

**TESTIMONY
OF**

JOHN GREENE

HALCYON ASSET MANAGEMENT LLC

**ABI Field Hearing
Study to Reform Chapter 11**

October 17, 2012

TESTIMONY OF JOHN GREENE, HALCYON ASSET MANAGEMENT LLC

To the Commissioners of the American Bankruptcy Institute
Commission to Study the Reform of Chapter 11:

My name is John Greene, and on behalf of Halcyon Asset Management LLC (“Halcyon”), I am pleased to provide this statement in connection with the American Bankruptcy Institute Commission Field Hearing on Chapter 11 Reform.

Founded in 1981, Halcyon and its affiliates constitute a global investment firm with approximately \$10.5 billion of assets under management. Of that \$10.5 billion, approximately \$4.5 billion is in hedge fund and related separate account assets and approximately \$6 billion is in bank loan strategies. Halcyon is privately owned by 14 partners who average 15 years of experience with the firm and 26 years of investment experience. With offices in New York and London, the firm employs approximately 100 in total staff, over 45 of whom are investment professionals. Halcyon manages capital for a diverse group of investors, including leading pension funds, endowments, foundations, financial institutions, insurance companies, hedge funds and high net worth individuals throughout the world.

I have more than 13 years’ experience in high yield distressed debt investing. I joined Halcyon in March 2002, and during my tenure, I have focused on distressed asset investing. Prior to joining Halcyon, I worked as a distressed securities analyst for J.P. Morgan Chase, where I started my career in 1999, and where I published research on distressed and high yield securities, made proprietary trading recommendations, and worked with J.P. Morgan Chase's London-based European High Yield Research team. I received my B.A. from Franklin & Marshall College in 1999.

Halcyon appreciates the opportunity to express its views on the importance of vibrant capital markets to the bankruptcy process. Halcyon would also like to take this opportunity to respond to certain public comments made in recent articles and publications questioning the role and benefits of the capital markets in the bankruptcy process.¹ Halcyon believes that distressed investors play an important role in the bankruptcy process – as they do in our financial system as a whole – by providing liquidity and capital to companies in distress and a market for distressed companies’ debt and securities. Fully functioning capital markets in bankruptcy are necessary for distressed investors to participate in the chapter 11 process in a way

¹ See e.g., Robert J. Keach & Albert Togut, *Commission to Explore Overhauling Chapter 11*, Am. Bankr. Inst. J. 36 (June 2011); Statement of Bettina M. Whyte, Member, ABI Comm. to Study the Reform of Ch. 11 (Initial Public Hr’g, Washington D.C., April 19, 2012), available at commission.abi.org.

which benefits both the reorganization process and the economy as a whole; changes to the Bankruptcy Code that would undermine the functioning of the capital markets and the free market principles in the reorganization process are ill-advised because of the detrimental impact such changes would have on the reorganization process.

The benefit of distressed investor participation is not limited to providing liquidity and capital. Both inside and outside of bankruptcy, active efforts by distressed investors improves enterprise value and helps bring about corporate operational, financial and governance reforms improving the viability of companies in which they invest.² These benefits, too, would be lost if changes to the Bankruptcy Code make capital market participation in the reorganization process more difficult. We hope these comments assist the Commission in formulating its recommendations to Congress on the future role of the capital markets in bankruptcy.

IMPORTANCE OF CAPITAL MARKETS TO LIFE CYCLE OF DISTRESSED COMPANIES

A. No Bankruptcy Time Out for Companies' Need to Access the Capital Markets.

The capital markets raise funds or “capital” for companies by buying and selling long term debt or equity backed securities. Objective reliable price signals developed in the secondary market set the benchmark for the cost of capital. A wide range of parties participate in the capital markets, each with varying risk profiles, ranging from oversecured first lien priority debt to speculative equity investments. This variety in risk appetite is beneficial to corporate borrowers, at all stages of a company’s life cycle, particularly during times of financial distress. A borrower’s credit risk is typically priced at the front end, when the company procures funding. However, as circumstances change and a company’s credit becomes riskier, access to active functioning capital markets enables participants with greater risk tolerance to replace the original lenders who may be more risk-averse. Thus, credit costs typically remain low—because original investors with lower risk tolerances know that a ready market exists in which they can dispose of their holdings, should the risks associated with the company’s credit exceed levels they are prepared to tolerate. Low credit costs are beneficial, of course, to corporate borrowers.

For distressed companies, the continued functioning of capital markets before, during and after the commencement of a bankruptcy case is critical. There is no “bankruptcy time out” for a company’s need to access the capital markets. To the contrary, access to the capital markets—particularly the market for distressed debt—is essential to improving a

² See generally, Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, February 2010; Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J.FIN.ECON., 401-32 (1997).

company's chances of reorganizing successfully.³ Specifically, the capital markets provide a company with debt refinancing opportunities – both pre-and post-bankruptcy – often under circumstances where the primary market, comprised of more traditional risk-adverse lenders, are no longer willing to extend credit. Chief among these opportunities is debtor-in-possession financing, which is often essential for a company to operate its business during the bankruptcy and endeavor to reorganize. The capital markets also provide liquidity during the pendency of a bankruptcy case, including for payments to creditors who may not want or be able to wait for the resolution of the bankruptcy case to obtain a recovery. Finally, the capital markets provide such companies with ready access to mezzanine, second-tier, or third-tier lending.⁴ The result is continued operations, job preservation and maximization of value for all stakeholders.

Robust debt trading during a bankruptcy should be encouraged. It permits creditors with different risk profiles, financial resources and familiarity with the bankruptcy process to participate. The introduction of sophisticated distressed investors is beneficial to the entire process. For example, it is these creditors who have the financial resources to invest in the company if the debtor requires incremental additional financing. Because of their familiarity with the bankruptcy process, these investors generally are the ones with the appetite and willingness to make a long-term investment. In many instances, the debtor's original creditors, be they traditional bank lenders, investment-grade bondholders, vendors, retail customers, or employees, are ill equipped or are otherwise unwilling to navigate the often lengthy bankruptcy process. Traditional bank lenders and "investment grade focused" bondholders, for example, are often subject to regulatory and internal limitations that prohibit them from tolerating certain risk levels, holding certain types of claims or taking certain actions that may be required to maximize value in a bankruptcy. Indeed, Europe's financial crisis has been exacerbated by the fact that European insolvencies do not benefit from capital market participants who often drive U.S. restructurings to successful resolution; the European banks, who are the original creditors, are subject to regulatory restrictions that constrain their ability to implement strategies successfully embraced by U.S. capital market participants.

B. Debt Trading Benefits The Restructuring Process as a Whole.

Debt trading provides reluctant owners a means of exit and risk mitigation. The replacement of original creditors with investors who have the expertise, resources and financial flexibility required for distressed situations also can increase a company's chances of restructuring by solving "collective action" problems. When disparate debt owners are replaced by a group of sophisticated financial players, the debtor gains negotiating counterparties who are

³ See generally, Suniati Yap, *Investing in Chapter 11 Companies: Vultures or White Knights?*, 2 Sw. J. L. & Trade Am. 153, 154 (1995) (discussing ways that distressed investors can act as "white knights" that rescue troubled companies).

⁴ See Richard E. Mikels & Ella Shenhav, *Bankruptcy's Impact on Financial Markets*, Am. Bankr. Inst.J., Dec.-Jan. 2012, at 2.

fluent in the language of the bankruptcy process, understand its multiple risks, and have the capital to consider significant investments in the company. Negotiating with a single group of financial investors may then be more fruitful for the debtor than attempting to negotiate with a variety of disparate creditor groups.⁵

In this way, in addition to providing a valuable source of liquidity for original creditors to exit, the involvement of distressed investors can facilitate a company's restructuring by providing an active and knowledgeable counterparty with which management can negotiate to maximize value for all of the company's stakeholders. In many instances, such intervention early enough can avoid the need for a bankruptcy case altogether.⁶ Thus, distressed investors oftentimes are the drivers and instruments of change that salvage a troubled company.⁷ Moreover, unlike other knowledgeable participants in the restructuring process (such as restructuring professionals), distressed investors' interests are more aligned with maximizing the value of the estate. This is because distressed investors' own money is at stake unlike other bankruptcy professionals, attorneys and financial advisors who are paid out of the bankruptcy estate's assets irrespective of the outcome of the case.⁸ The best check and balance on the system is to have the actual adverse parties (who are the true economic stakeholders) directly negotiate at arms' length with the debtor and with each other.

**C. Importance of Capital Markets
Does Not End Upon Completion of Bankruptcy.**

Notably, the important role played by the capital markets does not end at the completion of the bankruptcy process. Upon emergence from bankruptcy, a reorganized company has newly minted debt and securities. The capital market can create a market for these securities, thereby both building and establishing value for the reorganized company. In other circumstances, a company will emerge from bankruptcy but still have contingent assets that have yet to be liquidated (e.g. avoidance actions or other litigation claims). Upon liquidation of such contingent assets, creditors are typically entitled to distributions; however, just as at the commencement of a bankruptcy case, certain creditors may not want to or be able to wait for the receipt of such recoveries and thus want to "cash out." The capital markets remain a means by which those creditors can liquidate their contingent recoveries.

⁵ Yap, at 158 (noting that investors can reduce the administrative burden on the debtor, and that consolidation of claims "enables the debtor to focus on meaningful negotiations with a sophisticated party . . . [that] bring a wealth of resources, both monetary and mental, into the reorganization process").

⁶ See Stephen G. Moyer, David Martin, & John Martin, *A Note on Distressed Investing, Buying Companies by Acquiring their Debt*, Baylor Univ., Sept. 20, 2012, at 2.

⁷ *Id.* at 31.

⁸ See Brav, Jiang & Kim, at 2-3.

D. Economy as a Whole Benefits Through Active Capital Markets in Distressed Debt.

Finally, it is worth noting that, in the current global economy, access to capital markets and the participation of distressed investors has a positive impact on the economy generally because it allows banks or other regulated financial institutions to remove problem or “toxic” assets from their books. This permits these entities to deploy their capital more efficiently and, presumably, for the benefit of the economy as a whole. The U.S. has proven more resilient to the adverse impacts of the global financial crisis, and this is in part, a reflection on the U.S. bankruptcy regime which, among other things, offers substantially greater flexibility, transparency and certainty. This predictability ultimately reduces transaction and bankruptcy costs, and thereby encourages broad participation in the system.⁹

E. Certainty and Uniformity in Enforcement of Creditor Rights Are Vital for Capital Markets.

The benefits outlined here depend on an active, functioning market. This, in turn, depends on market participants’ ability to access information and clearly identify and enforce their legal rights, including upon an event of default and/or bankruptcy. Thus, transparency regarding a company’s finances and certainty and predictability regarding the enforcement of remedies and rights in bankruptcy are of paramount importance. Uncertainty in any guise, but particularly with respect to the uniform enforcement of creditors’ legal rights and remedies, is detrimental to properly functioning capital market. The net result of such uncertainty is increased costs for companies seeking financing from the debt markets, as participants who could be beneficial to the process opt not to participate or, if they do, charge more for their participation.

The most disastrous form of interference in the capital markets would be to limit recoveries based on the price at which a creditor purchases a claim. Neither the price paid nor the creditor’s motivations in purchasing debt can be relevant to any aspect of the bankruptcy process, except in rare circumstances where those motivations are illegal or fraudulent. Outside of bankruptcy, the global financial system involves a myriad of transactions each of which relies on the certainty of legal rights associated with a particular claim or asset. Any amendment to the Bankruptcy Code that would eliminate or weaken parties’ ability to enforce their legal rights upon a company’s bankruptcy filing is ill-advised and would harm, not improve, companies’ ability to successfully reorganize in bankruptcy. Creditors who purchase claims on the secondary market should be entitled to the benefits for which they bargained to the same extent as other creditors in bankruptcy. It is imperative that the treatment of a claim under a plan of reorganization be based upon the nature and value of that claim, and not upon the discount at

⁹ See e.g., Ziad Raymond Azar, *Bankruptcy Policy: A Review and Critique of Bankruptcy Statutes and Practices in Fifty Countries Worldwide*, Cardozo J. Int’l & Comp. L., Summ. 2008, at 18-19, 34-35.

which a creditor may have purchased the claim. Any contrary rule would upend the economy in general, reverse three hundred years of the market's understanding of negotiable instrument law,¹⁰ and sound the death knell of the secondary market in bankruptcy. Accordingly, such an amendment to the Bankruptcy Code would have immediate adverse consequences for the capital markets as a whole, and free market economies in general.

Lenders and investors must have confidence in their ability to realize upon their investment in the event of a bankruptcy. This includes reliance on the enforcement of contracts, applicable state and non-bankruptcy federal legal rights, including enforcement of lien priority, and the absolute priority rule. The lack of clear rules regarding the application of the contract rate of interest, including default interest, during bankruptcy, provides an instructive example of the costs of uncertainty, including the wasted years and extensive litigation costs resulting therefrom. We encourage the Commission to recommend steps to create as much clarity, predictability and transparency as possible to ensure enforcement of bargained-for rights, lest investors be unwilling to participate in the reorganization process.

In short, the efficient functioning of capital markets is itself necessary to successful reorganizations. Information barriers or uncertainty in connection with a creditor's ability to enforce its legal rights creates the potential for manipulation of the bankruptcy process by management and old equity who may seek to retain control and/or value at the expense of the company's true economic stakeholders.

**F. Case Example: *In re W.R. Grace & Co.*, Case No. 01-1139,
Honorable Judge Judith K. Fitzgerald (Bankr. D. Del. 2001)**

The chapter 11 bankruptcy case of W.R. Grace & Co. (referred to herein as "Grace" or the "Company") illustrates the potential problems and costs faced by creditor

¹⁰ See First Report on Public Credit; Report on the Public Credit (Jan. 9, 1790), in which Alexander Hamilton as Secretary of U.S. Treasury rejects the proposal of any discrimination between an original holder and a subsequent holder or transferee.

"It involves this question, whether a discrimination ought not to be made between original holders of the public securities, and present possessors, by purchase. Those who advocate a discrimination are for making a full provision for the securities of the former, at their nominal value; but contend, that the latter ought to receive no more than the cost to them, and the interest: And the idea is sometimes suggested of making good the difference to the primitive possessor." . . . "The Secretary . . . is induced to reject the doctrine it contains, as equally unjust and impolitic, as highly injurious, even to the original holders of public securities; as ruinous to public credit. It is inconsistent with justice, because in the first place, it is a breach of contract; in violation of the rights of a fair purchaser. The nature of the contract in its origin, is, that the public will pay the sum expressed in the security, to the first holder, or his *assignee*. The intent, in making the security assignable, is, that the proprietor may be able to make use of his property, by selling it for as much as it *may be worth in the market*, and that the buyer may be *safe* in the purchase." (emphasis in original).

participants, as well as the judicial system, when courts create uncertainty by refusing to enforce contracts as written and permit old equity to retain value while at the same time denying a company's creditors the benefit of their bargain with the debtor.

The fallout from courts refusing to enforce creditors' bargained-for rights will likely increase the cost of capital to corporate borrowers. Participants in the capital markets may increase the prices at which they will lend in order to mitigate both the risk that a court will refuse to enforce the benefit of their bargain, and the litigation costs associated with enforcing their creditor rights.

Grace commenced its bankruptcy case in April 2001, and despite being in bankruptcy for more than eleven years, has yet to emerge from bankruptcy or pay its pre-petition creditors. In stark contrast, Grace's owners have not suffered at all. As provided in Grace's chapter 11 plan, "old equity" will remain as Grace's owners upon its emergence from bankruptcy. Shortly before Grace's bankruptcy in 1998 and 1999, certain bank lenders loaned the Company \$500 million of "short term loans" scheduled to mature in May 2001 and May 2003.

Prior to and at the time of its bankruptcy filing, Grace was a robust and financially sound company and was paying its debts as they came due. However, because of the increasing cost of asbestos related claims and litigation, the Company filed for bankruptcy to obtain the benefit of section 524(g) of the Bankruptcy Code which permits a debtor to channel its asbestos litigation to a special trust.

After many years of litigation with its asbestos creditors to estimate the value of the unsecured asbestos liability, Grace, asbestos creditors and a committee representing Grace's shareholders reached a settlement on how they would divide up the value of Grace's estate. This settlement served as the basis for Grace's reorganization plan. Key terms of the settlement left "old equity" intact as owners of a reorganized company worth more than \$4 billion today and paid creditors 100% of the principal amount of their pre-petition claims plus some post-petition interest at rates *less* than those applicable under the creditors' contracts. The "plan" interest rate reflected the rate management and shareholders wanted to pay, as opposed to the rates that management and shareholders had agreed to pay pre-bankruptcy as set forth in the bank lenders' contracts. Grace's chapter 11 plan *de facto* bestowed on the Company's shareholders the value realized by the plan's imposed cuts on creditors' bargained-for contractual rights.

Outside of bankruptcy, upon an event of default, lenders would have been able to exercise whatever rights and remedies had been agreed to by the borrowers, as set forth in the governing agreement, including accelerating the debt and taking legal action to recover the amounts due and payable. However, because of the automatic stay, Grace's lenders along with its other creditors, were unable to take any legal enforcement action. Despite the express terms of the contracts, the Company would not be required to repay its "short term" loans on maturity, whether accelerated by bankruptcy or otherwise.

Participants in the capital markets understand and expect that upon the commencement of a bankruptcy case, the automatic stay provisions of the Bankruptcy Code will prevent debtors, as a general matter, from paying creditors for claims arising pre-petition. However, creditors do not expect that their non-bankruptcy law rights, including bargained-for and other state and federal property rights, will be nullified at the debtor's choosing (and, in the case of Grace, at the shareholders' choosing). Specifically, although the Bankruptcy Code may temporarily prevent financial lenders from enforcing their remedies, the Code does not void the applicable provisions of such creditors' otherwise valid debt contracts, including provisions governing defaults and the consequences of such defaults. Nor do creditors expect that the Bankruptcy Code will permit shareholders to recover anything unless and until all creditors have been paid in full, including the recovery of post-petition interest to make up for the payment delays and risks caused by the bankruptcy process.

Historically, both inside and outside of bankruptcy, the capital markets have relied on the unquestioned bedrock corporate and bankruptcy principle mandating that shareholders only recover after all creditors receive payment in full. Notably, there is no corollary principle that in essence permits borrowers to deny creditors their bargained for recoveries while at the same time permitting shareholders to keep such creditor denied recoveries for themselves. To implement this bedrock principle in bankruptcy, a plan can only be confirmed if its proponents establish (pursuant to section 1129 of the Bankruptcy Code) that the plan satisfies what is referred to as the "absolute priority rule" such that no junior creditor or equity interest recovers any value unless the more senior class of creditors has been paid in full. Grace's plan violated the absolute priority rule by permitting shareholders to recover while at the same time paying creditors *less* than the amounts such creditors were legally entitled to under their contracts.¹¹

Sharply surprising the capital markets, the bankruptcy court agreed with Grace and confirmed the plan while at the same time disregarding the lenders' votes which overwhelmingly rejected the plan. This issue has recently arisen in other cases including *Dow Corning*, in which litigation over the appropriate interest rate continues more than seventeen years after Dow first filed for chapter 11 in May 1995.¹²

Grace further serves as a warning to participants in the capital market to ensure active participation during the bankruptcy process. In Grace, the pre-petition management and board of directors remained in place. The goal of the board of directors and management from the outset, and throughout the case, was to cap and channel the mounting asbestos liability for the benefit of Grace's shareholders. One can only speculate how the Company would have

¹¹ See also, *In re General Growth Properties, Inc.*, 451 B.R. 323, 328 (Bankr.S.D.N.Y. 2011) (where bankruptcy court rejected debtors' attempt to pay creditors less than contractual rate and concluded that where shareholders retained equity worth \$6 billion on emergence from chapter 11, secured creditors were entitled to recover their 2% higher default rate postpetition interest.)

¹² *In re Dow Corning*, Case No. 95-20512 (DPH) (Bankr.E.D.Mich.).

treated its creditors if a new board had been appointed upon the commencement of bankruptcy; an eleven year plus bankruptcy case would not likely have been the result. Such an extended time in bankruptcy for a company may benefit management, but comes at a tremendous cost not only to all creditors but to the courts as well because of the substantial waste of judicial resources

Creditors of Grace have paid a significant price because of the confusion and delay associated with Grace's efforts to deny creditors the benefit of their bargain. Payout of creditor recoveries has been held hostage to very expensive and lengthy litigation which continues today.

The solution to end this uncertainty and the wasteful litigation it has spawned would be to clarify section 1129 of the Bankruptcy Code such that in circumstances when equity interests receive any value under a plan, the plan cannot be confirmed unless and until all the more senior creditor classes receive payment in full in accordance with their applicable contractual and non-bankruptcy law rights, including state and federal law rights. Such amendment to section 1129 would reduce the future potential risk for abuse by debtors and "old equity" to invade creditors' recoveries and it would reaffirm the principle that equity takes last.

On behalf of Halcyon, I would like to thank the Commission for allowing us the opportunity to share our views on these important issues. Halcyon in coordination with the MFA is committed to working constructively with the Commission regarding any proposed amendments to the Bankruptcy Code.