The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing

Michelle M. Harner
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Cover Page Footnote
Assistant Professor of Law, University of Nebraska-Lincoln College of Law. I presented this Article at the Yale/Oxford Shareholder and Corporate Governance Conference in October 2007, and I benefitted from the comments of, and my discussions with, the participants in that conference and in faculty colloquia at St. John's University School of Law, University of Nebraska-Lincoln College of Law, and University of Nebraska-Lincoln College of Business Administration. I also appreciate the very helpful comments from Steve Bradford, Colleen Medill, Christopher Mirick, Juliet Moringiello, Susan Poser, Nancy Rapoport, and Sandy Shandro; the assistance of various restructuring professionals in the United States and the United Kingdom; and the assistance of my very talented research assistants, William Barager and Heather Quitmeyer. Nevertheless, all opinions, errors, and omissions in this Article are my own. Finally, I thank the Millstein Center for Corporate Governance and Performance at Yale University and the University of Nebraska-Lincoln College of Law for financial support.

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ARTICLES

THE CORPORATE GOVERNANCE AND PUBLIC POLICY IMPLICATIONS OF ACTIVIST DISTRESSED DEBT INVESTING

Michelle M. Harner*

Activist institutional investors traditionally have invested in a company's equity to try to influence change at the company. Some of these investors, however, are now purchasing a company's debt for this same purpose. They may seek to change a company's management and board personnel, operational strategies, asset holdings, or capital structure.

The Chapter 11 bankruptcy cases of Allied Holdings, Inc. and its affiliates exemplify the strategies of activist distressed debt investors. In the Allied cases, Yucaipa Companies, a distressed debt investor, purchased approximately 66% of Allied's outstanding general unsecured bond debt. Yucaipa used this debt position to exert significant influence over Allied's Chapter 11 cases and business operations, including its labor contract with the Teamsters. Yucaipa emerged as Allied's majority shareholder under Allied's confirmed plan of reorganization.

Allied is not an isolated example. In 2006, distressed debt investors raised a record $19 billion in investment funds. The research shows that some investors are using these investment funds for activist purposes. Indeed, activist distressed debt investing is on the rise in both the United States and the United Kingdom. This activism is changing the dynamics of corporate restructurings and presenting new challenges for corporate management and public policy makers.

* Assistant Professor of Law, University of Nebraska-Lincoln College of Law. I presented this Article at the Yale/Oxford Shareholder and Corporate Governance Conference in October 2007, and I benefited from the comments of, and my discussions with, the participants in that conference and in faculty colloquia at St. John's University School of Law, University of Nebraska-Lincoln College of Law, and University of Nebraska-Lincoln College of Business Administration. I also appreciate the very helpful comments from Steve Bradford, Colleen Medill, Christopher Mirick, Juliet Moringiello, Susan Poser, Nancy Rapoport, and Sandy Shandro; the assistance of various restructuring professionals in the United States and the United Kingdom; and the assistance of my very talented research assistants, William Barager and Heather Quitmeyer. Nevertheless, all opinions, errors, and omissions in this Article are my own. Finally, I thank the Millstein Center for Corporate Governance and Performance at Yale University and the University of Nebraska-Lincoln College of Law for financial support.
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INTRODUCTION

Can an unsecured creditor influence the general corporate affairs of its 
debtor company? Yes. Consider the Chapter 11 cases of Allied Holdings, 
Inc. and certain of its affiliates. Allied is the largest vehicle transporter in 
North America.1 In July 2005, Allied filed a bankruptcy case under 
Chapter 11 of the U.S. Bankruptcy Code.2 Its primary debt obligations at the 
time consisted of approximately $180 million in secured bank financing, 
$150 million in unsecured notes, and $47 million in other unsecured 
debt.3 In May 2006, two funds owned by the Yucaipa Companies purchased $98.8 
million of Allied’s unsecured notes. Yucaipa emerged as the single largest 
holder of Allied’s prebankruptcy debt.4

Yucaipa then used its debt position to control the direction and the 
outcome of Allied’s restructuring efforts. Yucaipa negotiated directly with 
the company and the company’s unsecured creditors’ committee regarding 
the company’s business and financial restructuring plan.5 It also negotiated 
directly with the company’s labor union to obtain necessary concessions on 
the company’s labor contract.6 When the dust settled, Allied emerged from

1. Disclosure Statement for Joint Plan of Reorganization of Allied Holdings, Inc. and 
   Affiliated Debtors Proposed by the Debtors, Yucaipa and the Teamsters National 
   Automobile Transportation Industry Negotiating Committee at 14–15, In re Allied Holdings, 
   Disclosure Statement].
3. Allied Disclosure Statement, supra note 1, at 5, 7–9, 19–20, 40 (showing total of 
   $196.6 million in general unsecured claims, which includes $150 million in unsecured 
   notes).
4. Id. at 20–21.
5. Id. at 3–4.
6. Id. at 34–35, 45; see also John R. Emshwiller, Controversy, by the Truckload, WALL 
   ST. J., May 2, 2007, at A4 (explaining that Allied first “allowed Yucaipa to assist the
bankruptcy with approximately $200 million less debt, a new secured financing facility, a modified labor contract, and a new controlling shareholder—Yucaipa.7

The primary lesson of Allied is simple: institutional investor activism no longer is confined to a company’s shareholders. An investor now has an alternative, and additional, avenue for activism—distressed debt. An investor can purchase the debt of a financially troubled company and then try to influence corporate matters by exercising or threatening to exercise its contractual and statutory rights as a debtholder. This Article refers to this type of activity by an investor as “activist distressed debt investing.”

Activist distressed debt investing is changing the dynamics of corporate restructurings.8 Large creditors, rather than the debtor’s management, are now making key decisions in the debtor’s restructuring process. These decisions may or may not benefit the debtor and its other stakeholders.

This development is particularly notable in the United States, where financially troubled companies historically have had the upper hand in restructuring negotiations with debt and equity holders. The U.S. bankruptcy laws generally are viewed as prodebtor, allowing the management of a debtor company to stay in control of the company throughout the restructuring process, absent extraordinary circumstances.9 In fact, U.S. bankruptcy was once viewed by company management as a defensive measure to hostile takeover bids.10 But the tides may be changing.


9. See, e.g., DAVID A. SKEEL, JR., DEBT’S DOMINION 212-32 (2001) (discussing prodebtor aspects of Chapter 11 in an historical context); id. at 216 (noting that Chapter 11 of the Bankruptcy Code adopted “an explicitly manager-friendly approach to corporate reorganization”); J. Bradley Johnston, The Bankruptcy Bargain, 65 AM. BANKR. L.J. 213, 293–301 (1991) (explaining management control in Chapter 11 process and observing that “[m]anagement’s postpetition control of a debtor’s operations is complemented by specific, individual Code provisions which give management substantial control over the reorganization process itself”); Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. PA. L. REV. 669, 688–94 (1993) (explaining historical grounds for management control in Chapter 11 context); see also George W. Kuney, Hijacking Chapter 11, 21 EMORY BANKR. DEV. J. 19, 21–23 (2004) (explaining that “[s]ince [the Bankruptcy Code’s enactment,] it has been portrayed as a debtor-friendly statute featuring a fresh start for debtors and the prospect of reorganization for businesses” and positing that such portrayal may be erroneous (footnote omitted)).

Creditors are now asserting more control in the restructuring process. This shift in control plays into the hands of activist institutional investors in the distressed debt market. It also appears to align the U.S. restructuring process more closely with the traditionally more creditor-friendly process of the United Kingdom. These changes come at a time when other countries are working to revamp their corporate bankruptcy laws to reflect a traditional U.S.-style restructuring—that is, a debtor-controlled process.

Notably, Allied is not an isolated example. The number of reported instances of distressed debtholders seeking to influence change at, or acquire, the issuer company has increased over the past ten years in both the United States and the United Kingdom. High profile U.S. cases include FiberMark Inc., Kmart Corporation, Loews Cineplex Entertainment Corp., Maidenform Brands, Inc., McLeodUSA Inc., National Equipment Services, Inc., New World Pasta Company, Rand McNally & Co., Regal Entertainment Group, and XO Communications, Inc. In the United

Rosenzweig, The Untenable Case for Chapter 11, 101 YALE L.J. 1043, 1050 (1992)); David A. Skeel, Jr., Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11, 152 U. PA. L. REV. 917, 918 (2003) ("Chapter 11 no longer functions like an anti-takeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with asset sales and faster cases.").

11. See, e.g., Baird & Rasmussen, supra note 10, at 1237–42 (explaining increased creditor control exercised through financing contracts); Skeel, supra note 10, at 923–27 (same).

12. See, e.g., Nathalie Martin, Common-Law Bankruptcy Systems: Similarities and Differences, 11 AM. BANKR. INST. L. REV. 367, 392–97 (2003) ("Although major strides have been made toward allowing a business to rehabilitate, the new [U.K.] laws attempt to achieve these goals through proceedings that are entirely creditor driven."); Karin S. Thorburn, Corporate Governance Practices in Europe: Antidote to Enron?, 27 VT. L. REV. 887, 891 (2003) ("Creditors, and in particular secured lenders, are comparatively well protected in the United Kingdom. The U.K. insolvency procedures are strictly creditor-oriented."); see also Andy Scruton & Lee Smith, Introduction to the United Kingdom's Enterprise Act 2002, AM. BANKR. INST. J., July–Aug. 2004, at 36, 36 ("The United Kingdom has historically been perceived as a creditor-friendly jurisdiction, particularly with respect to secured creditors.").


Kingdom, the list includes Cordiant Communications Group, Damovo Group, Drax Group, Energis Communications Ltd., Gate Gourmet Group, Jarvis plc, Marconi plc, MyTravel Group plc, Polestar Group, Schefenacker plc, and Telewest Communications plc. Institutional investors increasingly are looking to the distressed debt market not only to make a quick profit, but also to create value by proactively influencing corporate governance. They may seek to change a company’s management and board personnel, operational strategies, asset holdings, or capital structure.

Yet the use of distressed debt holdings to monitor and influence corporate governance has received little attention in legal scholarship regarding institutional investor activism. This Article seeks to fill this

case); Terry Brennan, JLL Partners Keeps New World Pasta, DAILY DEAL, Nov. 18, 2005 (on file with the Fordham Law Review) (New World Pasta case); Lisa Gewirtz, Equipment Rental Firms a Hot Item, DAILY DEAL, Mar. 24, 2006 (on file with the Fordham Law Review) (National Equipment Services case); Kmart Exits Chapter 11, Names New Chairman, CHI. TRIB., May 7, 2003, at 5 (Kmart case); Peter Lauria & Kelly Holman, Patience Pays for Onex, DAILY DEAL, June 21, 2004 (on file with the Fordham Law Review) (Loews case); Judy McDermott, BNP Paribas Slips into Maidenform Financing, BANK LOAN REP., Apr. 5, 2004, at 3 (Maidenform case); John E. Morris, LPs Go Down-Market, DAILY DEAL, Apr. 26, 2004 (on file with the Fordham Law Review) (Regal Entertainment Group case); Chris Nolter, McLeodUSA to Seek Lenders' OK, DAILY DEAL, Oct. 19, 2005 (on file with the Fordham Law Review) (McLeod case); Prepacks Offer Creditors Unusual Opportunity for 100% Recovery, MANAGING CREDIT RECEIVABLES & COLLECTIONS, Mar. 2003, at 1 (Rand McNally case).


16. See infra Part III.B.

void. It uses a combination of empirical data and selected case studies to provide support for its conclusions.\textsuperscript{18}

The data suggest two key findings. First, some institutional investors are strategically using distressed debt investments to influence corporate governance and, in some instances, acquire the company.\textsuperscript{19} Second, activist distressed debt investing is causing a slow, but noticeable, convergence of the U.S. and the U.K. corporate restructuring processes.\textsuperscript{20} Specifically, in both countries, distressed debt investors are increasingly taking charge of the restructuring process and placing the management of the troubled company in a secondary or supporting role. For this reason, this Article characterizes the prevailing restructuring process as a "management-neutral" process, which differs from a "management-driven" (historically associated with U.S. bankruptcy laws) or "management-displacing" (historically associated with U.K. bankruptcy laws) process.\textsuperscript{21}

The increasing influence of activist distressed debt investors and the development of a management-neutral restructuring process raise a new set of policy issues for U.S. and U.K. policy makers to consider. Distressed debt investors may provide much needed financing and, in some cases, operational guidance to troubled companies. Their investment goals, however, may or may not align with the goals of the company, the company's other stakeholders, and the underlying bankruptcy regime. Consequently, the appropriate role of distressed debt investors in the corporate restructuring process requires thoughtful consideration and discussion. This Article provides research and analysis of the relevant issues to further and enhance that discussion.

Part I provides basic background information on the distressed debt market. It then introduce the practice of activist distressed debt investing through the four case studies described in Part II. Each case study is based

\begin{itemize}
\item \textsuperscript{18} For a detailed discussion of the survey and its results, see Hamer, supra note 8, pts. III, IV. The case studies are set forth in Part II infra.
\item \textsuperscript{19} See infra Part III.B.
\item \textsuperscript{20} See infra Part III.C. This Article uses the phrase "restructuring process," as opposed to "restructuring law" or "restructuring culture," because, as discussed below, differences continue to exist between U.S. and U.K. corporate bankruptcy laws and cultures. See infra Part III.C.5.
\end{itemize}
on a high-profile corporate restructuring in either the United States or the
United Kingdom that involved institutional investors as distressed
debtholders. The companies studied are Allied Holdings, Inc.,
Schefenacker plc, Jarvis plc, and Kmart Corporation.

Part III analyzes the details of the four case studies in light of U.S. and
U.K. restructuring processes, laws, and cultures. It first compares and
contrasts the opportunities for activist distressed debt investing under U.S.
and U.K. corporate restructuring laws. It then analyzes the primary
objectives and strategies of activist investors in U.S. and U.K.
restructurings. This analysis leads to a discussion of U.S. and U.K.
restructuring processes. The Article concludes in Part IV with some
general observations and comments on activist distressed debt investing and
management neutrality in the restructuring process.

I. OVERVIEW OF THE DISTRESSED DEBT MARKET

The distressed debt market emerged as a popular investment strategy for
institutional investors in the late 1980s and early 1990s. The market
attracted additional investors in the early 2000s. The telecom bust and
corporate scandals of the time presented enticing investment opportunities
for high-risk players.

Since then, the market has continued to grow. In 2006, distressed debt
investors raised a record $19 billion in investment funds. Fundraising in
2007 is projected to break this record. Distressed debt investors can raise
this level of funding because, among other things, their funds generally perform as well as, or better than, more traditional markets. The trend of increased activity and interest in the distressed debt market shows no signs of retreat, particularly with predictions of the inevitable economic downturn in the business cycle. In fact, well-known institutional investors such as Kohlberg Kravis Roberts, HSBC, and Carlyle have established distressed debt funds to take advantage of this trend.


27. See, e.g., Moore, supra note 24 (“The drumbeat of disaster around the credit markets has been growing louder and more insistent.”); see also Kabir Chibber & John Glover, Looming Crash Prompts Jump in Distressed Debt Hiring, BLOOMBERG, May 30, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=as41gwxvySmQ&refer=home (“Restructuring groups are growing faster in Europe than in the U.S. as companies in the U.K., France and Germany pile on record amounts of debt, according to Standard & Poor’s.”); Helen Fowler, Wind of Change for Distressed Debt, FIN. NEWS ONLINE, Mar. 1, 2007, http://www.efinancialnews.com/usedition/index/content/1047285255 (“Private equity firms, hedge funds, traditional long-only equity managers and fixed income managers are moving into distressed debt in preparation for a potential credit market downturn.”). Interestingly, investors’ interest levels have remained high despite a slower distressed market. For example, in the United States, distressed bonds were reported at 4.4% of all non-investment grade bonds in April 2006, down from averages of 6.2% in 2005 and 7% in 2004. See Liz Moyer, Dunking Distressed Debt, FORBES.COM, May 2, 2006, http://www.forbes.com/funds/2006/05/01/distressed-debt-hedge-funds-cx_lm_0502debt.html; STANDARD & POOR’S, U.S. DISTRESSED DEBT MONTHLY MONITOR: GLOBAL FIXED INCOME RESEARCH (Apr. 2006), available at http://www2.standardandpoors.com/spf/pdf/fixeed income/DistressReport_April2006.pdf. Nevertheless, observers predict that “the size of the defaulted and distressed markets will increase considerably in the next two years as both new defaults and an increasing distress ratio add to the supply of distressed debt.” ALTMAN & SWANSON, supra note 26, at 3. In addition, distressed debt investors are “poised to buy distressed commercial real-estate assets from ailing institutions” and become more active participants in that particular distressed space. Lingling Wei & Peter Grant, Some Vulture Funds Set to Buy, WALL ST. J., Sept. 29, 2008, at A10.

1. Types of Distressed Debt

The phrase "distressed debt" is subject to multiple, often imprecise definitions. Some investors define distressed debt narrowly as the indebtedness of a company that has commenced or is expected to commence a bankruptcy or insolvency proceeding. Other investors define the phrase more broadly as indebtedness with a yield to maturity of 1000 basis points over the riskless rate of return. The phrase essentially is used to describe the debt of a financially troubled company that carries a high risk of default or nonpayment and, in turn, a potentially high rate of return.

Public bonds issued by a company that has been downgraded by a ratings agency to non-investment grade or "junk" status are a prime example of distressed debt. Public bonds, however, are not the only type of distressed debt that trades. Banks are increasingly syndicating commercial loans or selling their loans once a company experiences financial distress. This


30. See, e.g., LHABITANT, supra note 22, at 99; Hedge Fund Consistency Index, Distressed Securities, http://www.hedgefund-index.com/SectorDefinitions.asp#Distressed Securities; see also ALTMAN, supra note 23, at 4 (using this narrow definition to reference only "defaulted" debt).

31. See, e.g., LHABITANT, supra note 22, at 99; Libby Bruch, Standard & Poor's U.S. Distressed Debt Monthly Monitor: Distressed Debt No Threat for Now, INVESTING IN BONDS, available at http://www.investinginbonds.com/news.asp?catid=36&id=1387; see also ALTMAN, supra note 23, at 4 (using this broader definition to reference all "distressed" debt); Marykay Fuller, The Distressed Debt Market—a Major Force That’s Here to Stay, RECOVERY, Spring 2006, at 15, 15, available at http://www.r3.org.uk/uploads/documents/spring2006.pdf ("Historically, ‘distress’ has been defined as debt trading between 80 per cent and 90 per cent of par value but the European market with its excess liquidity recently has seen ‘distressed’ debt trading between 90 per cent and 95 per cent of par.").


33. See, e.g., LHABITANT, supra note 22, at 100 (explaining that a distressed debt investor may purchase "bank debt, corporate debt, trade claims, lease contracts, private placements, common or preferred stock and/or warrants").

practice is a definitive change for banks, which historically maintained large in-house workout departments to take charge of troubled credits and work with troubled companies to maximize the bank’s return.35

In addition to bonds and bank loans, the trade debt of troubled U.S. companies also trades frequently, particularly once the company files for bankruptcy.36 Trade debt includes claims against a troubled company held by the company’s suppliers and vendors. These parties generally are anxious to liquidate their claims and avoid involvement in the bankruptcy process.37 This practice is common in the United States because U.S. bankruptcy law permits such claims trading, and the claims represented by the trade debt carry a vote on, and potential recovery under, the debtor’s reorganization plan.38

Some distressed debt investors also loan money directly to troubled companies.39 These loans carry a high interest rate to compensate the


35. See, e.g., Mark Thompson, Recent Developments Involving Distressed Bank Debt, in XVII BANKING AND COMMERCIAL LENDING LAW, ALI-ABA RESOURCE MATERIALS 427, 429, 454 (1996); Krassoff & O’Neill, supra note 22 (noting trend among regulated banks to sell distressed loans quickly); see also John Houghton, A Fresh Approach, LEGAL WK., Sept. 28, 2006, at 28, 28 (noting similar trend in U.K.); Roundtable: The Restructuring Elite Await Their Next Boom, BANK LOAN REP., Apr. 2, 2007, at 14, 14 (“Most of the banks have flushed their workout departments as they have increased their syndication departments and they have, as a matter of conscious risk management, reduced their exposure to the credits they are syndicating.” (interview with Jim Millstein, Lazard Freres & Co.)).


37. See, e.g., Tung, supra note 36, at 1702 (explaining that suppliers often prefer cash rather than a debtor’s securities, which might be distributed under a plan); see also Marcia Pledger, Shopping for Ideas: Homeplace Looking for Ways to Improve, PLAIN DEALER (Cleveland), Jan. 17, 1999, at 1-H (“Generally, vendors sell their claims at a substantial discount because they prefer to get some cash quickly instead of being involved in bankruptcy proceedings.”).

38. Rule 3001(e) of the Federal Rules of Bankruptcy Procedure specifically contemplates and governs claims trading in U.S. bankruptcy cases. FED. R. BANKR. P. 3001(e).

39. See ALTMAN, supra note 23, at 11 (noting trend of distressed companies turning to nontraditional lending sources, which now offer rescue financing); see also Kit R. Roane, Hedging Their Debts, U.S. NEWS & WORLD REP., Apr. 10, 2006, at 38, 38–39 (“Some hedge fund companies, like Ritchie Capital Management, have formed new divisions that focus only on direct lending.”).
investors for the higher risk of default. They also include tight financial and operational covenants and acceleration provisions that give the investor significant control over the company upon a default. Lenders issuing these types of distressed loans often are said to be "loaning to own." This phrase refers both to the lender’s ability to take over the company, or at least its assets upon a default, and the tight financial covenants associated with the loan, which may help facilitate a default.

2. Types of Distressed Debt Investors

Investors in distressed debt typically are institutional investors. This Article uses the phrase "institutional investor" to mean hedge funds, private equity firms, and banks that have established proprietary trading desks. Pension funds and mutual funds qualify as institutional investors but, subject to a few exceptions, are not directly active in the distressed debt market. Similarly, insurance and leasing companies may invest directly

40. See Altman, supra note 23, at 11 ("These loans are being made at 350–450 bp over LIBOR in 2006 and in order to hit the funds’ target rates of return, leverage of two to three times the investment is commonly utilized."); see also The Vultures Take Wing, supra note 28, at 78 (noting that, in one “loan-to-own” situation, “[t]he hedge fund charged a credit-card-like rate of interest . . . [and] secured the right for ten years to buy over 3 m[illion company] shares for $10 each”).

41. This phrase also is used to describe the practice of buying distressed debt to acquire ownership of the company, as discussed further, infra in Part III.B. See Krasoff & O’Neill, supra note 22, at 19.

42. See, e.g., Altman, supra note 23, at 4 (noting that nonbank institutions now provide “more than three-quarters of the funds” for highly leveraged syndicated loans); William May et al., Fitch Ratings, Loan Issuance Boom Shifts Refinancing Risk Strongly to Loan Market 5 (2007), available at http://www.fitchratings.com/dtp/pdf3-07/iloa0726.pdf (noting that nonbank institutions held over 70% of the leveraged loan market in the first quarter of 2007); see also The Vultures Take Wing, supra note 28, at 77 ("According to Standard & Poor’s . . . , non-banks such as hedge funds now make roughly half of all high-yielding leveraged loans and hold the lion’s share of the secondary market."). Certain high-profile individuals, such as Carl Icahn and Wilbur Ross, have established their own firms to facilitate distressed debt investments. See Phyllis Berman & Lea Goldman, Let Us Prey, Forbes, Apr. 2, 2001, at 138.

43. Pension funds and certain other institutional investors often are prohibited under their charters or applicable regulations from holding below investment grade securities. Mutual funds, on the other hand, typically can, but choose not to, invest in distressed debt. See, e.g., Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 UCLA L. Rev. 561, 580 (2006) ("Hedge funds, like mutual funds, hold pools of assets. Unlike mutual funds, they engage in a wide variety of investment strategies, including investing in distressed securities, illiquid securities, securities of companies in emerging markets, derivatives, and arbitrage opportunities."). Nevertheless, some mutual funds do hold small distressed investments. See Berman & Goldman, supra note 42, at 140 ("A few [mutual funds], like Third Avenue Value and Fidelity Capital & Income, have been known to dabble in defaulted bonds, but only have tiny portions of their portfolios there."); see also Rich Pickings, Fund Strategy, Apr. 3, 2006, at 20, 24 (noting existence of some mutual funds engaged in distressed debt investing, including in the United Kingdom). In addition, pension funds may invest indirectly in the distressed market through hedge funds or other distressed debt funds. See, e.g., Edward I. Altman & Shubin Jha, NYU Salomon Ctr., Market Size and Investment Performance of Defaulted Bonds and Bank Loans: 1987–2002, at 11 (2003), available at http://pages.stern.nyu.edu/~ealtman/MIP-87-02.pdf ("Several domestic
or indirectly in the distressed debt market. Their activity in that market, however, is nominal compared to that of hedge funds, private equity firms, and banks. Hedge funds appear to be the most active group in the distressed debt market, generating approximately “47% of annual [trading] volume in distressed debt and about one-third of the trading volume in leveraged loans and one-quarter [in] high-yield bonds” from 2005–2006.

B. General Strategies of Distressed Debt Investors

Investors purchase distressed debt at a discount off of its face value, reflecting the risk associated with the investment. Investors generally realize gain on distressed debt investments when the debt issuer achieves, or the market anticipates, a successful turnaround. For example, an investor who purchases a company’s distressed debt for 50% of par makes a 100% profit on the investment if the company ultimately repays the debt in full.
Not all distressed debt investors seek to realize gain by holding the debt until maturity or redemption. Different investors use different strategies to realize their target rate of return on distressed debt.\(^4\) A typical distressed debt investment strategy is selling the debt for a profit shortly after its purchase, but before maturity or redemption.\(^4\) Investors invoking this practice are akin to traders, flipping the debt quickly to realize gain resulting from small movements in the market.\(^5\) These investors typically have short-term investment horizons (less than one year).\(^5\)

Investors with long-term investment horizons (more than one year) generally seek to realize gain through one of two key strategies.\(^5\) First, investors may purchase distressed debt and hold the debt until payment at maturity or redemption.\(^5\) Second, an investor may purchase distressed debt to try to acquire equity in the company through a debt-for-equity exchange as part of the company’s financial restructuring.\(^5\) The investor then realizes gain on the investment by liquidating its equity position at a later date.

Investors with long-term investment horizons also may invest in a company’s distressed debt to acquire control of the company.\(^5\) This

\(^4\) Distressed debt investors also may invest in both the debt and equity of the distressed company. “Distressed arbitrage” is a form of combination investing that “involves purchasing publicly traded bonds of bankrupt companies and selling their common stock short.” Donna Klinger, Here Be Dragons, NACUBO BUS. OFFICER, Apr. 2002, at 33, 33. For a general description of hedge fund investment strategies, see generally HEDGE FUNDS: INVESTMENT AND PORTFOLIO STRATEGIES FOR THE INSTITUTIONAL INVESTOR, supra note 43.


\(^5\) See, e.g., ROSENBERG, supra note 22, at 29 (“[These investors], also known as speculators and traders, are the traditional type of vultures who dart in and out of securities looking for a good trade.”).

\(^5\) See ALTMAN & SWANSON, supra note 26, at 25 app. D (describing “[h]olding period of 6 months to [one] year”).

\(^5\) See, e.g., id.; LHABITANT, supra note 22, at 100; ROSENBERG, supra note 22, at 29–33.

\(^5\) See ALTMAN & SWANSON, supra note 26, at 25 app. D (referring to these types of investors generally as “Active/Non-Control” and noting that they typically hold debt for one to two years); LHABITANT, supra note 22, at 100–01; ROSENBERG, supra note 22, at 29–33.

\(^5\) See ROSENBERG, supra note 22, at 29–33; see also DEBTWIRE, NORTH AMERICAN DISTRESSED DEBT MARKET OUTLOOK 2008, at 16 (2008) (on file with the Fordham Law Review) [hereinafter DISTRESSED DEBT MARKET OUTLOOK 2008] (reporting that, “[w]hile hedge funds expressed the least interest in loan-to-own, they were the most comfortable with swapping debt for minority equity stake”); DEBTWIRE, NORTH AMERICAN DISTRESSED DEBT MARKET OUTLOOK 2007, at 20 (2007) (on file with the Fordham Law Review) [hereinafter DISTRESSED DEBT MARKET OUTLOOK 2007] (reporting that over 40% of survey respondents indicated that they do not “seek equity control via a ‘loan to own’ strategy,” but “are interested in acquiring non-control positions via debt-for-equity swaps”).

\(^5\) See ALTMAN & SWANSON, supra note 26, at 25 app. D (referring to these types of investors generally as “Active/Control” and noting that they typically exit the investment after two to three years); LHABITANT, supra note 22, at 100; ROSENBERG, supra note 22, at
Article uses the term "control" in this context to mean the ability to influence board or management decisions at the company as either a debtholder or a shareholder after a debt-for-equity exchange. The object of this control typically is to enhance or create value at the company. It is this new or additional value that allows the investor to realize a meaningful gain on its investment.

Historically, value-creation investing was pursued primarily by private equity firms. Hedge and other distressed funds, however, are now invoking this strategy. These investors seek to purchase a controlling position in the company's distressed debt (typically 34%)—either alone or with other like-minded investors—and then to use this control to help the company turn around its financial situation. Whether this strategy actually adds long term sustaining value to the company, or is otherwise in the company's best interests, is subject to considerable debate. Part III addresses this debate.

Regardless of strategy, distressed debt investors must understand the bankruptcy laws applicable to the debt issuer. Even if the investor has a short term investment horizon or the company is attempting an out-of-court

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29 ("As restructuring proceeds, [the debtholders] negotiate a plan of reorganization that casts them in a leading role. These vultures then run the company themselves or bring in experienced management."); Granger, supra note 49, at 20 (explaining strategy of "controll[ing] the debt and ultimately tak[ing] the equity upside in a business, through either a consensual or non-consensual route").

56. In addition, investors may hold and try to use a company's debt and equity to influence affairs prior to any restructuring or exchange. For example, distressed debt investor Third Point LLC held both the equity and debt of Salton, Inc. When Third Point was unable to influence corporate affairs to its satisfaction as an equity holder, it warned the company that it would seek to do so as a debtholder. Salton Inc., Amended Statement of Beneficial Ownership (Sched. 13D/A), exhibit 1 (Apr. 27, 2005) (explaining, in a letter from Third Point to Salton's CEO, that "[i]n the likely event that an out of court restructuring is not reached, I look forward to personally dedicating my considerable energy to serving on the creditors committee and seeking your ouster at that time").

57. See, e.g., LHABITANT, supra note 22, at 100 (explaining strategy of activist investor to realize value); ROSENBERG, supra note 22, at 29 (explaining that these investors "throw their fate in with a company for the long term, staying with it after it has climbed out of the depths"); see also William W. Bratton, Hedge Funds and Governance Targets, 95 GEO. L.J. 1375, 1418-20 (2007) (providing empirical evidence on hedge fund shareholder activism and noting that "[h]edge fund activism, by its own terms, is about shareholder value creation").

58. See, e.g., Igino Beverini & Bruno Cova, How Hedge Funds Are Changing Distressed Debt, INT'L FIN. L. REV., June 2006, at 12 (explaining convergence in activities between hedge funds and private equity funds); Matthew Judd, Hedge Funds and Private Equity Converge, INT'L FIN. L. REV., Jan. 2006 supp., at 14 (explaining that "[s]ome have described hedge funds as value finders and private equity funds as value creators" and exploring the trend of hedge funds doing both); see also Gemma Westacott, Private Equity Funds Bristle as Hedge Funds Muscle In, LAWYER (U.K.), Feb. 13, 2006, at 13, 13; Duncan Kerr, Private Equity and Hedge Funds Slug It Out, FIN. NEWS ONLINE, Feb. 26, 2007, http://www.efinancialnews.com/usedition/index/content/1047285236.

59. See, e.g., ALTMAN & SWANSON, supra note 26, at 25 app. D (noting that "Active/Control" investors generally need to acquire at least one-third of the target company's distressed debt).

60. See infra Part III.B.3.
restructuring, bankruptcy law sets the stage for the restructuring negotiations and drives how the market values the distressed debt. The case studies in Part II highlight the importance of a given country’s bankruptcy laws. Part III then provides an overview of U.S. and U.K. bankruptcy laws and explores opportunities for investor control under those laws.

II. CASE STUDIES OF ACTIVIST DISTRESSED DEBT INVESTING

The foregoing explanation tells just part of the story. Only the actual practices of distressed debt investors and examples of activist distressed debt investing can complete the picture. This Article references a survey administered to potential distressed debt investors to flesh out these investors’ practices and objectives. The results of this survey are fully detailed in a separate article and used throughout the analysis in Part III. This Article also relies on the reported results of troubled company restructurings in the United States and the United Kingdom.

The level of reported debtholder activism tracks the level of activity in the distressed debt market. Consequently, few examples of activist distressed debt investing exist before the late 1980s. Since that time, deal activity peaked in the early 1990s, and then again in the early 2000s. The four case studies below represent examples of activist distressed debt investing in both the United States and the United Kingdom.

A. Allied Holdings, Inc.

The restructuring of Allied Holdings, Inc. is a prime example of how institutional investors are using distressed debt and the Chapter 11 process to influence the affairs of troubled companies. Yucaipa purchased approximately 66% of Allied’s unsecured notes, which essentially gave Yucaipa control of Allied’s plan of reorganization process. Yucaipa used this control not only to facilitate a debt-for-equity exchange in which it acquired a majority of Allied’s new common stock, but also to negotiate a new secured financing agreement and modified labor contract for Allied.

61. See infra Part II.
62. See infra Part III.
63. See generally Harner, supra note 8.
64. See supra Part I.A.
65. See ROSENBERG, supra note 22, at 7–24.
66. See id.
67. Allied Disclosure Statement, supra note 1, at 20–21 (stating that Yucaipa holds $98.8 million of the $150 million in outstanding unsecured notes). Thus, Yucaipa held approximately 50% of all of Allied’s unsecured debt. See id. at 7, 20–21, 40 (estimating $196.9 million in total general unsecured claims and explaining that the stock of reorganized Allied would be distributed on a pro rata basis to the holders of allowed general unsecured claims).
Allied also is noteworthy because it demonstrates the strategic value of distressed debt investments. Allied basically was a repeat play for Yucaipa, which also acquired the second largest vehicle transporter—Performance Transportation Services, Inc.—out of bankruptcy in January of 2007. These two transactions gave Yucaipa control of over 50% of the U.S. vehicle transportation market.

The story of Allied's financial troubles is fairly typical. Allied began experiencing liquidity problems with a decline in the new car market, rising fuel costs, and increased labor expenses. It tried to address its liquidity issues by streamlining operations and implementing workforce reductions. These changes, however, simply were not enough. Allied needed to restructure its balance sheet and renegotiate its labor contract. Allied turned to Chapter 11.

In its Chapter 11 case, Allied secured debtor-in-possession financing and tried to reach a new agreement with its union, the International Brotherhood of Teamsters. Allied's negotiations with the Teamsters stalled, and it filed a motion with the bankruptcy court to implement emergency modifications to its labor contract. The bankruptcy court granted this emergency motion in May 2006, and the Teamsters began considering responsive options, including a strike. This stalemate between Allied and the Teamsters proved to be a golden opportunity for Yucaipa.

Yucaipa purchased $98.8 million of Allied's unsecured notes approximately one year after Allied's Chapter 11 filing and shortly after tensions between Allied and the Teamsters peaked. Yucaipa first worked with Allied and the Teamsters to try to reach a consensual deal. When Allied made the decision to seek bankruptcy court approval to terminate its labor contract, Yucaipa pursued a different path. Yucaipa entered into direct negotiations with the Teamsters, reaching an agreement that included


70. See Emshwiller, supra note 6 ("Allied and Performance together account for an estimated 50% of the new vehicles hauled by truck in the U.S."); Thomas L. Gallagher, Yucaipa to Acquire Allied, TRAFFIC WORLD, Mar. 5, 2007, available at 2007 WLNR 4237546 (noting that, after the Allied acquisition, Yucaipa "would control more than 60% of the U.S. new-car hauling market"); Allied Holdings to Be Taken over by Yucaipa Cos., TRANSPORT TOPICS ONLINE, Mar. 5, 2007, http://www.ttnews.com/articles/basetemplate.aspx?storyid=17090 (noting that Yucaipa "would control 60% to 70% of the U.S. new-car hauling market").


72. Id.

73. Id. at 34–35.


75. Allied Disclosure Statement, supra note 1, at 21.

76. Id. at 34–35; see also Emshwiller, supra note 6 (explaining that Allied first "allowed Yucaipa to assist the company in talks seeking contract concessions from the Teamsters" and then "Yucaipa began negotiating with the Teamsters on its own").
a 15% wage cut.\textsuperscript{77} Yucaipa and the Teamsters then made a joint proposal to Allied regarding a proposed plan of reorganization.\textsuperscript{78}

Yucaipa’s and Allied’s divergence in approach with respect to the Teamsters did not go unnoticed. In fact, some shareholders asserted that Yucaipa and the Teamsters conspired to reach a deal adverse to the company and its shareholders. Hawk Opportunity Fund, L.P. and IRA FBO Mark F. Zimmer filed a federal class action lawsuit against Yucaipa and others under the Racketeer Influenced and Corrupt Organizations Act.\textsuperscript{79} The Rutland family, which founded Allied and continued as officers and shareholders of the company, made similar allegations in their objection to the joint plan of reorganization ultimately proposed by Allied, Yucaipa, and the Teamsters.\textsuperscript{80} The bankruptcy court overruled the Rutland family’s objection to Allied’s plan.\textsuperscript{81} The federal lawsuit mentioned above was dismissed without prejudice by the plaintiff shareholders.\textsuperscript{82}

Despite some resistance by shareholders and even the company itself, Yucaipa now holds a majority ownership interest in the reorganized Allied Systems Holding, Inc.\textsuperscript{83} Allied’s plan of reorganization was sponsored by Allied, Yucaipa, and the Teamsters and supported by Allied’s unsecured creditors’ committee. Yucaipa’s influence over the plan’s ultimate terms, however, is undeniable. The plan provided for an exchange of Allied’s unsecured debt for equity in the reorganized company and gives Yucaipa substantial control rights over the company’s affairs. For example, Yucaipa can appoint four of the company’s five board members, including the company’s CEO, and has the discretion to direct a sale of the company’s Canadian assets.\textsuperscript{84} Yucaipa also was instrumental in securing $315 million in postbankruptcy financing for Allied.\textsuperscript{85}

\textsuperscript{77} Allied Disclosure Statement, \textit{supra} note 1, at 34–35; \textit{see also} Emshwiller, \textit{supra} note 6 ("The International Brotherhood of Teamsters, which represents about 3,300 Allied workers in the U.S., agreed to back a 15% wage cut for those workers."); \textit{Allied Holdings to Be Taken over by Yucaipa Cos.}, \textit{supra} note 70 ("Allied . . . approved the deal in spite of a 15% wage cut.").


\textsuperscript{81} \textit{Allied}, No. 05-12515, slip op. at 23, 27, 28 (May 18, 2007) (Docket No. 3113) (confirming plan of reorganization and overruling objections to plan).

\textsuperscript{82} Notice of Dismissal Without Prejudice, \textit{Hawk}, No. 1:07-CV-0907 (May 18, 2007) (Docket No. 3).

\textsuperscript{83} Allied Sys. Holdings, Inc., Current Report (Form 8-K), item 5.01 (June 4, 2007).

\textsuperscript{84} Allied Disclosure Statement, \textit{supra} note 1, at 18, 49.

\textsuperscript{85} \textit{Id.} at 45 (noting that Yucaipa played a “key role” in obtaining exit financing); Allied Sys. Holdings, Inc., Current Report (Form 8-K), item 2.03 (May 31, 2007).
B. Schefenacker plc

Similar to Allied, Schefenacker plc began as a family-owned company in the automotive sector. It commenced business in 1935 and was headquartered in Germany. Schefenacker produces approximately one-third of the vehicle rear-view mirrors sold throughout the world.

Schefenacker’s fortunes deteriorated after acquiring the business of one of its competitors in 2000. The debt incurred to finance the acquisition weighed heavily on Schefenacker’s balance sheet. In 2004, Schefenacker tried to address its financial difficulties through a refinancing of its senior secured bank debt. Schefenacker’s German banks, apparently weary of the situation, seized the refinancing as an opportunity to sell their holdings of €250 million to foreign entities, primarily London-based hedge funds and other institutions.

The new holders of Schefenacker’s bank debt took an active role in the company’s ongoing restructuring efforts. Schefenacker implemented major corporate changes at the behest of the debtholders. Most notably, Schefenacker moved its corporate headquarters from Germany to England. The holders reportedly viewed England as a friendlier forum for Schefenacker’s restructuring efforts. Schefenacker also appointed a chief restructuring officer. Simultaneously, Schefenacker’s CEO and CFO were dismissed, and the bank debtholders retained the right to appoint a new CEO.

These corporate governance changes were part of an overall financial restructuring negotiated between the company, its bank debtholders, and its creditors.

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86. See Evans-Pritchard, supra note 15.
88. See Evans-Pritchard, supra note 15; see also Schefenacker CVA, supra note 87, at 22–25 (explaining financial issues leading to restructuring).
89. See Evans-Pritchard, supra note 15 (“German banks sold off most of their Schefenacker loans to UK hedge funds and institutions, so more than 90[%] of creditors are now based in London.”); Kevin Reed, German Business Avoids Insolvency in UK Move, ACCOUNTANCY AGE, Nov. 8, 2006, http://www.accountancyage.com/accountancyage/news/2168185/german-business-ducks (same); see also Oliver Wihofszki, Hedge Funds to Hold Majority in Schefenacker, FIN. TIMES DEUTSCHLAND, Feb. 12, 2007, available at LEXIS, Europe Intelligence Wire File (abstract) (same and noting that in the last few months Schefenacker has had two new CEOs”).
91. See Evans-Pritchard, supra note 15.
92. Schefenacker CVA, supra note 87, at 23.
93. Id. at 23, 29–30.
majority shareholder, Dr. Alfred Schefenacker.94 The company's major customers also participated in the negotiations.95 The restructuring plan contemplated a debt-for-equity exchange that provided the bank debtholders with a controlling ownership position in the company. Dr. Schefenacker retained approximately 20% of the company's equity under the plan, and approximately 5% of the equity was earmarked for the holders of Schefenacker's unsecured bonds.96 The plan also included a new financing package for the company underwritten by Deutsche Bank A.G. Both Dr. Schefenacker and the bank debtholders committed to subscribe to part of the financing package.97

Schefenacker's unsecured bond holders were on the periphery of the restructuring negotiations. At the time, the unsecured bonds were trading at approximately 20% of face value.98 Most of the leverage in the restructuring negotiations rested with the bank debtholders. Accordingly, the financial restructuring plan proposed to exchange the €200 million of unsecured bond claims for 5% of the company's equity and €7.5 million in cash and warrants to acquire additional equity.99

Schefenacker proposed to compromise its unsecured bond claims through a company voluntary arrangement (CVA).100 The bank debtholders, however, did not hide their intentions to pursue the restructuring plan through an enforcement sale if bondholders failed to approve the CVA.101 After two modifications to the CVA, the bondholders approved the CVA on May 2, 2007. The CVA's implementation is subject to the satisfaction of certain conditions precedent, including the recognition and enforcement of the CVA under Chapter 15 of the Bankruptcy Code.102

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94. Id. at 25 (“Intensive negotiations were conducted among the representatives of the Term Lenders, the representatives of the OEMs and representatives of Dr. Schefenacker in order to determine whether agreement could be reached on the provision of further funding and terms for a financial restructuring . . . .”).
95. See id. at 25, 43.
96. Id. at 28.
97. Id. at 28–29.
98. See Here to Stay, supra note 46, at 24.
100. Id. at 2–3, 7–9.
102. Schefenacker Verified Petition, supra note 99, at 7–9; see also Schefenacker, No. 07-11482, slip op. (June 14, 2007) (order recognizing proceeding relating to Schefenacker CVA as a foreign main proceeding, issuing injunction, and closing case). A group of Schefenacker's bondholders objected to the Verified Petition, alleging that Schefenacker failed to provide full disclosure of information relevant to the restructuring and that Germany, not England, is Schefenacker's center of main interest. See Bondholder Group Objection to Chapter 15 Petition at 1–3, Schefenacker, No. 07-11482 (June 11, 2007) (Docket No. 40) [hereinafter Schefenacker Bondholder Objection]. These bondholders appealed the Schefenacker Approval Order, but subsequently withdrew the notice of appeal. See Notice of Appeal, Schefenacker, No. 07-11482 (June 25, 2007) (Docket No. 88); Notice
Jarvis plc is a U.K. engineering services company that encountered financial difficulties in 2004. The company embarked on an aggressive growth strategy between 1997 and 2003, “result[ing] in revenue growth to £1.1 billion in 2003, from £261 million six years earlier—an average of 27% a year.” This rapid growth, however, masked operational and financial weaknesses that eventually were revealed following a tragic train accident and subsequent investigation into Jarvis’s affairs in 2002. By 2004, the company faced a severe liquidity crisis. New business and the resulting cash flows were drying up, and existing management could not agree on a rescue plan.

Jarvis’s most pressing issue was its £310 million of institutional debt, which was in default. Jarvis’s banks, primarily Barclays and Royal Bank of Scotland, were willing to assist Jarvis with its restructuring efforts, but they kept Jarvis on a very short leash. The banks granted Jarvis extensions of its facilities and additional capital in small increments that were based on the company’s progress in its restructuring efforts. Jarvis in turn worked closely with the banks to design and implement a viable turnaround plan. The banks had a say in major restructuring decisions, including the appointment of Alan Lovell as Jarvis’s new CEO in late 2004.

A key component of Jarvis’s turnaround plan involved the restructuring of its business operations. This restructuring included the sale of Jarvis’s London tube line operations and certain noncore assets. It also involved

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104. Id. at 113.
105. Id. at 114.
106. Id. at 114-15.
109. See, e.g., John Waples, Lovell Fights to Keep Jarvis on the Rails, SUNDAY TIMES (London), Dec. 12, 2004, at 10 (“[Lovell] was encouraged to take the post by Royal Bank of Scotland, one of the lead creditors at Jarvis and a former lender to both Costain and Dunlop Slazenger.”).
finding an exit strategy for Jarvis with respect to fourteen open private finance construction projects. The latter task proved challenging because of the number of parties involved in the projects and the complexity of the deal structures. Ultimately, Jarvis reached a global settlement on the construction projects under which it capped its total liability, received a release from its guaranty obligations, and agreed to make a cash contribution to the completion of the projects.

The other key aspect of Jarvis’s turnaround plan was the restructuring of its balance sheet. Jarvis needed to restructure its long-term debt obligations, which presented an opportunity for distressed debt investors. In early 2005, Barclays and Royal Bank of Scotland sold Jarvis’s debt to ten U.S. hedge funds, including Canyon Capital and Strategic Value Partners. Deutsche Bank AG also invested in Jarvis’s debt and took the lead in restructuring negotiations with the company. At the time, observers speculated that these investors purchased the debt “with the point of forcing a debt-for-equity swap at a later date.” In fact, this is precisely what happened.

Negotiations between Jarvis and its debtholders resulted in a new financial package for the company and majority ownership of the company for the debtholders. Under the package, debtholders would receive approximately 95% of the company’s equity in exchange for approximately £378 million in debt. The exchange would reduce the company’s net indebtedness to less than £20 million and dilute the holdings of existing shareholders to less than 5%. The package also contemplated “a placing and open offer, conditionally underwritten by Deutsche Bank, to raise approximately £50 [million] of new money.”

Jarvis needed to obtain existing shareholder approval in order to implement the proposed debt-for-equity exchange. Accordingly, in July 2005, Jarvis distributed a restructuring circular to its shareholders explaining the terms of the exchange and the results of the operational

Se9698H (explaining terms of sale of tube line operations); see also Jarvis Unaudited Results for 2005, supra note 108, at 11.

111. See Simonsen & Cassady, supra note 103, at 117.

112. See id. at 120; Statement Re Transactions, supra note 110 (explaining terms of settlement); see also Jarvis Unaudited Results for 2005, supra note 108, at 11-12.


114. See Simonsen & Cassady, supra note 103, at 121.


117. See Simonsen & Cassady, supra note 103, at 120-21; see also Michael Harrison, Shareholders Wiped Out in Jarvis Debt Restructuring, Independent (London), May 24, 2005, at 58.

118. See Jarvis Unaudited Results for 2005, supra note 108, at 1, 12.
A C T I V I S T D I S T R E S S E D D E B T I N V E S T I N G

Shareholders then voted in favor of the exchange at an extraordinary general meeting in late 2005. Although the exchange substantially diluted the existing shareholders' equity position, it apparently was viewed as a more favorable result for the company than delisting or filing bankruptcy.

D. Kmart Corporation

On January 22, 2002, Kmart Corporation and thirty-seven of its U.S. subsidiaries filed for Chapter 11 protection in the U.S. Bankruptcy Court for the Northern District of Illinois. A flawed expansion plan in the 1980s and intense competition from retailers such as Wal-Mart and Target played a major role in Kmart's financial demise. In addition, creditors and shareholders attributed blame to Kmart's management team, alleging gross mismanagement and corporate waste. Ultimately, the shareholder claims against management were dismissed or settled. Nonetheless, the government's investigations into the conduct of Kmart's former CEO and CFO are ongoing.

Most observers believed that Kmart's bankruptcy marked the beginning of the end for the 103-year-old retail giant. At least one distressed debt investor, however, saw things differently. ESL Investments, Inc. (ESL)—the hedge fund established by Edward Lampert and headquartered in Greenwich, Connecticut—saw Kmart's situation as an opportunity for change and profit.

Shortly after Kmart's bankruptcy, ESL began purchasing Kmart's prepetition bank, bond, and trade debt. ESL ultimately acquired $382 million in principal amount of bank debt, $1.177 billion in principal amount of bond debt, and $61 million of trade debt. These investments resulted in ESL holding approximately 35% of the bank debt, 51% of the bond debt,
and 25% of Kmart's estimated total prepetition debt of $6,009,184,238.\textsuperscript{127} In addition, ESL worked with another investment fund—Third Avenue Trust (Third Avenue)—that owned $99 million in principal amount of bond debt and $79 million of trade debt.\textsuperscript{128} ESL and Third Avenue were Kmart's largest creditors and together controlled Kmart's restructuring process.\textsuperscript{129}

On September 11, 2002, approximately eight months after Kmart’s bankruptcy filing, ESL and Third Avenue were appointed to a statutory committee of bank and bond creditors in Kmart’s Chapter 11 case, referred to as the Financial Institutions’ Committee.\textsuperscript{130} As committee members, ESL and Third Avenue had access to Kmart’s business plan, financial statements, and other information relating to Kmart’s restructuring efforts. They also had a seat at the negotiating table. By October 2002, Kmart’s CEO, James Adamson, was quoted as saying that ESL and Third Avenue had “refocused” the company and that they were pushing for a quick exit from Chapter 11—a strategy with which Adamson did not necessarily agree.\textsuperscript{131}

ESL and Third Avenue prevailed. By the end of January 2003, Kmart had appointed a new CEO, entered into an Investment Agreement with ESL and Third Avenue, and filed its disclosure statement and related plan of reorganization with the SEC and the bankruptcy court.\textsuperscript{132} ESL also took a “hands-on” approach to Kmart’s business plan and proposed the postbankruptcy board of directors and management team.\textsuperscript{133} Kmart’s plan of reorganization terminated the current board of directors and gave ESL and Third Avenue the right to appoint four of the nine directors on the new, postbankruptcy board.\textsuperscript{134} Edward ultimately was appointed as Kmart’s chairman of the board.\textsuperscript{135}

Under Kmart’s plan of reorganization, ESL and Third Avenue received approximately 50% of the company’s new common stock.\textsuperscript{136} In exchange for this stock, the investors agreed to cancel their debt claims against the company and invest approximately $140 million in the reorganized

\textsuperscript{127}. Id. at x–xvii, 54, 74.
\textsuperscript{128}. Id. at 74.
\textsuperscript{129}. Id. at vii, 74–77.
\textsuperscript{130}. Id. at 18. The law firm Jones Day represented the Financial Institutions’ Committee. I was a lawyer at Jones Day at the time, but I did not work on the engagement. My husband also was a lawyer at Jones Day at the time and did actively work on the engagement. Nonetheless, my knowledge of, and all information in this Article regarding, the Kmart cases is based on the publicly available sources cited herein.
\textsuperscript{131}. See, e.g., Muller, supra note 46.
\textsuperscript{132}. Kmart Corp., Current Report (Form 8-K), item 5 (Jan. 28, 2003).
\textsuperscript{134}. Id.
\textsuperscript{135}. Kmart Holding Corp., Statement of Beneficial Ownership (Sched. 13D), at 11 (May 15, 2003).
\textsuperscript{136}. See Kmart Holding Corp., Statement of Ownership (Sched. 13G), item 4 (Mar. 10, 2004); Kmart Holding Corp., Statement of Beneficial Ownership (Sched. 13D), at 2, 15 (May 15, 2003).
company. ESL also received the right to purchase additional new common stock for a period of two years and agreed to invest up to an additional $60 million in the form of a note, at the company’s election.

Kmart’s common stock soared in value from $15 per share to $109 per share after the company’s emergence from bankruptcy. ESL and Lampert continued to play an active role in Kmart’s business and management postbankruptcy. They streamlined Kmart’s business operations and orchestrated its merger with Sears Roebuck & Co. in 2005. Lampert continues to serve as Chairman of the Board, and ESL and its affiliates continue to own approximately 42.5% of the merged company. The merged company is facing some challenging issues. Nevertheless, Kmart’s immediate postbankruptcy performance increased its stock value and resulting return to certain prepetition creditors by 543% over an 18-month holding period.

III. RESTRUCTURING TRENDS AND ACTIVIST DISTRESSED DEBT INVESTING

The case studies of Allied, Schefenacker, Jarvis, and Kmart demonstrate that debtholders in both the United States and the United Kingdom can influence far more than the terms of a company’s financial contracts. They can influence management decisions, personnel changes, and the capital structure of a company. But exactly how are debtholders accomplishing these feats? What are the consequences for the debt issuer, its management, and its shareholders? What is the resulting effect, if any, on restructuring processes in the United States and the United Kingdom? This Article analyzes these and other related issues below.

A. Distressed Debt as an Activist Tool

A company needs cash to survive. This basic fact provides a world of opportunity for the distressed debt investor. A troubled company may ask its debtholders to, among other things, provide additional capital, waive loan defaults, forbear from exercising remedies, or compromise the debt. Each of these requests presents the debtholders with an opportunity to influence corporate affairs, and perhaps, even to seize control of the company.

141. Id. at 9.
The extent of a debtholder's influence depends largely on three factors: the characteristics of its debt holdings, its statutory rights, and its contractual rights. Debt characteristics refers to the amount and type of debt held by the debtholder. For example, a debtholder holding senior secured debt generally is in a stronger negotiating position than one holding subordinated unsecured debt. A debtholder's position is enhanced further if it holds a controlling (i.e., more than 34%) or majority (i.e., more than 50%) stake in the debt. A controlling or majority debtholder often uses its statutory and contractual rights as leverage in its negotiations with the company.

Allied, Schefenacker, Jarvis, and Kmart demonstrate the importance of these three factors. In each case, debtholders purchased a controlling stake in a tranche of debt subject to compromise in the company's restructuring. The debtholders then relied on their statutory and contractual rights to influence the terms of the company's restructuring. In Allied and Kmart, the debtholders used their blocking position in any vote on a Chapter 11 plan to influence management and operational changes and facilitate a debt-for-equity exchange. In Schefenacker and Jarvis, the debtholders asserted their rights as controlling secured debtholders to effectuate an out-of-court restructuring of the companies' respective capital structures, despite the existence of junior creditors and shareholders. In each case, the debtholders ended up owning a controlling position in the reorganized company's equity.

A debtholder's statutory rights can differ significantly from country to country. As shown by the similar results in Allied, Schefenacker, Jarvis, and Kmart, a debtholder's statutory rights in the United States and the United Kingdom overlap to some extent. As shown by the different approaches used in the cases, however, differences do exist and do affect

144. Under both U.S. and U.K. law, secured creditors generally have superior rights to payment and to the collateral securing their loans. See, e.g., BRUCE G. CARRUTHERS & TERRENCE C. HALLIDAY, RESCUING BUSINESS 162–63 (1998) (discussing the benefits to security and noting that “[s]ecurity helps a creditor in relation to the debtor but equally important, protects a creditor from other creditors”); see also VANESSA FINCH, CORPORATE INSOLVENCY LAW 75–79 (2002) (providing an overview of secured creditors' rights in United Kingdom); IAN F. FLETCHER, INSOLVENCY IN PRIVATE INTERNATIONAL LAW 188–91 (James J. Fawcett ed., 2d ed. 2005) (same); Ingrid Michelsen Hillinger & Michael G. Hillinger, 2001: A Code Odyssey (New Dawn for the Article 9 Secured Creditor), 106 COM. L.J. 105 (2001) (providing an overview of secured creditors' rights in the United States outside of bankruptcy). These rights give secured creditors substantial leverage in restructuring negotiations, particularly if the creditors' claims are undersecured or just fully secured and leave little value for other stakeholders. For an overview of creditor priorities in both U.S. and U.K. insolvencies, see CARRUTHERS & HALLIDAY, supra, at 39–40.

145. See infra Part III.A.1–2.
146. See supra Part II.A, D.
147. See supra Part II.B–C.
148. See supra Part II.
149. See, e.g., FLETCHER, supra note 144, at 4–8 ("[D]espite numerous general resemblances, national insolvency laws and procedures differ from one another almost infinitely in ways both great and small.").
the types of opportunities presented to distressed debt investors in each country.

1. Opportunities for Activist Distressed Debt Investing Under U.S. Law

In the United States, corporate bankruptcy generally is not viewed as a disgraceful event. Large corporate failures such as United Airlines, Macy's, and Kmart have largely desensitized the American public to the stigma once associated with bankruptcy. This growing public acceptance of corporate failure, coupled with the well-developed U.S. bankruptcy laws, allows investors in the United States to use the bankruptcy system in their negotiations with troubled companies.

The Bankruptcy Code is the primary source of U.S. bankruptcy law. The Bankruptcy Code provides two basic alternatives for a financially troubled company. The company can attempt to reorganize its financial affairs under Chapter 11 of the Bankruptcy Code. Alternatively, it can liquidate its assets to pay its creditors under Chapter 7.

A company in a Chapter 11 case generally stays in control of its business and the restructuring process. A company in a Chapter 7 case, however, loses control of both. A Chapter 7 trustee is appointed to manage and liquidate the company’s assets; investigate and pursue claims on behalf of the company (which can include claims against former management); and

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150. See, e.g., Erin K. Healy, All's Fair in Love and Bankruptcy? Analysis of the Property Requirement for Section 109 Eligibility and Its Effect on Foreign Debtors Filing in U.S. Bankruptcy Courts, 12 AM. BANKR. INST. L. REV. 535, 542 & n.41 (2004) (“While a bankruptcy filing in other countries continues to carry significant stigma, U.S. companies and individuals are not subjected to the same shame merely as a result of filing a petition for bankruptcy.”); Martin, supra note 13, at 25–26 (“There seems to be less stigma associated with a failing business in the United States than with a personal bankruptcy, probably due to the U.S. notion that some risk is good and necessary to a well-functioning capitalist economy.”).


154. See generally id. §§ 701–727 (general Chapter 7 provisions of Bankruptcy Code).

155. Id. § 1107 (discussing duties of company as a debtor in possession).
pay the company's creditors. For this reason, companies prefer to address their financial issues in the Chapter 11 context.

a. Debtholders' Rights Under Chapter 11

Debtholders can play a significant role in a company's Chapter 11 case from the very outset. Debtholders can file an involuntary petition for bankruptcy against the company, thereby triggering the Chapter 11 case. The company's board of directors also has the ability to file a voluntary petition for bankruptcy on behalf of the company. In either context, the company's board and management team typically stay in place and run the Chapter 11 case for the company. Certain parties, including debtholders, can seek to displace the board and management with a trustee, but the appointment of a Chapter 11 trustee is the rare exception, rather than the rule.

Threats to commence an involuntary bankruptcy petition against the company or to seek the appointment of a Chapter 11 trustee are useful weapons in a debtholder's arsenal. These threats, however, typically are made in the negotiating room and rarely ripen into full-blown litigation. Companies and debtholders generally recognize the value destruction that can accompany such litigation.

Consequently, debtholders often invoke different means to influence a Chapter 11 debtor's corporate affairs. These means include the priority and

156. Id. §§ 701-704 (discussing selection of trustee and duties of trustee).
157. Id. § 303 (discussing involuntary bankruptcy case).
158. Id. § 301 (discussing voluntary bankruptcy case).
159. Id. § 1104 (discussing appointment of trustee or examiner).
160. See Gilson & Vetsuypens, supra note 17, at 1012 (explaining that, in an empirical study, in “twenty-five percent of cases involving bankrupt firms, creditors threatened to petition the court to have a trustee appointed unless managers resigned”; however, a trustee was appointed in only one of these cases); see also Peter Edmonston, Atkins Cleared to Emerge, DAILY DEAL, Dec. 22, 2005 (on file with the Fordham Law Review) (noting that unsecured creditors threatened to sue debtor regarding prepetition transactions, but then dropped suit for concessions in plan); Adina Genn, Hurting Firms Dart for Bankruptcy Protection, LONG ISLAND BUS. NEWS (N.Y.), Sept. 30, 2005, at 5A (“The threat of creditor-proposed plans may be daunting enough to persuade companies in bankruptcy to reach a consensus with their creditors more quickly ...” (quoting Rick Antonoff, Pillsbury Winthrop Shaw Pittman LLP)).
161. See Alexander L. Paskay & Frances Pilaro Wolstenholme, Chapter 11: A Growing Cash Cow—Some Thoughts on How to Rein in the System, 1 AM. BANKR. INST. L. REV. 331, 337 (1993) (“There are several areas within bankruptcy litigation that lead to excessive costs. These include bad faith litigation, unnecessary stay litigation under section 362(d)(2), adequate protection and cash collateral litigation, and disclosure statement litigation.”); see also Stewart L. Cohen & David Peress, Administrative Insolvency: What's a Secured Creditor to Do?, AM. BANKR. INST. J., July/Aug. 2001, at 34, 34 (“[L]itigation over issues such as conversion, dismissal and adequate protection leads to the incurrence of additional expenses as time marches on and ultimately contributes to administrative insolvency.”); Bruce V. Bigelow, Reorganization Cost Peregrine $54.7 Million: Final Accounting Given in Bankruptcy Filings, SAN DIEGO UNION-TRIB., July 8, 2006, at C-1 (explaining large fees and delay incurred in the Peregrine Systems, Inc. Chapter 11 case because of “hostile and contentious’ litigation”).
voting scheme associated with a Chapter 11 plan of reorganization and postpetition (i.e., postbankruptcy) and prepetition (i.e., prebankruptcy) contract rights.

i. Influence Through the Plan Process

The plan of reorganization is a key component of Chapter 11. Fundamentally, the plan is a contract between the debtor and its creditors. The plan details how the debtor will reconfigure its capital and, in some instances, operational structure, and includes the terms of repayment of the debtor's prepetition debt. The debtor typically designs and presents the plan after consultation with the debtor's major creditor groups. After an initial period during which the debtor has the exclusive right to propose a plan, creditors and shareholders also may propose a plan for the debtor.

Debtholders can use the plan process to their advantage in a number of respects. First, the debtholder can seek a seat at the plan negotiating table. Debtors often reach out to the holders of their secured debt to discuss the treatment of the debt under the plan. If the debtor does not make this gesture, creditors can be proactive. A creditor's motion for relief from the automatic stay, objection to the use of cash collateral, or motion for the appointment of a trustee can help open a dialogue with the debtor on the structure and terms of the plan. The amount of debt held by a debtholder also can get the debtor's attention. Allied exemplifies this strategy. Yucaipa emerged virtually overnight as the company's largest

163. Id.
164. Id. § 1121(c)-(d). This "exclusivity" period may be extended or shortened. The appointment of a Chapter 11 trustee terminates the debtor's exclusivity.
165. See, e.g., ROSENBERG, supra note 22, at 30. Distressed debt investors have several options for purchasing a seat at the negotiating table, including by buying into a distressed loan or bond issuance or directly lending to the debtor. See supra Part I.A.1; see also Suniati Yap, Investing in Chapter 11 Companies: Vultures or White Knights?, 2 Sw. J.L. & TRADE AM. 153, 163 (1995) (noting that, in certain circumstances, an investor may be able to purchase a debtor's debt through a tender offer).
166. The automatic stay of section 362 of the Bankruptcy Code prohibits a debtholder—even a secured debtholder—from taking any action against a debtor or its property on account of a prepetition debt without prior bankruptcy court approval. 11 U.S.C. § 362. In addition, a debtor must obtain the debtholder's consent or bankruptcy court approval to use the debtholder's cash collateral. Id. § 363. As noted above, a debtholder also may request the appointment of a trustee or examiner in the debtor's Chapter 11 case. Id. § 1104. These sections provide a debtholder with standing to be heard before the bankruptcy court on issues often central to the debtor's restructuring efforts. Id. § 1109. Activist investors also may file objections to relief being requested by the debtor to assert their position and interest in the debtor's case. See, e.g., Second Lien Committee's: (1) Objection to Debtors' Motion for Authority to Enter into Conditional Waiver and Forbearance Agreement with the DIP Lenders; and (2) Notice of Offer to Purchase Substantially All of the Debtors' Assets for $175 Million Under Bankruptcy Code Section 363 and to Act as Stalking Horse Bidder in Court Authorized Auction Process, In re Werner Holding Co. (DE), Inc., No. 06-10578(KJC) (Bankr. D. Del. Jan. 18, 2007) (Docket No. 940) (objecting to debtors' requested relief under DIP Loan and making offer to purchase debtors' assets).
Unsecured debtholders also have an opportunity to influence plan negotiations by seeking appointment to the official committee of unsecured creditors (the creditors' committee). The creditors' committee typically consists of seven or more of the debtor's largest unsecured creditors, and it acts as a fiduciary for all of the debtor's unsecured creditors. A creditors' committee generally receives access to the debtor's financial and business plans and can greatly influence the direction of the debtor's Chapter 11 case. Kmart is typical of this strategy. ESL and Third Avenue were appointed to the Financial Institutions' Committee after purchasing a controlling amount of Kmart's bank and bond debt. ESL and Third Avenue then used their committee seats to open a direct line of communication with the company. A committee seat, however, also can create potential conflicts for an activist debtholder.

Second, debtholders holding a controlling position in the debt likely have a blocking position in the plan voting process. Under a reorganization plan, creditors' claims, as well as shareholders' interests, are separated into classes. Creditors holding at least half in number and two-thirds in amount of the claims voting on the plan in each class must vote to approve the plan. If the type of debt held by the debtholder is designated as a separate class, the debtholder should be able to control the class vote. If the debt is classified with other secured or unsecured debt, the debtholder may need the cooperation of other holders to assert a firm blocking position. Notably, a controlling debtholder proposing its own plan or working with the company to propose a plan can try to structure the voting classes in a manner favorable to the debtholder.

167. See supra Part II.A.
168. 11 U.S.C. § 1103; see also ROSENBERG, supra note 22, at 30.
170. See supra Part II.D.
171. A committee member's access to nonpublic information and fiduciary duties to other creditors may restrict the creditor's ability to pursue its own interests. See, e.g., ROSENBERG, supra note 22, at 31 (explaining conflict for committee members created by holding nonpublic information); Zipes & Lambert, supra note 169, at 244–49 (explaining potential issues raised by claims trading and committee members who represent specific interests).
172. 11 U.S.C. § 1122 (discussing plan classification); see also ROSENBERG, supra note 22, at 32–33 (explaining blocking tactics in Chapter 11 context).
174. ESL Investments, Inc. (ESL) joined forces with Third Avenue Trust (Third Avenue) in Kmart to create a blocking position. See supra Part II.D; see also ROSENBERG, supra note 22, at 32 (explaining the blocking tactics of one distressed debt investor as follows: "If he cannot for some reason build the required position in the bonds, he will link arms with other investors whose holdings can make up the difference").
175. For a general discussion of issues relating to plan classification, see Peter E. Meltzer, Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment, 66 AM. BANKR. L.J. 281 (1992).
In Allied, Yucaipa exercised this sort of control over the treatment and classification of secured claims. For example, Class 1 under Allied’s plan addressed the classification and treatment of “Allowed Other Secured Claims.” The plan contemplated that this class would be subdivided “so that each holder of any Secured Claim against each Debtor is in a Class by itself, except to the extent that there are Secured Claims that are substantially similar to each other and may be included within a single Class.” The plan then listed six different potential treatments for secured claims to be selected and implemented by Yucaipa. If a secured claim was paid in full or reinstated under section 1124 of the Bankruptcy Code, the secured creditor was deemed unimpaired and could not vote on the plan. If other treatment was accorded to the secured claim, the secured creditor was entitled to vote. The plan also gave Yucaipa the right to amend or modify the treatment accorded to any secured claim, including whether or not its holder was entitled to vote on the plan, up to three days before the plan confirmation hearing. This structure gave Yucaipa substantial flexibility in deciding whether to pay off or negotiate with secured creditors to obtain an affirmative vote on the plan from each secured claim class.

To confirm a plan of reorganization, each class of impaired creditors and shareholders must vote in favor of the plan. If the requisite vote is not obtained, the debtor (or plan proponent) can still seek court approval of the plan under the “cramdown” provisions of the Bankruptcy Code. To do so, the debtor (or plan proponent) must show that at least one class of impaired creditors voted in favor of the plan and that the plan is fair and equitable and satisfies the absolute priority rule.

A distressed debt investor’s ability to participate in plan negotiations or influence the company’s reorganization is enhanced if the investor holds secured debt or a position in multiple tranches of the company’s debt. Security allows a debtholder to demand repayment in full before the company makes any distributions to junior creditors. It also allows the creditor to “credit bid” its debt in, or potentially block, a sale of the debtor’s assets that are included in the debtholder’s collateral package. Likewise, holding a position in multiple tranches of the company’s debt makes it more


177. Id.

178. Id.

179. Id.

180. Id.


182. Id. § 1129(b) (discussing cramdown requirements).

183. Id.

184. See supra note 144 (discussing rights of secured creditors in the United States and United Kingdom).

185. For a discussion of credit bidding in the context of debtor-in-possession financing, see infra Part III.A.1.a.ii.
difficult for the debtor to weaken the debtholder’s blocking position through plan classification. It also gives the debtholder a larger stake in the company and the results of the restructuring, which often equates with a more influential voice at the negotiating table.

In Kmart, ESL, and Third Avenue held a portion of each of Kmart’s significant unsecured debt—i.e., Kmart’s bank, bond, and trade debt. Their multiple holdings gave ESL and Third Avenue a vote in each of three separate classes under the Kmart plan. Class 3 contemplated a 40% recovery for bank claims, Class 4 contemplated a 14.4% recovery for bond claims and Class 5 contemplated a 9.7% recovery for trade claims. ESL and Third Avenue collectively held approximately 35% of the bank debt, 56% of the bond debt, and 32% of the trade debt. Although the two debtholders alone could not carry the vote in each class, they likely could block each class from accepting the plan.

ii. Influence Through Contract

Debtholders also may gain an advantage in a Chapter 11 case through their postpetition or prepetition contracts with the debtor. One of the most influential contracts in a Chapter 11 case is the debtor-in-possession financing facility (DIP Loan). DIP Loans provide a debtor with access to capital on a postpetition basis. This financing often is critical to the debtor’s successful reorganization, providing the debtor with sufficient liquidity to operate its business during the Chapter 11 case.

The Bankruptcy Code includes special protections for lenders under DIP Loans. For example, a debtor can offer “superpriority” to a DIP Loan lender, allowing the lender to be paid ahead of other priority claims established by the Bankruptcy Code. Similarly, the debtor can offer the lender a priming first lien in assets encumbered by prepetition security interests, allowing the lender to trump the interests of prepetition secured creditors. These protections are subject to certain qualifications and to

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186. If a debtholder holds a blocking position in all impaired classes of claims, or at least the significant classes, the debtor most likely will be unable to cram down the plan over the debtholder’s objection. See 11 U.S.C. § 1129(b) (discussing cramdown requirements).
188. For a discussion of ESL and Third Avenue debt holdings, see supra Part II.D.
190. See, e.g., In re Ames Dep’t Stores, Inc., 115 B.R. 34, 36 (Bankr. S.D.N.Y. 1990) (“It is given that most successful reorganizations require the debtor-in-possession to obtain new financing simultaneously with or soon after the commencement of the Chapter 11 case.”).
191. 11 U.S.C. § 364(c)(1)–(3) (allowing the debtor, under certain circumstances, to offer a debtor-in-possession financing loan (DIP Loan) lender priority ahead of all administrative claims and a security interest in encumbered assets or a junior interest in encumbered assets).
192. Id. § 364(d)(1) (allowing the debtor, under certain circumstances, to offer a DIP Loan lender a first security interest in encumbered assets).
court approval. Nevertheless, they help debtors attract postpetition credit and provide control opportunities to the DIP Loan lender.

DIP Loan lenders also can obtain significant contractual protections. These protections include financial and operational covenants that allow the lender to foreclose on its collateral package or otherwise exercise control over the debtor’s assets upon a default.193 A DIP Loan lender’s rights often can be exercised without further approval of the court or relief from the automatic stay.194 Moreover, DIP Loans typically provide the lenders with veto rights over operational changes, assets, acquisitions, or dispositions or other major transactions related to the debtor’s restructuring efforts.195 These rights essentially allow the lenders to dictate how and if the debtor achieves its restructuring goals.

A distressed debt investor interested in influencing a debtor’s affairs may use a DIP Loan for this purpose.196 A distressed debt investor acting as a company’s DIP Loan lender gains several advantages. It is given access to nonpublic information about the company, and it can demand frequent financial and operational reports from the debtor.197 It can try to influence the debtor’s business decisions through covenants.198 A DIP Loan lender also may seek to credit bid its debt for the company’s assets if the restructuring efforts fail.199

The use of DIP Loans to influence management decisions or acquire ownership of the company is becoming more common.200 For example, distressed debt investor Black Diamond Commercial Finance LLP invoked this strategy in the Chapter 11 case of Werner Co. Werner is the world’s

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193. *See Kuney, supra* note 9, at 56 (“A violation of these covenants is typically an event of default under the DIP loan documents entitling the lender to relief from the stay and the ability to immediately realize upon its security, begin assessing default interest rates and penalty fees, and terminate any further financing.”); *see also* Baird & Rasmussen, *supra* note 10, at 1239–40; Skeel, *supra* note 189, at 1918–19.


195. *See Kuney, supra* note 9, at 52–57.

196. *See Baird & Rasmussen, supra* note 10, at 1245–46 (observing that entrenched management “will readily agree to covenants that give them breathing space today even if these terms promise to deliver the business to the creditors should current efforts not pan out”).

197. *See Kuney, supra* note 9, at 52–53.

198. *Id. at 53–54 & nn.162–64; see also* Sris Chatterjee et al., *Debtor-In-Possession Financing*, 28 J. BANKING & FIN. 3097, 3108 (2004) (”In 90% of the cases, DIP loans have restrictions on specified operating expenses and operating activities.”).

199. 11 U.S.C. § 363(k) (2006); *see also* David Peress & Thomas C. Prinzhorn, *Nontraditional Lenders and the Impact of Loan-to-Own Strategies on the Restructuring Process*, AM. BANKR. INST. J., Apr. 2006, at 48 (discussing loan to own strategies); *infra* Part III.A.1.a.ii (discussing Werner’s and Radnor’s Chapter 11 cases).

200. *See, e.g.*, Skeel, *supra* note 189, at 1920–21, 1931 (suggesting that DIP Loans have replaced claims trading as the control mechanism of choice for distressed debt investors and citing U.S. Air’s parent company UAL Corp. and TWA as two cases in which the DIP Loans were used to dictate the terms of the Chapter 11 cases and give the DIP Loan lenders control of the debtors).
leading manufacturer and distributor of ladders. Its financial troubles were sparked by a highly leveraged balance sheet and increased production costs. Black Diamond extended Werner a $99 million DIP Loan to help Werner address these issues in the Chapter 11 context. After approximately nine months in Chapter 11, Werner decided to sell its business. A group led by Black Diamond emerged as the successful bidder, with the majority of the purchase price paid through the cancellation of indebtedness, including the DIP Loan.

The Chapter 11 case of Radnor Holding Corp. is another example of this practice. In Radnor, Tennenbaum Capital Partners LLC and two of its affiliates made certain prepetition investments in Radnor. These investments included the purchase of $25 million in preferred stock and the extension of $85 million in secured credit. Radnor’s financial situation, however, did not improve. The company then entered into a sale agreement and DIP Loan agreement with Tennenbaum. The DIP Loan provided Radnor with sufficient liquidity to consummate a sale in Chapter 11 and allowed Tennenbaum to credit bid its secured claims against Radnor in the


203. See Press Release, Werner Co., supra note 201 (describing closing of sale); Michael Roknick, Werner Sale a Done Deal; Jobs Safe Under Terms of Sale, HERALD (Sharon, Pa.), June 11, 2007, available at http://www.sharon-herald.com/homepage/local_story_162214 545.html?keyword=leadpicturestory (noting that Werner “completed its sale to a multi-investment group in a deal valued at $270 million”); see also Werner, No. 06-10578(KJC), slip op. (Apr. 26, 2007) (Docket No. 1366) (order approving sale); Debtors’ Motion for Entry of an Order (I) Approving Sale of Substantially All of Debtors’ Assets Free and Clear of Liens, Claims, Interests, and Encumbrances; (II) Authorizing and Approving the Purchase Agreement; (III) Authorizing and Approving the Assumption and Assignment and Sale of Certain Executory Contracts and Unexpired Leases in Connection with Such Sale; (IV) Authorizing the Exemption of the Sale from Stamp and Similar Taxes and (V) Granting Related Relief, Werner, No. 06-10578 (KJC) (Mar. 27, 2007) (Docket No. 1231) [hereinafter Werner Sale Motion] (explaining terms of proposed sale).


sale process. Tennenbaum's bid to acquire ownership of Radnor through its prepetition and postpetition secured claims was approved by the Delaware Bankruptcy Court.

The investor in Radnor used its prepetition secured creditor position to negotiate the DIP Loan and to enhance its bidding leverage in the contemplated asset sale. Other distressed debt investors likewise may find opportunities to assert control over a debtor under the terms of their prepetition contracts. Acceleration, default interest rate, and subordination provisions are among the provisions that may be useful in this context. The utility of such prepetition provisions, however, is limited by the automatic stay, reinstatement, and other similar provisions of the Bankruptcy Code. Prepetition contract provisions often are more useful to investors in the out-of-court restructuring context.

b. Debtholders' Rights Outside of Chapter 11

A Chapter 11 case is an expensive and time-consuming process. In addition, it can adversely affect a company's business operations. Although the stigma historically associated with bankruptcy is less pervasive in the United States, some customers, vendors, suppliers, and others remain hesitant to do business with a bankrupt company. Accordingly, in some circumstances, an out-of-court restructuring may preserve more value for the company and its stakeholders. An out-of-court restructuring typically is a consensual restructuring of the company's capital structure.


207. See Radnor Disclosure Statement, supra note 204, at ii–iii (explaining that the bankruptcy court approved the debtors' motion to sell substantially all of their assets to Tennenbaum and that "[t]he Debtors closed on the Sale on November 29, 2006").


210. Vendors and suppliers can incur significant monetary losses on prepetition claims in a bankruptcy case. In addition, these parties can incur significant expenses if they try to participate in the debtor's Chapter 11 case. Consequently, these parties may prefer not to do business with a bankrupt or potentially bankrupt business. See generally Jon M. Labovitz, Taking a Fresh Look at DIP Budgeting, AM. BANKR. INST. J., Mar. 2005, at 34, 34 n.35 (describing factors that may strain relations between debtors and their vendors, suppliers, and customers).

Debtholders can wield significant influence in an out-of-court restructuring. This potential for influence stems largely from the debtholders’ contractual rights, with the threat of bankruptcy (and the debtholders’ rights under bankruptcy law) looming in the background. The same type of covenants, default and acceleration provisions, and collateral rights discussed above in the context of DIP Loans can be very useful to distressed debt investors seeking control. These provisions are common in loan documents with distressed companies. They also are used in bond indentures; however, covenants in indentures governing public bond issuances tend to be weaker than their counterparts in the private loan setting. Consequently, the threat of bankruptcy and a distressed bondholders’ blocking position in any Chapter 11 case may be more useful to an individual distressed bondholder than the terms of the indenture itself.

An individual debtholder also can influence the results of an out-of-court restructuring by withholding its consent to the restructuring plan. A company cannot bind dissenting debtholders, called “holdouts,” to an out-of-court restructuring plan. The holdout problem frequently presents itself in the context of public bond issuances. The Trust Indenture Act of 1939 governs bonds, notes, debentures, and other certificates of indebtedness and the related indentures issued through a public offering.

agreements and noting that these “agreement[s] may either provide an extension of the time period in which the debtor’s obligations become due, without altering the amount of the claims of the creditors, or fashion a settlement, sometimes known as a composition agreement, which will reduce the amount to be paid to creditors with provisions for payment either in cash or over a period of time”).

212. See, e.g., Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 Rutgers L. Rev. 1211, 1222–23 (1994) (“[I]f a debtor lacks ready cash or its financial distress is too acute in other ways, immediate bankruptcy reorganization may be preferable to attempting a workout.”); James H.M. Sprayregen et al., *Chapter 11: Not Perfect, but Better than the Alternative*, Am. Bankr. Inst. J., Oct. 2005, at 1, 60 (“[C]hapter 11 is but one, albeit a critical, part of a broader restructuring market that also includes a vast number of out-of-court workouts because it serves as a critical court-supervised market of last resort when a consensual deal is not made.”).


216. 15 U.S.C. §§ 77aaa, 77ddd(a) (2006); see also George W. Shuster, *The Trust Indenture Act and International Debt Restructurings*, 431, 437 (2006) (“Section 316(b) was adopted with a specific purpose in mind—to prevent out-of-court debt restructurings from being forced upon minority bondholders.”). Interest payments
Under the Act, an indenture cannot permit the impairment or modification of an individual bondholder's right to receive the "payment of the principal of and interest ... on or after the respective due dates ... or to institute suit for the enforcement of any such payment" without the consent of the bondholder.\(^\text{217}\)

The consensual nature of an out-of-court restructuring limits its usefulness. For example, most out-of-court restructuring plans involve a restructuring only of the company's bank and bond debt.\(^\text{218}\) General unsecured claims held by customers, suppliers, vendors, and others remain intact, as do shareholders' interests. This result is in stark contrast to Chapter 11, under which creditors' claims and shareholders' interests can be modified or even extinguished without the consent of the holder.

c. Debtholders' Rights Under Prepackaged and Prenegotiated Restructurings

If holdouts prevent an out-of-court restructuring, the company may pursue a prepackaged restructuring plan. A prepackaged restructuring plan looks very similar to an out-of-court restructuring in that it typically modifies the payment terms of only bank and bond debt.\(^\text{219}\) It, however, also may seek to facilitate an asset sale or a debt-for-equity exchange. A company proposing a prepackaged plan uses the Bankruptcy Code to eliminate any holdout problems and to implement structural changes that might not otherwise be feasible in the out-of-court context.\(^\text{220}\)

Mechanically, a company negotiates and solicits acceptances of the prepackaged plan outside of bankruptcy. This solicitation process is governed by applicable nonbankruptcy law, typically federal securities laws.\(^\text{221}\) The company strives to obtain approval of the plan from more than half in number and two-thirds in amount of each class of debtholders whose rights are modified under the plan.\(^\text{222}\) This approval threshold satisfies the
plan voting requirements under the Bankruptcy Code. The company then commences a Chapter 11 case to obtain court approval of the plan, which binds any dissenting debtholders and allows the company to cram down the plan on shareholders. The cram-down feature in this context permits a debt-for-equity exchange that otherwise would require shareholder approval. Bally Total Fitness Holding Corporation is an illustration of the prepackaged plan technique.

A distressed debt investor who holds a position in a company’s debt sufficient to meet the Bankruptcy Code’s plan voting requirements—either alone or with like-minded investors—can use the prepackaged plan process to its advantage. The process often is quicker and cheaper than a traditional Chapter 11 case. It also allows an investor to influence the company’s restructuring despite dissenting debt and equity holders.

Nevertheless, the prepackaged plan process can be unsatisfying from the distressed debt investor’s perspective. The investor generally is limited to restructuring the company’s bank and bond debt. More complex changes to the company’s contracts, corporate structure, or unsecured trade debt generally are not feasible under this process. Likewise, solicitation of the prepackaged plan occurs prior to the Chapter 11 filing and without court oversight, and thus, is subject to potential challenge in the subsequent Chapter 11 case.

Accordingly, some distressed debt investors find a prenegotiated plan process more attractive. In this process, the company and the investor negotiate the terms of the Chapter 11 plan prior to filing the Chapter 11 case. The plan can include any provision permitted under the Bankruptcy Code and affect any class of claimants because all impaired classes are given an opportunity to vote on the plan. The solicitation of the

223. See id. §§ 1129(a)-(b), 1141 (explaining requirements for, and impact of, plan confirmation).
224. See Disclosure Statement with Respect to Joint Prepackaged Chapter 11 Plan of Reorganization of Bally Total Fitness Holding Corporation and Its Affiliate Debtors at 20–49, In re Bally Total Fitness of Greater New York, Inc., No. 07-12395 (BRL), 2007 WL 2779438 (Bankr. S.D.N.Y. June 27, 2007) (Docket No. 36) [hereinafter Bally Disclosure Statement] (explaining terms of prepackaged plan of reorganization); Motion of Debtors for Order, Pursuant to Section 1127(A) of the Bankruptcy Code and Bankruptcy Rule 3019, Authorizing the Debtors to Modify Their Joint Prepackaged Chapter 11 Plan of Reorganization, Bally, No. 07-12395 (BRL) (August 13, 2007) (Docket No. 179) [hereinafter Bally Motion to Modify] (explaining terms of modified prepackaged plan of reorganization); see also infra note 340.
225. See, e.g., Ayer et al., supra note 219, at 16.
226. See, e.g., Yap, supra note 165, at 173 (explaining requirements for prepackaged Chapter 11 plan); see also GILSON, supra note 22 at 192 (“Prepacks work best for firms whose problems are more financial than operational in nature and that have relatively less trade and other nonpublicly traded debt outstanding.”).
227. See Ayer et al., supra note 219, at 56.
228. See id. (describing the prenegotiated or “pre-arranged” plan process).
229. See id. ("The most significant procedural difference between a pre-arranged plan and a prepackaged plan is that solicitation occurs after the bankruptcy case has been filed and after the court has approved a disclosure statement.").
2. Opportunities for Activist Distressed Debt Investing Under U.K. Law

The stigma often associated with bankruptcy continues to permeate the public’s perception of corporate failure in the United Kingdom. The U.K. public generally is less forgiving of corporate failure than its U.S. counterpart. This negative perception of bankruptcy stems largely from the United Kingdom’s historical treatment of bankrupts—individuals could be thrown in prison and corporations were turned over to their creditors.

The United Kingdom has tried to alleviate this stigma through amendments to its bankruptcy laws. In 1985, 1986, and 2002, the United Kingdom passed major revisions to its corporate bankruptcy laws designed to foster a more rescue-oriented culture. The Insolvency Act of 1986 (the Insolvency Act), as amended by the Enterprise Act of 2002 (the

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232. See, e.g., Finch, supra note 144, at 197 (“In England insolvency, including corporate insolvency, is regarded as a disgrace. The stigma has to some extent worn off but it is nevertheless still there as a reality.”); see also Vantis Warns on Companies Calling Themselves Bankrupt, FIN. ADVISER, Mar. 9, 2006, available at http://www.ftadviser.com/FinancialAdviser/Archive/Features/article/20060309/da8e7a88-ea 43-11dc-ab39-0015171400aa/Vantis-warns-on-companies-calling-themselves-bankrupt.jsp (“While bankruptcy can relieve uncertainty and stress, it also has a stigma associated with it. Directors may find it virtually impossible to raise future credit.”) (quoting Adrian Doble of Vantis)).

233. See Martin, supra note 12, at 370-78, 392-98 (explaining history behind U.K. bankruptcy law and observing that, “[w]hile English laws themselves became more lenient over time, this unforgiving attitude toward unpaid debt and credit never really changed”). See generally Carruthers & Halliday, supra note 144.


235. See generally Enterprise Act, 2002, c. 40 (Eng.); Insolvency Act, 1986, c. 45 (Eng.); Insolvency Act, 1985, c. 65 (Eng.).
Enterprise Act),\textsuperscript{236} is the primary source of bankruptcy law in the United Kingdom.\textsuperscript{237} Similar to the Bankruptcy Code, the Insolvency Act provides a troubled company with both restructuring (called administration) and liquidation alternatives.\textsuperscript{238} In stark contrast to Chapter 11, however, a company’s management is subject to the direction and control of a third-party administrator in the restructuring context.\textsuperscript{239} Accordingly, many companies and investors continue to view the United Kingdom’s bankruptcy laws as unfavorable and, more importantly, uncertain.\textsuperscript{240}

\textit{a. Debtholders’ Rights in an Administration}

Debtholders, as well as the company or its directors, may petition the court for an administration order for the company.\textsuperscript{241} The appointment of an administrator then follows the entry of the administration order. Alternatively, certain parties may appoint an administrator without court intervention.\textsuperscript{242} These parties include the company and debtholders who hold a qualifying floating charge—i.e., a lien on substantially all of the company’s assets.\textsuperscript{243}

The stated purpose of an administration is the rehabilitation of the company.\textsuperscript{244} “The out-of-court route for appointment of an administrator by the company and/or its directors was also introduced to encourage the greater use of the administration procedure.”\textsuperscript{245} Nevertheless, historically, directors and officers have been reluctant to consider an administration because of the likely loss of control to an administrator.\textsuperscript{246} This reluctance works to the advantage of investors trying to influence corporate affairs
who may be able to extract concessions or implement change at the company in exchange for covenant waivers or additional credit that permits the company to avoid filing an administration.247

If an administration is filed, one or more insolvency practitioners will be appointed as administrators.248 Administrators are officers of the court and are obligated to act in the best interests of all creditors.249 They also have extensive powers over the company, with the ability to control the company’s management, corporate affairs and assets, and to formulate the company’s restructuring plan.250

Secured debtholders, particularly those holding a floating charge, have significant influence in an administration. First, an administrator cannot bind secured debtholders to its proposed plan without the debtholders’ consent.251 Second, floating charge holders have the ability to select the administrator in both an in- and out-of-court administration.252 Although the administrator still owes its duties to all creditors, the party hand-selecting the administrator has at least a perceived advantage.253

Unsecured debtholders also can get a seat at the negotiating table in a company’s administration. For example, investors holding 10% or more of the company’s debt can force the administrator to hold a meeting of

247. Likewise, management may use its debtholders’ concerns regarding U.K. bankruptcy law to its advantage. For example, management may cite its potential liability under the United Kingdom’s wrongful trading laws and threaten administration as a means to obtain necessary waivers or additional liquidity for the company. See Insolvency Act, 1986, c. 45, § 214 (imposing liability on directors under certain circumstances for wrongful trading).
249. Id. paras. 3(2), 5 (describing role of administrators).
250. Id. paras. 59–64 (describing powers of administrators).
251. See id. para. 73(1). An administrator can, however, sell assets subject to a floating charge without court approval and assets subject to a nonfloating (fixed) charge with court approval, provided that the creditor’s priority in the sale proceeds is maintained. Id. paras. 70, 71.
252. Id. paras. 14(1), 36(1); see also Mark Broude et al., An Overview of Global Insolvency Regimes, in THE GUIDE TO DISTRESSED DEBT AND TURNAROUND INVESTING 31, 40–41 (Kelly Deponte ed., 2007) (describing administration process and noting that a floating charge holder “is entitled to advance notice and is given the ability to appoint its own choice as administrator”).
253. Notably, the 2002 amendments to the Insolvency Act were intended to weaken the influence of secured debtholders with floating charges in a company’s rescue efforts. See U.K. DEPT. OF TRADE & INDUS., PRODUCTIVITY AND ENTERPRISE: INSOLVENCY—A SECOND CHANCE (2001); Tyler, supra note 234 (“The Act weakened the rights of unsecured creditors, including the Crown, [and] made it easier for directors to call in an administrator when their businesses ran into trouble.”). For example, the amendments severely limit a floating charge holder’s ability to invoke administrative receivership. See Insolvency Act, 1986, c. 45, § 72A (as amended by Enterprise Act, 2002, c. 40, § 250). For a general discussion of administrative receivership, see FINCH, supra note 144, at 234–72. Nevertheless, opportunities still exist for secured debtholders to influence the administration process. See, e.g., Insolvency Act, 1986, sched. B1, paras. 14, 35–37 (as amended by Enterprise Act, 2002, c. 40, sched. 16); see also Dennis, supra note 245, at 23 (explaining that banks and other financial institutions participated in amendment process and certain concessions, which “have the effect of retaining much of the power in the insolvency process in the hands of secured creditors”).
creditors and appoint a creditors' committee. In addition, investors holding 51% in value of the company's debt can approve or block an administrator's proposed restructuring plan. If the plan is approved, it binds all unsecured debtholders with notice of the administration.

Unfortunately, the negotiation that occurs in an administration is likely to focus primarily on the allocation of sale proceeds. Administration rarely is used to implement a free-standing reorganization of the company. Consequently, investors wanting to influence corporate affairs must acquire secured debt or institute discussions with the company and other major stakeholders in advance of any administration.

b. Debtholders' Rights Outside of Administration

A troubled company and its debtholders also may seek to restructure the company's affairs under a statutory composition or general corporate law. The Insolvency Act includes one form of composition—a CVA. The Companies Act of 2006 (Companies Act 2006) provides another form of composition called a scheme of arrangement (Scheme). Each type of composition represents a compromise and new contract between the company and its stakeholders. Alternatively, a company with a concentrated debtholder group may try to restructure its finances in a less

255. Insolvency Rules, 1986, S.I.1986/1925, pt. 2, para. 2.43 (U.K.); see also Broude et al., supra note 252, at 41.
256. See, e.g., Broude et al., supra note 252, at 41 ("While restructurings can be, and occasionally are, accomplished in an administration through a 'company voluntary arrangement' or 'scheme of arrangement,' the more likely outcome by far will be either the going-concern sale on a relatively accelerated basis or the piecemeal liquidation of the debtor's assets.").
259. Except in the context of a CVA for small businesses, neither a CVA nor a Scheme includes a pre-effective date moratorium on the enforcement of creditors' rights. Consequently, a CVA or a Scheme may be coupled with an administration. See Insolvency Act, 1986, c. 45, § 1A, sched. A1 (as amended by Insolvency Act, 2000, c. 39, sched. 1, paras. 2, 4 (Eng.)); see also id. sched. B1, para. 42 (as amended by Enterprise Act, 2002, c. 40, sched. 16) (describing moratorium available in an administration); FINCH, supra note 144, at 328, 332–33.
formal manner under the Companies Act 2006 and the United Kingdom’s common law.260

i. Influence Through a CVA

A CVA is similar to a U.S. out-of-court restructuring in that it proceeds largely without court supervision and is a consensual restructuring agreement between the company and its creditors. Unlike its U.S. counterpart, however, a CVA is not subject to a significant holdout problem for at least two reasons. First, U.K. bond issuances are not subject to any unanimous consent requirement for the modification of payment terms similar to that imposed on U.S. bond issuances under the Trust Indenture Act.261 Rather, most bond issuances are subject to collective action clauses, which allow a supermajority vote (75%) to bind all bondholders to a restructuring of the terms of the bonds under the indenture.262 Second, the Insolvency Act allows a company to bind dissenting unsecured creditors to the CVA, provided that the CVA receives requisite stakeholder approval.263

The company generally negotiates the terms of the CVA with its major debtholders. It also works with these debtholders to identify and appoint an insolvency practitioner as a trustee to implement the CVA.264 Although a CVA generally is considered an out-of-court process, the trustee must file certain reports with the court.265 The CVA generally takes effect without formal court approval, unless a creditor appeals within twenty-eight days of the filing of the trustee’s report indicating creditor approval of the CVA.266

260. See infra Part III.A.2.b.iii.
262. See id. at 381 (noting that most European indentures require only a supermajority vote (i.e., 75%) to restructure the economic terms of the bonds); see also Kenneth Kletzer, Resolving Sovereign Debt Crises with Collective Action Clauses, FRBSF ECON. LETTER, (Fed. Reserve Bank of S.F., S.F., Cal.), Feb. 20, 2004, at 1, available at http://www.frbsf.org/publications/economics/letter/2004/el2004-06.pdf (explaining, in the context of sovereign bonds, collective action clauses and noting studies comparing “interest rate premiums between bonds issued with and without CACs, focusing on bonds issued in the UK with those issued in the US”).
263. Insolvency Act, 1986, c. 45, § 5(2)(b); see also Broude et al., supra note 252, at 42–43; FINCH, supra note 144, at 332.
265. Id. §§ 2(2), 4(6) (indicating, in the first report, the voting deadlines and terms and purpose of CVA and, in the second report, the results of vote).
266. Id. § 6. A company is not required to separate creditors into separate classes under a CVA, and a CVA is approved if creditors holding at least 75% in value of unsecured claims and at least 50% of equity holders vote in favor of the CVA. Insolvency Rules, 1986, S.I.1986/1925, pt. 1, paras. 1.19(1), 1.20(1) (U.K.); see also FINCH, supra note 144, at 332. If creditors, but not equity holders, approve the CVA, the company may still seek to implement the CVA. Insolvency Act, 1986, c. 45, § 4A(3) (as amended by Insolvency Act,
In Schefenacker, the distressed debt investors negotiated with the company and its controlling shareholder to formulate a comprehensive restructuring plan. The plan used a CVA to compromise the claims of Schefenacker’s unsecured bondholders and shareholders. The insolvency practitioners appointed under the CVA made the required filings with the court and oversaw the voting on, and subsequent implementation of, the CVA. The deal between the distressed debt investors as secured creditors, the company, and Dr. Schefenacker was documented in a separate agreement.

Schefenacker is an example of the use of a CVA outside of an administration. An administration was not needed because the secured creditors agreed to a moratorium while the parties worked to negotiate the CVA. Moreover, the company did not default on its unsecured bonds until February 2007, shortly before the proposal of the CVA to the bondholders. A standstill provision in the bond indenture prevented the bondholders from taking action against Schefenacker without the consent of the secured creditors.

ii. Influence Through a Scheme

A Scheme is akin to a Chapter 11 plan in several respects. It may be used to bind both secured and unsecured creditors, as well as shareholders. It also involves a formal court procedure that requires significant disclosure to, and involvement of, the court. A Scheme is not itself an insolvency proceeding, but may be used by an administrator in an administration.

Distressed debtholders in the United Kingdom may use a Scheme in a manner similar to a CVA. For example, the debtholders may work with the company to design a financial restructuring plan that gives the debtholders control over the company through a debt-for-equity exchange. The primary

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267. See supra Part II.B.
269. Id. at 23; see also Schefenacker Extends Moratorium with Creditors, EUR. INTELLIGENCE WIRE, Nov. 28, 2006, available at LEXIS, Europe Intelligence Wire File.
270. Schefenacker Bondholder Objection, supra note 102, at 7–8.
272. See Mayr, supra note 13, at 505 (“For example, the U.K. ‘scheme of arrangement’ procedure, which exists in some form in numerous jurisdictions, provides a mechanism to obtain expeditious court approval of consensual reorganization plans.”).
273. See Companies Act, 2006, c. 46, § 899(1), (3) (Eng.); see also FINCH, supra note 144, at 325 (“One advantageous feature of the scheme of arrangement is that, if the arrangement is approved, it may modify the rights of shareholders and creditors and may do so without their consent.”).
274. See Companies Act, 2006, c. 46, §§ 895–897; see also FINCH, supra note 144, at 325.
differences to consider include the ability to bind dissenting creditors under a Scheme and the time and expense associated with court oversight of a Scheme.275

Part 26 of the Companies Act 2006 governs Schemes.276 Under that section, debt and equity holders must be separated into different classes of parties holding similar claims against or interests in the company.277 This classification requirement is similar to that imposed under Chapter 11. To proceed with a Scheme, at least 75% in value and 50% in number of the claims or interests in each designated class must approve the Scheme.278 This approval threshold is more stringent than that required for either a CVA or an administration plan. Notably, all classes must approve the Scheme.279 The court can bind dissenting parties only if their class approves the Scheme; a Scheme cannot be crammed down on nonconsenting parties like a Chapter 11 plan.

Debtholders used Schemes to implement debt-for-equity exchanges in the restructurings of MyTravel and Telewest. In MyTravel, the Scheme converted the company’s senior secured and subordinated bond debt into approximately 97% of the new company’s equity and diluted the holdings of existing shareholders to less than 3% of the equity.280 In Telewest, the Scheme converted the company’s notes and debentures into 98.5% of the new company’s equity and diluted the holdings of existing shareholders to 1.5%.281 In both cases, bondholders tried to block approval of the Schemes in order to obtain a greater recovery.282 The Telewest Scheme was approved and implemented as proposed by the company and senior

275. See, e.g., Broude et al., supra note 252, at 42 ("Unlike CVAs, however, Schemes are court-intensive procedures which are more difficult and expensive to implement.").

276. Companies Act, 2006, c. 46, §§ 895–900 (section 900 relates to the reconstruction or amalgamation of any company or companies); see also Finch, supra note 144, at 324–31 (describing generally the procedures).

277. See Companies Act, 2006, c. 46, § 899(1); see also Broude et al., supra note 252, at 42 ("Also unlike in a CVA, where all creditors vote as part of a single class, creditors in a Scheme will vote in separate classes of creditors holding common interests.").

278. Companies Act, 2006, c. 46, § 899(1), (3) (discussing voting requirements).

279. Id.


282. The bondholders in Telewest disputed classification based on the conversion rate applied to the bonds; the bondholders in MyTravel disputed the company’s ability to accomplish a reconstruction or scheme without classifying bondholders and giving them a vote on the proposed plan. See, e.g., Underhill & Edwards, supra note 280, at 34–36 (same); Fraser Hem, Courting Hope, Legal Wk. (U.K.), Feb. 2, 2006, at 26 (describing bondholder disputes in MyTravel and Telewest); Bondholders’ Opposition to Schemes of Arrangement, BLG Banking L. Briefing (Barlow, Lyde & Gilbert, London, U.K.), Mar. 2005, at 4, 4, available at http://www.blg.co.uk/pdf/Banking%20Law%20Briefing-17-01.03.2005.pdf (same).
debtholders. The MyTravel dispute was resolved consensually and the Scheme was approved and implemented.\textsuperscript{283}

iii. The Jarvis Approach

Finally, a company may implement a capital restructuring completely out of court and without a CVA or Scheme. A company can achieve this type of restructuring under general U.K. law with the cooperation of the debtholders and the requisite consent of shareholders.\textsuperscript{284} This type of restructuring is limited in that it can only affect the rights of debtholders who consent (or who have agreed to be bound by the consent of others under the applicable debt documents). Accordingly, it typically is used in a debt-for-equity exchange with a concentrated debtholder group.

Jarvis illustrates this type of restructuring. Jarvis worked closely with its small group of senior debtholders to obtain a moratorium, additional capital, and ultimately, a restructuring agreement.\textsuperscript{285} For this reason, Jarvis did not need to invoke an administration for a moratorium, or a CVA or Scheme to bind its debtholders. The contemplated restructuring of a debt-for-equity exchange simply required the approval of shareholders. This approval was necessary because the exchange would substantially dilute the shareholders' interests. The restructuring was presented to, and passed by, shareholders as a resolution at an extraordinary meeting of creditors called under the Companies Act 2006.\textsuperscript{286}

c. Debtholders' Rights Under Prepackaged Restructurings

U.K. bankruptcy law does not explicitly facilitate a prepackaged restructuring plan process. Nevertheless, troubled companies and their debtholders are pursuing prepackaged plans as an alternative to simple administrations and administrative receiverships.\textsuperscript{287} This process allows the parties to negotiate the sale of the company or substantially all of its assets prior to initiating an administration.\textsuperscript{288} The parties also agree upon the individuals who will serve as administrators. The administrators then implement the sale immediately upon commencement of the administration.\textsuperscript{289}

\begin{itemize}
\item \textsuperscript{283} See Underhill & Edwards, supra note 280, at 36; Hern, supra note 282; Bondholders' Opposition to Schemes of Arrangement, supra note 282, at 4.
\item \textsuperscript{284} See Companies Act, 2006, c. 46, §§ 336–340; see also FINCH, supra note 144, at 229–31.
\item \textsuperscript{285} See supra Part II.C.
\item \textsuperscript{286} See JARVIS UNAUDITED RESULTS FOR 2005, supra note 108, at 1, 11–12; Completion of Restructuring, supra note 120.
\item \textsuperscript{287} See generally Broude et al., supra note 252, at 40–43 (discussing use of prepackaged administrations).
\item \textsuperscript{288} See id.
\item \textsuperscript{289} See id. In a prepackaged administration, the administrators still owe a duty to all creditors. Thus, the administrators need to perform sufficient due diligence regarding the company's affairs and the proposed sale to satisfy their duty. Some observers criticize the
Distressed debt investor BlueBay Asset Management and several banks used this prepackaged approach in The Polestar Group's restructuring. The Polestar Group is one of Europe's largest independent printers. They worked with the company to implement a capital restructuring through a debt-for-equity exchange. Specifically, the parties negotiated the sale of the senior debtholders' collateral—i.e., substantially all of the company's assets—to a new entity. The senior lenders agreed to write off approximately two-thirds of their debt in exchange for the equity of the new company. Polestar's junior debt of approximately £350 million and its existing equity, held by a private equity firm, was wiped out. Polestar's underfunded pension plan was closed, but Polestar agreed to contribute £45 million to the plan over a twelve-year period. The asset sale was accomplished by an administrative receiver immediately upon the commencement of an administrative receivership by the senior lenders. A similar prepackaged approach works in the administration context as well.

Prepackaged administration process for, among other things, lack of transparency. See, e.g., Carolyn Swain, Mind the Pre-pack, LAWYER (U.K.), July 3, 2006, at 32, 32.


291. See, e.g., Nick Hassell, Polestar Investors Lose Millions, TIMES (London), Dec. 8, 2006, at 62 (explaining that Polestar's senior debtholders were "asked to write off two thirds of their investment, or £250 million," which would have reduced their total outstanding debt to approximately £125 million); Publishing Firm Once Owned by Maxwell Slashes Debts by £550m, BIRMINGHAM POST (U.K.), Dec. 9, 2006, at 22, available at LEXIS, Birmingham Post File; Grant Ringshaw, Printer to Write Off £300m, SUNDAY TIMES (London), Oct. 22, 2006, at 3.

292. See Sandy Shandro, Golden Oldies: How Traditional Insolvency Law Concepts Are Invaluable in Restructuring, AM. BANKR. INST. J., Mar. 2007, at 30, 30 ("The restructuring plan that was adopted involved the sale of the group to a bank-owned Cayman investment vehicle and its recapitalisation via a debt-for-equity swap and the provision of new monies to the group so as to reduce its bank indebtedness by approximately US$1.4 billion.").

293. See supra note 291.

294. See supra note 291.

295. See, e.g., Richard Tett & Charles Magoffin, The Living Dead: How Pension Trustees Have Become Active, Even Accepting Creative Solutions, in Major Restructurings, INT'L FIN. L. REV., Apr. 2007, at 24, 25 ("After extensive discussions, a creative solution was agreed whereby the Polestar pension scheme and deficit was transferred to a separate SPV company ringfenced away from the Polestar Group... In exchange, Polestar agreed to pay the pension scheme a total of £45 million over 12 years.").


297. Prepackaged administrations are feasible because, among other things, "the administrator has the power to sell the company's business without court review of the sale process or court approval of the sale." Broude et al., supra note 252, at 41. Troubled companies and their debtholders are using this restructuring mechanism more frequently. See, e.g., Costcutter Helps with Stocks as FreshXpress Takes Shape, GROCER (U.K.), July 28, 2007, at 4 ("FreshXpress purchased 56 Kwik Save stores in an £18m pre-pack administration deal, earlier this month."); Precedent Set for Private Equity Restructuring, INT'L FIN. L. REV., July 2007, at 8, 8 [hereinafter Private Equity Restructuring] (describing Damovo prepackaged administration and explaining that "this is the first time that European holding companies have been placed in administration in England under the EC Regulation..."
B. Objectives and Strategies of Activist Distressed Debt Investors

Institutional investors have one primary and common objective—to make money. Consequently, an institutional investor’s decision to pursue an activist distressed debt investing opportunity is an economic decision. It turns on whether untapped or underutilized value exists at the distressed company. This value may be hidden in real property, noncore assets, operational improvements, or industry consolidation. The economic nature of the investment decision applies on both sides of the Atlantic.

Notably, not all distressed debt investors desire to influence corporate affairs. In fact, the number of known activist investors is relatively small. Nevertheless, these investors are flush with capital and can have a significant impact on a distressed company’s affairs. They can seek to influence corporate affairs through board representation, management changes, or a controlling ownership interest in the company. This section analyzes each of these strategies and the ultimate objective of value creation below.

1. Board and Management Control

Management frequently is the target of activist investors. Potential conflicts between management and the investors drive this trend. Management, or at least key members of management, and the investors may have different goals for the company’s operations and capital structure and management compensation packages. Regardless of the exact conflict, the result is the same. Top executives, typically the CEO and CFO, are replaced either shortly before or during the restructuring process.

For example, management may want to avoid bankruptcy, which distressed debt investors may view as advantageous or necessary.
Alternatively, management may disagree with a debt investor’s restructuring goals or timeline for the company. In Kmart, the CEO was openly skeptical about the restructuring timeline proposed by ESL and Third Avenue. The CEO believed that Kmart should take its time in bankruptcy to fix operational problems. He was quoted as saying, “You need to emerge with the right capital structure, and with enough capital to fix the business and ensure [vendor] support... [i]f you don’t, then you could end up back in bankruptcy.” ESL and Third Avenue, on the other hand, pursued a quick emergence. Kmart emerged from bankruptcy on the debtholders’ timeline and with a new CEO at the helm.

Several other factors may result in a management change. Management may be viewed by the activist investor and others as being part of the problem that triggered the company’s financial distress. The distressed debt investor also may want its own designee in a leadership position. For example, in Jarvis, the Royal Bank of Scotland encouraged an individual from a prior deal relationship to accept the CEO position. In Allied, Yucaipa appointed a new CEO in connection with the company’s emergence from Chapter 11.

In addition, a distressed debt investor may seek representation on the board of directors. Such representation assists the investor in influencing

ultimately triggered the CEO and CFO’s resignation and Calpine’s Chapter 11 case. See Disclosure Statement for Debtors’ Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code at 13–14, 53, In re Calpine Corp., No. 05-60200(BRL), 2007 WL 4565223 (Bankr. S.D.N.Y. June 20, 2007) (Docket No. 5016); Affidavit of Eric N. Pryor Pursuant to Local Bankruptcy Rule 1007-2, at 3–4, 42, Calpine, No. 05-60200(BRL) (Dec. 21, 2005) (Docket No. 2); see also Roane, supra note 39, at 39 (noting hedge funds’ role in management’s resignation and the company’s bankruptcy filing); Jim Polson & Bradley Keoun, Calpine Executives Ousted as Bankruptcy May Be Near, BLOOMBERG, Nov. 29, 2005, http://www.bloomberg.com/apps/news?pid=10000103&sid=aPn9hGDV3YIM&refer=us (noting that the CEO and CFO of Calpine “were the primary drivers keeping the company out of bankruptcy for the past three years” (quoting Jeffrey Wolinsky, Standard & Poor’s)).

305. See, e.g., Muller, supra note 46, at 101–02.

306. Id. at 101.

307. See, e.g., Mitchell Pacelle & Amy Merrick, Salvage Operation: Behind Kmart Exit from Chapter 11: Investor’s Big Bet—As Debt He Held Lost Value, Mr. Lampert Forced Out CEO, Pushed Up Timetable—Still Facing Wal-Mart, Target, WALL ST. J., May 6, 2003, at A1 (“[Lampert’s solution for Kmart was to] [g]et the company out of bankruptcy court fast. Mr. Adamson said he would do his best to accelerate events, ... [b]ut Mr. Lampert was already losing confidence in the Kmart chief. And within weeks, he made his decision known: Management had to change.”); see also Kmart Corp., Annual Report (Form 10-K), at 77–78 (Mar. 24, 2003) (describing former CEO James Adamson’s resignation from, and severance agreement with, Kmart).

308. See, e.g., Waples, supra note 109 (“[Lovell] was encouraged to take the post by Royal Bank of Scotland, one of the lead creditors at Jarvis and a former lender to both Costain and Dunlop Slazenger.”).


310. See Harner, supra note 8, at 87–88 (data reporting that, of those respondents who invest in distressed debt and responded to applicable question, approximately 43% seek control of the board of directors at least 1% of the time, with approximately 16% doing so more than 50% of the time).
management, operational, and capital changes at the company. Some investors try to obtain this representation prior to any restructuring. For example, in Radnor, Tennenbaum obtained a seat on the company’s board prior to the Chapter 11 case.\textsuperscript{311} This prestructuring representation does not necessarily allow the investor to direct company action;\textsuperscript{312} however, it does provide the investor with nonpublic information and a direct line of communication to the decision-making body at the company.

Most distressed debt investors seek board representation in the restructured company. This representation may be explicit in the terms of the restructuring itself. For example, in Schefenacker, the agreement among the senior debtholders, the company, and Dr. Shefenacker provided for a five-member board.\textsuperscript{313} During the first three years after implementation of the agreement, Dr. Schefenacker could appoint one director and, of the four largest shareholders, each could appoint one of the remaining four directors.\textsuperscript{314} Thereafter, the three largest shareholders could each appoint one director and the remaining two directors would be appointed by ordinary resolution of the shareholders.\textsuperscript{315}

2. Ownership Changes

Some activist investors want control of the entire company, rather than just a few isolated management decisions.\textsuperscript{316} This type of control can be achieved to some extent through board representation. The activist investor’s control is strengthened significantly, however, if the investor uses


\textsuperscript{312} An investor’s representative must be mindful of its fiduciary duty of loyalty to the corporation. See id. at 844–45 (explaining that Tennenbaum’s representative acted appropriately by abstaining from certain votes).

\textsuperscript{313} Schefenacker CVA, supra note 87, at 105.

\textsuperscript{314} Id.

\textsuperscript{315} Id. Similar explicit provisions were included in the Allied and Kmart plans of reorganization. See Allied Plan, supra note 176, at 42 (Yucaipa received the right to appoint four of five postpetition board members); First Amended Joint Plan of Reorganization of Kmart Corporation and Its Affiliated Debtors and Debtors-in-Possession, supra note 126, at 35 (ESL and Third Avenue received the right to appoint four of nine postpetition board members).

\textsuperscript{316} An increasing operational play for activist investors in Europe is to encourage the company to relocate its country of incorporation (or centre of main interests) to a country that is viewed as more creditor-friendly. See supra Part II.B (discussion of Schefenacker); see also Ken Baird & Paul Sidle, Insolvency: Flitting Boom, LAWYER (U.K.), July 2, 2007, at 29, 29 (describing the move of Deutsche Nickel and Schefenacker’s country of incorporation from Germany to the United Kingdom); Private Equity Restructuring, supra note 297, at 8 (describing the move of Damovo’s country of incorporation from Luxembourg to the United Kingdom). The location of a company’s centre of main interest is important under the European Union Regulation on Insolvency Proceedings because it determines jurisdiction in conflict of law situations. See, e.g., Broude et al., supra note 252, at 39–40. This migration of distressed companies from one country to another is similar to the forum shopping that may take place in connection with a company’s Chapter 11 filing in the United States.
its influence over management or the board to acquire a controlling or majority ownership interest in the company.

Acquiring an ownership interest often is a subobjective of activist investors.\(^\text{317}\) These investors invest in troubled companies with the intention of forcing a debt-for-equity exchange. In the United States, this type of restructuring is most frequently accomplished through a traditional Chapter 11 plan, as in Allied and Kmart, or a prenegotiated plan, as in Granite Broadcasting Corporation.\(^\text{318}\) An out-of-court debt-for-equity exchange generally is not an option for large public companies in the United States. In the United Kingdom, on the other hand, a public company such as Jarvis may accomplish a complex debt-for-equity exchange with little or no substantive court involvement.\(^\text{319}\)

Once in control, the activist investor can unlock the value that initially drew the investor to the troubled company. In Kmart, part of this value was the company's substantial real estate holdings. Shortly after Kmart's emergence from Chapter 11, Kmart sold a portion of this real estate to Sears and Home Depot for approximately $900 million.\(^\text{320}\) This move, together with cost reductions and other operational changes, significantly increased Kmart's stock value. A similar strategy was used by distressed debt investors in the Chapter 11 cases of Loews Cineplex and Regal Entertainment Group. The investors in both cases realized a substantial profit from their postbankruptcy ownership positions.\(^\text{321}\)

An activist investor also may be looking to consolidate its holdings or create synergy in a particular industry. This appears to be the case in Allied, where Yucaipa now controls over 50% of the U.S. vehicle-transporter market.\(^\text{322}\) Distressed debt investors pursued a similar strategy with U.K. cable operators NTL Inc. and Telewest. The investors acquired

\(^{317}\) See Harner, supra note 8, at 85 (data reporting that, of those respondents who invest in distressed debt and responded to the applicable question, approximately 40% attempt to acquire a controlling ownership interest in the company at least 1% of the time); see also DISTRESSED DEBT MARKET OUTLOOK 2008, supra note 54, at 16 (reporting that "there was a pick up of direct lending to distressed issuers in 2007, particularly those issuers linked to commodities or the housing downturn"); DISTRESSED DEBT MARKET OUTLOOK 2007, supra note 54, at 20 ("Only 20% of respondents said they would never pursue such a strategy, while over 40% said lending into situations for equity control was either part of their core strategy or a course of action they would consider on an exceptional basis in 2007.").

\(^{318}\) See supra Part III.A.1.a,i,c.

\(^{319}\) See supra Part III.A.2.b.iiii.

\(^{320}\) See, e.g., Matt Miller, The Property Play, DAILY DEAL, May 26, 2006 (on file with the Fordham Law Review) ("In 2004 [after emerging from bankruptcy], Kmart booked more than $1 billion through property sales, primarily to Home Depot and Sears. The retailer ended its year with a $1.1 billion profit.").

\(^{321}\) See, e.g., Lauria & Holman, supra note 14 (explaining that distressed debt investors who acquired Loews through a debt-for-equity exchange made a substantial profit on subsequent sale of Loews Cineplex Entertainment Corp. (Loews) to private equity buyers; one such investor reportedly made over $200 million on the sale); Morris, supra note 14 (explaining that distressed debt investors who acquired Regal Entertainment Group through a debt-for-equity exchange realized, in one instance, sevenfold gain through special dividends and other value appreciation).

\(^{322}\) See supra Part I.A.
the equity of NTL and Telewest through their respective restructuring plans with the stated intention of merging the two companies after the restructurings were complete.\footnote{323}{See, e.g., Griffiths, supra note 15 (explaining contemplated merger of NTL and Telewest upon completion of debt-for-equity exchange and noting that analysts argue a merger of Telewest and NTL would create a company better able to take on the United Kingdom’s dominant pay-TV operator BSkyB).}

Regardless of how an investor chooses to operate the troubled company after the debt-for-equity exchange, few investors maintain this investment for more than one to three years.\footnote{324}{See Harmer, supra note 8, at 83 tbl.2 (data reporting that, of those respondents who invest in distressed debt and responded to the applicable question, approximately only 13% were willing to maintain an equity investment longer than three years, with approximately 58% wanting to be out of the investment in one to three years); see also ALTMAN & SWANSON, supra note 26, at 25 app. D; LHABITANT, supra note 22, at 100; ROSENBERG, supra note 22, at 29–33.} Rather, most investors look to realize gain on their distressed debt investments through an initial public offering or private sale of the equity.\footnote{325}{See supra Part 1.B (discussing investment strategies).} This investment reality raises the question of whether distressed debt investors are really improving the long-term value of the company or just the short-term liquidity of their holdings.

3. Value Creation (or Destruction)

Activist investors seek to make their money by enhancing or creating value at the company.\footnote{326}{See, e.g., Partnoy & Skeel, supra note 17, at 1034–35 (explaining, in the context of the Tower Automotive Chapter 11 cases, how hedge funds and other distressed lenders may have incentive to destroy, rather than create, corporate value).} The concept of value creation in this context, however, can be deceiving. What is seen as value enhancing to the investor can be value destructive to the company on either a pre- or postrestructuring basis.\footnote{327}{See supra Part 1.B (discussing investment strategies).}

The issue of value creation or destruction is present in both U.S. and U.K. restructurings and is most troubling in the prerestructuring context. During this period, the solvency of the company may still be in question, and both creditors junior to the distressed debt investors and existing shareholders may still have some interest in the company.\footnote{328}{Directors generally owe their fiduciary duties to the company and the shareholders, as the residual owners of the company. If a company is almost, but not completely, insolvent (often referred to as the "zone of insolvency"), the directors may still owe duties to shareholders. See Companies Act, 2006, c. 46, § 170 (Eng.) (directors owe duties to the company); see also id. §§ 171–177 (detailing directors' duties).} This scenario places the company's management in a delicate position. Management must fulfill its fiduciary duties, which may still be owed exclusively or at
least partially to the company’s shareholders. Yet management is facing demands from a controlling debtholder that may end up owning the company at the end of the restructuring.

Conflicts between management, the controlling debtholder, other debtholders, and existing shareholders can be value destructive. Some observers in the United States believe that activist investors can add delay and expense to the restructuring process. This type of conduct in turn reduces distributions to junior creditors and any likelihood that shareholders can maintain their interests. It also can cause the company to run out of money before a restructuring plan is approved.

American Remanufacturers, Inc. is an example of conflicts leading to a loss of value for the company and its stakeholders. American Remanufacturers filed a Chapter 11 case in November 2005. Simultaneously with its case filing, American Remanufacturers sought bankruptcy court approval of a DIP Loan from its prepetition senior lender, Black Diamond. The DIP Loan contemplated $31 million in credit and a quick sale of the company’s assets to Black Diamond for approximately $32 million. Two of American Manufacturer’s junior debtholders, DDJ Capital Management LLC and Airlie Opportunity Master Fund, Ltd., objected to the DIP Loan and proposed their own financing package and stand-alone restructuring plan for the company.

329. See infra note 370.
330. For a discussion of management fiduciary duties, see infra Part III.C.4.
331. See, e.g., ROSENBERG, supra note 22, at 32, 89–91, 99 (noting that “to some [investors], . . . blocking tactics lengthened the bankruptcy process,” and describing several cases where such delay materialized, including Coleco Industries and Wheeling-Pittsburgh Steel Corporation); see also Roane, supra note 39, at 38–39 (noting that the distressed debt investors dispute in the FiberMark Chapter 11 case cost “about $60 million over the course of seven months”).
333. Motion for an Order Pursuant to Sections 361, 363 and 364 of the Bankruptcy Code (1) Authorizing the Debtors to Obtain Postpetition Financing, (2) Authorizing the Use of Cash Collateral, (3) Authorizing Repayment of Certain Prepetition Secured Debt, (4) Granting Liens and Superpriority Administrative Expense Status, (5) Providing Adequate Protection and (6) Scheduling and Approving the Form and Method of Notice of Final Hearing at 7, Am. Remfrs., No. 05-20022 (PJW) (Docket No. 14) (describing maximum borrowing amount under DIP Loan as $31 million); Am. Remfrs. Original Sale Motion, supra note 332, at 9 (describing the purchase price as amounts outstanding under the DIP Loan, plus $1.1 million).
be resolved, the company converted its case to a Chapter 7 case, and a Chapter 7 trustee was appointed.\textsuperscript{335} A member of the senior bank group purchased the company’s inventory assets at a fire sale for $7.7 million.\textsuperscript{336}

Not every distressed investment situation leads to conflict, and, regardless, distressed debt investors may be the only or best source of rescue capital for the company.\textsuperscript{337} A distressed debt investor that offers new capital to the restructured company, either directly or by improving the company’s balance sheet through a debt-for-equity exchange, can give a troubled company a second chance. These investors can create value by deleveraging the company’s balance sheet and instituting operational changes, as was accomplished in Kmart, Loews, Regal Cinema, Jarvis, and other cases discussed above.

Activist investors also can create value by influencing changes at the company that make the company more attractive to potential buyers, which may be either the investors themselves or third parties.\textsuperscript{338} A sale of the company or its assets on a going-concern basis can enhance the productivity of the company’s assets, including its personnel. Werner and Polestar demonstrate how asset sales to distressed debt investors can create a recovery pool for other creditors and continue the utility of the company’s assets. In both cases, business operations continued, employees retained their jobs, and some value was created for junior creditors in Werner and pension beneficiaries in Polestar.\textsuperscript{339} Bally Total Fitness demonstrates how

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335. See Am. Remfrs., No. 05-20022 (PJW), slip op. at 2 (Nov. 17, 2005) (Docket No. 88) (converting Chapter 11 cases to Chapter 7 cases); see also Peress & Prinzhorn, supra note 199, at 57 ("After four days of confusing disputes about definitions of third parties, priming and subordination, the company lawyers informed the court that the company had run out of cash and converted to a chapter 7 liquidation."); FITCH RATINGS, A CASE STUDY APPROACH TO U.S. SECOND-LIEN LEVERAGED LOAN RECOVERY EXPECTATIONS 5 (2007) [hereinafter A CASE STUDY APPROACH], available at http://fitchratings.com (subscription required, on file with the Fordham Law Review).

336. See A CASE STUDY APPROACH, supra note 335, at 5 ("A member of the company’s senior lender group subsequently purchased the company’s inventory assets at a fire sale for $7.7 million.").

337. See, e.g., Harvey R. Miller & Shai Y. Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?, 78 AM. BANKR. L.J. 153, 183 (2004) (noting that a single investor or a single group of investors [including hedge funds and other distressed debt investors] may amass funds to purchase an entire firm (or its assets) at costs that may exceed $1 billion, thus removing risk of potential losses due to dismemberment of the firm (or its assets) and the increased costs associated with breakups"); Yap, supra note 165, at 158–61 (suggesting that distressed debt investors add corporate value through offering otherwise unavailable financing and monitoring management).

338. This technique involves the creation of a new company to serve as an acquisition vehicle. The new company is owned by the distressed debt investors, who can, among other things, contribute their debt holdings to the company for purposes of credit bidding. For an example of this technique in practice, see Werner Sale Motion, supra note 203, at 1–4, 6–11, which describes the structure of a sale facilitated by a new acquisition company.

339. See, e.g., Roknick, supra note 203 (noting that the “[t]erms of the [Werner] sale also call for the retention of managers and employees” and that unsecured creditors reached a deal with the company and purchasers whereby they would receive “a piece of proceeds
investors can help position the company for a sale to a third party at a higher price.\textsuperscript{340}

Whether rescues by distressed debt investors result in long-term value for the company is uncertain. Commentators have different views on this issue, and it is one of the primary critiques of distressed debt investments.\textsuperscript{341} The issue stems partly from the conflicts discussed above and partly from the investment horizons of distressed debt investors.\textsuperscript{342} Even an investor with a long-term investment horizon generally desires to be out of the investment within one to three years.\textsuperscript{343} In contrast, the company desires to be in business and profitable beyond that time frame.\textsuperscript{344}

Activist distressed debt investing is not a perfect solution to a company’s financial troubles, but it is a solution. Institutional investors also are

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\textsuperscript{340} Bally Total Fitness originally filed a prepackaged plan of reorganization in its Chapter 11 case that contemplated a debt-for-equity exchange with its distressed debt investors. Subsequently, Bally Total Fitness received and accepted an offer for the company that exceeded the value of the original plan and even provided a small return to existing equity holders. See Bally Motion to Modify, supra note 224, at 8–12.

\textsuperscript{341} See, e.g., Baird & Rasmussen, supra note 10, at 1245–46 (noting that “[t]he crucial question is the extent to which private lenders’ self-interest is aligned with the interests of all the investors in the corporation” and answering this question with cautious optimism); see also Henry T.C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 S. CAL. L. REV. 811, 820–22 & n.22 (2006) (noting issue of short-termism with respect to institutional investors such as hedge funds). For a discussion of the general debate regarding value creation and institutional investors such as hedge funds, see Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 IOWA J. CORP. L. 681, 682–84 (2007), and Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1083–87 (2007).

\textsuperscript{342} See Fuller, supra note 31, at 17 (explaining the conflicts that may arise in the distressed debt investing context, including a “divergence in time horizons when determining a value realisation”).

\textsuperscript{343} See supra note 324.

\textsuperscript{344} The long-term value creation issue is less troubling on the back end of restructurings involving debt-for-equity exchanges. Distressed debt investors, as owners of the reorganized company, should invest efficiently in positive net present value transactions, meaning that surplus cash is distributed to shareholders, including the investor. See, e.g., Mihn Van Ngo, Agency Costs and the Demand and Supply of Secured Debt and Asset Securitization, 19 YALE J. ON REG. 413, 422 (2002) (“In order to maximize returns, shareholders desire that managers invest corporate funds in all available positive net present value projects.”); see also E.C. Lashbrooke, Jr., The Divergence of Corporate Finance and Law in Corporate Governance, 46 S.C. L. REV. 449, 449–50 (1995) (“The basic finance theory that managers should maximize the value of the corporation by investing in all positive net present value projects serves the dual purpose of maximizing the value of the corporation and the wealth of shareholders.”). This efficient investing strategy is in contrast to that sometimes pursued by management, where “managers have an incentive to retain an extra amount of cash beyond levels necessary to fund positive net present value projects” and invest it in negative net present value projects. See, e.g., Ngo, supra, at 422–23. This strategy also should provide at least short-term value to other stakeholders. Those stakeholders must then assess whether this strategy causes the company to pass over long-term growth opportunities to their detriment. Cf Lashbrooke, supra, at 450 (providing other examples and explanations for managers passing over positive net present value opportunities).
pursuing the strategy with more vigor as an independent, alternative means of influencing corporate affairs. Companies and other stakeholders thus must understand the strategy and how it is changing the corporate restructuring landscape.

C. Distressed Debt as a Catalyst for Convergence in U.S. and U.K. Restructurings

Distressed debt investors in both the United States and the United Kingdom have the opportunity to fill, and can accomplish similar objectives in, an activist role. As discussed above, activist investors can influence management decisions, trigger management personnel changes, and acquire control of the company. This activism is changing the way companies approach and react in restructuring contexts. It also is changing the traditional roles of management, trustees, and debtholders in U.S. and U.K. restructurings.

1. U.S. Exportation of Distressed Debt Investing

Distressed debt investing first took hold in the United States. It began as a small, niche market primarily used by hedge funds that often were (and still are to some extent) called “vulture” investors. The nickname refers to these investors’ perceived practice of scavenging company carcasses for value. The market itself prospered under the U.S. Chapter 11 process, which allows parties to buy and trade claims against bankrupt companies. Investors quickly realized the potential value in the claims trading market.

Distressed debt investing has since developed into an investment strategy independent of Chapter 11 that focuses on a much broader pool of troubled companies and distressed debt instruments. It also has expanded beyond U.S. borders. The overseas restructuring processes, however, traditionally are very different from the U.S. process. Distressed debt investors thus either had to change their investment objectives or change the

345. See, e.g., Rich Pickings, supra note 43, at 20 (“Vultures are basically value investors, trying to buy an asset for a price well below its intrinsic or fair value.”).
346. For a discussion of claims trading, see supra Part I.A.1.
347. See, e.g., Beverini & Cova, supra note 58 (noting move of U.S. funds into European markets); Tett, supra note 45 (same); see also Fuller, supra note 31, at 15 (noting U.S. influence on European distressed debt market). “There is now more than $1.1 trillion (£579 billion) worldwide under hedge fund management, with London at the centre of Europe’s hedge fund management industry, responsible for approximately two-thirds of the $325 billion (£171 billion) in funds under management in Europe.” Houghton, supra note 35, at 28; see also Edward I. Altman & William Stonberg, The Market in Defaulted Bonds and Bank Loans: 2005 Review and 2006 Predictions, J. PORTFOLIO MGMT., Summer 2006, at 93, 94 (“We know of 160 distressed debt investors. At least two dozen operate outside of the United States, and another 10–15 European-based investors who do not have a U.S. operation.”); Rich Pickings, supra note 43, at 22 (“Analysts say Europe still lags behind America in the opportunities it provides for distressed debt investors, but that this situation is changing as its high-yield corporate bond market and national insolvency laws evolve.”).
restructuring processes. The latter appears to be occurring in both the United States and the United Kingdom.

2. Convergence in U.S. and U.K. Restructuring Processes

U.S. and U.K. bankruptcy laws "on the books" are different in many respects. Both countries now offer a reorganization alternative that focuses on rescuing troubled companies. Nevertheless, the mechanics of each country's reorganization laws differ in several key respects. For example, management stays in place in Chapter 11, but is displaced in an administration. The Chapter 11 automatic stay generally prohibits the termination of prebankruptcy contracts, but the U.K. moratorium does not. Moreover, the DIP Loan structure in the United States has no identical counterpart in the U.K. administration process.

Based on these and other statutory differences, U.S. bankruptcy law generally is viewed as more debtor-oriented, and U.K. law is viewed as more creditor-oriented. The concepts of a debtor-in-possession and management staying in place in Chapter 11 cause the U.S. process to be characterized as management-driven. The appointment of an administrator under administration causes the U.K. process to be characterized as management-displacing. As is often the case, however, the law on the books does not necessarily reflect the law in practice.

The presence of an activist investor can change the restructuring landscape and the application of bankruptcy law. In the United States, management may continue to operate the company as a debtor-in-possession and may continue to have an exclusive opportunity to propose a plan of reorganization. These factors, however, do not mean that management has control of the restructuring process or the development of the restructuring plan. Likewise, in the United Kingdom, an administrator may receive all of the powers of management upon the commencement of the administration. The management team, however, typically remains in place, and the administrator relies on management to exercise its powers. The administrator's powers may be further

348. For a discussion of Chapter 11 and administration, see supra Part III.A.
349. See supra Part III.A.
350. See Armour et al., supra note 21, at 1727–28.
352. Management turnover in connection with a Chapter 11 case is not a new development. Lenders (primarily banks) have long had the ability through their financing contracts and general influence over the debtor to cause the board of directors to replace the debtor's CEO. See, e.g., Baird & Rasmussen, supra note 17, at 937–39. The successor CEO and the board, however, traditionally were then permitted to retain control of the debtor's business and restructuring. Activist investors typically are not willing to leave either historical or new management with this type of control.
353. See, e.g., Broude et al., supra note 252, at 41 ("Under a court approved protocol, it is possible that the administrator may leave much of the day-to-day management decisions to existing management under the administrator's supervision . . . ").
diminished by the desires of a distressed debt investor, particularly in the prepackaged administration context.

Activist investors are using both the U.S. and the U.K. restructuring processes to influence the affairs of troubled companies. They have identified opportunities under the laws of both countries to effect the same end. Their focus on this common end—i.e., obtaining control in distressed situations—has pushed the restructuring practice in both the United States and the United Kingdom toward a more “management-neutral” process.

3. The Common Theme of Management Neutrality

The word “neutral” is commonly defined as “impartial; . . . indistinct; indeterminate.” It conveys a notion of an unbiased and unobtrusive observer. It also accurately describes the general posture of management in corporate restructurings when distressed debt investors are present.

Activist investors rarely replace the entire board or management team of a company at the start of a restructuring. These investors frequently need the expertise of existing management to assist in the operation of the business and the implementation of a turnaround plan. For this reason, management remains in place. This basic premise applies regardless of whether the company files a Chapter 11 case or an administration.

Activist investors, however, do not hesitate to encourage a top-level management change if they consider it necessary to create value. The boards and management of troubled companies are well aware of this fact. Consequently, management staying in place does not necessarily equate to management staying in charge. Management often is relegated to a supporting role in restructurings with distressed debt investors.

Casting management in a supporting role suggests that someone else is leading the restructuring. The most likely candidate for this leadership role

355. This Article uses the term “management” to mean historical management, as opposed to restructuring professionals placed on the management team in a CRO or CFO capacity. A restructuring professional does not face the same pressures as historical management, who has a history and presumably wants a future with the company. Restructuring professionals also are typically placed on the management team at the behest of, or to appease, lenders and distressed debt investors.
356. Typically, distressed debt investors will encourage only a change at the CEO level or the engagement of an outside restructuring professional as CRO or CFO at the beginning of a restructuring. See, e.g., *supra* Part II (discussing case studies); see also Bally Total Fitness Holding Corp., Current Report (Form 8-K) (Apr. 30, 2007) (announcing change in top management approximately one month before announcement of restructuring deal with debtholders); Quinn, *supra* note 15 (noting change in Damovo’s chairman of the board in connection with restructuring). Alternatively, as in Gate Gourmet, distressed debt investors may not seek any change in top management. Press Release, Gate Gourmet, Gate Gourmet Names David N. Siegel Chairman and CEO (June 8, 2004), available at http://www.gategourmet.com/about/pressreleases/2004/pr_2004_0608_seigelannouncement.html (noting that Mr. Siegel remained with Gate Gourmet throughout the restructuring announced in 2005 and thereafter).
357. See *supra* note 303.
is the distressed debt investor. Activist investors seek to fill this leadership role and to take charge of the restructuring process. They frequently work with their own restructuring professionals to design rescue plans and bring the necessary parties to the negotiating table.

As a result, a process is emerging in which distressed debt investors and the company's other stakeholders, including junior creditors, shareholders, labor unions, and major contract parties, negotiate (or fight about) the company's restructuring plan.\(^{358}\) The distressed debt investor typically has the most leverage and controls the key terms of the company's reorganization. Other stakeholders influence the allocation of distributions and may obtain a minority stake in the reorganized company. Management for the most part listens and reacts to the restructuring proposals and at most may try to mediate disputes among the stakeholders. Management rarely is the party designing and insisting on a particular restructuring plan.

In Allied, this process played out as a negotiation among the company, Yucaipa, and the Teamsters. The company eventually dropped out of the picture, and the distressed debt investor emerged to complete the restructuring negotiations with the Teamsters, the creditors' committee, and then members of the company's management team.\(^{359}\) Yucaipa ended up owning the company and obtaining a modified labor contract. The Teamsters received the right to approve the company's new CEO and to observe the conduct of the company's board.\(^{360}\) The creditors' committee received the right to appoint one of the four members of the company's board.\(^{361}\) Yucaipa also entered into amended and restated employment agreements with certain members of management, including the company's CFO and General Counsel.\(^{362}\)

The Schefenacker restructuring involved a similar process. The primary parties around the Schefenacker negotiating table were the company's senior debtholders, its controlling shareholder, and its major customers, i.e., certain original equipment manufacturers (OEMs) in the automotive industry.\(^{363}\) The parties worked together to determine short- and long-term funding sources for the company, the treatment of claims and interests held by junior creditors and shareholders, and the revised terms of the company's supply contracts with the OEMs. They also determined the allocation of ownership in the reorganized company. The senior debtholders received a controlling ownership interest, Dr. Schefenacker received approximately a 20% interest, and the OEMs received

\(^{358}\) This process, described herein as a management-neutral process, also could be described as a creditor-controlled process. However, this Article uses the term management-neutral process to highlight the changing role of management in corporate restructurings. This term is more illustrative of potential issues with the emerging process given management's role as the company's agent and its corresponding fiduciary duties.

\(^{359}\) See supra Part II.A (discussion of Allied restructuring).

\(^{360}\) See supra Part II.A.

\(^{361}\) See supra Part II.A.

\(^{362}\) See supra Part II.A.

\(^{363}\) See supra Part II.B (discussion of Schefenacker restructuring).
approximately a 10% economic interest (giving them the right to receive that percentage of any dividend, distribution, or return on the company’s equity).364

This theme of management neutrality similarly is present in other corporate restructurings. The Kmart restructuring turned largely on the ability of ESL and Third Avenue to broker a settlement among the prepetition facility lenders, prepetition bondholders, and the trade creditors’ committee.365 The Jarvis restructuring required significant oversight by the company’s banks and the intervention of a CRO to facilitate the sale of the company’s tube line operations and a comprehensive settlement of the company’s contingent construction project liabilities. It also involved a new capital structure designed largely by distressed debt investors.366

The terms “management neutrality” and “management-neutral process” as used here do not imply an absent or inactive management team. To the contrary, management may be quite active in a management-neutral restructuring. Management often is the primary source of the relationships and expertise necessary to facilitate and implement the company’s restructuring plans. Consequently, management typically is present at the negotiating table and adds value to the process. But management generally does not control the process.

The convergence of U.S. and U.K. restructuring processes toward a more management-neutral process is a general observation. There will, of course, be varying degrees of management neutrality and exceptions to the general observation in individual cases. Nevertheless, the general pattern of

364. See supra Part II.B.

366. See supra Part II.C. Other examples in the United Kingdom include Damovo and Gate Gourmet. In Damovo, distressed debt investors purchased a majority of the company’s bonds when they dropped in value. See Quinn, supra note 15. They then negotiated a restructuring plan that included exchanging £240 million in bonds for a majority ownership position in the company. See id.; see also Guy Dixon, Damovo to Retain Glasgow HQ as Creditors Move In, SCOT. ON SUNDAY, Dec. 24, 2006, at Business 1, available at http://business.scotsman.com/energyutilities/Damovo-to-retain-Glasgow-HQ.28378I0.jp. In Gate Gourmet, distressed debt investors purchased the company’s mezzanine debt and then negotiated a majority ownership position in the restructured company. See Houghton, supra note 35; Heather Timmons, Big Airline Catering Service Faces Trouble at Every Turn, N.Y. TIMES, Aug. 16, 2005, at C7.
restructurings involving distressed debt investors evidences strong management-neutral tendencies, and these tendencies represent a change from the historical restructuring processes under U.S. and U.K. laws.

4. Management Neutrality and Management Fiduciary Duties

The development of a management-neutral restructuring process raises potential corporate governance issues under U.S. and U.K. law. In both countries, directors and officers act as fiduciaries for the company.367 In the United States, these duties are owed primarily to shareholders when the company is solvent.368 When the company is insolvent, directors’ and officers’ fiduciary duties are owed to creditors.369 When solvency is questionable, the beneficiary of directors’ and officers’ duties is less clear. In general, management is said to owe duties to the entire corporate enterprise.370

367. With respect to U.K. law, see Companies Act, 2006, ch. 46, § 170 (Eng.) (U.K. directors owe duties to the company). See also id. §§ 171–177 (detailing U.K. directors’ duties); 7(2) LORD MACKAY OF CLABTERN, HALSBURY’S LAWS OF ENGLAND § 1083 (4th ed. 2004) [hereinafter HALSBURY’S LAWS OF ENGLAND] (“The directors of a company owe a fiduciary duty to act bona fide in what they consider to be the interests of the company (and not for any collateral purpose); and to make full and honest disclosure to the shareholders before they vote on a resolution.”). With respect to U.S. law, see N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (“It is well settled that directors owe fiduciary duties to the corporation.”). See also Floyd v. Hefner, No. H-03-5693, 2006 U.S. Dist. LEXIS 70922, at *21 (S.D. Tex. Sept. 29, 2006) (noting that officers and directors generally owe duties to the corporation). In both the United States and the United Kingdom, officers generally are held to the same fiduciary standard as directors. See Donovan Waters, Property Management Concepts and the Entity Trust in the Common Law Setting, J. INT’L TRUST & CORP. PLANNING, June 2007, at 73, 78 (discussing general corporate law principles in common law countries, including the United States and the United Kingdom, and noting that “there is [a] fiduciary obligation that attaches to both directors and executives vis-à-vis the corporation”); see also Lyman P.Q. Johnson & David Millon, Recalling Why Corporate Officers Are Fiduciaries, 46 WM. & MARY L. REV. 1597, 1610–11 (2005) (arguing for a more detailed and thoughtful analysis of officers’ fiduciary duties and noting that “although officers and directors occupy distinctive roles in corporate governance, most corporate law authority uncritically obliterates that distinction when it comes to fiduciary duties”).


369. See, e.g., N. Am. Catholic, 930 A.2d at 101 (“When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.”); see also HALSBURY’S LAWS OF ENGLAND, supra note 367, § 1083 (“The directors’ obligation to act . . . in the interests of the company includes an obligation to have regard to the interests of the creditors generally when the company is insolvent . . . .”); Shandro & Sidle, supra note 258, at 34–35 (explaining this rule under English common law and speculating that the rule continues under Companies Act 2006).

370. See, e.g., Hallinan, 2007 U.S. Dist. LEXIS 503, at *32 n.29 (noting that once a corporation enters the zone of insolvency, the directors owe fiduciary duties to the corporations’ creditors, in addition to its shareholders (internal quotation marks omitted)); see also HALSBURY’S LAWS OF ENGLAND, supra note 367, § 1083 (“The director’s obligation
Regardless of the beneficiary, can management fulfill its fiduciary duties in a neutral capacity? A fiduciary generally must “act for the benefit of another person on all matters within the scope of their relationship.” In a management-neutral process, management is reacting to the demands of the various parties in interest. Management may work to reconcile these demands, but it rarely is in a position to reject demands wholesale. This inability to act is particularly acute with respect to the demands of the distressed debt investor, who potentially may be management’s future employer.

If the company is hopelessly insolvent and its creditors have negotiated the restructuring plan, perhaps management’s inability to act is not an issue. Management’s duties are owed to creditors, and implementing a creditor-approved plan arguably satisfies these duties. In this respect, removing management from the process may eliminate agency costs typically associated with the separation of corporate ownership (here, held by the creditors) and corporate management.

But what if the plan is negotiated only with certain creditors, or the company’s solvency is in dispute? In this situation, it is unclear whether a supporting or neutral role by management is sufficient to satisfy its fiduciary obligations. Management, as a fiduciary, is responsible for pursuing a course of action on behalf of the company that is in the best... in the interests of the company includes an obligation to have regard to the interests of the creditors generally when the company... of doubtful solvency or on the verge of insolvency since in such circumstances it is the creditors’ money which is at risk.”); Shandro & Sidle, supra note 258, at 35 (explaining U.K. law and noting that “[there is no indication as to the time when directors should cease to act in the interests of the company (taking into account the other interests) and consider or act in the creditors’ interests”). For a general discussion of management’s fiduciary duties in the zone of insolvency under U.S. law, see Rutheford B. Campbell, Jr. & Christopher W. Frost, Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere), 32 J. CORP. L. 491 (2007). Notably, the Delaware Supreme Court has held that directors owe no fiduciary duties to creditors in the zone of insolvency. See N. Am. Catholic, 930 A.2d at 101 (“When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders....”)

371. BLACK’S LAW DICTIONARY 658–59 (8th ed. 2004); see also HALSBURY’S LAWS OF ENGLAND, supra note 367, § 1083 n.5 (“[A] fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.” (citation omitted)).

372. See supra note 369 and accompanying text (discussion of management’s fiduciary duties to creditors).

373. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1933) (“The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.”); Edward S. Adams, Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results, 73 B.U. L. REV. 581, 601 (1993) (explaining that “the agency relationship [in the corporate form] exposes owners to the risk that managers will use owners’ funds for management’s benefit, thereby creating agency costs—the costs to the principal of obtaining faithful and effective performance by its agent”).
interests of all of the members of the beneficiary class.\textsuperscript{374} A restructuring plan negotiated among major creditors may not be in the best interests of unrepresented creditors or shareholders. Management may need to take a more assertive role in these instances to protect the beneficiaries of its duties.

A complete analysis of the impact of a management-neutral restructuring process on management's fiduciary duties is beyond the scope of this Article. This issue is likely to arise more frequently in the future as the strategies developed by activist investors become more common.

5. Continued Divergence of U.S. and U.K. Restructuring Cultures

Another issue related to the convergence of U.S. and U.K. restructuring processes is the domino effect, if any, on U.S. and U.K. restructuring cultures. The traditional differences between U.S. and U.K. restructurings reflect not only different laws, but also distinctly different cultures. The U.S. culture generally is viewed as more aggressive and contentious.\textsuperscript{375} The U.K. culture generally is viewed as more conciliatory.\textsuperscript{376} The differences in culture stem, at least in part, from the perceived consequences of a bankruptcy filing in the respective countries.

In the United States, a bankruptcy filing may be used by the parties—both the company and creditors—to facilitate their restructuring goals.\textsuperscript{377} Although most companies prefer to avoid a bankruptcy filing, either the company or its creditors may view a Chapter 11 filing (or the threat of a filing) as advantageous. U.S. companies and their creditors often negotiate out of court with the confidence of a Chapter 11 backstop. If all else fails, they can seek to achieve their goals through the Chapter 11 process. As one of Granite Broadcasting's preferred shareholders explained in an email.

\textsuperscript{374} See supra notes 367–70 and accompanying text (discussion of fiduciary duties). This concern is particularly acute in the United Kingdom, where management's duties are owed to the corporation and not specifically to shareholders or creditors. HALSURY'S LAWS OF ENGLAND, supra note 367, § 1083.

\textsuperscript{375} See, e.g., David F.W. Cohen & Maxine M. Kerr, An Overview and Comparison of the Canadian and American Corporate Reorganization Regimes, BUS. CREDIT, Jan. 2003, at 65, 65 ("American reorganization proceedings are, typically, litigious and protracted in nature."); Naomi Rownick, UK Law Firms Fail to Cash in on Insolvency and Restructuring, LAWYER (U.K.), June 9, 2003, at 2 (noting that the American culture is more litigious than the U.K. culture); see also Katherine Yung, Aggressive Approach: Dallas Firm Is Intense—Whether It's Hiring, Investing or Litigating, DALLAS MORNING NEWS, Sept. 3, 2006, at 1D (explaining the legal strategies of U.S.-based distressed debt investor, Highland Capital Management LP, as "filing numerous lawsuits and forcing troubled companies into involuntary bankruptcy").

\textsuperscript{376} Commentators have described the U.K.'s culture generally as being polite, secretive, and conflict adverse." Kerry Shannon Burke, Regulating Corporate Governance Through the Market: Comparing the Approaches of the United States, Canada and the United Kingdom, 27 J. CORP. L. 341, 373 (2002). \textsuperscript{377} See, e.g., Miller & Waisman, supra note 337, at 181 ("The sooner a trader or group of traders can force a debtor out of Chapter 11, the sooner they can monetize their claim and obtain a return on their speculation, without regard to any other factor, including whether or not the debtor had been fully rehabilitated when it was pushed out of Chapter 11.").
regarding his failure to respond to Silver Point's proposed out-of-court restructuring plan, "I'd rather fight in [Chapter] 11. I'd rather have a battle." 378

Companies and creditors take a very different view of a U.K. administration. These parties often are negotiating with a sense of fear and uncertainty about the administration process. 379 For management, the potential loss of control, inability to secure financing, and termination of key contracts are possible results of an administration. For creditors, the undeveloped nature of the law and the uncertainty regarding the resolution of intercreditor disputes gives pause. For all, the filing of an administration is used as a threat to bring parties to the negotiating table.

The negotiating table itself also is very different in the United Kingdom. Historically, corporate restructurings in the United Kingdom followed the "London Approach." This approach basically involved a troubled company's lenders meeting, agreeing to a standstill, and agreeing to a restructuring plan for the company. 380 The entire process was accomplished out of court and had the characteristics of a "gentlemen's agreement." Cooperation and consent were key elements of the process. If these elements were lacking, the Bank of England would step in to assist. 381

The London Approach worked well for many years in the United Kingdom, where corporate debt at the time was concentrated in a handful of financial institutions. 382 Beginning in 2001-2002, the London Approach fell by the wayside. 383 Corporate debt holdings became less concentrated, and the public bond markets emerged as an alternative financing source for U.K. companies. Nevertheless, the consensual and cooperative nature of the London Approach still guides U.K. restructuring practice. 384

Activist investors looking to invest in both the United States and the United Kingdom must adapt to the differences in their respective laws and cultures. A U.S. distressed debt investor operating with a Chapter 11 mindset might find it difficult to achieve its restructuring goals for a U.K. company. Such an investor does not have a "Chapter 11"-type backstop in the United Kingdom. One U.S.-based distressed debt investor, Highberry Ltd., discovered this fact when it tried to force Colt Telecom Group plc into an administration to effect a debt-for-equity exchange. 385 The U.K. court

379. See supra Part III.A.2.a; see also Broude et al., supra note 252, at 43 ("As a result of the many practical difficulties involved in trying to achieve an in-court restructuring in the UK, consensual out-of-court restructurings[] are the preferred approach whenever practical.").
381. See, e.g., id. at 220 (explaining role of the Bank of England).
382. See Armour et al., supra note 21, at 1757–59 (explaining London Approach and role of concentrated debt in that process).
383. See, e.g., FINCH, supra note 144, at 224–25 (discussing limits on approach).
385. Re Colt Telecom Group plc, [2002] EWHC (Ch) 2815, [14] (Eng.) ("What is not in issue is that a key object of the proposed administration is to achieve what Highberry call[s]
rejected this approach. Similarly, distressed debt investors investing in U.S. companies need to have a fighting spirit. In both countries, distressed debt investors need to understand fully not only the applicable bankruptcy laws, but also how cultural influences may impact their investment strategies.

It remains to be seen whether globalization in the distressed debt market will cause a convergence in restructuring cultures similar to what has occurred in restructuring processes. Repeat players at the negotiating table in both the United States and the United Kingdom may facilitate a modified approach to restructuring negotiations. Alternatively, repeat players may become knowledgeable and comfortable enough with the different laws and customs that some divergence of the U.S. and U.K. restructuring cultures continues. If investors are able to achieve their ultimate goal of profitability in the current cultures, change may be viewed as unnecessary and potentially risky.

IV. FUTURE IMPLICATIONS: SOME OBSERVATIONS AND COMMENTS

Distressed debt investing is not a new investment strategy. It is, however, becoming more prominent. Institutional investors have substantial funds to place in distressed situations, and activist investors are not hesitant to flex their economic muscle. These investors increasingly are using distressed debt investments to influence corporate governance and acquire control of troubled companies. The strategies of activist distressed debt investors are changing the dynamics of corporate restructurings and may require troubled companies, other creditors, and legislators to rethink their approaches to the restructuring process.

A. Potential Winners and Losers in a Management-Neutral Restructuring Process

The presence of activist investors in a company’s capital structure changes the dynamics of any restructuring. This change occurs whether the company is based in the United States or the United Kingdom, and, as discussed above, it primarily affects management’s role in the restructuring process. Management frequently loses control of the process and is relegated to a more neutral role as a supporting, rather than primary, participant. Other stakeholders determine the fate of the company, typically under the strong influence of the activist investor.

Distressed debt investors clearly benefit from this change in U.S. and U.K. restructuring processes, but the impact on the company, management, and other stakeholders is less certain. Under a management-neutral process, distressed debt investors have the opportunity to influence changes at the

* a restructure. What they actually mean is a transfer of value in the company from the shareholders to the bondholders—either by conversion of debt to equity or simply by payment from Colt’s cash or both.”

386. See id. at [109] (rejecting administration petition).
company. These changes can enhance the investors’ individual returns and give the investors control of the company. Moreover, the process is less regulated than a more traditional shareholder proxy context, which may allow the investor to influence corporate affairs more quickly, with less expense, and reduced disclosure obligations.387

The company also may benefit from a more management-neutral process. For example, this process may facilitate the removal of historical management that either was ineffective or contributed to the company’s financial difficulties. It also may eliminate agency costs by effectively placing management decisions in the hands of the future owners.388 The potential for value-destructive behavior by distressed debt investors and other stakeholders, however, creates a potential downside for the company.389

Management and minority-interest holders—e.g., junior creditors and shareholders—are most vulnerable in a management-neutral process. Management’s loss of control, coupled with its existing fiduciary duties, places management in an awkward position because management may not be able to adequately fulfill its duties in a neutral or reactive role.390

Management’s potential conflicts increase if the distressed debt investor will control the reorganized company and in turn management’s future with the company. Likewise, minority-interest holders are potentially prejudiced by management’s inability to act on their behalf. The perilous position of minority-interest holders is further exacerbated by their lack of representation or leverage at the restructuring negotiating table.

B. Potential Consequences of a Management-Neutral Restructuring Process

Despite the potential downside for the company, management, and minority-interest holders, a trend toward a management-neutral restructuring process is emerging in the United States and the United Kingdom. This trend reflects a convergence of the traditionally management-driven U.S. process and the traditionally management-displacing U.K. process. It also will likely affect the results of U.S. and U.K. restructurings and could affect their respective bankruptcy laws.

For example, a management-neutral restructuring process led by activist investors most likely will focus on speed and maximizing the investors’ return. This focus suggests that prepackaged restructuring plans or going-concern asset sales may become the preferred restructuring methods. Traditional U.S. stand-alone restructurings in Chapter 11 and traditional U.K. piecemeal asset sales in administration do not necessarily foster

387. For a general discussion of proxy solicitation rules and the use of proxy contests by hedge funds, see Briggs, supra note 341.
388. See supra note 373 and accompanying text.
389. See supra Part III.B.3.
investors’ objectives. Consequently, one would expect to see more nontraditional restructurings in the United States and the United Kingdom.

A trend toward more nontraditional restructuring methods is emerging. In the United States, prepackaged or prenegotiated plans and, in particular, going-concern asset sales under section 363 of the Bankruptcy Code are becoming more common. This change in restructuring methods has received considerable attention in the past ten years. Admittedly, this change is not attributable solely to activist distressed debt investing or a more management-neutral restructuring process. Nevertheless, the increasing influence of activist investors should be considered as a contributing factor to the change.

Moreover, historical experiences with creditor-controlled situations in the United Kingdom suggest that quicker results may accompany increased creditor control in the restructuring context. For example, prior to the revisions to the Insolvency Act, creditors holding a floating charge over a company’s assets could cut their losses and maximize their return by appointing an administrative receiver to liquidate the company’s assets. Likewise, under the London Approach, creditors worked together to restructure the company’s financial affairs quickly in an out-of-court setting. Accordingly, the distressed debt investors’ preference to negotiate out of court and then pursue the quickest means of implementation, whether through a Chapter 11 case, an administration, or an out-of-court process, is not surprising.

Although pursuing restructurings in a traditional U.K. creditor-controlled manner may provide a quick return, it may not provide the best or desired return for the distressed debt investor. For this reason, U.K. restructurings in a more management-neutral process likely will focus more on maximizing corporate value than its historical counterpart, particularly when the investor is interested in a debt-for-equity exchange. This focus will encourage reorganization, rather than liquidation, alternatives. In addition, when coupled with the traditional U.K. values of speed and minimal judicial oversight, this focus likely will encourage new and innovative restructuring methods. The prepackaged administration is a prime example of a nontraditional restructuring method that fosters the objectives of most distressed debt investors.


393. For a general discussion of administrative receivership, see FINCH, supra note 144, at 234–72.

394. See supra Part III.C.5.
C. Potential Responses to a Management-Neutral Restructuring Process

As discussed above, the emerging trend toward a management-neutral restructuring process is changing U.S. and U.K. restructurings. Do these changes warrant or require any type of legislative response? The answer depends largely on the goals of the underlying insolvency regime. If the goal is to rehabilitate troubled companies and to let management control the rehabilitation process, then legislative change might be needed. If the goal is to ensure equitable distributions to junior creditors and shareholders, then legislative change also might be needed. If the goal is to maximize corporate value and utility, however, then arguably legislative change is not required.

Management-led corporate rehabilitation is possible, in theory, under current U.S. and U.K. law. The debtor-in-possession concept facilitates this possibility under Chapter 11, and CVAs, Schemes, and general corporate law provide a similar opportunity under U.K. law. Nevertheless, each of these structures permit, if not encourage, substantial creditor involvement. Creditor involvement can lead to creditor control. Accordingly, a legislative fix, if desired in this context, would need to eliminate or severely restrict creditor involvement in the restructuring process.

An example of such a legislative scheme is France's safeguard procedure. The safeguard procedure is a court-supervised restructuring process that may be invoked only by the legal representative of a solvent company. Management remains in control of the company, and the judicial administrator, appointed to assist management, "has no specific duties to creditors." The safeguard procedure does provide for two statutory creditors' committees, but these committees have limited rights in the process and can only act to bind members of the committee. The CEO of the Eurotunnel Group invoked France's safeguard procedure and stayed in

395. See Harner, supra note 8, at 105–06 (discussing potential legislative responses to activist distressed debt investing in the United States in light of the Bankruptcy Code's dual goals of debtor rehabilitation and creditor recovery maximization).

396. Lender involvement in the affairs of a distressed company currently is subject to judicial restraint under theories such as lender liability, equitable subordination, recharacterization, and deepening insolvency. See Baird & Rasmussen, supra note 17, at 939–40. In addition, in Chapter 11, a court can designate an entity's vote on the plan if the entity's acceptance or rejection of the plan was not in good faith. 11 U.S.C. § 1126(e) (2006).


398. Broude et al., supra note 252, at 44; see also 2 DOING BUSINESS IN FRANCE, supra note 397, §§ 18.03[2], [3][g][ii].

399. See Broude et al., supra note 252, at 44; 2 DOING BUSINESS IN FRANCE, supra note 397, § 18.03[2].
control of Eurotunnel's restructuring process, despite the presence of both U.S. and U.K. distressed debt investors.\textsuperscript{400}

France's safeguard procedure, however, does not completely isolate management from creditor influence. For example, the restructuring plan must be approved by the committees.\textsuperscript{401} With respect to creditors not on the committees, the company must obtain their consent to the plan or provide such creditors the proscribed statutory treatment—i.e., payment in full over a ten-year period.\textsuperscript{402} Moreover, shareholders must consent to any impairment of their interests.\textsuperscript{403} Presumably, management's control could be enhanced by adjusting the payment terms for nonconsenting creditors or providing a similar cramdown mechanism applicable to both creditors and shareholders.

Notably, what weakens management's ultimate control under France's safeguard procedure strengthens the protection of junior creditors' and shareholders' interests. Accordingly, a government considering insolvency legislation and desiring to protect these interests might enact similar legislation. The difficulty with crafting such legislation is finding the appropriate balance between protecting minority interests and fostering corporate rehabilitation. Whether France's safeguard procedure strikes the appropriate balance remains to be seen.

Alternatively, an insolvency regime concerned more with minority interests and less with management control might focus on legislation that enhances the protection of these interests in nontraditional restructurings. For example, a statutory scheme could be developed that permits, and in turn regulates the terms of, prenegotiated asset sales.\textsuperscript{404} The scheme could require the retention of an independent restructuring professional who would be responsible for reviewing the terms of the proposed transaction, ascertaining a fair valuation of the company, and providing full disclosure to the court regarding the terms of the transaction and the results of the professional's due diligence. The scheme also could require that a certain

\begin{itemize}
  \item \textsuperscript{400} Eurotunnel's chairman, Jacques Gounon, controlled Eurotunnel's restructuring and managed to retain 13% of the company for existing shareholders. See, e.g., Alistair Osborne, 'How We Won Fight to Save Eurotunnel,' DAILY TELEGRAPH (London), June 30, 2007, at 33, available at http://www.telegraph.co.uk/finance/markets/2811328/How-we-won-fight-to-save-Eurotunnel.html (explaining Gounon's control over the process); Ian Watson, Light at the End of the Chunnel, BUSINESS (U.K.), June 2, 2007, available at LEXIS, The Business File ("Gounon has given the business world a virtuoso performance in arm-twisting and brinkmanship."). Gounon used France's safeguard procedure to Eurotunnel's advantage. See Osborne, supra (explaining that "[t]he [safeguard] procedure gave judicial teeth to Mr. Gounon's brinkmanship and bravado").
  \item \textsuperscript{401} See 2 DOING BUSINESS IN FRANCE, supra note 397, § 18.03[3][g].
  \item \textsuperscript{402} See id.
  \item \textsuperscript{403} See Broude et al., supra note 252, at 49.
  \item \textsuperscript{404} The scheme suggested here would be designed to facilitate quick approval and implementation of prenegotiated asset sales. The specifics of the scheme could be varied to add protection for minority interests or to enable further sales to new investors. For a proposed legislative scheme that would permit nonplan asset sales under the current Chapter 11 process, see George W. Kuney, Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy, 40 HOUS. L. REV. 1265 (2004).
\end{itemize}
percentage of the transaction value be set aside for unsecured creditors, that a certain number of employees continue with the new business, or that existing shareholders receive some minority interest in the new business. The protections afforded to minority interests could vary depending on the valuation of the company or the priorities of the legislature. The scheme could allow for quick implementation—e.g., a mandatory court hearing within twenty days of the filing of the case and the professional's report. Court oversight, even on an expedited time table, would provide additional protection to minority interests.

A legislative response similar to that described above would incorporate several of the techniques currently being used by companies and distressed debt investors outside of Chapter 11 and administration proceedings. For example, the contemplated out-of-court negotiations mirror a prepackaged Chapter 11, and the selection of a restructuring professional mirrors a prepackaged administration. The proposed scheme, however, enhances these two existing proceedings by streamlining the process and establishing more definitive rules to govern approval of the transaction and the rights of minority-interest holders.

The foregoing discussion presumes that the underlying insolvency regime requires or demands a legislative solution, but it may not. The current practices of distressed debt investors may maximize corporate value, which may be the ultimate goal of the insolvency regime. The transaction value generated in restructurings largely is driven by the market. Distressed debt investors vying for control pay market value for the company or risk being outbid by other investors monitoring distressed situations. In fact, competition among distressed debt investors may increase the market value of the company.\textsuperscript{405} The ultimate question of impact on corporate value is one that can be answered only through further empirical research and analysis.

\textbf{CONCLUSION}

The emerging influence of activist investors in the corporate restructuring process raises a new set of policy issues for U.S. and U.K. policy makers to consider. Activist investors are changing the restructuring landscape and offering alternative rescue opportunities for troubled companies. Their activism, however, also raises questions regarding the appropriate role of management in the restructuring process, the protection of minority-interest

\textsuperscript{405} Whether the market sufficiently protects minority interests is open to debate. For example, if the market determines that the value of the company is insufficient to provide a return on minority interests, then presumably minority interests are not entitled to a return. This position, however, relies on existing priority schemes and on the validity of market indicators. For a discussion of a market approach to value maximization in corporate restructurings, see Sprayregen et al., \textit{supra} note 212, at 60–62. \textit{See also} Harner, \textit{supra} note 8, at 105–06 (suggesting that markets complement, but should not replace, legislation governing the debtor-creditor relationship, at least in the context of activist distressed debt investing).
holders, and the creation or destruction of corporate value. This Article sets the stage for the necessary public policy debate by describing the investment practices and strategies of activist investors and analyzing how activist distressed debt investing is changing the dynamics of corporate restructuring processes in the United States and the United Kingdom.

The results of this policy debate may differ in the United States and the United Kingdom based on the historical goals of their bankruptcy laws. For example, a legislative response to create a more balanced playing field among distressed debt investors, the company, and the company's other stakeholders may further the traditional dual goals of corporate rehabilitation and creditor recovery maximization underlying the U.S. Bankruptcy Code.\textsuperscript{406} A legislative response, however, may not be necessary in an insolvency regime that focuses solely on creditor recovery maximization or that facilitates creditor control in troubled situations. The continued reluctance of U.K. legislators to adopt a debtor-in-possession insolvency structure may foreshadow a reluctance to interfere with the increased creditor control fostered by activist distressed debt investors.\textsuperscript{407}

Distressed debt investors have a role to play in corporate restructurings. The policy debate encouraged by this Article should help define the appropriate parameters of this role. It also should assist corporate management and other stakeholders in assessing the changing tenor of the restructuring processes in the United States and the United Kingdom. Even in the United States, a troubled company no longer can initiate restructuring negotiations with the confidence that its management will control the process. If an activist investor is involved, it likely will emerge as the dominant party at the negotiating table.

\textsuperscript{406} See supra note 395 and accompanying text.

\textsuperscript{407} See supra Part III.A.2.