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New York
January 15, 2008 **Washington, D.C.**

CLIENT UPDATE*

Distressed Investing and Bankruptcy

For the last 15 years, there has been an active trading market for distressed claims against or interests in a debtor. Depending on the claims or interests being acquired, and whether they are being acquired before or after the commencement of a bankruptcy proceeding, they may trade on a stock exchange, through specialized brokers, or through private sales. Since 2001, the hedge fund boom has led to ever-increasing numbers of distressed investment funds and dollars allocated for such investments.

If the "experts" are correct, we are in or near the beginning of a recession, in which case many distressed investment opportunities will come to the fore. With stiff investment competition, understanding the bankruptcy process and utilizing knowledgeable professionals will be more important than ever. With that in mind, this memorandum summarizes certain issues relating to distressed investing in a company that is in or winds up in a bankruptcy proceeding: claim risks; trading restrictions; receiving/trading reorganization securities; strategic/control investments.

I. Claim Risks

A buyer should consider, in addition to basic valuation metrics, any limitations that bankruptcy law (statutory and case law) may place upon the rights of the buyer with respect to the investment.

For example:

- Claims purchased from a fiduciary (e.g., an insider, control person) come with risks that should be examined before purchase. Most fiduciaries have access to nonpublic information and their claims are more likely than those of unaffiliated creditors to be subject to examination, objection and, potentially, suit. Things to be aware of:
    - Inside Information -- Receipt of the insider's inside information likely will result in the buyer becoming "restricted"[1] (and, perhaps, even being deemed an "insider").

[1] That is, being unable to trade or subject to trading restrictions. Trading on a "big boy" letter may not solve this problem.

* This *Client Update* is not legal advice. Should you wish legal advice with respect to the matters discussed herein, please contact us.

- If the fiduciary-seller acquired the claim after filing of the bankruptcy petition, the buyer's claim could be limited to the purchase price paid by the fiduciary instead of the face value of the claim (at issue would be using the fiduciary's "insider" knowledge to trade "against" the debtor).

- Lawsuit Target -- Insiders are much more likely to be investigated to see whether any valid causes of action exist against them. Accordingly, diligence on the insider-seller should be undertaken.

- If the seller received payments voidable as preferences (Bankruptcy Code § 547), the buyer's claim may be disallowed until the preference is returned (that would be the case under Bankruptcy Code § 502(d) were the claim still in the seller's hands). Be aware of the extended period (one year) governing preference claims against insiders.

- If the seller's claim would be subject to equitable subordination (Bankruptcy Code § 510(c)), so too may be the claim in buyer's hands. (This should not be the case with open-market transactions (e.g., public bonds).)

- In bankruptcy, any portion of an unsecured claim consisting of unmatured interest (measured as of the bankruptcy case filing date) will be disallowed.

Managing the risks:

- Perform thorough research to determine whether the claim is subject to any defenses.

- Negotiate for appropriate representations, warranties, covenants and indemnities from the seller in the sale and assignment documents.[2]

- Negotiate a purchase price holdback.

- Purchase an option, rather than the claim.

- Deal with creditworthy sellers.

These approaches may prove expensive or simply not feasible or successful, but this can be factored into the purchase decision and pricing.

[2] Commonly-used distressed debt sale documentation contains representations, warranties and indemnities; however, depending on the facts and circumstances of the investment at issue, additional or modified representations, warranties, covenants and indemnities may be called for.

II. Trading Restrictions

A. Nonpublic Information/Fiduciaries

If the buyer or seller of distressed debt has access to nonpublic information, the ability to trade the debt may be compromised. While this issue naturally gives rise to concerns about securities fraud-type claims, to date, bank debt and trade claims have not been determined to be "securities" and, therefore, the securities laws have not been applied.[3] However, even in the absence of the application of securities laws, private state law fraud claims may be possible. Therefore, trading in such instances should include a big boy letter to limit the likelihood of, and the strength of, a counterparty suit.

The more pressing concern, perhaps, is whether the buyer or seller is a fiduciary. As noted earlier, being a fiduciary or buying claims from a fiduciary comes with additional concerns. The claim could be subject to subordination (if bad acts are alleged), reduction or disallowance because of the seller's fiduciary status, the nature and origin of the claim, and the timing of seller's acquisition of the claim. This may affect the marketability of the claim.

Members of official committees may be deemed to be fiduciaries and are almost certainly privy to nonpublic information. Indeed, it is now common for official committees to voluntarily, or under a bankruptcy court mandate, establish information wall procedures and provide for periodic certification regarding trading. Therefore, investors who intend to trade actively in the claims or interests of a chapter 11 debtor may be better off not serving on a committee. However, this can be a difficult choice because committees often play a critical role in shaping the reorganization of a chapter 11 debtor.

B. NOL Orders

Significant net operating loss carryovers ("NOLs") can be used to reduce the company's taxable income after it emerges from bankruptcy and begins earning profits. The ability to utilize a company's NOLs is subject (under the Internal Revenue Code) to limitation based on certain ownership changes of the company. For this reason, bankruptcy courts have frequently entered orders restricting the transfer of claims and stock on the grounds that such transfers could jeopardize the company's NOLs (by exceeding the ownership change limitations). For an investor looking to actively trade these claims or interests or accumulate a control position, it is very important to engage counsel to review any proposed NOL order.

[3] Some commentators and practitioners believe the well-developed secondary market for bank debt may at some point result in such claims becoming subject to the securities laws.

III. Trading Reorganization Securities

The issuance and resale of securities issued under a chapter 11 plan ("Reorganization Securities") in exchange for outstanding claims against or interests in the debtor generally are exempt from the registration requirements of the securities laws. The exemption is contained in Section 1145 of the Bankruptcy Code, which reflects two key policy objectives: (1) facilitating reorganizations by enabling the creation of "plan currency"; and (2) exempting creditors -- often involuntary recipients of Reorganization Securities -- from the burdens of registration with the SEC.

Accordingly, for most distressed investors, Reorganization Securities can be freely traded upon receipt. However, if a distressed investor will own a significant equity stake in the reorganized debtor or have other meaningful influence over the debtor (such that it might be deemed an "affiliate" of the debtor), the investor may not be able to take advantage of the Section 1145 registration exemption and, therefore, may face challenges in selling the shares it receives. Such an investor should speak to counsel about this issue before a plan is filed, if at all possible.

IV. Strategic Distressed Investments/Gaining Control

Purchasing a strategic position in one or more classes of claims or interests of the debtor gives the investor "standing" to be heard in the chapter 11 case, will give the investor leverage in plan negotiations, and assist in the investor's efforts to acquire control of the debtor, if that is the objective.

There are various methods used for gaining control of a distressed business: (1) buying the business or principal assets through a "363 sale"; (2) funding a reorganization plan; (3) purchasing claims from the existing creditors of the debtor in order to obtain a controlling stake in post-reorganization equity; and (4) filing a competing plan.

A. A "363 Sale"

A sale under Section 363 of the Bankruptcy Code of the business (or key assets) (a "363 sale") is permitted when there is a sound business justification to skirt the more elaborate safeguards of the plan confirmation process.

In the first stage of a 363 sale, the debtor obtains bankruptcy court approval of the auction procedures, including, oftentimes, bid protections for (including break-up fee protection) a "stalking horse" bidder. The second stage of the 363 process is the auction (after a marketing period) and, after selection of a winning bid, confirmation of that bid by the bankruptcy court. To the extent not completed before the first stage, between the first and second stages the debtor and the proposed purchaser should negotiate the purchase agreement, due diligence should be finalized, and financing and regulatory approval (if necessary) should be obtained.

The key benefits of a 363 sale, in addition to speed and economy, are that the sale will be free of liens, claims and interests, and virtually insulated from subsequent attack, as it will have the benefit of a federal court approval order.

B. Funding a Reorganization Plan

Often, a chapter 11 case will present an opportunity for an investor to fund the chapter 11 plan through an equity investment, and thereby gain control of the debtor. Gaining control of a debtor or assets through a reorganization plan may be more attractive than a 363 sale because of the added flexibility that a plan may offer. Unlike a 363 sale, a reorganization plan also allows liabilities to be satisfied with newly issued equity and new loan agreements with lower interest rates and extended principal payment schedules. Under a 363 sale, the purchaser typically can only use cash to acquire the assets. The drawback to the plan process is that it is a significantly longer, more complicated and more expensive process.

C. Purchasing Claims against a Debtor

1. Conversion of Fulcrum Security to Equity

In lieu of funding a chapter 11 plan through a new equity investment, many distressed investors seeking to obtain control of a chapter 11 debtor (or at least to capture the upside of post-reorganization equity) invest in the so-called "fulcrum security". The fulcrum security, in simplest terms, is the security or claim most likely to be converted into post-reorganization equity of the debtor as part of the chapter 11 plan.[4] The fulcrum security may be first or second lien debt, senior unsecured bonds, subordinated bonds, or trade claims. It all depends on the capital structure of the debtor and the debtor's valuation.

If a sufficient amount of the fulcrum security has been purchased (for instance, a "blocking position" (discussed below)), the investor should be in a position to negotiate plan treatment with the debtor and creditors committee. Depending on the rate at which the fulcrum security is converted to equity under a plan, the distressed investor may achieve control of the reorganized debtor.

2. Blocking Position

In order for a class to approve a reorganization plan, at least two-thirds in amount of the claims that are actually voted in such class must vote in the affirmative. Therefore, if a distressed investor buys one-third in amount of the claims, the investor has substantial influence on plan negotiations as it can "block" that class's acceptance of the plan. Often, because only claims that are voted count, a blocking position can be attained with ownership of less than one-third of the total amount of such claims.

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[4] Stated differently, it is the claim or debt that will not be able to be paid in cash or new or reinstated debt if the debtor is to emerge from chapter 11; thus, it must be converted into equity in the reorganized debtor.

Note that if an investor acquires a blocking or control position in a class and aggressively seeks to use that position solely for its own benefit (i.e., in a way that would not generally benefit the class of which it is part), it is possible that the investor's votes could be disqualified as cast in bad faith. The Bankruptcy Code does not define "bad faith." However, if the investor opposes the debtor's reorganization plan in order to receive better treatment than the other creditors in its class, bad faith could be found.

D. Proposing a Competing Plan

Under certain circumstances, a creditor can propose a competing plan (i.e., one opposed by the debtor). A distressed investor who is considering proposing a nonconsensual plan must be aware that the chapter 11 process is heavily-weighted in the debtor's favor. Besides information control, incumbent management and the like, the debtor has an exclusive period (up to a maximum of 18 months after the filing date) during which it is the only entity allowed to propose a reorganization plan (unless the exclusive period is terminated for "cause" – a very difficult burden to satisfy). Thereafter, an investor can introduce a competing plan. The mere specter of a realistic competing plan, though, should provide substantial leverage to the distressed investor in consensual plan negotiations.

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If you have any questions concerning this memorandum, or would like some assistance on a particular distressed debt transaction, please contact John Ashmead or Ron Cohen. Messrs. Ashmead and Cohen regularly advise hedge fund clients (and others) on the matters touched upon herein.

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