The Five Basic Truths of Distress Investing

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TRUTH 1

- **IN THE USA, NO ONE CAN TAKE AWAY A CORPORATE CREDITOR'S RIGHT TO A MONEY PAYMENT OUTSIDE OF CHAPTER 11 OR CHAPTER 7 PROCEEDING.**

- Why is this important?
- It makes voluntary offers to exchange securities fail; i.e. THE HOLDOUT PROBLEM. (Argentina as an example of a sovereign).
- Why is this so?
- In the United States issues of credit instruments must comply with the TRUST INDENTURE ACT of 1939.

TRUTH 1

- Section 316b: "*Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates,* ***shall not be impaired or effected without the consent of such holder.***"
- The TIA protection in the United States against depriving a creditor of rights to interest and principal payments does not necessarily apply in other jurisdictions, such as Canada.

TRUTH 2

- **CHAPTER 11 RULES INFLUENCE ALL REORGANIZATIONS**

- Reorganization of a troubled company, whether through the voluntary exchange of securities or through relief under Chapter 11, involves, in the final analysis, recapitalizing a company. Successful recapitalizations invariably involve reducing, delaying, or eliminating contractual requirements that the company make cash interest or principal payments.
- Rules like the “absolute priority rule” must be followed whether a reorganization is voluntary or mandatory.
- Why?
- HOLDOUTS and the real threat of an involuntary filing.

TRUTH 3

- **SUBSTANTIVE CHARACTERISTICS OF SECURITIES**

- For a security to have value, it has to have the promise of delivering a cash bailout to a holder. Cash bailouts come from three disparate sources:
- **1.** Payments by the company, whether for interest, principal, premium, dividends, or share repurchases.
- **2.** Potential sale to some sort of a market, not just an outside passive minority investor (OPMI)—a market such as the New York Stock Exchange, but also other markets, such as takeover markets.
- **3.** Control or elements of control of the company. Common stocks without economic value can sometimes have a governance value.

TRUTH 3

- Example:
- Rule 1145 of the bankruptcy code prevents persons getting 5 percent or more of the common stock to be outstanding from selling those shares in public markets unless they are held, fully paid, for one year, after which common shares can be dribbled out weekly at the greater of 15 percent of the daily volume or 1 percent of the outstanding issue.
- Many if not most recipients of common stocks upon the consummation of a plan of reorganization (POR) are passive rather than control investors. For example, commercial banks and insurance companies by definition are non-control investors. Frequently, they are required to take common stock in a POR, which may not have an immediate market-out.

TRUTH 4

- **<u>RESTRUCTURINGS ARE COSTLY FOR CREDITORS</u>**

- The administrative costs of in-court restructurings are borne by creditors (affect their recoveries)
- They are paid as you go.
- They are paid in cash.

- Why?
- Lawyers have an incentive to prolong cases in defending their client interests, AND they get paid by the estate.
- Financial professionals get large “success” fees, where success only means “the end of the case”.

TRUTH 5

- **<u>CREDITORS HAVE ONLY CONTRACTUAL RIGHTS</u>**

- Residual rights belong to owners (e.g., a duty of directors for fair dealing in relationships with owners).
- The beneficiaries of duties of care and fair dealings by boards of directors and other control persons flow directly to the owners of firms.
- Lenders to solvent firms are entitled only to those rights that are spelled out in loan agreements and bond indentures, plus several other rights provided by law: lenders obtain protection under statutes governing fraudulent conveyance and fraudulent transfers.

TRUTH 5

- When actually insolvent, the role of the board of directors shifts from protecting the interests of owners to protecting the interests of creditors.