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Hedge Funds: A New Dimension in Chapter 11 Bankruptcy Proceedings

Bo J. Howell*

I. INTRODUCTION

Hedge funds are becoming prominent players in bankruptcy proceedings. In fact, some experts have stated that hedge fund involvement in Chapter 11 cases has become pervasive and extremely active.1 Opinions regarding their involvement in bankruptcy proceedings range from critics who demonize the funds to proponents who see the value in having a flexible, unrestrained creditor.2

The growing financial pressure on hedge funds is increasingly driving them into the bankruptcy realm. Hedge fund involvement in bankruptcy is relatively new, but their presence brings a great deal of liquidity and sophistication to bankruptcy cases.3 As active debt and equity traders, hedge funds are increasingly turning to distressed investment, which brings them into direct contact with the bankruptcy system.4

From a hedge fund's perspective, a distressed company is an investment that can create above-market returns.5 Hedge funds are increasingly interacting with insolvent debtors to turn an investment into a quick profit.6 In addition, the relatively high risks inherent in distressed debtors and bankruptcy proceedings are consistent with the hedge fund industry in general, which seeks to manage high-risk, high-reward investment.


5. Fisher & Buck, supra note 1, at 24.
6. Gilhuly, supra note 3, at 452.
The result, according to *The Economist*, is a rise in Chapter 11 bankruptcies, particularly among low-rated American companies.\(^7\) The growing presence of hedge funds in corporate finance affects Chapter 11 bankruptcies in many ways, including an increased average number of creditors for a distressed company, a lack of familiarity between creditors and debtors, and an expansion in the variety of loan types, including “senior or first-lien creditors (who have first dibs on a company's assets), second-lien creditors (who also have claims over the assets of a company, but who get paid only after first-lien creditors), mezzanine creditors, senior subordinated debt holders and subordinate debt holders.”\(^8\) Since hedge funds interact with distressed debtors at different points in time and in different creditor-debtor relationships, bankruptcy proceedings are becoming more complex, lengthier, and costly.\(^9\)

Often, strategic goals of hedge funds have a direct impact on Chapter 11 bankruptcy proceedings. The presence of hedge funds in bankruptcy proceedings is raising new legal issues, which implicate government regulators, such as the U.S. Securities and Exchange Commission, and the bankruptcy system. Hedge funds’ aggressive attempts to achieve relatively quick profits have raised issues regarding *ad hoc* committee disclosure, equitable subordination, and debt recharacterization.

For better or worse, it appears that hedge fund involvement in bankruptcy proceedings is established. As a result, it is important to understand how hedge funds approach Chapter 11 proceedings and what issues arise after a hedge fund becomes involved. Part II presents a structural and mechanical overview of hedge funds and how they operate. Part III discusses the impact of hedge funds on bankruptcy proceedings and the various issues that arise when a hedge fund engages a distressed debtor or other creditors. Finally, Part IV summarizes the costs and benefits of hedge fund involvement in Chapter 11 proceedings.

II. AN OVERVIEW OF HEDGE FUNDS

Traditionally, public financial institutions raised capital through the public market. Over the past fifteen years however, there has been a "migration of capital from traditional financial institutions into private
or quasi-private funds," including hedge funds.\textsuperscript{10} Hedge funds have been described as "the mysterious rich uncle of the investment industry family; no one agrees on his age, occupation or history, but everyone knows that he is related."\textsuperscript{11} More precisely, hedge funds are pools of capital that are "privately organized, professionally administered, and not widely available to the public."\textsuperscript{12}

A. Structural Overview

Like other investment vehicles, such as mutual funds, hedge funds are theoretically basic: A specific and limited group of investors combines their money and shares in the returns.\textsuperscript{13} In addition, hedge funds invest in some of the same assets as other investment vehicles. Despite these basic theoretical similarities, however, the reality is that hedge funds are significantly different from most investment vehicles. The higher minimum buy-in, risky investment strategies, fee structures, and non-public nature of hedge funds separate them from other industry players.

Traditionally, hedge funds limited their availability to wealthy individuals or institutional investors, but more recently some funds reduced their minimum investment amounts or provided back-door access through mutual funds.\textsuperscript{14} Regardless, hedge fund investors use various business structures to take advantage of favorable tax treatment and other regulatory loopholes.\textsuperscript{15} The most important loophole is the SEC's registration exemption, although the Commodities Futures Trading Commission ("CFTC") also has registration exemptions.\textsuperscript{16} In addition, hedge funds are extremely flexible because, unlike regulated investment companies, hedge funds are free from diversification requirements or other investment restrictions.\textsuperscript{17}

The combination of regulatory freedom, the ability to leverage assets, and market

\begin{itemize}
  \item \textsuperscript{11} Joseph Hellrung, \textit{Hedge Fund Regulation: Investors Are Knocking at the Door, But Can the SEC Clean House Before Everyone Rushes In?}, 9 N.C. Banking Inst. 317, 319 (2005).
  \item \textsuperscript{13} Gilhuly, \textit{supra} note 3, at 452.
  \item \textsuperscript{15} Hellrung, \textit{supra} note 11, at 320.
  \item \textsuperscript{16} Id. at 321.
  \item \textsuperscript{17} Jessica Natali, \textit{Trimming the Hedges is a Difficult Task: The SEC's Attempt to Regulate Hedge Funds Falls Short of Expectations}, 15 U. Miami Bus. L. Rev. 113, 116 (2006).
\end{itemize}
flexibility allow hedge funds to capitalize on risky investments and maximize their returns.

Today, the term hedge fund is a "catch-all classification for many unregistered privately managed pools of capital." As a result, four securities statutes possibly regulate hedge fund activities, including: (1) the Securities Act of 1933 ("Securities Act"); (2) the Securities Exchange Act of 1934; (3) the Investment Advisors Act of 1940; and (4) the Investment Company Act of 1940. These Acts have indirectly shaped the evolution and structure of hedge funds because the funds mold themselves into the available exemptions.

Hedge funds generally utilize Section 4(2) of the Securities Act—the private placement exemption—which "exempts issuers who sell securities only to 'accredited investors' without any form of 'general solicitation or advertising.'" Under Section 4(2), hedge funds can circumvent the SEC registration requirement by avoiding public offerings and limiting availability to accredited investors. SEC Regulation D, which implements Section 4(2), contains four requirements for any investor utilizing the registration exemption:

1. the fund cannot utilize general solicitation or advertising in marketing its securities;
2. the fund can only sell its securities to 'accredited investors' and up to 35 other purchasers (who must possess sufficient financial and business knowledge and experience in order to evaluate the risks associated with the fund);
3. the fund advisor must be available for questions from prospective purchasers; and
4. the securities issued by the fund cannot be redeemed for at least a year after purchase and cannot be resold.

Currently, Regulation D also sets threshold limits for qualification as an accredited investor. The threshold requirement for legal entities is $5 million in assets. For individuals, the threshold is either a net worth of $1 million or a gross annual income of $200,000 ($300,000 for married couples). If a party does not meet the definition of an accredited investor, Rules 506 and 502 of Regulation D require the issuer to "furnish the purchaser with non-financial information material

19. Hellrung, supra note 11, at 323 (footnotes omitted).
20. Id.
21. Id. at 324 (quoting SEC, Implications of the Growth of Hedge Funds vii (Staff ed. 2003); Natali, supra note 17, at 318).
22. Mota, supra note 12, at 59.
25. Id.
to an understanding of the business and of the securities being offered, as well as any relevant financial statements and the information contained therein.”

The increased information requirements usually result in hedge funds transacting only with accredited investors.

B. Mechanical Overview

Hedge funds are usually limited liability companies, limited partnerships, or general partnerships. A fund manager directs the funds and levies a 2-5% management fee as well as a 20-40% performance fee. Hedge funds lock-up investors' capital for varying periods of time. Unlike traditional lenders, such as banks or mutual funds, hedge funds have more flexibility in, and control over, their investments. "In order to effectuate their goals, [hedge funds] almost always have a representative sit on the board or oversight body for the entity and usually have captive management or professionals monitoring the progress and implementing the strategy they want implemented in order to garner the returns they seek.” Thus, hedge funds are closely involved with their investments.

Hedge funds are modern day corporate raiders. “In order to insure higher returns than traditional equity markets, the rallying cry of hedge [funds . . . has been their ability – and willingness – to pursue aggressive and multiple investment strategies.” Hedge funds create wealth by using short selling—the speculation that security prices will drop—and other leverage strategies as well as direct investment in operating companies or in the distressed markets. To implement quick return strategies, hedge funds pour large amounts of capital into companies, which gives the funds a controlling stake and allows them to force their agenda upon the company. In addition to using public securities to assert control, an increasingly popular strategy involves privatizing a public company through an equity buyout.

Finally, second-lien and subprime loans are two additional strategies that hedge funds have used to pursue rapid returns. Second-lien

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27. Id. at 119.
29. Id.
30. Id. at 216.
31. Id. at 217.
32. Id.
34. See id. at 220 (discussing the example of hedge funds in the restaurant industry).
35. Id. at 221.
36. Id. at 221-22.
loans are security interests in a borrower's collateral, but the interests are subordinate to first-lien creditor's interests.\textsuperscript{37} Further, the loans frequently involve extensive inter-creditor agreements, which attempt to regulate creditors' rights in the event of bankruptcy.\textsuperscript{38} Thus, a hedge fund's extension of a second-lien loan to a distressed debtor brings the fund into direct contact with the debtor, other creditors, and the bankruptcy system. In addition, subprime loans, which are high-priced loans to high-risk individuals,\textsuperscript{39} are consistent with the hedge fund industry's high-risk, high reward approach. But the higher default rate in subprime loans progressively brings hedge funds in direct contact with the bankruptcy system.

C. Hedge Fund Industry Growth

Hedge funds are increasingly popular because of their alleged ability to outperform the stock market and other investments. The rise of securitization has made hedge funds increasingly popular because the funds are able to spread investment risks through multiple investment vehicles.\textsuperscript{40} Between 1985 and 2005, hedge funds and other alternative investments expanded their share of the capital market from 16% to 50%.\textsuperscript{41} In 2005, the hedge fund industry boasted 8,000 funds with combined assets over $1 trillion.\textsuperscript{42} By 2006, the value of the hedge fund industry was $1.5 trillion, although there was a 9.4% decrease in the amount invested.\textsuperscript{43}

As stated earlier, second-lien and subprime loans directly affect the bankruptcy system because the loan-types bring hedge funds in direct contact with distressed debtors, other creditors, and the bankruptcy courts. The rise of second-lien and subprime lending has created new financial markets, which hedge funds have dominated.\textsuperscript{44} "Until 2003, second lien debt was not a major part of the financial landscape. The current wave of second lien debt traces its origins to efforts to circumvent anti-layering covenants found in many high-yield public debt indentures."\textsuperscript{45} Since 2003, however, the second-lien market increased

\textsuperscript{38} Futter & Wells, supra note 10, at 222.
\textsuperscript{40} Futter & Wells, supra note 10, at 214.
\textsuperscript{41} Id.
\textsuperscript{42} Natali, supra note 17, at 114.
\textsuperscript{43} Futter & Wells, supra note 10, at 214-15. The amount invested in 2005 was $139.6 billion as opposed to the $126.5 billion in 2006. Id. at 215.
\textsuperscript{44} Id. at 221-22.
\textsuperscript{45} Gilhuly, supra note 3, at 461.
from $3.076 billion to more than $16.298 billion. In 2005, second-lien loans alone constituted a $15 billion market, a ten-fold growth from 2002. From 2005 to 2006, more than $51.6 billion in new second-lien loans originated. Within the last fifteen years, the securitization of subprime loans created a $1.3 trillion industry. Further, the recent collapse of the subprime market has caused the interaction between hedge funds and the bankruptcy system to exponentially expand.

III. HEDGE FUNDS’ IMPACT ON BANKRUPTCY PROCEEDINGS

One area of hedge fund activity that has yet to receive much attention is bankruptcy, but hedge funds are quickly establishing their presence in many Chapter 11 cases. A growing number of hedge funds are investing in distressed and bankrupt companies to achieve greater returns. Hedge fund involvement in Chapter 11 cases—also known as the corporate reorganization process—benefits distressed debtors through increased financing and competitive financing terms. Although hedge funds may provide some benefits to the corporate reorganization process, their presence also raises a number of concerns, including more complex, costly, and lengthy bankruptcy proceedings.

Hedge funds have already established their presence in many Chapter 11 cases as first- or second-lien creditors, unsecured creditors, debtor-in-possession (DIP) lenders, and equity holders. Further, a fund’s aggressive pursuit of profits often creates conflicts between hedge funds and the distressed debtor or other creditors, who often hold the “rehabilitationist” view that the purpose of reorganization is to create a stronger, healthier corporate entity that benefits all interested parties.

A. Pre-PetitionRestructurings

One emerging bankruptcy trend is the pre-petition restructuring of Chapter 11 debtors. The pre-packaging of bankruptcy petitions is a result of creditors negotiating the restructure prior to filing in an at-

46. Id. at 451.
47. Futter & Wells, supra note 10, at 222 (quoting Don Durfee, Meet Your New Bankers: Hedge funds have a pile of cash to lend. Should you take it?, CFO.com (Feb. 1, 2006)).
48. Id. at 222.
49. Id.
50. Fisher & Buck, supra note 1, at 24.
51. Id.
tempt to expedite the process. Hedge funds prefer pre-packaged deals because it allows them “more control over the final outcome and ... less risk of a fire sale of assets.” Hedge funds are willing to fund the minimal operations of a Chapter 11 debtor to keep the entity moving towards a liquidity event (such as a sale or merger), so the hedge fund does not get stuck at the back of the creditors’ line in bankruptcy proceedings. Accordingly, hedge funds are becoming actively involved with distressed debtors prior to the filing of a bankruptcy petition.

As a source of necessary capital, hedge funds are able to create an influential relationship with the distressed debtor. In essence, the funds are able to provide what most other creditors will not – capital. Once the distressed debtor has filed for bankruptcy, a hedge fund will use its position to structure and confirm a reorganization plan. The ultimate goal is to quickly steer the distressed debtor through the bankruptcy process in order to become a profit-making entity.

If a hedge fund becomes an equity-holder prior to the bankruptcy filing, it can utilize Bankruptcy Code Section 1129(b) to cram the pre-packaged plan onto objecting senior creditors. Thus, the fund can avoid the priority rule by claiming its capital contribution as new value under the new-value corollary, discussed below.

Unfortunately, pre-packaged plans are worthwhile only if they are quickly implemented, which in turn requires creditors to agree on the terms. The problem arises when a hedge fund sits towards the bottom of the food chain. In that situation, the fund will often hold out for better terms—particularly if they control the majority of a voting class. Generally, all voting classes must approve submitted plans prior to confirmation. Often, a hedge fund with a number of first- and second-lien loans will use their position to block votes in an effort to negotiate a higher pay-off position.

In effect, hedge funds are able to strategically invest in distressed companies to position themselves in the event the company restructures or files for bankruptcy. The fact that the debt is easily transferable complicates matters because debt holders are constantly turning

55. Id.
59. Id.
60. Id.
61. Id.
over, even during pre-packaged bankruptcy negotiations. In the end, conflicts between creditors often result in many creditors and the distressed debtor losing out.

B. New Value Corollary

A hedge fund that is an equity holder prior to bankruptcy may run into some issues while attempting to retain its equity position in the reorganized debtor. In some cases, the absolute priority rule bars insiders who invest in a distressed debtor from receiving equity holdings in the reorganized debtor. Whenever a plan is proposed that will grant the benefit of equity ownership to only old equity holders, the plan must be treated as property within the meaning of Section 1129(b)(2)(B)(ii). The absolute priority rule rejects such plans. In other words, if old equity holders provide new capital in return for an equity stake in the reorganized debtor, then the old equity holders must list the anticipated equities as property.

However, a "new-value" corollary allows insiders to avoid the absolute priority and confirm a Chapter 11 plan that allows for the retention of the insider's equity holdings. As a result, a hedge fund looking to retain its equity holdings in a distressed debtor may do so by meeting the requirements of the new-value corollary. The new-value requirements are: (1) the old equity holder must provide a full-value transaction in cash, which is subject to a market test, and (2) all senior-class creditors, interested parties, and competitors must have a full and fair opportunity to contribute new capital and receive ownership interests in the reorganized debtor.

Although the United States Supreme Court has not recognized a "new-value" corollary to the absolute priority rule under the current Code, the Court's rulings on the issue imply that the rule has survived the enactment of the 1978 Bankruptcy Code. All but the Eighth and Eleventh Circuit Courts have held the corollary survived the 1978 Bankruptcy Code. As a result, old equity holders may provide new value to the distressed debtor in return for equity holdings in the reorganized entity, so long as the senior creditors have the opportunity to do so first. In other words, the old equity holders cannot finance a

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62. Id.
63. Gilhuly, supra note 3, at 454-55.
64. Id. at 458.
65. Id. at 454.
67. Id. at 426.
68. 5 BANKR. SERV. L. ED. § 45:449 (2007).
69. In re Bonner Mall Partnership, 2 F.3d 899, 907 (9th Cir. 1993).
new claim to the reorganized entity unless every senior creditor first refuses the opportunity.

Ultimately, a hedge fund that is also a pre-petition equity holder may remain an equity holder in the reorganized debtor if it satisfies the particular requirements for the new-value corollary. Through the corollary, a hedge fund may be able to buy a position that allows it to cram down a favorable reorganization plan. Given that many hedge funds have the capital necessary to satisfy the new-value requirements, such a strategy may be particularly effective in achieving the fund's goals.

C. Post-Petition Fund Behavior

Hedge funds tend to follow a number of similar post-petition patterns. Following their investment strategies, hedge funds are likely to continue to push for a liquidity event, which requires them to make a play for ownership of the restructured business.70

As hedge funds attempt to solidify their positions and buttress their priority, the lack of documentation regarding the hedge fund and debtor's rights and obligations will lead to increased adversary proceedings.71 Because traditional creditors' remedies are not available to hedge funds, the types of issues they raise are likely to be novel.72

Rather than fights over liquidation, foreclosure, adequate protection, valuation, exclusivity, conversion and then plan confirmation fights, [hedge funds] typically ha[ve] sale or liquidation of the company (or conversion of a chapter case) as their only threat for a dawdling borrower. Furthermore . . . [a]ctive participation in the management and strategic direction of the company will raise more questions of control liability, lender liability, re-characterization of debt into equity, equitable subordination and other legal machinations only rarely seen by creditors in traditional lending and insolvency situations.73

Ultimately, the flexible, high risk, and unregulated behavior of hedge funds will bring a host of unique bankruptcy issues to the system's doorstep. Securities and finance issues will become more common in Chapter 11 cases and bankruptcy courts will need to expand their knowledge and adapt to novel issues.

70. Futter & Wells, supra note 10, at 242-43.
71. Id. at 243.
72. Id.
73. Id.
1. Section 363: Sales of Assets

Section 363 sales of assets occur outside a Chapter 11 reorganization plan and are consistent with hedge funds' overall strategy. "In contrast to the negotiated plan where many disputes are resolved through negotiation and distribution rather than litigation, a quick Section 363 sale can leave unsecured creditors with nothing if the sale proceeds are insufficient to pay even the secured debt in full." Thus, unsecured creditors prefer negotiated plans that allow them some, albeit limited, recovery.

If a Section 1102 creditor committee cannot agree on an 'SPM carve-out' of the proceeds from the asset sales, unsecured creditors have few viable options. An SPM carve-out allows an undersecured senior creditor and unsecured creditor committees to negotiate structured arrangements that bypass junior creditors. The carve-out allows the senior creditor to quickly reach a realization event by rallying the support of unsecured creditors in return for the latter's limited recovery. Hedge funds, however, have one advantage over most unsecured creditors: readily available capital. This allows hedge funds to finance Section 363 asset sales, supply debtor-in-possession funding, or acquire reorganization equity. All three options support "loan to own," a strategy in which hedge funds attempt to quickly buy low and sell high.

Courts have recognized that Section 363 asset sales can be beneficial to all parties, but hedge funds may pursue these sales even at the expense of other creditors' interests. As a result, courts view such sales as exceptional and only grant them when they are supported by an identifiable business judgment.

In the case In re Lionel Corp., the Second Circuit articulated seven factors for courts to consider when deciding whether to approve a Section 363 sale. The factors include:

74. Miller & Waisman, supra note 53.
76. Id.
78. Id.
79. Berman & Brighton, supra note 2, at 31 (internal quotations omitted).
80. Id. For a more detailed example of loan to own, see the In re Radnor Holdings Corp. case. (In re Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006)).
81. Miller & Waisman, supra note 53.
82. Id.
83. Miller & Waisman, supra note 53 (discussing In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983)).
(i) the proportionate value of the assets to the whole estate, (ii) the elapsed time since filing, (iii) the likelihood that a plan will be proposed and confirmed in the near future, (iv) the effect of the proposed disposition on future reorganizations, (v) the proceeds to be obtained vis-à-vis any appraisals, (vi) which alternative (use, sale, or lease) is being contemplated, and (vii) whether the asset is increasing or decreasing in value. These factors are not exclusive; however, for approval a sale must ultimately aid the debtor's reorganization.

Hedge funds that pursue Section 363 sales often look to sell out their position, and "[q]uick sales or ill-conceived reorganizations are often the best way to achieve the objectives of such financial speculators." Such strategies clearly conflict with the rehabilitationist view of Chapter 11, which holds that bankruptcy should balance the competing interests of all parties involved. As a result, hedge funds can expect to incur substantial resistance to Section 363 sale proposals.

2. Ad Hoc Committees

Bankruptcy Code Section 1102(a) states that unless the debtor is a small business and a party requests otherwise, "the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate." Section 1102(a) "provides for the appointment of creditors' and equity security holders' committees, which will be the primary negotiating bodies for the formulation of the plan of reorganization." Hedge funds with large unsecured debts against a debtor are eligible to serve on creditors' committees at the discretion of the U.S. Trustee.

The problem with hedge funds serving on creditors' committees is that they usually purchase debt at a discount, which creates tension and conflicts with other unsecured creditors who directly loaned capital to the debtor at fair market value. In addition, serving on a credi-

84. Id. (citing In re Lionel Corp., 722 F.2d at 1070-71).
85. Id. (citing In re Lionel Corp., 722 F.2d at 1070-71).
86. Id.
87. Id.
90. See Fisher & Buck, supra note 1, at 86 (discussing "a hypothetical example to illustrate some of the ways in which bankruptcy practice will need to adapt to the increasingly prominent rule of hedge funds in bankruptcy proceedings").
91. Id.
tors' committee restricts a fund's ability to trade debtors' securities. The presence of inter-creditor conflicts and trade restrictions can force hedge funds to seek alternative control over corporate reorganization.

Pursuant to Section 1102, hedge funds may also form *ad hoc* committees with other like-minded investors. A strong *ad hoc* committee lacks statutory authority but may create enough of an advantage within a bankruptcy case to block certain classes of claims. Unfortunately, multiple *ad hoc* committees, which are often present in complex litigation, tend to increase adversarial proceedings and extend the bankruptcy process.

3. Federal Rule of Bankruptcy Procedure 2019

A hedge fund's involvement in an *ad hoc* committee raises disclosure issues, which hedge funds generally try to avoid. Historically, hedge funds have been able to escape government regulation. Thus, their involvement in bankruptcy proceedings may subject them to the type of disclosure that they traditionally try to avoid. Whether Federal Rule of Bankruptcy Procedure 2019 requires *ad hoc* committees to disclose both the committee financial information and its members' information is a critical question because hedge funds generally prefer to operate under a veil of secrecy.

When *ad hoc* groups form, and the members and debtor coordinate their shared interests prior to the bankruptcy filing, there is a tendency for non-member parties (i.e., other creditors or the court) to demand disclosure of the group and committee members' financial information. Most hedge funds will resist calls for financial disclosure, but if the debtor moves forward into Chapter 11 bankruptcy proceedings the bankruptcy court may force disclosure.

Bankruptcy courts have tools available for supervising hedge funds in their proceedings. These tools include disclosure under Rule 2019 and equitable remedies such as vote designation or subordination of claims. Rule 2019 requires *ad hoc* committees to:

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92. *See id.* (noting that committee creditors receive nonpublic information on the debtor, which places them in a fiduciary function).

93. *Id.*

94. *See id.*

95. Fisher & Buck, *supra* note 1, at 86.


File a verified statement setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the ... [ad hoc] committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of the ... organization or formation of the committee, ... the amounts of claims or interests owned by the ... members of the committee ... the times when acquired, the amounts paid therefore, and any sales or other disposition thereof.98

In addition to these requirements, ad hoc committees also must provide the court with a copy of the instrument granting them the authority to act on behalf of the committee members and show any material changes to the verified statement.99 Failure to follow Rule 2019 may result in a court's refusal to further hear the ad hoc committee or even a dismissal of all previous actions and statements by the committee.100

Some Bankruptcy courts have made it clear that ad hoc committees, including their members, are required to make extensive public disclosure.101 Traditionally, "counsel to ad hoc committees [would] file a disclosure identifying the members of the committee and their aggregate (but not individual) holdings."102 More recently, in In re Northwest Airlines Corp., the Southern District of New York Bankruptcy Court mandated that ad hoc committee members must provide "extensive Rule 2019 public disclosure regarding their claims [or] interests, including their complete trading histories in the debtor's securities."103 This represents a major shift in the continuing-disclosure rule because it "requires each member of an ad hoc committee to [continually] disclose its specific holdings as well as the timing and amount paid to acquire such holdings."104 The shift has not been accepted by all courts and whether this trend will continue is yet to be seen.

Critics of the In re Northwest Airlines Corp. decision argue that Rule 2019 applies to protective committees acting "in a representative

98. FED. R. BANKR. P. 2019(a).
99. Id.
100. FED. R. BANKR. P. 2019(b).
101. Flaschen & Mayr, supra note 96.
102. Id.
103. Flaschen & Mayr, supra note 96 (discussing In re Northwest Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007)). However, in Scotia Development, the Bankruptcy Court for the Southern District of Texas rejected a motion to compel ad hoc committees to comply with Rule 2019(a). Id. (discussing In re Scotia Dev. LLC, 375 B.R. 764 (Bankr. S.D. Tex. 2007)).
104. Id.
and fiduciary capacity.' The rule, however, does not distinguish between committees with a fiduciary relationship and those without one. Even Chapter X, Section 210, and Rule 10-211 (which is nearly the same as Bankruptcy Rule 2019) do not distinguish between a fiduciary and non-fiduciary committee. Contrary to the text of Rule 2019, counsel to ad hoc committees generally voluntarily file Rule 2019 statements identifying group members so other litigants can be confident in the group's size and composition. Ultimately, neither the text nor traditional practice clarifies whether Rule 2019 applies to all ad hoc committees.

Arguing Rule 2019 does not apply to ad hoc committees is difficult because committees have traditionally satisfied some of the requirements of the rule. Case law suggests there are two plausible arguments against the application of the rule to ad hoc committees. First, the rule does not apply and committees have been voluntarily submitting to partial Rule 2019 disclosures. Second, the rule does apply and the partial disclosures do not satisfy the 2019 requirements. But in either case the success of the argument lies in whether a committee can convince a bankruptcy court that Rule 2019 does not apply in the first place.

To date, proposed arguments regarding the inapplicability of Rule 2019 to ad hoc committees have failed. One failed argument is Rule 2019 does not apply to ad hoc committees because fiduciary responsibility is a fundamental component of Rule 2019. But in ad hoc committees there is no fiduciary relationship. The language of Rule 2019, however, pertains to not only fiduciary committees but to all entities that represent more than one creditor. The rule does not define the capacity in which the entity or committee must act in order for the requirements to apply. As a result, the argument that Rule 2019 requires a fiduciary duty element is incorrect.

Another failed argument against the application of Rule 2019 to ad hoc committees is the debtor has no legitimate use for the information. This argument fails to recognize the systemic purposes of Rule 2019, which facilitates cooperation between the debtor and creditors by helping the debtor recognize which creditors have a good faith interest in reorganization. Further, the rule allows courts to monitor ad hoc committee action by examining the members' interests. This is

105. Id.
106. Id.
107. Id.
108. Flaschen & Mayr, supra note 96 (internal quotations omitted).
109. FED. R. BANKR. P. 2019(a); Compare with Flaschen & Mayr, supra note 96 (failing to note that the rule's language applies to more than "committees").
110. Id.
particularly important when a bankruptcy judge is weighing arguments from various parties. In addition, some bankruptcy players are likely to be familiar with hedge funds, but the rule levels the playing field for all participants. Most hedge funds are relatively new, and their participation in bankruptcy proceedings has been brief. Thus, *ad hoc* committees have been unable to present a plausible argument as to why Rule 2019 does not apply to *ad hoc* committees.

As a result, hedge fund impact on bankruptcy is still unknown, but the fight over Rule 2019 is important because it may open the door to hedge fund disclosure, at least to a limited degree. The outcome of this issue and its impact on both hedge funds and their involvement in bankruptcy proceedings are unclear. In all likelihood, a split among the circuit courts will force the Supreme Court to address the issue.

D. Second-Lien Loans

Hedge funds are also heavily involved in the second-lien market, which impacts bankruptcy proceedings in a number of ways. Second-lien issues tend to increase the length of Chapter 11 reorganizations and the number of adversaries involved in the proceeding. Although second-lien loans can be a source of needed capital for a distressed debtor, the increase in time and conflicts resulting from such transactions can harm both debtors and hedge funds. Prolonging a liquidity event is generally contrary to a fund's interest because there is a greater possibility of the fund's assets devaluing. For the debtor, increased adversaries redirect resources to litigation, not reorganization.

The creation and rapid expansion of the second-lien loan and subprime lending markets has created novel bankruptcy issues. The increasing rate of insolvency among hedge funds and their investments has propelled issues between first- and second-lien holders to the forefront of bankruptcy proceedings. In fact, "[o]ne cannot discuss the explosion of hedge fund investments in insolvency scenarios without addressing the dramatic explosion of two forms of second-lien financing commonly marketed in the U.S: (i) second-lien term loans designed for sale in the institutional loan market; and (ii) second-lien high-yield offerings." Part of the problem with second-lien loans is the lack of market consistency. A pre-agreement analysis of each

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111. See Futter & Wells, *supra* note 10, at 222 (noting that "the relationship between the first and second lien holders ... has received the most attention ... and it is the conflict between these two that has most bankruptcy experts intrigued").


113. *Id.* at 464.
intercreditor transaction is important.\textsuperscript{114} The complexities and uncertainties of secured second-lien creditor involvement will inevitably complicate Chapter 11 cases.\textsuperscript{115} The lack of consistency between intercreditor agreements and the relatively new position of second-lien creditors will create heated disputes in bankruptcy courts.\textsuperscript{116}

Traditionally, first-lien lenders resisted sharing collateral with second-lien lenders.\textsuperscript{117} The current reality, however, is that first-lien lenders need to accommodate second-lien lenders in order to navigate through restructuring.\textsuperscript{118}

Important issues for most first lien lenders include: (i) control of enforcement actions during an agreed-upon standstill period; (ii) ability to force asset sales free and clear of liens; (iii) agreement of second lien holder not to challenge liens or to object to asset sales; (iv) the ability to put DIP financing in place that primes the second liens; (v) the ability to obtain adequate protection without the second lien holders' objection; (vi) inability of second lien creditors to obtain cash payments (e.g., by way of adequate protection) in a bankruptcy case; and (vii) a broad waiver by the second lien holders' rights that would arise in bankruptcy from holding collateral, with the preservation of rights they would have if they were unsecured.\textsuperscript{119}

Second-lien lenders are willing to accommodate many of these issues because of their protected priority and interests.\textsuperscript{120} "High priority issues for most second lien lenders include: (i) the ability to assert rights of an unsecured creditor; (ii) the ability to vote their claims in bankruptcy; (iii) a limited duration of an enforcement standstill; and (iv) 'tag along' rights whenever the first lien creditors obtain new collateral."\textsuperscript{121} Thus, any structured agreement will require first-lien creditors to address the second-lien creditor's high priority issues.

In addition, debtors are generally supportive of second-lien lenders because they can get a lower interest rate on much needed financ-

\textsuperscript{114} Id. Although details on these agreements is beyond the scope of this article, some of the controversial terms include: (1) waiver of the right to oppose adequate protection for first debt lien; (2) waiver of the second lien creditors' right to seek adequate protection other than replacement liens; (3) use of cash collateral; (4) DIP financing; (5) asset sales; (6) plan voting agreements; (7) are there limits on future first and second lien debt; (8) are two sets of security documents needed; (9) separate credit documents; and (10) amendment and consent rights. See generally id. (discussing these issues in more detail).
\textsuperscript{115} Id.
\textsuperscript{116} Id. at 467.
\textsuperscript{117} Gilhuly, supra note 3, at 470.
\textsuperscript{118} Id.
\textsuperscript{119} Id. at 471.
\textsuperscript{120} Id.
\textsuperscript{121} Id.
Debtors must recognize, however, that although the availability of financing will increase as a result of second-lien lenders, the debtor’s ability to access first-lien financing may be limited by the terms of second-lien agreements. Therefore, the increase in financing has a price.

In sum, hedge fund involvement in the second-lien market will increase the amount of confrontation with more traditional first-lien creditors. Both categories of creditors need to be aware of their counterpart’s interests and demands. To reach a liquidity event quickly, a hedge fund needs to work with first-lien creditors. Prolonged disputes will diminish a fund’s opportunity to profit. Ultimately, hedge funds can obtain preferential status because second-lien-secured-creditor status allows the rights to excess collateral value and adequate protection, “cash collateral leverage, credit bidding opportunities, and a significant voice in the debtor’s restructuring plan.”

E. Loan-to-Own: Debt and Equity Investment

Hedge funds are often involved in loan-to-own arrangements with distressed companies. The funds apply this strategy by acquiring loans (debt investments) or by purchasing securities (equity investments) from distressed companies. “These two avenues allow hedge funds to influence any restructuring that takes place, and to have potential ownership interest in the companies after restructuring.”

The first avenue, debt investments, may occur both pre- and post-petition. In a pre-petition debt investment, hedge funds can provide needed capital during the restructuring process by offering “second-lien financings, or consolidate (‘roll-up’) multiple secured loans into a single-credit facility.” These loan agreements allow the hedge fund to become the debtor-in-possession (DIP) lender. Pre-petition activities may also include short/long transactions in debt or equity and balance sheet arbitrage. Regardless of the methods used, hedge funds are ultimately looking to control a company’s restructuring.

By providing DIP loans, hedge funds can acquire a super-priority status, gain access to inside information, and even use their creditor

122. Gilhuly, supra note 3, at 471.
123. Id. at 472.
124. Id. at 455.
125. Id. at 454.
126. Id.
127. Gilhuly, supra note 3, at 454.
128. Id.
129. Id.
130. Id. at 455.
status to credit bid during asset sales. Because DIP loans are included in Chapter 11 plans, lending hedge funds can have a significant impact on the creation and confirmation of a Chapter 11 restructuring plan.

Alternatively, equity investments give hedge funds similar advantages to debt investment, but with higher risk and higher potential rewards. Like debt investment, equity investments may occur pre- or post-petition. During either period, the value of the distressed company's stock is significantly low. Once a hedge fund becomes an equity investor, it can push for the "appointment of equity committees that will have an official voice in shaping the reorganization plan . . . ." Also, similar to debt investment, the ultimate goal is to buy low and sell high.

Hedge funds implement their equity investment strategies by providing a secured loan in return for creditor status and an equity stake in the debtor. The hedge fund's package will also include numerous benefits, such as board membership. Eventually, if the debtor is unable to implement a successful reorganization plan, the hedge fund will attempt to convert its debt into ownership "and eliminate the 'out-of-money' creditors and equity classes." Essentially, the funds will fast-track the debtor to profitability.

The displaced parties will often object on a number of grounds, such as breach of a fiduciary duty, inaccurate value, availability of a better transaction, equitable subordination, debt recharacterization, or a lack of good faith. The displaced parties will attempt to convince a court that an outcome, which balanced all parties' interests, existed. But despite the potential for inequitable conduct, the loan-to-own action of a hedge fund can also benefit distressed debtors by rapidly returning them to profitability. Loan-to-own transactions are comparable to a Section 363 sale of assets because both transactions

131. Id.
132. Gilhuly, supra note 3, at 455.
133. Id. at 456.
134. Id.
135. Id.
136. Id. at 456-57.
137. Gilhuly, supra note 3, at 457.
139. Id.
140. Id.
141. Id. at 44.
142. Id. at 46.
circumvent the bankruptcy process. Loan-to-own agreements, however, may be prepackaged, which results in quicker, economical outcomes than the Section 363 asset sales. In other words, the debtor does not need to start the bankruptcy process before utilizing a loan-to-own transaction. Accordingly, absent unfair conduct, the loan-to-own arrangement may lead the debtor to a stronger post-reorganization position.

F. Equitable Subordination

In some instances, a hedge fund's conduct is inequitable, which could result in substantial harm to the hedge fund's interest. Generally, “money loaned by corporate insiders is as green as money loaned by non-insiders; absent inequitable conduct, an insider’s claim to recover a loan to a corporation ranks pari passu with claims of non-insider lenders.” In fact, the codification of equitable subordination in Section 510(c) of the Bankruptcy Code helps to ensure that “hedge funds are able to acquire both debt and equity in a company’s capital structure without undue risk that debt claims will be subordinated.”

Courts use equitable subordination to change creditors' priority of payment when a creditor engages in inequitable conduct that injures other creditors or gives the violating creditor an unfair advantage. Application of equitable subordination must be consistent with the Bankruptcy Code since insider debt is beneficial to distressed debtors because inside investors usually have a better understanding of the debtor's business and a stronger interest in its success.

Bankruptcy Code Section 510(c) allows equitable subordination “for purposes of distribution of 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 to permit a court to transfer a subordinated lien to the estate. Under Section 510(c) “[t]he court's power is broader than the general doctrine of equitable subordination and encompasses subordination on any equitable

143. Landers, supra note 138, at 46.
144. Id.
146. Id. at 1259.
149. Id.; see Peter A. Alces, Clearer Conceptions of Insider Preferences, 71 WAULQ 1107, 1108 (1993) (defining an insider as someone in a close relationship with the debtor, which allows them to manipulate or control the debtor).
150. 11 U.S.C. 510(c)(1).
grounds." 151 In addition, Congress has stated that "under existing case law, a claim is generally subordinated only if [the] holder of such [a] claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination. . . ." 152 Thus, the standards for triggering bankruptcy equitable subordination is lower than the general civil requirements of equitable subordination.

1. The Enron Expansion

Equitable subordination should be a serious concern for hedge funds that aggressively pursue their self-interest in a bankruptcy proceeding.

A fund that has acted aggressively for its own agenda through a "loan to own" strategy, captive management and board control, or through the aggressive pursuit of a liquidity event without regard for the company's prospects for successful reorganization or the impact on other creditors, particular in a situation where the fund can be construed to be an "insider" or in a position of control, may find itself subject to equitable subordination under Bankruptcy Code section 510(c). . . . 153

The aggressive pursuit of strategic goals may place hedge funds in a losing position, making pre-petition restructuring agreements more attractive.

Generally, equitable subordination applies to creditors that behave inequitably and harm other creditors or benefit from the inequitable conduct. 154 In the Enron case, however, the court held that "buyers of bankruptcy claims are now subject to subordination not just for their own conduct, but also for conduct of previous owners of the claims, regardless of whether the conduct was connected to the claims." 155 This extension of equitable subordination to subsequent debt purchasers is known as the "Enron expansion." Experts argue that this expansion of equitable subordination will severely affect the bankruptcy-claims-trading market, which could limit the liquidity available to distressed Chapter 11 debtors. 156

152. Id. (citing 124 Cong. Rec. H11095 (1978); S17412 (1978); (remarks of Rep. Edwards and Sen. Deconcini)).
153. Futter & Wells, supra note 10, at 248 (footnote omitted).
155. Id. (discussing In re Enron Corp. 333 B.R. 205, 210 (Bankr. S.D.N.Y. 2005)).
156. Id.
In the *Enron* case, the court's "Enron expansion" had a direct impact on five hedge funds that had purchased claims valued at over $47 million. An adversary proceeding known as the "Megacomplaint" alleged that the seller of the claims had acted inequitably and demanded subordination of the claims. Although the funds did not appear to have any knowledge of the seller's actions, the bankruptcy court held: (1) equitable subordination applies to conduct unrelated to the claim; (2) the subordination could apply to a transferee; and (3) the transferee could not argue a good faith purchaser defense.

The three-pronged "Enron expansion" relied on questionable precedent and debatable policy conclusions, and created a number of potentially unfavorable effects on distressed debtors. First, the decision will likely shrink the bankruptcy-claims-trading market, which will cause creditors to "be more reluctant to deal with distressed or high-risk companies because of the possibility that they would be left holding bankruptcy claims and forced to incur the expense and inconvenience of being claim holders." Second, the decrease in the secondary market liquidity will cause a liquidity tightening in the primary market. Third, the tightening of the primary market will increase the number of distressed debtors. The result is a spiraling crisis that could affect the entire U.S. debt market.

Purchasers of bankruptcy claims will also find it very difficult to react to the new market conditions. Claims purchasers lack reliable information for calculating the statistical probability of subordination of a particular claim. They do not have sufficient information about any particular upstream claimholder's actions, and even if they did, they cannot calculate the magnitude of damages caused by the inequitable behavior. And in electronic [over-the-counter] markets, like bond trading, the trades are typically anonymous, so it is impossible to learn about upstream holders.

Therefore, the lack of reliable market information regarding equitable subordination will create uncertainty in the bankruptcy-claims-trading market. Further, given the unpredictable nature of equitable subordination claims, it is difficult to calculate the value of a tainted claim.
Ultimately, the "Enron expansion" has increased the uncertainty and impact of equitable subordination. The expansion may apply beyond the bankruptcy-claim-trading market. In fact, the expansion may apply to pre-petition claim or debt purchases.\textsuperscript{166} If the \textit{Enron} ruling gains strength, it could undermine the availability of liquidity for distressed debtors, shrinking the U.S. debt market.

2. The Third Circuit Perspective

The Third Circuit has a unique perspective on equitable subordination which hedge funds should be aware of and plan accordingly. First, the Third Circuit has held that creditor misconduct is not a necessary element of equitable subordination, and the equitable subordination remedy is unavailable when inequitable conduct did not cause harm.\textsuperscript{167} As a result, offending parties can retain their profits if their inequitable conduct does not harm outside creditors. Second, the court has held quantifiable facts must support any remedy beyond disgorgement of profits.\textsuperscript{168} In sum, the Third Circuit's perspective focuses on the ultimate injury to non-benefiting parties, and without such quantified injury the doctrine does not apply.\textsuperscript{169}

G. Debt Recharacterization

Debt recharacterization "is a court's attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else."\textsuperscript{170} Debt recharacterization is another important issue for hedge funds because it can affect the transaction that ultimately brings the hedge fund into the bankruptcy proceeding. In a bankruptcy proceeding, a debt investment has a higher priority than a capital investment.\textsuperscript{171} Debt investments are purchases of a debtor's unsecured debts, while capital investments are purchases of the debtor's equity.\textsuperscript{172} Capital investments create some type of ownership interest in a debtor, such as equity holdings. If a hedge fund wants to maintain a higher priority in a bankruptcy proceeding, it must clearly establish that its investment is debt by showing that it purchased a debtor's secured or unsecured claims as opposed to purchasing equity,

\textsuperscript{166} Id.
\textsuperscript{167} \textit{In re} Submicron Sys. Corp., 432 F.3d 448, 462 (3d Cir. 2004).
\textsuperscript{168} Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 991 (3d Cir. 1998).
\textsuperscript{169} Id. at 991-92.
\textsuperscript{170} \textit{In re} Submicron Sys. Corp., 432 F.3d 448, 456 (3d Cir. 2004).
\textsuperscript{172} See id.
i.e., an ownership position, in the debtor. If it does not, a fund risks having its "debt" recharacterized as a capital investment, which will lower the fund's priority and status.

In addition, insider loans create debt recharacterization issues because the insider has a strong interest in the longevity of the distressed debtor, which makes insider-loan transactions look like a capital investment. In other words, an insider's interest in the distressed debtor is more consistent with an equity holder than a creditor. Thus, debt recharacterization is a substantial threat to insider investments. As a result, distressed debtors may suffer from lack of investments from insiders who have a better understanding of the debtor's business.

Ultimately, debt recharacterization prevents equity holders from characterizing their holdings as debt, and therefore obtaining a higher priority. The dichotomy of debt and equity establishes that equity holders receive their benefits if the corporate entity is successful while creditors receive protection if the entity fails. Allowing an equity holder to reap both the benefits of success and protection of failure is inconsistent with the bankruptcy process and unfair to other creditors. Thus, debt recharacterization operates to keep debt and capital investments separate, which establishes predictability in transactions with the corporate entity.

1. The Majority View: The Third, Fourth, Fifth, Sixth, and Tenth Circuits

Some courts consider the parties' intent at the time of the transaction determinative of a debt's character. The majority of federal circuit courts apply varying tests to determine whether to recharacterize a debt. For example, the Sixth Circuit uses an eleven-factor test to determine whether an investment was debtor equity in the recharacterization context. The factors examined include:

1. the name given to the instruments, if any, evidencing the indebtedness;
2. the presence or absence of a fixed maturity date and schedule of payments;
3. the presence or absence of a fixed rate of interest and interest payments;
4. the source of repayments;
5. the adequacy or inadequacy of capitalization;
6. the identity of interest between the creditor and the stock holders;
7. the security, if any, for the advances;
8. the corporation's ability to obtain financing from outside lending institutions;
9. the extent to which the ad-

175. Id. at n.8 (citing Roth Steel Tube Co. v. Comm'r, 800 F.2d 625 (6th Cir. 1986) and In re AutoStyle Plastics, Inc., 269 F.3d 726, 749-50 (6th Cir. 2001)).
vances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.176

Thus, the Sixth Circuit looks at a number of factors in determining whether an investment is debt or equity.

The Fifth Circuit uses a similar multi-factor test, but adds the following factors: (1) the enforceability of principal and interest payments; (2) the relation of the investment to other creditor investments; (3) the amount of capitalization; and (4) the debtor’s repayment of the loan.177 In addition, the Third Circuit has recognized and applies the factors from both tests.178

In order to facilitate this priority scheme, bankruptcy courts must have the authority to determine the classification and order of claims.179 The Fourth Circuit distinguished equitable subordination from debt recharacterization based on the separate purposes involved.180 Specifically, the court stated that “a bankruptcy court’s recharacterization decision rests on the substance of the transaction giving rise to the claimant’s demand, its equitable subordination decision rests on its assessment of the creditor’s behavior.”181 Debt receives a higher priority than equity.182 The court also recognized that debt maintains its classification despite the application of equitable subordination.183 Finally, the court noted its decision was consistent with “every other circuit that has considered the question.”184 To date, the Third, Fourth, Sixth and Tenth Circuits have similarly and consistently applied debt recharacterization.185

In fact, “[d]uring the past twenty years, debt recharacterization has displaced equitable subordination as a favored cause of action for bankruptcy trustees and creditors’ committees seeking to invalidate

176. Id.
177. Id. (citing Estate of Mixon v. U.S., 464 F.2d 394, 402 (5th Cir. 1972)).
180. Id. at 232.
181. Id. (internal emphasis omitted).
182. Id. (citing 11 U.S.C. § 726 (2000)).
183. Id. (citing In re Hedged-Inv. Asocs., Inc., 380 F.3d 1292, 1297 (10th Cir. 2004)).
184. In re Dornier Aviation, 453 F.3d 225, 232 (4th Cir. 2006) (citing In re Submicron Sys. Corp., 432 F.3d 448, 454 (3d Cir. 2004); Hedge-Inv., 380 F.3d at 1297; In re AutoStyle Plastics, Inc., 269 F.3d 726, 747-48 (6th Cir. 2001)).
185. Id.
loans or other debt claims held by insiders in bankruptcy cases."\textsuperscript{186} This is because it is "a 'no fault' cause of action that does not require proof of equitable conduct be the insider/creditor."\textsuperscript{187} Thus, debt recharacterizations should be a concern for hedge funds, particularly when the fund has a pre-position equity position in the debtor.

2. The Minority View: The Eleventh Circuit

Unlike the majority of circuits, the Eleventh Circuit does not follow a multi-factor test. Instead, the court embraced a two-prong test,\textsuperscript{188} deeming a contribution capital when the trustee proves either: (1) the debtor's initial undercapitalization; or (2) that other disinterested lenders would not have extended credit under the circumstances.\textsuperscript{189} The Eleventh Circuit's test does not follow state or federal precedent and essentially limits insider loans to debtor-in-possession financing.\textsuperscript{190} However, this test remains a minority perspective, recognized only in the Eleventh Circuit.\textsuperscript{191}

3. The Rejecter: The Ninth Circuit

Finally, the Ninth Circuit has rejected debt recharacterization claims, holding that Section 510(c), which governs equitable subordination, precludes bankruptcy courts from recharacterizing debts outside of Section 510(c).\textsuperscript{192} In essence, the Ninth Circuit forbids debt recharacterization as an attempt to avoid the express provisions of the Bankruptcy Code.

The remaining circuits—First, Second, and Seventh Circuits—have not clearly established a test for debt recharacterization. Regardless, the broad acceptance of debt recharacterization requires that hedge funds remain aware of how a circuit court will analyze the transaction between the fund and the debtor. Clearly establishing the character of the investment, as either debt or capital, is important once the bankruptcy proceeding begins or when the transaction comes under scrutiny. Ignoring debt recharacterization could substantially influence the fund's preferred investment in the debtor and the overall goals and strategy of the fund.

\textsuperscript{186} Wilton & Moeller-Sally, supra note 145, at 1257. The cited article does a nice job of discussing the history and development of debt recharacterization, which is beyond the scope of this article.
\textsuperscript{187} Id. at 1259.
\textsuperscript{188} Id. at 1260.
\textsuperscript{189} Id. (quoting In re N & D Props., Inc., 799 F.2d 726, 733 (11th Cir. 1986)).
\textsuperscript{190} Id. at 1260-61.
\textsuperscript{191} Wilton & Moeller-Sally, supra note 145, at 1261.
\textsuperscript{192} Id. at 1267 (discussing In re Pac. Express, Inc., 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986)).
The presence of hedge funds in Chapter 11 cases marks a cultural shift in bankruptcy practice, as some hedge fund strategies create conflicts with the Code’s traditional emphasis on the rehabilitation of debtors.\footnote{Fisher & Buck, supra note 1, at 88.} Large amounts of capital, a preference for high-risk and high-rewards, and aggressive investment strategies make hedge funds a formidable force in bankruptcy.\footnote{Gilhuly, supra note 3, at 506.} As hedge fund involvement in Chapter 11 cases continues to grow, some of the discussed issues may resolve themselves, particularly if the market becomes more consistent or transparency increases. In the meantime, practitioners need to be prepared to handle the complexity and uniqueness of Chapter 11 proceedings involving hedge fund creditors.

Hedge fund involvement in bankruptcy can be very beneficial as funds are willing to bear more risk than traditional lenders and are able to provide necessary capital.\footnote{Id. at 458.} In addition, hedge fund investing, particularly through second-lien loans, may actually eliminate the need for Chapter 11 bankruptcy relief.\footnote{Id.} Further, DIP post-petition financing can sustain a distressed company throughout the reorganization process.\footnote{Id.} Finally, hedge funds create flexibility in the market, allowing high-risk creditors to remain involved and freeing low-risk creditors to pursue other investments.\footnote{Id.}

The disadvantages of hedge fund involvement in bankruptcy include increased complexity, expenses, and lengthy proceedings.\footnote{Id.} Like every other bankruptcy player, hedge funds are likely to aggressively pursue their interests. Unlike some players, however, the advantages that hedge funds can obtain also create additional burdens. For example, hedge funds often seek to establish an \textit{ad hoc} committee to promote their interests, “adding costs and administrative burdens to an already struggling debtor’s business.”\footnote{Id. at 458-59.} The committees will provide the funds with inside information and greater control over the restructuring process.\footnote{Id. at 459.} In addition to committee control, hedge funds—with their immense capital—can acquire control over an entire class of creditors,\footnote{Id.} which allows the fund to pressure the debtor...
into a specific restructuring plan that may be good for the fund but of questionable benefit to the company.203

Hedge funds' interests often conflict with other traditional creditors and even the debtor. Hedge fund strategies tend to be more aggressive and focused on the short-term. They are also not necessarily concerned with the future of the debtor, which means their presence creates uncertainty and increases tension in a bankruptcy proceeding; further, the secrecy surrounding hedge funds compound these issues.

Finally, in Chapter 11 proceedings where a powerful hedge fund is involved, the fund's strategies, which aggressively seek to protect its own interests, will complicate the proceedings and make them more expensive and less likely to reach a consensus among the various creditors and the debtor.204 A hedge fund may vigorously challenge senior debt holders as it seeks to shore up its relatively weak position or achieve its strategic goals,205 and the creation of ad hoc committees and the debtor's resistance to hedge fund strategies will likely fuel conflicts.206

In sum, hedge funds—like every other player in a bankruptcy proceeding—bring their own issues and interests to the table, and bankruptcy practitioners need to be prepared to adapt to the changing landscape.207

203. Id.
204. Futter & Wells, supra note 10, at 246-47.
205. See id. at 247 (noting that “[t]here has already been, and most likely will continue to be, extensive litigation between the holders of the senior debt, and the funds holding second lien debt over the enforceability and validity in chapter 11 of their inter-creditor agreements”).
206. Id. “The debtor wants to pursue a plan that will entail wiping out the current equity and giving equity in the reorganized debtor to existing creditors.” Id.
207. Fisher & Buck, supra note 1, at 88.