

Hedge Fund and Private Equity Funds' Influence in the Chapter 11 Process

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Introduction

- In recent years, private equity firms and hedge funds have become increasingly frequent figures in high-profile Chapter 11 cases
- Commentators have speculated that the involvement of private equity firms and hedge funds has led to an increased emphasis on the pre-bankruptcy stage of a restructuring
- Pre-bankruptcy negotiations can be outcome-determinative of a case and occur without the oversight of the Bankruptcy Court, the United States Trustee or any statutory committee

Questions Presented

- Have private equity firms and hedge funds shifted the balance of power in Chapter 11 cases?
- Do pre-bankruptcy agreements (including RSAs and DIP/cash collateral agreements) make the Chapter 11 process more efficient or simply lead to increased litigation, costs and delay?
- Do post-petition plan support agreements (PSAs) violate the Bankruptcy Code prohibitions against vote solicitation?

Private Equity

- A private equity firm, often referred to as a sponsor, is an investment manager that purchases significant equity positions in operating companies
- Private equity firms typically raise capital through external sources (usually limited partnerships), including pension and retirement funds, insurance companies, high net worth individuals and endowment
- Firms charge investors management fees and collect a percentage of profits
- Firms often purchase equity through a leveraged buyout and seek to exit investments in 3-7 years

Hedge Funds

- A hedge fund is an investment manager that pools capital from accredited individuals and institutional investors and invests in alternative investments, including derivatives
- Hedge funds often employ a long/short strategy and use sophisticated investment techniques, such as arbitrage and hedging
- Some hedge funds' strategy includes purchasing distressed bonds in anticipation of increasing recovery in an anticipated Chapter 11
- Fulcrum security is often, but not always, the focus

Regulation of Private Equity and Hedge Funds

- Before 2012, private equity firms and hedge funds were for the most part unregulated
- Since the enactment of the Dodd-Frank Act, most private equity and hedge funds are required to register as investment advisors and are subject to reporting requirements with the Security and Exchange Commission

Private Equity vs. Hedge Funds

- Some private equity funds sponsor buyouts through Chapter 11, increasing their return when private equity ultimately divests the investment
- Unlike hedge funds, private equity funds do not typically acquire distressed debt, but will more typically look at acquiring a controlling equity stake in a target company

Utilization of Chapter 11 – Private Equity Sponsored Plans

- One typical strategy is for a private equity firm to negotiate with a distressed company's management to exchange the reorganized company's controlling equity in exchange for a cash infusion
- A private equity sponsored Chapter 11 plan will often eliminate the existing debt securities in exchange for the issuance of new debt securities on restructured terms or a minority equity share, or in some instances, contingent value rights (warrants, options, etc.)

Utilization of Chapter 11, (*continued*)

- A hedge fund may look to control a Chapter 11 process by acquiring the fulcrum security
- In the case of either a private equity sponsored plan or a pre-arranged plan negotiated with hedge funds holding debt securities, agreements are often negotiated in advance of a bankruptcy filing and implemented through a prearranged Chapter 11 plan

Private Equity Plan Sponsorship or Hedge Fund Prearranged Plans

- The distressed company will enter into a restructuring support agreement (“RSA”) whereby it will agree to pursue confirmation of the plan under certain prenegotiated terms
- Parties to an RSA have involvement (if not veto power) over most major decisions in the case
- Creditors who are disadvantaged or disenfranchised by such an arrangement will usually contest the plan through litigation

Typical Aspects of a Prearranged Chapter 11

- An RSA or plan support agreement (“PSA”) which provides that the agreement will terminate if deadlines for certain approvals are not met
 - These usually include approval of the RSA/PSA, disclosure statement and plan
- A “fiduciary out” that excuses the debtor’s obligations under the RSA/PSA if its fiduciary duties require otherwise

RSAs/Control Over Process

- Have plan sponsors or fulcrum security holders supplanted the decision-making of the Bankruptcy Courts? Do RSAs or PSAs tie the Courts' hands?
- Do RSAs advance the process by streamlining the process and facilitating a faster exit from Chapter 11? Or do they simply lead to a longer and more expensive process because of the inevitable objections from non-parties to the RSA?

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