debt market has greatly expanded in the types of products offered and the amount of investment provided. He commented that the industry is marked by the need for extensive due diligence given the importance of knowing all stakeholders’ positions. Mr. Tannor observed that, despite the decrease in bankruptcy filings, in-court reorganizations and liquidations such as the American Airlines and Lehman proceedings can both provide outsized returns to investors. He added that, other than reorganizations and liquidations, special situation opportunities such as the recent banking crisis in Cyprus present interesting but labor-intensive investment prospects. Mr. Skapof remarked that pre-arranged bankruptcies have become increasingly common.

Fundamentals in Assessing Investment Opportunities

The panel also discussed key issues in assessing investment opportunities. Mr. Tannor recognized that determining investment opportunities is case- and claim-specific, but observed that the choice of counsel and the make-up of the committee of creditors in in-court restructurings are vital considerations. He further noted that the prospect of a rights offering, which is an issue of rights that entitles participants to purchase additional equity from the company, is a critical concern. He anticipates an opportunity for plans of reorganization funded in whole or part by trade creditors, which is different from bondholder-funded plans that are typically seen in the marketplace. Mr. Sarachek remarked that investors must understand the dynamics of the players, and particularly the interests of any private-equity firm that may be funding an in-court or out-of-court restructuring. He also advised that the sophistication of the players in the distressed situation matters and highlighted the value of understanding the legal questions involved. He also emphasized the importance disclosure, recognizing that trading based on non-public information happens. Mr. Powers added that, in this regard, it is critical that anyone who receives information under a non-disclosure agreement understand their responsibilities under the federal securities laws.

Valuing Distressed Investments

Mr. Kornfeld raised the question of how to value distressed investments. Mr. Tannor commented that he performs a classic credit analysis and added that unsecured claims are multi-dimensional. They are the most dangerous part of the capital structure but offer greater rewards, according to Mr. Tannor. Mr. Sarachek noted that, when dealing with a reorganizing business that could be the target of a merger, like American Airlines, an investor must place a premium on the debtor’s equity. Mr. Sarachek also opined that the size of the investment matters. Mr. Tannor said instead that he takes a more “macro” view, and that he would be willing to invest in a minority position under the right conditions. Mr. Skapof added that, with respect to in-court proceedings, valuing an investment based on expectations of a settlement is not risky because traditionally disputes heard in bankruptcy court settle.
Participating in Rights Offerings
The panel described the unique opportunities and issues surrounding the use of rights offerings in out-of-court restructuring proceedings. Mr. Tanner highlighted the importance of engaging the debtor and other stakeholders early in the process to participate in any rights offering. Mr. Sarachek noted that rights offerings can be approved in bankruptcy even though they cut against the concept of parity among all unsecured creditors, which is a guiding principle in bankruptcy court. Mr. Hirschfield and Mr. Skapof advised that investors looking to participate should be involved in the process. Mr. Hirschfield emphasized that it is “very important” that participants in in-court proceedings object to any proposed undesirable treatment of their claims to avoid waiving their rights. Mr. Rose recognized that rights offerings are unique in bankruptcy proceedings because they move value around the capital structure in ways that can be inequitable. He noted in this regard that rights offerings do not involve new money but rather, re-order the distribution scheme otherwise in place in bankruptcy court. He further recognized the need for additional guidance from courts, particularly on the "fairness doctrine" in bankruptcy that provides that claims must be recognized in the order of their legal and contractual priority.

Current Legal Landscape on Make-Whole Premiums and the Trust Indenture Act
Mr. Hirschfield noted that the legal landscape is continuously changing. Mr. Rose discussed that the presence of a make-whole premium, which is a lump-sum payment that becomes due to the lender under a note indenture when repayment occurs before the stated maturity date, could affect returns on a distressed investment. He cautioned that traders review carefully the relevant indenture. Mr. Powers then discussed two recent judicial decisions in New York involving the Trust Indenture Act of 1939, No. 14-cv-8584, 2014 WL 7399941 (S.D.N.Y. Dec. 30, 2014) (Failla, J.) and MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entm't Corp., No. 14-cv-7091, 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015) (Scheindlin, J.), which each found that the Trust Indenture Act was potentially violated by the failure of out-of-court restructurings to provide for the make-whole premium.

Mr. Rose also discussed a recent decision, In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), which had an element of discussion on disclosure obligations under the Federal Securities Laws. In that case, the bankruptcy court found that the company’s disclosure in its offering materials — that there was a potential the company may have to in the future file for a bankruptcy — was sufficient disclosure about the risk that a make-whole premium would not under all circumstances be made. Separately, Mr. Skapof emphasized the importance of the venue for disputes in the restructuring, which he recognized could be outcome-determinative.

Mr. Rose remarked that the number of bankruptcy filings may increase as minority stakeholders test the boundaries of these decisions.

“Despite the decision in MPM Silicones, I think there still may be an argument to be made about the degree of disclosure [on make-whole premiums in a company’s offering materials]. But in this particular case, the bankruptcy court held that the generalized disclosure that there might be a bankruptcy, and once someone goes into bankruptcy they could lose everything, that was adequate.” – Marc Powers

“You really need to play devil’s advocate. You need to look at the documents really critically. You really need to think what arguments can creative counsel make in the case to some kind of bankruptcy judge as to why the position that you think is the case may not be the case.” – Marc Hirschfield

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