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Bankruptcy: Activist Investors and Chapter 11

Jared A. Ellias

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Jared Ellias[1]

A major shift in Chapter 11 practice in the past decade has been the emergence of hedge funds that specialize in investing in distressed debt. Their presence in the reorganization of large firms is pervasive; in 2009 and 2010, they invested in more than 70% of the Chapter 11 cases of large firms. Distressed hedge funds wield more than $100 billion in capital and aim to use their expertise in the bankruptcy process to profit from investing in the claims of large distressed firms. Towards that end, they deploy both activist and passive investing strategies. While recent research has shed some light on the impact of these funds on the bankruptcy process, much remains unknown.

Background on Junior Investors in Bankruptcy

Take, for example, one of the most important activist investing strategies: buying lower-priority claims like unsecured debt and equity and hiring lawyers to participate in the bankruptcy process. I refer to this strategy as "junior activism." Junior activists are well-known for their willingness to challenge managers and senior creditors in the board room and the court room. Like activist investing more generally, junior activism is a source of controversy. Critics view junior activists as opportunists that file meritless motions and objections to extract hold-up value settlements. To quote Wilbur Ross in his testimony to the American Bankruptcy Institute's Reform Commission, "[junior creditors] know that terrorist [litigation] tactics can lead to concessions from economically superior claimants and that even when they don't, litigation sometimes results in decisions that bestow value on the nominally lower ranking class."[2] In theory, this frivolous litigation is

1. Summarized and excerpted from Jared Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?*, 8 J. LEGAL ANALYSIS 493 (2016).

2. Wilbur L. Ross, Jr., *American Bankruptcy Institute Commission to Study Reform of Chapter 11* at 3 (2013).

also thought to increase bankruptcy costs, undermining the Chapter 11 policy goal of maximizing creditor recoveries.

Junior activists, however, believe they counter the perverse incentives of managers of Chapter 11 debtors. Chapter 11 leaves managers in control of the bankruptcy process and requires them to maximize creditor recoveries. In performing this duty, managers face what economists call a "moral hazard." If the firm is reorganized in a transaction that is appraised at a discount to the firm's true value, managers and senior creditors can profit at the expense of junior claimants by extracting value that otherwise might go to junior constituencies. Junior activists claim they intervene to stop managers and senior creditors from exploiting their control over the bankruptcy process to enrich themselves at the expense of junior claimants.

Empirical Study and Findings

Which of these views of junior activism is accurate? I attempted to answer that question using a hand-collected dataset of 107 large firms that filed for Chapter 11 in 2009 and 2010. To measure junior activism, I developed a methodology that I refer to as a "litigation score." My intuition was to treat the observable portions of junior activism—the litigation, their court victories, and the identity of junior activists—as a proxy for things not reliably observable, such as out-of-court negotiations. The more litigation—objections to the debtor's key motions, requests for judicial relief like motions to appoint trustees and examiner—the higher the score. This methodology allowed me to distinguish the cases in which junior activists were relatively more active from the ones in which they appeared to play less of a role.

My findings are consistent with the view that junior activists play an important role in corporate governance that is consistent with bankruptcy's policy goals. First, the evidence suggests that junior-activist litigation is associated with an increase in the appraised value of the restructuring transaction. This supports the view that junior activists improve Chapter 11. Depending on the facts of the case, the junior activist might have increased the appraised transaction value by pushing a reluctant management team into a transaction that maximized the true value of the firm. Alternatively, the junior activist might have prevented management and senior lenders from obtaining an artificially low appraisal from their investment banker.

Additionally, I examine the market prices of senior claims at the end of the bankruptcy process and find no evidence that the observed increase in the appraisal results in the firm being overvalued or senior creditors undercompensated.

Second, for a subset of the sample, I was able to calculate the market value of the firm's outstanding debt and equity on the date the firm filed for bankruptcy. This allowed me to control for the market's recovery expectations at the beginning of the bankruptcy process. I found that, controlling for changes in credit market conditions and other important variables, junior activism appears to be positively correlated with higher creditor recoveries than the market anticipated prior to the bankruptcy process. This suggests that junior activists are, at the least, savvy investors. It also provides support for the view that they contribute expertise that improves the outcome of the bankruptcy process.

Third, by analyzing bond and loan returns around key bankruptcy hearings, I found a positive relationship between post-hearing returns for junior claimholders and the presence of a junior activist. This correlation appears to be driven by the junior activist's prosecution of objection to management's motions. While I do not observe all of the data I would need to come to firm conclusions, the observed increase in the value of the junior claim does not appear to be a transfer from senior creditors. This finding, too, is consistent with the notion that junior activists play a crucial governance role that checks management's powers as debtor-in-possession at important points in the bankruptcy process.

Fourth, by examining the range of estimated value by firms that recapitalized with supporting investment-banker appraisals, I found that the range appears to be narrower for the cases with junior-activist involvement. This is consistent with the notion that junior activists contribute expertise that reduces the randomness of the appraisal process and, together with the evidence of higher appraisals, is broadly consistent with the expectation that junior activists positively influenced the governance of bankrupt firms by constraining opportunistic underappraisal.

Still, some evidence was consistent with the predictions of the critics of junior activism. I observed payments outside of the absolute priority rule in 27% of sample cases. However, the value distributed outside of the absolute priority rule was relatively small—generally ranging between 1% and 3% of the appraised transaction value. It seems unlikely that these small settlements would make the investment that junior activists make in lawyer and investment-banker fees profitable, suggesting that hedge funds would be unlikely to litigate opportunistically in search of these small observed payments.

The evidence also linked junior-activist litigation to higher attorneys' fees. This makes intuitive sense. After all, if junior activists are filing objections, the debtor's attorneys will incur additional fees in responding to them and preparing for trial. However, the magnitude of the implied cost increase is relatively low, and direct bankruptcy costs themselves are a mere 1.3% of the appraised value of the median sample case. I did not observe a relationship between junior activism and the length of the bankruptcy case, which is inconsistent with the worry of critics that overly litigious hedge funds prolong bankruptcy cases.

Conclusion

The results in the study offer some support both to the claims of junior activists and to the claims of their detractors. On the whole, however, the findings are inconsistent with the claim that activist investors abuse the bankruptcy system by extracting hold-up payments. I did not find evidence of large payments outside of the absolute priority rule, and junior activists appear to focus their efforts on relatively more valuable cases, inconsistent with the expectation of indiscriminate litigation. Moreover, I found evidence suggesting that junior activism is correlated with unexpectedly high creditor recoveries and other corroborating evidence that support the view that junior activists contribute expertise to bankruptcy cases that lead to better outcomes.

However, it is important to qualify these results by noting that my methodology cannot eliminate the possibility that the observed positive correlation between junior activism and the final appraisal is better explained as nonrandom and savvy selection of target firms by sophisticated investors. It does seem unlikely that junior activists would correctly identify undervalued firms and then reduce their returns by the millions of dollars they spend on lawyers and investment bankers to participate in the process, but my results cannot conclusively reject this possibility. Nonetheless, I do think that the results shift the burden of proof onto the critics of junior activism to show that there is a problem with overly litigious hedge funds abusing the bankruptcy system. Further research is needed to learn more about the impact hedge funds might have on the bankruptcy process, but the results in this study cautiously suggest that junior-activist investing strategies might be, on average, beneficial.