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Are Litigious Hedge Funds a Problem? A Study of Activism

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Financial Statements

By JARED A. ELLIAS

Are Litigious Hedge Funds a Problem? A Study of Activism

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 percent of the chapter 11 cases of large firms.¹ 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.² To that end, they deploy both active and passive investing strategies. While recent research has shed some light on the impact of these funds on the bankruptcy process, much remains unknown.

In a recent paper,³ the author conducted the first study of one of the most important active-investing strategies: Buying lower-priority claims like unsecured debt and equity and hiring lawyers to participate in the bankruptcy process (hereinafter, the “study”). This strategy is referred to as “junior activism.” Junior activists are well-known for their willingness to challenge managers and senior creditors in the boardroom and courtroom. Like activists 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 ABI Commission to Study the Reform of Chapter 11, “[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.”⁴ In theory, this frivolous litigation is also thought to increase bankruptcy costs, undermining the chapter 11 policy goal of maximizing creditor recoveries.

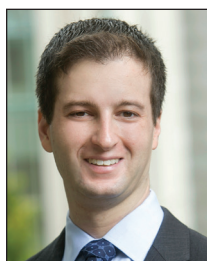
Junior activists, on the other hand, believe that they counter the perverse incentives of managers of chapter 11 debtors. Chapter 11 leaves managers in

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 would go to junior constituencies if the process was run fairly. Junior activists claim that 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. Which of these views is accurate?

This article summarizes the main results from the study. Obviously, it is not possible to generalize and say that junior activists are always acting in line with the predictions of their detractors or that they never are. In reality, both views of junior activism are probably correct in individual cases, and anecdotal evidence supports both positions. The study moves the debate forward by using quantitative tools to try to estimate the average effect of junior activism across a sizable sample of bankruptcy cases. The two views of junior activism provide different testable empirical predictions about junior activism.

If the criticism of junior activism is accurate, junior activism is expected to be correlated with settlements outside of the absolute priority rule (suggesting that the junior activist might have received hold-up value), and we would expect to see increases in bankruptcy costs. If junior activists are correct, junior activism is expected to be associated with an increase in the appraised value of the restructuring transaction, implying higher creditor recoveries and allocation of the firm’s value in line with the absolute priority rule.

These predictions were taken to a hand-collected dataset of 107 large firms that filed for chapter 11 in 2009-10. To measure junior activism, a methodology was developed that could be referred to as a “litigation score.” The intuition behind this research design is that portions of junior activism could be observed systematically in all bankruptcy cases: The litigation, their court victories and the identity of junior activists were treated as a proxy for the things that could not be reliably observed, such as out-of-court negotiations. The more litigation — the objections to the debtor’s key motions, requests for judicial relief like motions to appoint trustees and examiner — the



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1 This finding emerges from the empirical study that this paper summarizes. While the author cannot identify what percentage of the claims they held, the classes of debt they invested in had a face value in excess of \$180 billion.

2 See “Hedge Fund Industry — Assets under Management,” BarclayHedge, available at www.barcleyhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html (showing distressed hedge funds have managed over \$100 billion in assets since 2006; unless otherwise indicated, all links in this article were last visited on Nov. 23, 2015).

3 Jared A. Ellias, “Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?,” Forthcoming 2015, *Journal of Legal Analysis*, available at jla.oxfordjournals.org/content/early/2015/09/12/jla.lav010.full.pdf.

4 Remarks of Wilbur L. Ross to the ABI Commission to Study the Reform of Chapter 11 during ABI’s Annual Spring Meeting, April 19, 2013 (National Harbor, Md.), available at commission.abi.org.

higher the score. The methodology is explained in greater detail in the study, but it generally allowed one to distinguish the cases where junior activists were relatively more active from the ones where they appeared to play less of a role. Table 1 summarizes observed junior activist litigation.

Let's review the findings that are consistent with the view that junior activists play an important role in corporate governance that is consistent with bankruptcy 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 positively impact 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 firm's true value. Alternatively, the junior activist might have prevented management and

senior lenders from obtaining an artificially low appraisal from their investment banker. In addition, the market prices of senior claims at the end of the bankruptcy process were examined and no evidence was found that the observed increase in the appraisal results in the firm being overvalued and senior creditors undercompensated.

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

Third, bond and loan returns were examined around key bankruptcy hearings, and a single relationship between post-hearing returns for junior claimholders and the presence of a junior activist was found. This correlation appears to be driven by the junior activist's prosecution of objection to management's motions. While more data would be needed 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 is also consistent with the notion that junior activists play a crucial governance role that checks management's powers as a debtor in possession at important points in the bankruptcy process.

Fourth, the firms that recapitalized with supporting investment banker appraisals were examined to look for evidence of junior activist influence. These investment bankers calculated a range of estimated value, with a high, low and mid-point estimate. The range appears to be narrower for the cases with junior activist involvement, which 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

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Table 1: Litigation Activity of Junior Activists

Objections to Management's Major Motions	Filed			
	n	%		
Finance Motion	35	32.71%		
Disclosure Statement	40	37.38%		
Sale Motion	18	16.82%		
Reorganization Plan	21	19.63%		
Junior Activist Extraordinary Requests for Relief	Filed		Granted	
	n	%	n	%
Appoint Examiner	8	7.48%	1	0.93%
Appoint Trustee	2	1.87%	0	0.00%
Terminate Exclusivity	5	4.67%	1	0.93%
Appoint Additional Official Committee	12	11.21%	8	7.48%
File Own Plan	4	3.74%		
Identity of Junior Activist				
	n	%		
Hedge Fund or Private-Equity Firm Observed	60	56.07%		

Table 2: Estimated Value of Distributions Outside of Absolute Priority in Favor of Junior Activists

Consideration	Estimated Value				
	Minimum	Maximum	Mean	Median	Standard Deviation
Warrants (n=17) / Cash (n=5)					
Value of Cash (n=5)	900,000	11,000,000	6,380,000	7,000,000	3,615,522
% Total Enterprise Value (n=5)	1.00%	4.80%	3.02%	2.43%	1.73%
% Funded Debt (n=5)	0.50%	2.50%	1.50%	1.30%	0.70%
Equity (n=10)*					
Value of Equity (n=9)	1,240,000	99,400,000	24,000,000	4,386,000	33,900,000
% Reorganized Equity (n=10)	1.00%	7.50%	3.75%	3.50%	2.12%
% Total Enterprise Value (n=9)	0.27%	3.15%	1.92%	1.69%	1.15%
% Funded Debt (n=9)	0.18%	2.86%	1.37%	1.45%	0.89%

* In six cases, warrants and equity were distributed outside of the absolute priority rule, so the total value of the distribution was higher.

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tent with what one would expect if junior activists positively influenced the governance of bankrupt firms by constraining opportunistic underappraisals.

On the other hand, some evidence supported the contentions of the critics of junior activism. Payments outside of the absolute priority rule were observed in 27 percent of sample cases. However, the value distributed outside of the absolute priority rule was relatively small (generally ranging between 1-3 percent of the appraised transaction value). Table 2 on p. 29 summarizes distributions outside of the absolute priority rule. It seems unlikely that these small settlements would make the investment that junior activists make in lawyer and investment banker fees profitable, which suggests that hedge funds would be unlikely to litigate opportunistically in search of these small observed payments.

Evidence was also found that suggests that junior activist litigation is associated with higher attorneys' fees, which 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 percent of the appraised value of the median sample case. In addition, a relationship between junior activism and the length of the bankruptcy case was not observable, which mitigates the worry of critics that overly litigious hedge funds prolong bankruptcy cases.

Conclusion

The results of the study support both the claims of junior activists and the claims of their detractors. On the whole, the findings are inconsistent with the claim that activist investors buy junior claims and abuse the bankruptcy system to extract hold-up payments. No evidence was found 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 liti-

gation. Moreover, the study found evidence suggesting that junior activism is correlated with unexpectedly high creditor recoveries and other corroborating evidence that supports the view that junior activists contribute expertise to bankruptcy cases that lead to better outcomes.

[T]he results in the study 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, but further research is needed to learn more about the impact that hedge funds might have on the bankruptcy process[.]

However, it is important to qualify these results by noting that the methodology used in the study could not eliminate the possibility that the observed positive correlation between junior activism and the final appraisal is better explained as a non-random 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 the results from the data cannot conclusively reject this possibility. Nonetheless, the results in the study 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, but further research is needed to learn more about the impact that hedge funds might have on the bankruptcy process. The results in this study cautiously suggest that junior activist investing strategies might be, on average, beneficial. **abi**

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