Distress Investing Risks

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Risk?

- What is it?
- The word risk conveys the idea that there is uncertainty around the realization of a particular outcome, and depending on what the outcome is there are all sorts of risk including:

  - ✓ Market risk: uncertainty about future prices of securities
  - ✓ Investment risk: uncertainty about whether there will be a permanent impairment of capital in a business.
  - ✓ Credit risk: uncertainty about whether there will be a money default
  - ✓ Reorganization risk: uncertainty about how a troubled issuer will recapitalize and what consideration, if any, are to be received by each class or creditor or party in interest.

Key here is that "risk" must be qualified by the word before it.

Risks relevant to analyzing distressed situations

- Categories of risks in the analysis of distress situations:
  - Risks associated to the alteration of priority of payments in bankruptcy;
  - Risks in the valuation of either:
    - The collateral in which the creditor has an interest in or,
    - The company as a going concern.
  - Risks associated with the reorganization process itself, i.e. how the issuer will recapitalize and what consideration if any different classes will receive.
  - Other risks

Risks associated with the alteration of priority of payment

1. <u>Equitable Subordination Risk:</u> Imposes due diligence to claim buyers. Where does it come from?

- Section 510(c) and the Doctrine of Equitable Subordination.

- Section 510(c) of the Bankruptcy Code provides that after notice and hearing, **the court may: under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim**, or all or part of an allowed interest to all or part of another allowed interest; or order that any lien securing such a subordinated claim be transferred to the estate.

- Courts have discretion in determining whether equitable subordination is warranted. The doctrine of equitable subordination is generally applied where it is alleged that a creditor participated in some conduct that injured other claimants and resulted in the creditor obtaining an unfair advantage over those claimants.

Equitable subordination risk

- Important points to remember:
  - Equitable subordination of claims <u>unrelated</u> to inequitable conduct is permitted;
  - Equitable subordination is applicable to claims in the hands of a transferee;
  - The "good-faith" defense will not protect transferees

Equitable subordination risk

- How do judges determine grounds for equitable subordination?
- The principal question presented is whether the claimants violated the "rules of fair play and good conscience" in their dealings with the corporation and its creditors, and in their management of corporate affairs.
- Three prong test from the Mobile Steel case:
  1. A creditor must have engaged in inequitable conduct;
  2. That conduct injured other creditors or conferred an unfair advantage to the acting creditor; and
  3. The subordination of the acting creditor’s claim is not otherwise inconsistent with the bankruptcy code.

Equitable subordination risk

- Inequitable conduct is important when insiders or control persons are involved. For insiders or control persons, inequitable conduct is found if the claimant has:
  - (i) committed fraud or illegality or breached its fiduciary duties;
  - (ii) left the debtor undercapitalized; or
  - (iii) used the debtor as a mere instrumentality or alter ego.
- The conduct must have harmed other creditors:
  - "a claim should be subordinated "only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct.""

Increased due diligence on claim buyers after Chapter 11 filing

1. Whether there is a pending equitable subordination proceeding on the original claim holder.
2. Whether a purchase will be effected through an assignment or a sale.
3. Whether the original claim holder is an insider, fiduciary, or control entity.
4. Timing of loan agreement amendments and/or indications that lenders are exerting control over the debtor.

Risks associated with the alteration of priority of payment

2. Substantive consolidation risk

What is substantive consolidation?

Substantive consolidation is the legal doctrine that pools the assets and liabilities of separate legal entities as if they were merged into a single survivor entity.

Any creditor claims against the debtor and/or the affiliates are treated as claims against the common assets of the consolidated debtor.

Risks associated with the alteration of priority of payment

- Substantive consolidation has the potential effect of changing the value of creditor claims through the <u>invalidation of any priority</u> that a claim may have due to <u>corporate structure</u> and thus affect the potential recoveries of certain creditors.

Substantive consolidation

- Remember structural subordination?

Unconsolidated Financials

Holding, Inc.	
Subsidiary 1 Stock	$500 Senior
	Equity

Subsidiary 1 Corp.	
Subsidiary 2 Stock	$250 Bank Loan
	Equity

Subsidiary 2 Corp.	
$1,500	Equity
	$500 Debenture

Consolidated Financials

Holding, Inc.	
$1,500	$250 Bank Loans
	$500 Sr. Notes
	$500 Debentures
	$250 Equity

Substantive consolidation

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Debentures have priority of payments since they lent to Sub 2 based on Sub 2 assets.

Consolidated Financials

Holding, Inc.	
$1,500	$250 Bank Loans
	$500 Sr. Notes
	$500 Debentures
	$250 Equity

If the estates are consolidated the debentures may lose priority because they are unsecured.

Substantive consolidation

- The principles underlying the remedy of substantive consolidation include the following:

  1. Unless there are compelling circumstances, courts are required to respect separateness;
  2. The harm that substantive consolidation addresses is nearly always that caused by debtors who disregard separateness;
  3. Mere benefit to the administration of the case does not justify substantive consolidation;
  4. Substantive consolidation is extreme and imprecise, and should be used rarely and as a remedy of last resort after considering and rejecting other remedies; and,
  5. Substantive consolidation may not be used offensively (i.e., having a primary purpose of tactically disadvantaging a group of creditors in the plan process or altering creditors' rights).

Who is going to propose substantive consolidation?

- Those creditors who will benefit from it, i.e. junior creditors whose claims reside in subsidiaries with no assets, for example.
- Courts use a three different tests to narrow down the circumstances that call for substantive consolidation:
  - In a three-part test, the proponent of substantive consolidation must prove *both* a **substantial identity** between the entities to be consolidated AND that **consolidation is needed to avoid harm or realize some benefit**.
  - If the proponent does so, then an objecting creditor must show that it relied on the separate credit of an entity and that it will be prejudiced by the consolidation.
  - Other tests are beyond the scope of the class.

Risks associated with the alteration of priority of payment

3. Intercorporate credit support and fraudulent transfer risk

- The most common type of credit support is that a corporate group member becomes a guarantor of the debts of another. Upstream guarantees can be problematic.

- In bankruptcy, the granting of credit support by a corporate member to another may be subject to scrutiny and possibly *avoidance as a fraudulent transfer.*

Fraudulent transfer risk

- Example:
  - An operating subsidiary of a corporate group, “Sub,” agrees to guarantee a loan that is extended to the corporate group parent, “Parent.”
  - The guarantee is secured by a lien on all of Sub’s assets.
  - Sub will not receive any of the proceeds of the loan for its own use, but the lender requires the guarantee because it needs the pledged Sub assets as collateral to justify making the loan.
  - If Sub neither receives any of the proceeds nor gets either any direct or indirect benefits from the loan, then the obligation incurred and transfer made by Sub **may be avoided** on grounds that it is a fraudulent transfer.
  - Go back to Prof. Germain section of fraudulent transfers.

Risks associated with the alteration of priority of payment

4. Defects in the perfection of Security Interest Risks

- The secured status of an alleged secured claim will invariably be challenged during a Chapter 11 case in a number of ways, including through avoidance actions under Sections 544(a) and 547, or through claims' objections under Section 502.
- A creditor is deemed secured if the financing statement can be found through a search of its name, and third parties are under no obligation to conduct exhaustive searches.
- Debtors, creditors committees, and trustees in bankruptcy have successfully challenged secured claims' security interests on the basis of errors in financing statements that were deemed misleading.
- Such challenges under either Section 502 or 544 will render an allegedly secured claim into an unsecured one.

Risks associated with the alteration of priority of payment

5. Critical vendor payments risk
   - It has become common practice to seek bankruptcy court approval to pay prepetition debt to vendors deemed critical to the reorganization of the debtor. A common rationalization for these payments is that they preserve the going-concern value of the debtor's business in the belief that vendors not paid for prior deliveries will refuse to make new ones, and as a result the firm will not be able to carry on, injuring all creditors.
   - Vendors in general have an interest to continue shipping to the debtor and to make the debtor feasible.
   - In most cases, critical vendor payments are simply preferences that circumvent priority of payment rules to the detriment of unsecured creditors, who have to wait in line until they get paid pursuant to an approved plan of reorganization (POR) or liquidation.

Risks associated with collateral or enterprise valuation

- The reorganization process heavily relies on valuations and play important roles in:

1. In issues of adequate protection (Section 361);
2. Relief from the automatic stay (Section 362);
3. Use, sale, or lease of property and what constitutes cash collateral (Section 363);
4. Obtaining credit and the granting of priming liens to DIP lenders (Section 364);
5. The process of claims' allowance as secured versus unsecured (Section 506);
6. Recourse or nonrecourse (Section 1111(b));
7. The analysis of solvency issues that is an integral part of the determination of preferential transfers (Section 547);
8. Fraudulent transfers (Sections 548 and 544);
9. The reclamation of vendor goods (Section 546);
10. Testing the feasibility of a proposed plan of reorganization (Section 1129(a)(11));
11. Calculating the recovery of various creditor classes, meeting the fair and equitable standards required of a cram down of creditors (Section 1129(b)(2));
12. Making sure that the best interests of creditors test is met through the performance of a liquidation analysis (Section 1129(a)(7))

Risks associated with collateral or enterprise valuation

1. <u>Collateral valuation risks</u>
   - Section 506(a) of the bankruptcy code provides guidance about the principles to be used in the valuation of the collateral securing a claim:

"Such value shall be determined in light of the purpose of the valuation and of the proposed <u>disposition</u> or <u>use</u> of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's I

interest."

   - What is really at stake is the actual valuation amount of the collateral for purposes of determining the amount of a secured claim, i.e., whether a secured creditor is oversecured or undersecured and whether it has both a secured claim to the extent of the collateral value and an unsecured claim for the deficiency. Section 506.

Risks associated with collateral or enterprise valuation

2. Deterioration of the value of the collateral risk
   - The questions of adequate protection and the lifting of the automatic stay seem to be the most commonly litigated questions in bankruptcy.
   - The granting of adequate protection to a secured creditor is not automatic, and it will be granted only after bringing a proceeding to lift the automatic stay.
   - Why would secured creditors do this?
   - To either **enforce their rights to foreclose on the collateral** securing the claim (stay is lifted), or **to assure that the value of their interests in the collateral will not diminish over time**.

Risks associated with collateral or enterprise valuation

- There are three reasons why collateral value may deteriorate over the pendency of a bankruptcy case:

  1. The debtor will continue to use the collateral and thus consume it or wear it out,
  2. The collateral value will decline due to deteriorating economic conditions, and/or,
  3. The debtor will be unable to properly maintain or protect its value.

Risks associated with collateral or enterprise valuation

2. Enterprise valuation risks

- The determination of enterprise value is key to the **allocation of creditor classes' recoveries** as well as **the performance of several bankruptcy mandated tests** that are needed to assess whether a plan of reorganization can be confirmed.

Risks associated with collateral or enterprise valuation

- As a general rule, the most junior classes (holders of equity in the prepetition debtor, junior subordinated, and junior creditors) will push for a larger valuation of the enterprise seeking to participate in the reorganization and stay in-the-money.
- The most senior classes are likely to prefer a lower valuation that in all likelihood will make the debtor more feasible and will facilitate the implementation of the plan.

Risks associated with collateral or enterprise valuation

- The interplay between the valuation of the enterprise and the availability of internal and/or exit financing will be important in coming up with the form of consideration that the debtor will use to satisfy allowed claims under the plan of reorganization and in shaping the resulting capital structure.

Reorganization risks

- There is a considerable amount of uncertainty about how each class of creditors will actually be formed and how they will fare in a reorganization.
- These risks can be mitigated somehow if you participate in the reorganization negotiations or have some degree of control over whether a vote can succeed or not, i.e. you own enough claims to block a vote (a blocking position) or have control of a class or classes.
- Uncontrolled professional costs and time to reorganization can pose material risks to class recoveries and form of consideration.