Buyer beware: Legal pitfalls in distressed investing

What legal challenges will distressed investors face in 2013? Bracewell & Giuliani lawyers Jennifer Feldsher and Adam Shane read the tea leaves.

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Active markets in high-yield bonds and high-leverage bank debt have many investors predicting a new wave of restructurings when interest rates begin to rise. With new "covenant-lite" debt deals mingling with already existent problem credits that were "amended and extended," special situations investors should see restructuring opportunities when the cycle turns. To be in a position to capitalize on these opportunities, however, investors will need to avoid the legal pitfalls that can impact returns on investment. This article discusses some of the pitfalls we expect distressed investors to face in 2013.

Simply stated, successfully investing in distressed companies in 2013 will continue to be challenging. Deals at the right price and with solvable problem sets appear likely to remain limited in the current low interest rate environment, ensuring that the distressed marketplace will remain highly competitive. In addition, it is still expected for historically low default rates and number of bankruptcy filings to continue.

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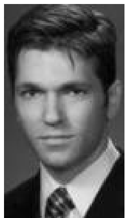
Once a deal is identified, investors will need to determine where to enter the capital structure to ensure the best seat at the bargaining table. Careful review of credit documents and intercreditor agreements will be extremely important to this task. This is particularly true in light of the many bankruptcy court decisions in the last few years upholding the express terms of intercreditor agreements, even if that means silencing parties on the cusp of recovering.

In addition, distressed investors have found having a blocking position in the fulcrum security – i.e., the tranche of debt where enterprise value breaks such that a portion of that debt is equitized and junior creditors are eliminated, vital to their loan-to-own strategies. However, given capital structures have not been simplified in recent years, identification of the correct "fulcrum" security will continue to be difficult.

Modern companies have capital structures composed of multiple levels of secured debt, in addition to multiple levels of unsecured debt and equity. Understanding the rights of creditors vis-à-vis each other and the debtor, therefore, will be an important component in financial modeling and a key driver of returns in 2013 and beyond.

Indeed, recent examples of miscalculations and the ramifications thereof abound. Creditors finding the fulcrum security below them in the capital structure have seen themselves cashed out at par or worse, forced to extend debt for a longer period at terms more favorable to the company. On the other hand, the creditors that have found enterprise value to run out at a senior level have been left with little or no recovery at all. At the bank debt level, these risks have been compounded by fraudulent conveyance rulings that have left senior lenders at greater risk from activist subordinated creditors. As a result, we have seen a recent rise in value being allocated to vocal subordinated groups, including the various "gifting" plans that have sparked litigation over the past few years.

Another pitfall of distressed investing is the speed at which restructurings are now occurring. Because bankruptcy cases are shorter, distressed investors are forced to be more vigilant starting from the outset of the Chapter 11 process to ensure the debtor does not "give away the store." DIP loan agreements containing milestones and short maturity dates can heavily impact a debtor's alternatives in Chapter 11 and influence the debtor's willingness to pursue a restructuring instead of a quick sale process. In some cases, DIP loan agreements have given DIP lenders control of the post-emergence entity, without any marketing process at all. Accordingly, if an investor is not reviewing and objecting to such encroachments, the debtor's restructuring options later in the case may be severely limited, markedly reducing returns for all creditors. Getting involved late in the process is often difficult and more costly which leads to diminishing potential returns.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Finally, given the limited number of credits pursuing formal restructurings, "club deals" will likely continue in 2013 with savvy investors teaming up on transactions to preserve upside. Whether via a formal ad-hoc committee or an informal group, creditors working together can trigger the new disclosure requirements under Bankruptcy Rule 2019 which requires disclosure of economic interests in the debtor, including any short or derivative positions or any participation interests. While disclosure of this information should not, in and of itself, impact an investors rights under the Bankruptcy Code, courts will surely not be blind to manifest investment strategies that favor failure over a successful restructuring.

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