Testimony Before the ABI Chapter 11 Reform Commission

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My name is Edith Hotchkiss. I am a professor in the Finance Department at the Carroll School of Management at Boston College, where I have been on the faculty since 1993. My research over the past 20 years has focused on various aspects of U.S. corporate debt markets, and particularly on the efficiency of the Chapter 11 process. In addition to my publications in peer reviewed academic journals, I have authored several book chapters and one text on the bankruptcy process, have served as an advisor to creditor committees of several large Chapter 11 cases, and have served as an independent advisor to FINRA on issues related to corporate bond market trading and transparency. I am honored to have the opportunity to discuss the work that I and other academics have performed regarding secondary trading and governance activity in distressed debt markets.

I understand that the Commission is considering reforms to chapter 11 that would place restrictions on claims trading in bankruptcy or weaken the rights of creditors who purchased debt on the secondary market, based on a concern that distressed-debt investing has an adverse effect on the bankruptcy process. My research and that of others in the field demonstrates, on the contrary, that a liquid secondary market for debt has tangible benefits for the bankruptcy process: more effective corporate governance and oversight, greater efficiency, a greater likelihood that the debtor will continue as a going concern, and a greater likelihood that the reorganized debtor will succeed following bankruptcy.

1. *Secondary market trading in claims of distressed and bankrupt firms leads to a consolidation of otherwise dispersed ownership of claims, resulting in greater efficiencies in the reorganization process.* My own and other academic research has shown that this consolidation of claims is associated with more oversight of the process and more efficient reorganizations, evidenced by a greater likelihood of out of court restructurings or prepackaged bankruptcies, less time spent in reorganizations, and a greater likelihood that the firm continues as a going concern.

My original study of this market, co-authored with Robert Mooradian (published in 1997 in the *Journal of Financial Economics*), was motivated by the growth in secondary market trading that emerged with the recession of the early 1990s. At that time, we tracked the involvement of approximately 75 self-identified institutional investors in distressed firms. We observed that as far back as the early 1990s these distressed-debt investors purchased claims in over 60% of firms that defaulted on public debt. Since then, the extent of claims trading in distressed companies has increased to the extent that significant changes in ownership structure are observed for virtually any restructuring public company. Our work showed that distressed-debt investors purchase claims at all levels of the capital structure, frequently accumulate at least 1/3 of a voting class of claims , and frequently become the post-restructuring equity owners of the firm, and thus can have a significant influence on the course of the restructuring. Our work has been updated in a recent study by Jiang et al. (2012), who specifically focused on the role of hedge funds, showing that hedge funds strategically choose positions in the capital structure where their actions can have a bigger impact on value.

The most recent evidence regarding the extent and influence of claims trading is provided by Ivashina et al. (2012), who studied 136 companies filing for Chapter 11 between 1998 and 2009. They are the only researchers who have been able to construct a full snapshot of claims ownership at the firm level, both at the time of filing and at the time of voting on a reorganization plan, permitting them to document the types of owners and the consolidation of claims during the case, and to relate these changes

to case outcomes.[1] Active investors, including hedge funds, are the largest net buyers of claims in bankruptcy. Trading leads to a higher concentration of ownership, particularly among claims whose holders are eligible to vote on the bankruptcy plan and among claims that represent the "fulcrum" security in the capital structure.[2]

Beyond showing that hedge funds have become the most active investors in the distressed debt market, all three of these studies paint a consistent picture, demonstrating that the consolidation of claims resulting from distressed-debt investing is associated with increases in efficiency measures for Chapter 11 outcomes, most notably a higher probability of emergence from bankruptcy and greater recoveries for junior claim-holders. Jiang et al. further show that active distressed-debt investors play an important role in balancing the power of the debtor, and that investment by hedge funds, in particular, results in efficiency gains. Jiang et al. also document that the presence of hedge funds is associated with a higher CEO turnover rate, higher incidence of the debtor's loss of exclusive rights to file a reorganization plan, and retention of key personnel via adoptions of KERPs. They further show for the cases they examine where the senior lenders are hedge funds, distributions to junior claimants were more favorable.

2. *Senior creditors have an important influence on the governance of firms well before defaults or bankruptcies. Impairing the security rights of these creditors could equally impair the ability of firms to maintain and/or obtain additional financing as they become distressed.*

Academic research demonstrates two facts regarding the influence of senior creditors early in a firm's decline. First, when firms violate covenants in lending agreements, the control rights of senior lenders influence firm actions in ways that appear to increase firm value. Nini et al. (2012) examined 3,500 incidences of financial covenant violations for the universe of U.S. firms filing quarterly and annual

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[1] Ownership structure is constructed using data from Chapter 11 claims agents, under a research project funded by the American Bankruptcy Institute (ABI) Endowment Fund.

[2] The "fulcrum security" is the class of claims whose holders ultimately receive the majority of the stock in the restructuring.

financial reports with the SEC between 1997 and 2008. Their study showed that covenant violations are followed immediately by declines in acquisitions and capital expenditures, sharp reductions in leverage and shareholder payouts, and increases in CEO turnover.[3] These changes coincide with amended credit agreements that contain stronger restrictions on firm decision making. Of critical importance, both operating performance and equity-market valuations improve following a covenant violation; in other words, strong creditor rights and the associated creditor intervention are associated with a turnaround in performance. This empirical evidence clearly shows that creditor influence on managerial decisions extends beyond states of default, and in particular that senior creditors begin to play an active role in corporate governance when firm performance first deteriorates.

The second important observation is that contractual restrictions on the borrower increase when firm performance declines. Both Nini et al. (2012) and a survey by Ayotte et al. (2012) describe the terms of financing available to declining firms. They note that much creditor control is exercised through secured lines of credit, which are extended to the firm both before and after it files a bankruptcy petition. Renegotiated credit agreements impose stronger contractual restrictions on the borrower, carry higher interest rate spreads, and are more likely to require collateral. The important point here, however, is that without these concessions it is unlikely that lenders would continue to extend credit, rather than terminating the credit agreements or even accelerating payments. As distressed firms increasingly rely on secured debt markets, they would lose access to financing without the ability to provide lenders with additional security.[4]

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[3] The influence of large creditors on corporate governance has been described anecdotally by legal scholars including Daniels and Triantis (1995) and Baird and Rasmussen (2006). Nini et al. (2012) are the first to provide comprehensive empirical support for these views.

[4] Interestingly, non-bank lenders also emerge as an important financing source for distressed firms. Hotchkiss et al. (2012) studies distressed firms owned by private equity sponsors and note that sponsors and other distressed debt investors frequently lend to portfolio companies.

3. *Involvement by hedge fund and other active investors in the governance of distressed firms is associated with value increases and improved post-reorganization performance.*

My earliest research showed that numerous firms continue to perform poorly after emerging from reorganizations, often re-entering Chapter 11 (so called Chapter 22s). Early researchers faulted the pro-debtor characteristics of the Bankruptcy Code for this behavior because it permitted debtors great leeway in satisfying the feasibility standard.[5] Active investors' ability to have a positive effect on the governance of distressed firms is important to mitigating this problem.

Research that specifically examines the role of hedge funds and other active investors in distressed firm governance points to their positive effect on firm value and performance. The investment strategies of some distressed-debt investors are more passive, seeking to profit from increases in value of purchased claims, or seeking to influence restructurings in a way that increase payoffs to a particular class of claims. More important to firm value and recovery, however, is the discipline imposed by investors that actively seek to influence firm performance.

In our study of active investors described above (Hotchkiss and Mooradian, 1997), we observed that firms that were targeted by active distressed-debt investors improved performance post-reorganization. We define active investors as those who take seats on firm boards and/or assume management positions in the company, or who gain control of the reorganized firm when they receive stock distributions in the reorganization. Prices of traded claims respond positively to the entrance of these investors. Notably, these are often long-term investors who hold stakes for a number of years beyond the reorganization.

This evidence is also consistent with a broader academic literature that examines the impact of activist hedge fund investment in equity markets. While this literature is too extensive to survey here, it is worth noting that a similar consensus appears from this body of work—that hedge fund investments are

[5] Hotchkiss (1995) found that nearly 40% of firms emerging from Chapter 11 in the 1980s continued to experience subsequent operating losses, and that subsequent failures were more likely when firms had not replaced their pre-bankruptcy management by the time a reorganization plan was proposed.

typically associated with value gains for the target companies.[6] Our research on the role of investors in corporate governance of distressed firms is also consistent with research in the corporate finance field demonstrating that the market for corporate control more broadly imposes an important discipline on management of underperforming firms (Jensen, 1986).

4. In seeking to protect their investment, senior lenders provide other functions central to a firm's ability to restructure in bankruptcy, including provision of DIP financing (discussed in earlier testimony), and providing exit financing and/or funding for a plan of reorganization.

Senior lenders often take the view that they can realize more value from a security interest in a debtor's assets by lending additional capital to facilitate reorganization rather than pushing for the firm's liquidation. The benefits of these capital infusions are largely self-evident, and they are central to a debtor's ability to successfully reorganize.

Empirical research shows the frequency with which firms obtain exit financing from an existing lender, or from the same investor who is funding a plan of reorganization. Our main source of empirical evidence for the latter point is our recent study of firms that borrowed in the leveraged loan market between 1997 and 2007, approximately 25% of which subsequently experienced a default (Hotchkiss et al., 2012). Of the 353 defaulting firms in our study that entered Chapter 11, 20% emerged with a hedge fund, sometimes an affiliate of a private equity sponsor, as the majority owner of the reorganized firm. Notably, in a number of those cases, the hedge fund obtained those claims by providing financing to the firm during the Chapter 11 case, and additionally provided capital to fund the reorganization plan. One can reasonably conclude from this data that the senior lenders are motivated to make capital available because they wish to maintain and if possible enhance the underlying value of their collateral. Absent that motivation, they may not be as willing to lend to enable the firm to reorganize.

[6] A useful survey of this literature is provided by Brav et al. (2012), who summarize it by explaining that "the evidence generally supports the view that hedge fund activism creates value for shareholders by effectively influencing the governance, capital structure decisions, and operating performance of target firms."

In short, my research and that of others in my field demonstrates that control exercised by distressed-debt investors and senior secured lenders has a positive effect on the bankruptcy process, increasing efficiency and making it more likely that debtors will reorganize and will succeed post-reorganization. I hope that the Commission will take these findings into account in considering potential reforms to chapter 11. I thank the Commission again for giving me the opportunity to testify today, and I am happy to answer any questions the Commissioners may have.

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