ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11

Field Hearing, October 17, 2012

New York, N.Y.

Transcript of Proceedings

Elliot Ganz: Good afternoon. Thank you for coming. On behalf of the Loan Syndications and Trading Association and the Managed Funds Association, it’s my pleasure to welcome you to the first Field Hearing of the American Bankruptcy Institute’s Commission to Study the Reform of Chapter 11. In particular, I would like to thank Sam Gerdano, the Executive Director of the ABI, and Jennifer Han, the Assistant General Counsel of the MFA, who were instrumental in putting this hearing together.

I would especially like to thank the members of the Commission who have joined us this afternoon, as well as many members of Commission Advisory Groups who are also in attendance. Of course, thank you to our distinguished panels of witnesses. Finally, thanks to Alicia Sansone and Lorena DeLuca and the rest of the LSTA staff who’ve worked so hard to put this together.

The $1.5 trillion leveraged finance market is large, broad, and deep. It provides financing to thousands of non-investment grade companies in America, fueling growth and, more importantly, jobs. Moreover, the market, once dominated by banks, is now overwhelmingly an institutional market. We’re not in Kansas anymore, Toto.

There are two things that are especially important to the smooth functioning of the market, legal clarity and financial liquidity. First, lenders and investors need to know what the rules are prior to entering into a transaction. They need to have the confidence that the rights they’ve bargained for will be respected and enforced.

Second, they need to know that they have the ability to sell their positions, especially when things go south. Just as no one would enter a movie theater that did not have emergency exits, lenders and investors will not enter into a loan or purchase a bond if there is no one on the other end to buy it, particularly in times of stress. Of course, the providers of that liquidity, like original investors, need to be able to rely on the clear rule of law.

The LSTA and the MFA have gone to great lengths over the past few years to ensure that these principles are respected and observed. We have been particularly active in the context of the Bankruptcy Code, which is where the rubber hits the road for lenders and investors. The LSTA has attempted to protect the rights of secured creditors, providers of liquidity, and distressed investors by participating as amicus in numerous important cases, such as RadLAX, Tousa, DBSD, W.R. Grace, Enron, Owens Corning, and others. While we are not always successful, we are always right. (Laughter)

We also led the long and ultimately successful fight for a fair and reasonable Rule 2019, a Bankruptcy Rule that was often used to force investors to disclose the prices they paid for their claims. It is worth noting that once the requirement to disclose price information was dropped from the rule, mischievous litigation over its enforcement has mysteriously disappeared.

The ABI has put together a highly distinguished Commission to study potential bankruptcy reforms. We appreciate the Commission’s focus on revisions to the Bankruptcy Code that could provide flexibility in facilitating business reorganizations under Chapter 11. We are concerned that the Commission is considering reforms into which that flexibility could come at the price of the clear, legal rules protecting the rights of secured creditors, the very rights on which the leveraged finance market depends.

We are also concerned about the prospect of legal changes that would introduce uncertainty into the claims trading market. We are, therefore, pleased to have this opportunity to testify before the Commission. Our witnesses will describe the size, breadth, and depth of the leveraged market, finance market. They will explain the importance of having clear laws that provide lenders and investors with the benefit of their bargains. Finally, they will demonstrate the importance of security and liquidity, highlight the positive role played by distressed investors in restructurings, and show how all of this is closely connected to the existence of a strong and clear Bankruptcy Code.

It is now my pleasure to turn the proceedings over to Bob Keach, past Chairman of the Board of the ABI and Co-Chair of the ABI Bankruptcy Commission.

In his day job, Bob is Co-Chair of Bernstein Shur’s Business Restructuring and Insolvency Practice Group, where his practice focuses on the representation of a broad range of parties in workouts and bankruptcy cases. Bob regularly serves as a panelist on national bankruptcy, lender liability, and creditor’s rights programs, and is the author of several articles on bankruptcy and creditors' rights. Bob is a contributing author to the *Collier Guide to Chapter 11* Practice and a fellow at the American College of Bankruptcy. Bob?

Robert Keach: Elliot, thank you. Welcome. As Elliot said, I’m Bob Keach, I’m one of the two Co-Chairs with Al Togut of the American Bankruptcy Institute’s Commission to study the reform of Chapter 11.

We first thank the LSTA for hosting this hearing. We’d like to thank the LSTA and the MFA for both identifying and coordinating the presentation of the witnesses and the witness statements, which we’ve had an opportunity to review in advance and which were comprehensive and well done, and we thank the authors for those statements. In particular, I want to thank Elliott for his tireless efforts on getting this off the ground.

I’d like to begin with some very brief remarks about the mission of the Commission and its activities to date, and then we’ll hear from, as Elliot said, a number of witnesses and we’ll have some time for Q & A between the commissioners and those witnesses, as appropriate and as time permits.

Why the need for reform? Why now? It has been over 30 years since the current Bankruptcy Code was enacted and a consensus has emerged over recent years that the current law needs an overhaul. Some would contend that the principal quality of the 1978 Bankruptcy Code was that the statute offered a balance between creditor and debtor interest, establishing what was often described as a level playing field for restructuring.

When first enacted, supporters of the 1978 Bankruptcy Code argued that it served the interest of all of those impacted by a debtor in distress, including employees, the surrounding community, the public interest, and creditor interest, but did so in a flexible way that balanced interest while meeting the debtor’s goal of succeeding in saving its business.

Detractors of the 1978 Code, and there were many, contended that the 1978 Code was too “debtor friendly”, that it led to long and inefficient cases, and that it provided too much discretion to bankruptcy judges. To the extent that the Code was modified after 1978, the detractors largely prevailed in the legislative battles.

For better or for worse, most of the changes of the Code since 1978 have exempted categories of claimants or transactions from the reach of bankruptcy law, have added additional categories of administrative or priority claims. Have limited or eliminated the discretion of the courts in administering Chapter 11 cases, and it provided for shorter time periods and faster, more truncated cases. Supporters of the original code would contend that many of those changes have not helped further the goal of restructuring or have had unintended consequences. However, at this point, that may all be moot.

It may be not a terribly relevant consideration to determine who was right or wrong, between the supporters or detractors of the 1978 Code. That’s primarily because, from the Commission’s standpoint, the world simply changed around the Code. The Code, even as amended, is not designed to deal with these changes. For the most part, a series of external factors drive the need for our rethinking of Chapter 11.

Since the Code’s enactment there’s been a market increase in the use of secured credit, placing secured debt at all levels of the capital structure. Many of the 1978 Code’s provisions assume the presence of asset value above the secured debt, asset value that is often not present in many of today’s Chapter 11 cases. The debt and capital structures of debtor companies today are more complex with multiple levels of secured and unsecured debt, often governed by equally complex inter-creditor arrangements.

The growth of the distressed debt markets in claims trading introduced another factor not present when the 1978 Code was enacted. That’s a factor which also challenges certain other premises underlying the 1978 Code. I would add, quickly, that the Commission does not see either of those events as a problem to be solved, but we see them simply as changes to be accepted as we look at what the code for the next 40 years will look like.

In addition, the Bankruptcy Code was developed in an area when the biggest employers were manufacturers with largely domestic operations. Many of our biggest employers today, however, are service companies. Many of the remaining manufacturers are less dependent on hard assets and more dependent on contracts and intellectual property as principal assets. The current code doesn’t deal well or efficiently with those assets.

Debtors are often multinational companies with the means of production of their operations offshore bringing international law and choice of law implications into the mix. Today’s debtor, in fact, is much more likely to be a group of companies, sometimes a large group of companies, than a single debtor. The impacts of these changes on the current restructuring regime have been dramatic.

The way we talk about Chapter 11, the way the courts and commentators and practitioners have talked about the purposes and goals of Chapter 11 has changed. Early decisions in the legislative history of the ‘78 Code emphasized that the primary purposes of the code were the rehabilitation of businesses, the preservation of jobs, and the preservation of tax bases at state, local, and federal levels. As time passed, these purposes competed with maximization of value owned by stakeholders as an equal and perhaps competing goal.

More recent discussions of the purpose and goals of Chapter 11 tend to emphasize value maximization to the exclusion of other goals and purposes. This development also calls for a fresh assessment of the purposes and goals of a U.S. restructuring regime. Given the added complexity in a statute that often does not have the tools or clear answers to deal with problems that arise, even the cases that do reorganize seem to cost more. Reorganization may be less efficient, more costly. This recognition that the world has changed in significant ways since the enactment of the 1978 Code and the related concerns is what brings this Commission together to consider the need for a prompt and thorough reevaluation of the code in light of these changes.

What is the Commission, what is its mission, and how is it doing its work? The charge of this Commission is nothing less than the study of the need for comprehensive Chapter 11 reform, by which we mean consideration of literally starting from scratch and reinventing the statute, much as was done in 1978. Accordingly, the Commission’s mission statement is equally ambitious.

It reads, “In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the Commission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization for business debtors, with the attendant preservation and expansion of jobs and the maximization and realization of asset values for all creditors and stakeholders.”

ABI, which I have been a part of for many years, is the logical organization to do this for a couple of fundamental reasons. First, ABI is not a political or government organization and, as part of its basic charter, it does not lobby or advocate for particular positions, or take sides. Thus, ABI has no interest other than intellectual honesty and, frankly, an open and complete process. Second, it’s over 13,000 members represent all segments of the bankruptcy and insolvency practice, including practitioners who advise small, midsize, large, and mega debtors, and large debtors and creditors.

Its membership includes judges, academics, financial advisors, investment bankers, and others. Given our 30-year, nonpartisan tradition, we feel that the ABI Commission has been and will be a forum for all voices and points of view.

Then ABI president, Geoff Berman, asked Al Togut and I to assist him in assembling a working group, i.e. the Commission, of what he called the best and brightest from among Chapter 11’s practitioners, academics, bankers, and even members of Congress to study possible business bankruptcy law reforms. With the formation of the Commission, we feel we’ve at least accomplished that task. The members of the Commission, the complete Commission, are on the screen. I won’t take the time to introduce the august body that surrounds me, but most of them are known to you. We’re pleased to have a number of the Commissioners here today.

The Commission is ably assisted by its reporter, an eminent Bankruptcy Scholar in her own right, Michelle Harner, who’s Professor of Law and Co-Director of the Business Law Program at the University of Maryland Francis King Carey School of Law. Professor Harner oversees the work of our advisory committees, provides critical research assistance, records the deliberations of the Commission and will assist in the production of our final product.

The Commission, in a series of meetings, has selected a number of topics for initial study, and for each topic we have an Advisory Committee of distinguished judges, academics, and practitioners to assist us to research the topic, to discuss possible reforms, and to report its work back to the Commission. Those topics, and the Advisory Committees, are also listed on the screen. I won’t take the time to read all 13 of them at the moment, but we’re also pleased to have a number of our Advisory Committee members and leaders here today. The Commission will also address other issues at the Commission level as well.

Why are we here today? The Commission realizes that despite the breadth of knowledge and experience on the Commission and its advisory committees, that many others around the country, including our witnesses today, from the bar, the judiciary, academia, the financial professions, business, and elsewhere, have critical information, experience, knowledge, data, and ideas to contribute to this important process. Accordingly, to access the wealth of knowledge, information, data, and ideas, and all of that experience, the Commission is holding field hearings around the country to hear and collect testimony on various issues, including all of the topics listed. We thank the LSTA and the MFA, and for all of you who are in attendance, for their interest and participation in this, the first, of many field hearings.

We’ll also be soliciting our and will be soliciting written submissions on all issues. It’s our goal to hear from every interest affected by potential restructuring legislation. Armed with this and the work of the advisory committees, the Commission will debate, study, and produce a series of recommendations that we hope will be part blueprint and part the outline of a new statute. The important thing here is that this process be open, thorough, and complete; that we do the work that a perfect Congress would do if it could. For that reason we want to hear from all of you today.

With that, and I thank you for your patience, we will hear from the witnesses. The Commission, at this point, is honored to acknowledge the first witness, Mr. Ted Basta.

Ted Basta: Good afternoon, my name is Ted Basta. I am Senior Vice President of Market Data and Analysis at the LSTA. I first wanted to say what an honor and a privilege it is to be asked to present in front of you all today and, more importantly, to be part of such an important initiative moving forward.

My role today is to present to you a set of facts, which will be supported by hard data. I was not asked to argue a particular point or a position, but rather present the results of my analysis. My understanding is that the speakers that will follow me today will expand upon my analysis by linking certain topics to the broader topic of Chapter 11 Reform.

The essential purpose of my testimony today is to establish four key points. First, the markets for secured leveraged loans and high-yield bonds are large and critical to the growth of corporate America, as are the benefits afforded by senior security to both the borrower, as well as the investor. Second, I will describe the lender base and show that the secondary trading markets are deep and liquid even during times of great distress.

Third, by presenting a number of case studies I will illustrate the liquidity and performance of a number of assets in bankruptcy and their subsequent appreciation and enterprise value. Finally, I will show the overwhelming majority of debtors that enter into debtor-in-possession, or DIP loans, do not liquidate, but rather either reorganize or are sold as growing concerns. I’ll then demonstrate the size, liquidity, and pricing of the DIP loan market and illustrate that secondary prices in the DIP loan market almost perfectly correlate with the broader loan market itself.

Let’s begin with the size and the role of the leveraged loan and high-yield bond markets. Leveraged loans and high-yield bonds are one critical part of the $38 trillion fixed income market in the United States. Leveraged loans and high-yield bonds, only each make up about three percent of the market, the funding they provide to non-investment grade borrowers are critical to the growth of corporate America and to our economy. It’s safe to say that the leveraged loan market has, in fact, experienced exponential growth over the past 10 to 15 years.

In many respect the leveraged loan market went mainstream in the year 2001. That year the Wall Street Journal began covering our marketplace. Since that time the number of U.S. companies accessing the leveraged loan market has doubled. Today, we provide funding to over 1,500 individual companies. While small in comparison to other fixed income markets, the high-yield bond and leveraged loan markets still account for trillions of dollars of funding. Currently there’s more than 1.5 trillion in leveraged debt outstanding with senior secured leveraged loans comprising more than one-third of the total.

Leveraged debt is also actively traded in liquid secondary markets with an estimated combined volume in 2012 of $2.7 trillion. As you can see on the chart on the left, there was little to no growth during the recession in the year that followed. During the financial crisis, credit markets mostly seized up, as both debt and equity markets tumbled.

We go back to 2008, the S&P 500 had plummeted 37% while leveraged loan returns fell a negative 29%. In 2009 markets rallied, as they normally do. Stocks gained 23% while loan returns hit a record 52% return. As this chart illustrates, since 2010 the credit markets have, in fact, come back on line in full force; 1.7 trillion of aggregate new issuance was done since the beginning of 2010.

I’ll now speak to the benefits of senior security in the capital structure, benefits realized by both the borrower as well as the investor. Senior secured loans sit atop the capital structure and offer corporate America a private and cheaper source of funding that otherwise would not be made available. As the chart to the right illustrates, senior secured loans have been priced in the primary market; that is they yield approximately 200 basis points less than unsecured bonds. That’s a 25% savings in borrower costs, which is passed directly on to the borrower base.

As a result of the protections afforded to secured lenders through the existing Bankruptcy Code, lenders are willing to accept this far lower yield on their investment because of recovery levels. Since bank loans are senior secured the recovery rates are far higher than all other debt. Again, it is because of these recovery rates investors accept a lower rate of return. The chart on the left shows the last three default cycles while the chart on the right illustrates the actual recovery levels during these three cycles.

According to an analysis by Moody’s Investors Service, which tracked more than 1,000 individual corporate defaults since 1987, average recoveries for senior secured loans were approximately 80 cents on the dollar. Compare that with recoveries of less than 50 cents on the dollar for senior unsecured bonds and 30 cents on the dollar for subordinated bonds. I think these results are basically undeniable. Moreover, the distribution of recoveries during the most recent default cycle, are even more striking than these averages represent.

This next slide contains analysis provided to us by Fitch Ratings where they analyze the distribution of high-yield bond and leveraged loan recoveries during the most recent default cycle. According to Fitch, 78% of recoveries were above 80 cents on the dollar with 67% above 90 cents on the dollar, and again that’s on the senior secured loan side, not the bond side. Furthermore, only 10% of loan recoveries were below 60 cents on the dollar and as you can see they were all contained within the 40 to 50 cent range. There were no recoveries below the 40 to 50 cent range for senior secured loans.

My next slide illustrates the importance of collateral or security even in the context of the high-yield bond market. As I explained earlier, during the years 2008 and 2009 the primary markets for both leveraged loans, as well as high-yield unsecured bonds all but seized up. As you can see from this slide, senior secured high-yield bond issuance increased dramatically and helped to provide the crucial liquidity that was otherwise unavailable in 2009. That year secured high-yield bond volume totaled $60 billion, a tenfold increase over 2008 and a fourfold increase from pre credit crisis levels.

I’ll now describe the lender base of the leveraged loan market and illustrate why the trading market has remained deep and liquid even during times of unparalleled stress.

Over the past 12 years the primary source of leveraged lending has shifted to the institutional lender base, as Elliot explained before, a tremendous amount of change over the past 10 to 15 years in our marketplace. If we were to go back to 1994, almost 70% of leveraged lending was funded by the banking community. Today, non-banks or institutional lenders comprise almost 87% of all leveraged loans. These institutional lenders are comprised of 235 individual investor groups; a number that, as you can see, has held steady for the past three years.

Now, I’ll speak to the secondary loan trading market and focus particular attention to liquidity levels during the height of the crisis when loan default rates hit a record of 10-plus%. A lot’s going on in this slide, I know. My first chart on the left is showing that in 2009 the default rate, the red line, peaked as the U.S. began to emerge from the recession, which was the deepest and longest downturn since The Great Depression. At that time only 10% of leveraged loans were in default or bankruptcy, while an estimated $480 billion of leveraged loans outstanding continued to perform.

As you can see in the chart on the right, liquidity levels in the secondary loan market remain mostly constant before, during, and after the recession. By assessing trade volumes as a percentage of outstanding, we can see that the annual turnover ratio, the gray line there, never dipped below 80%. I believe this to be because of the loan market’s diverse lender base and the varying level of risk and potential reward that each group is willing to accept. Secondary market prices are a great example of how the market is bifurcated by this risk.

The liquidity offered in today’s secondary loan market allows money managers to efficiently assess the risk-reward tradeoff and effectively shift in and out of riskier credits as their individual mandates allow. For example, by early 2009 loan prices had plunged across the rating spectrum. During that time loans priced at less than 80 cents on the dollar constituted more than half of overall trading and you can see that on the chart on the right hand side. As prices recovered, trade volumes on loans priced above 80 cents on the dollar, once again, dominated trading. Again, you can see that trend on the right chart.

Here we see this transfer of risks that I initially spoke of back and forth across the different lender groups. Let’s now take the time to take a look at these different lender groups. As market conditions change, obviously, so does the mix of institutional or non-bank lenders. There are four major constituents in the leveraged loan market today: collateralized loan obligations or CLOs, retail loan funds, hedge to stress and high-yield funds, and finally, finance and insurance companies.

Over the previous four years retail loan funds tripled to nearly 20% of the market, while CLOs filled 41% from a 52 market share. As the chart on the right shows us, CLOs have staged a formidable comeback this year. They now occupy almost 55% of all lending while hedge to stress and high-yield funds share has just about been cut in half from 40% of the market during the third quarter of 2011 to a little over 20% today.

To better illustrate this reduction in lending activity on the distress fund side, in the next slide I’ve caveated their quarterly market share in the primary against the performance of the secondary loan market. Just as a matter of background, when prices fall in the secondary loan market, yields in the primary and new issue market adjust upwards in order to stay competitive from the relative value standpoint. Without this distress investor class willing to buy risky assets in the secondary or lend in the primary market when conditions turn sour, the market could not efficiently exist.

In many cases distress funds and the like take on the elevated level of risk when market conditions worsen and other market participants are less willing to do so. As an example of this, during the market downturn of the third quarter of 2011, 94% of loan prices declined in the secondary market by an average of 500 basis points. The average fell just below 90 cents on the dollar. During that same period of increased risk and uncertainty, yields in the primary subsequently ran much higher and distress funds came in and provided the necessary liquidity, which turned out to be 40% of all primary lending. Today investors comprise less than 25% of funding as the secondary market has traded back above 96 cents on the dollar and yields have subsequently adjusted downwards.

I’ll now move into the next section where I’ll illustrate the liquidity and performance of the number of assets in bankruptcy. My analyst told me that this chart actually looks like something live from Bloomberg, so we’re pretty proud of it. The liquidity provided by different participants in the loan market is demonstrated by this first set of bankruptcies, one being large and one being small.

The first set of companies is Idearc and Masonite. Both of these companies filed for bankruptcy in March of 2009. That month the combined secondary trade volume almost tripled from the prior month to $1.2 billion before more than halving the following month and we see that in the chart to the left. In other words, both before and after the filings, volumes stayed relatively low with the spike around the bankruptcy filing date.

This suggests that during the filing process, regular way investors sold their positions to distress funds and the like who didn’t just come in for a quick profit, but stayed in for the long haul. As a result, volumes fell and the market normalized. Moreover, in tandem with the stabilization of the trading market post bankruptcy, we see the average bid-ask spreads of both companies’ loans tightening as price levels rallied, thus increasing the enterprise value of both companies.

Let’s now take a look at another set of companies. The second set of companies is Chrysler and General Growth Properties, again one large, one small. Thank you. Again, we see the same type of trends here. The combined secondary trade volume increased almost six-fold during the month of bankruptcy before normalizing once again during the preceding months. Just as we saw with Idearc and Masonite, distress funds moved in during the month of bankruptcy and as a result the market stabilized, bid-ask spreads tightened, and prices rallied.

My next slide speaks to the level of risk associated with lending to companies that have gone bankrupt. As we all are aware, sometimes things don’t turn around so quickly or if at all. As the Delphi case demonstrates, investing in companies that have filed for bankruptcy protection can be very risky and involves a high degree of volatility. Distress funds often provide debtors with the capital investments they need to emerge from bankruptcy as successful a growing concern. For example, in this case they recapitalized Delphi after years in bankruptcy and despite heavy volatility in the capital markets. More importantly, there was an uncertain path toward profitability here for the company, as well as the investors.

It’s also important to note that the recapitalization occurred despite the fact that the bonds had been essentially wiped out. We see that there measured by the gold line. At the same time we see the second lien debt, which is the green line, was trading roughly at 20 cents on the dollar. Since the date of the recap we see that the second lien loans have now more than tripled in price while the equity is up more than 50%.

I’ll now move on to the last portion of my presentation, the debtor-in-possession or DIP market. Our first slide in this section speaks to the success rate of companies, which have accessed the debtor-in-possession market. The LSTA was able to track 56 companies that have accessed the market since 2006, providing them with the liquidity needed to operate and restructure while in bankruptcy, thus preserving and in some cases increasing the enterprise value of these companies. Of the 56 companies who accessed the DIP market only two, Coach America and Winstar Communications, were liquidated rather than reorganized or sold off.

I’ll now review the liquidity of both the primary and secondary DIP markets as how they performed in the secondary relative to the broader market. During the first quarter of 2009, which was the height of the financial crisis, the default rate had spiked above 7% and DIP lending hit a record high of almost $12 billion, a sevenfold increase from the previous quarter. In turn, DIP trading volumes increased to a record high of $2-plux billion but even still, DIP trading only accounted for less than 2% of overall trading. As the economy improved and the U.S. exited recession, both DIP lending and trading volumes fell back to their natural levels soon thereafter.

As the chart on the right illustrates, the DIP market is not immune to market forces, though. Before, during, and after the recent credit crisis, DIP loans traded in almost perfect unison with the broader market, but as expected, because of their most senior secured position in the capital structure, DIPs didn’t trade as low during the crisis. Today the DIP market is once again trading on average above 100 cents on the dollar. It’s also very important to note that the same relationship I just described in the secondary exists in the loan primary markets. Thus, when secondary market prices plummeted at the height of the recession it became much more expensive to originate not only new DIP loans, but also other types of debt.

That concludes my presentation. I again thank you very much for the time.

Keach: Thank you. At this point in time we are going to break for some questions of the witness. Do you have a question? The chair recognizes Mr. Butler.

Jack Butler: Thank you. In Chairman Keach’s opening remarks he said that since the Code’s enactment, there’s been a marked increase in the use of secured credit, placing secured debt at all levels in the capital structure. He observed that the 1978 Code’s provision assumed the presence of asset value above the secured debt, asset values that Chairman Keach observed are not present in most of today’s Chapter 11 cases.

What I’d like to ask you, Mr. Basta, deals with your testimony involving the secured bond market, and the increased emphasis on the secured high-yield bond market in lieu of, or certainly in preference to, the unsecured high-yield bond market. The impact of this in bankruptcies right now is that there’s a lot more funded debt that is claiming security when Chapter 11 is filed. As your chart pointed out, much of this market developed in 2009 through 2012 and so we can see the results of that in the Chapter 11s to come.

The question I have for you is, how should the Commission think about this change in the marketplace? The emphasis of the unsecured market, the emphasis on the secured market, and the relationship that’s having to placing a different priority on funded debt investments over, for example, trade debt, employees, pensions, landlords, and many other stakeholders who would have previously shared in the priority. How should the Commission think about that in terms of thinking about priorities going forward?

Basta: I thank you first for your question, but unfortunately I think this question is better answered by the panelists that are going to follow me. I basically deal in the secondary leveraged loan market and I’m really not apt to be speaking about the secured high-yield bond market.

Keach: Okay, thank you. Chair recognizes Mr. Miller.

Harvey Miller: Mr. Basta, thank you. I get a few takeaways from your testimony, but first I point to the statement that you make that only 2 of the 56 tracked companies that accessed the DIP marketing since 2006 went into liquidation. I think if you look at 2007 to 2010, in the retail business, with the exception of one company, from Circuit City to Sharper Image and so on, every one of those companies was liquidated and required to liquidate under the terms of DIP financing. I’m not sure where your statistics come from.

Basta: Actually, this information was provided to us by our Counsel, Wilmer Hale. I didn’t specifically do this analysis.

Miller: Did you look at the retail market?

Basta: Yes, we did.

Miller: Would you agree that senior secure creditors have a tremendous influence in the terms and conditions of DIP lending?

Basta Absolutely.

Miller: Okay.

Basta: As well they should because they’re taking on that additional risk at that point in time once the company has already gone bankrupt.

Miller: I take it from your testimony you take the position that it’s better to be secured than unsecured?

Basta: Ah, yes.

Miller: And it would be your position, or maybe it’s not your position, that generally bankruptcy’s a hindrance to secured creditors?

Basta: I don’t think it’s a hindrance. I think it’s a normal part of the process when you’re an investor in debt.

Miller: Well would you support going back? I'm probably the last living expert on the Act of 1898, would you recommend… would you say, Ed?

[Inaudible 00:38:08] you're not the only one.

Miller: Would you support going back to what was the status of bankruptcy before the introduction of the automatic stay, that generally whenever there was secured creditor and that creditor was undersecured that was the end of the Bankruptcy?

Basta: No, I would not, no.

Miller: So do you think bankruptcy is good place to deal with secured creditors?

Basta: Yes, I do.

Miller: Okay, thank you.

Keach: The Chair recognizes Mr. Brandt.

Bill Brandt: I'm familiar with the last chart that’s up there. I think it's not that they are the only two companies to liquidate, but if I recall the particular two you're mentioning because I was involved in one of them, those are the two that did not pay their DIP loans back in full, which is rarity. The other companies, whether liquidated or not, I believe all paid their DIP loans back and one of the issues I've raised over the years is the pricing of the DIP loans, which seems odd given the marginal risk factor for lack of repayment. As you look at this chart, only two companies failed to pay back their DIP loans in full. Would that be a better way of stating this?

Ted B: I believe so.

Brandt: Thank you, sir.

Basta: What I will do for the Commission, is I will revert back to Wilmer Hale and come back to you with a specific answer to this question.

Wilmer Hale says it's fine [inaudible 00:39:24]

Basta: Myself included.

Deborah Williamson

Could you also, when you update this information, pull out the companies that are still in the midst of their organization, such as Interstate Bakeries and some of the others, because I think that also makes the data a little bit hard to understand.

Basta: Absolutely.

Keach: Any other question? Yes, Mr. Seery.

James Seery: Thank you, Bob. One quick question: does the LSTA take a position on whether a debtor should have consent rights with respect to the transfer of bank debt after a bankruptcy? Generally in the credit agreement borrowers have some say over the transfer, and many credit agreements relinquish that right after default. Does the LSTA have a position on whether those rights should continue if the credit agreements so provide it?

Basta: James, I'd have to point that question to my General Counsel, Elliot Ganz. Again, I run Market Data and Analysis, so I'm not geared to speak on the LSTA stance on that particular topic. If anyone has any questions on levered loans, I would love to answer them.

(Laughter)

Keach: Any other questions? I have one, but the Chairman's prerogative is going to be to go last. A quick question and if this is better answered by one of the other witnesses. Please feel free to punt it. You did talk both in your prepared remarks about the importance of debtor-in-possession financing. One of the concerns that we are looking at, given what Jack described and what I described in my opening remarks as what we can probably agree are, several over-leveraged or at least fully-leveraged companies that enter Chapter 11, is how one reconciles that state of existence with the ability to obtain debt financing in the marketplace. If you have in theory, a fully leveraged a company and an unyielding first lien lender, it's very hard under existing standards to prime that lender in order to achieve DIP financing. I assume the segment of the people you speak for who are active in the DIP markets would like greater access to opportunities to provide DIP loans. In the same respect secured creditors, in general, are in favor of the preservation if not the enhancement of secured creditor rights for existing lenders. If you have any thoughts on how the Commission can reconcile those two problems and those competing interests.

Basta: Again, I apologize. That type of question is just out of the realm of what I do day-to-day.

Keach: That’s why I gave you the opportunity to the punt, but all of your fellow-witnesses who are listening can remember that question because I'll ask them that later as well. Any other questions for this witness? We appreciate your patience with the questions, and also your testimony. Thank you.

Basta: Thank you very much.

Keach: Thank you. I think we are not going to go hear from A.J. Murphy and Lee Shaiman.

AJ Murphy: Good afternoon. To echo the previous comments, thank you very much for giving me the opportunity to address you today. My name is A.J. Murphy, and I'm the Co-Head of Global Leverage Finance at Bank of America Merrill Lynch. As part of that I run the origination of syndication, distribution efforts for all of our leveraged lending and high-yield bond origination.

I wanted to spend a few minutes talking about the importance in the par loan market and the original issuance of debt of secured credit to issuers in the non-investment grade market. To set the stage for a minute, I want to just say that what we are here talking about is generally non-investment grade debt, where obviously the proliferation of the use of secured debt exists. I will be talking not exclusively about leverage loans, but also about secured bonds to the point that was raised since clearly they’ve become a much bigger part of the market than they were a few years ago.

The first thing I want to say about the leverage loan market is that the loans in particular for any non-investment grade issuer are pretty much 100% in a secured market. Whether you're talking about banks or whether you're talking about the institutional lenders, they all looking for security in order to be part of the loan market. There are significant advantages to issuers to issuing into that market, so while some enter that market because they need the additional capital, others do because of the terms of that debt relative to what they might find in the bond market.

Most notably, interest rates on leverage loans are meaningfully lower than the high-yield bond market and, as importantly, the repayment of that debt is at par at any time, so in the first several years of a high-yield bond you're generally looking at a call price in the 120 cents on the dollar, per hundred dollars, loans again, are pre-paid at par. This is a choice that a lot of issuers make which is to get a lower cost of funding with more flexibility around the prepayment provisions.

The key point here that I'd like to make is that these two markets, the bond market and the bank market are additive to one another, but I don’t think we can assume that the participants on the institutional lender side for the leverage loan market would necessarily fall into the high-yield bond market were the leveraged loan market to not exist on a secured basis.

To say it differently, I think it's important to think about investors as existing along a continuum of risk, where different ones clearly have different risk appetites. The recovery values that we were pointing to earlier are just meaningfully different so people are willing to take a lower return, to take the risk given how much lower it has been historically. There is just the suitability factor, that if you what the people in the leverage loan market are willing to do and looking to do, it is simply that they often have lower risk tolerance.

The two things that would happen, if in fact, we were to move away from securing as much as we do in that loan market, is that you would have a shallower market for non-investment grade issuers and that we would have fewer dollars available and the prices would be higher, because of the fact that you would clearly have fewer people to borrow from.

I think that’s important because we have to remember that these are companies that are, again, being rated speculative grade. Non-investment grade means it's not of the grade of making an investment, so when you're buying that kind of debt you clearly need to know that you're going to have certain protections or you have to be ready to take a lot of risks. I think that when we think about what these companies need, many of these companies are growing companies, and many are still in a mode of their existence where they're going to be ramping up, where they're going to be hiring people, where they're going to be adding facilities, things like that.

The growth capital is important and having more capital available to them because there are different ways to access it by affording more protections to certain lenders, simply means more dollars available to these issuers. The next point from there I just want to make is that, again, it's often a choice on a menu that these issuers are looking for at the outset; they want to have different options as to how to set up their capital structure.

With that point I would say we'll get into the topic for a second, of the secured bond market. If I can just address that now, because I think the question is coming. What I would say is that in the period of 2008 and 2009 the leverage loan market, all but shut down. It was clearly a market that was built on a leveraged buyer given the low interest rate afforded in that market, but the high recovery values and the CLOs, et cetera, there's clearly a highly-leveraged component.

When the market and the world was deleveraging in the '08 timeframe, that market had a freeze, as I think everybody knows. The high-yield bond market is a market that’s more or less devoid of levered players and most people are buying straight up on a levered basis, because of that, that market was healthier, it was more efficient in that '08, '09 timeframe than the loan market. You could see that through the issuance slides that came earlier, where you saw the relative issuance and the loans just stopped on the leverage loan side.

There were many an issuer who needed to refinance debt because they had maturities or who simply needed to access capital for other reasons, and their options were pretty limited. Risk tolerance was a lot lower and there was a lot more reticence, understandably, on the part of investors to enter into these speculative grade markets.

The way to get those investors comfortable and, again, in many cases they were replacing bank loans, was in fact, to offer them security in a preferred position. Again, it was not always company-driven, so a lot of it was the market themselves. Some of these were pretty healthy companies, but for them to get an efficient cost of capital in a time when high-yield index which right now yields 6.5%, was in the high teens or twenties, buying down that rate was important. Offering that security was important and in many cases, you weren’t actually increasing the secured debt multiple that was … it wasn’t an additive secured debt as much as it was a replacement of loans for bonds.

I would say to get to that part of your question for a second, in more cases than not, I would say in most cases the first thing, the secured bond market tends to be a replacement of what would otherwise be bank debt, because even with what's now a far healthier bank market than what we had in 2008, there is still not the size and depth of market that we had when CLO issuance was at its peak back in the 2006 timeframe.

Sorry for that diversion I figured we would just hit that early.

I think the bottom line here is that for these markets, these secured markets for leveraged to exist for people to be able to issue into that, they need to know that they're going to have certain rights and protection afforded to them, if in fact a bankruptcy situation or a restructuring situation, more often the case, comes along. A few evidences of the sensitivity of investors around are we … The business that we run is a global business and what I see is there are jurisdictions where I can't sell secured debt because investors are not confident that those jurisdictions have a sound bankruptcy code.

There are countries where bankers will come to us and say, can we make a secured loan to this company that’s located in … I don’t want to name them out, but the bad countries, and I have to say I don’t think so because lenders stay away from that. They don’t think that they are afforded appropriate rights, they think it's a very weak Bankruptcy Code and therefore they don’t lend into it.

We do see some case studies around the world in places where they don’t seem to have appropriate protection. The bottom line here is, we are talking about getting these issuers as much access to capital as is available to them, so that they can operate their balance sheets and grow their businesses. Repay their debt as things change, and to give them the ability to, again, have a menu of options around that.

With that, since think we are going to cover some of the same territory, I will turn it over to Lee.

Lee Shaiman: Thank you, A.J. Good afternoon. My name is Lee Shaiman, I'm the Managing Director with Debt Funds Group of GSO Capital Partners, a division of the Blackstone Group. I oversee the management of portfolios and senior secured bank loans, high-yield bond and mezzanine debt securities that are held by CLOs, mutual funds and separately managed accounts.

Our investment clients represent a broad spectrum of the investment community, including domestic and foreign banks, insurance companies, pension funds, sovereign wealth funds, other fiduciaries and individual investors. GSO currently has approximately $55 billion under management and is one of the largest investor participants in the corporate loan market today.

I'm grateful to the Commission for the opportunity to testify regarding these important issues. I understand that the Commission is considering reforms to Chapter 11 of the Bankruptcy Code and would significantly curtail the rights of secured lenders generally, and holders of secured debt purchased in the secondary market, and this is why I'm here today. While I applaud the Commission's goal of preserving businesses, I share the concerned voice earlier by Ms. Murphy that such contemplated reforms would seriously impair the functioning of the capital markets, and thus be harmful to both businesses in and out of bankruptcy, as well as to investors.

I would like to underscore how such reforms would profoundly affect investor decision to purchase corporate debt, and could ultimately drive certain investors out of the market completely. This would dramatically reduce the availability of capital to non-investment grade companies, thereby raising the cost of borrowed capital.

First: diluting the protection of secured creditors' rights in bankruptcy will, in our opinion, result in the contraction of credit markets and an increase in the cost of credit. Capital markets, as Ms. Murphy explained, operate on a risk continuum that runs from the most highly secured debt at one end to the most speculative equity investment at the other. The price and availability of capital turns in large part on where an investment lies in that continuum.

My clients' strategies are centered on secured lending. When purchasing secured debt on behalf of our clients we first assess the borrower's financial health. Our analysis includes the sustainability of the company's earnings, its ability to pay its debts as and when they become due, and the availability of future credit if the borrower will rely on such credit, such as through refinancing to help it meet its obligations going forward.

The main goal of course is to lend to borrowers that do not get into trouble in the first place, but be able to repay its indebtedness out of revenues generated by business operations. We do understand, however, and we have the experience that no matter how robust our underwriting process is, a certain number of firms will not be able to pay their debts as they become due. These firms will either dissolve or seek to restructure with or without a judicial oversight. It is for that reason that we as secured lenders look to the enforceability of security interests as critical to the decision to lend to such companies in the first instance.

A borrower's risks are generally assessed and priced at the front end; that is when the loan is initially made. It is at that point that a lender determines the price of credit where the return that compensates the lender for the risk it is taking in advancing that loan. When a borrower can pledge security a lender is generally more willing to take on additional credit risks, because the lender believes that it will recover at least the value of the collateral pledged by the borrower if the borrower is unable to make repayment of the loan.

Indeed, through the past four credit cycles, as Ted showed earlier today, recoveries on defaulted secured bank loans have averaged around 80%, and medium recoveries have been significantly higher than that. Borrowers who are thus able to draw more credit and more attractive pricing as a result of those outcomes, without reliable, enforceable security interests lenders will charge more as compensations for the greater risks they face in making the loan. I believe that many lenders will not participate in a lending market if those outcomes had been different.

I invest debt on behalf of my clients on the expectation that our investment funds will be paid in full or receive the value of collateral pledged as a backstop against loan losses. Reforms that would eliminate or introduce uncertainty regarding the benefit of that bargain have the potential to harm capital markets in several ways.

First, such changes to the law would affect the ability to price the loan and find investors on the front end. For example, it would be difficult to price senior secured debt that can be segregated if the borrower reorganizes. Uncertainty as to whether a security interest would be enforceable in bankruptcy, when questionably make borrowing, particularly for these low-investment grade companies, significantly more expansive as lenders need to be compensated for the additional legal risk. Those risks are real.

Second, lessening the protections historically according to secured lenders … creditors, with reduced investor participation in the corporate loan market, and we'll reduce capital available to that market going forward. Lenders will not be willing to lend as much as they were unless they believed in the recoveries against the collateral which they viewed available to them on the frontend.

Third, changes would increase the cost of credit in light of the additional risks flowing from the possibility that the security interest would not be enforceable in bankruptcy. I point to the example that A.J. gave us earlier about other jurisdictions where these … either enforceability is unclear, or the ability to take collateral is nonexistent. The ability of those companies in those jurisdictions to finance is much more limited than it is here in the United States. Simply, those investors willing to go forward will demand higher credit spreads for the greater perceived of loss.

Fourth, such changes would alienate more risk-averse lenders potentially causing them to exit the market altogether. Having recently completed fundraising for a third mutual fund, I can tell you first hand, that investors consider the pledge or corporate assets to be an essential element in their decision to invest in funds that purchase sub-investment grade corporate debt.

Fifth, such changes will dramatically diminish the flow of capital to non-investment grade companies for all sorts of corporate purposes, thus limiting a company's potential for growth. I believe that the greater selling point for investors and non-investment grade companies is that those companies pledge their assets to secure this debit. If these security interests were rendered unenforceable many, probably most investors would not invest in non-investment grade companies, which could reduce the market by billions of dollars leaving only a fraction of the capital currently available to those companies, and thus limiting growth prospects and raising borrowing cost significantly.

The next point I'd like to make and it s equally important to my clients, is the soundness of the secondary market for both performing and distressed debt, the availability of these markets creates liquidity for the investor, thus making credit more broadly available to borrowers.

Lenders also take the secondary market into consideration when making loans in the first instance, and they rely on liquid secondary markets. These investments are made specifically with the understanding that they may be sold later. Most primary market lenders are not interested in, or are not able by their terms, to hold distressed debt, and as we noted before, in spite of the best analysis, companies' fortunes do change.

Reforms restricting primary investor ability to sell in the event of the borrowers' financial distress are making it less desirable for investors in the secondary market to buy such debt will increase the overall risk of primary lending. It will thereby decrease the number of investors in the capital markets and, again, drive up the cost of credit.

Another example, mutual funds must provide daily liquidity to their shareholders by way of daily redemption. The secondary market is the only mechanism to provide those funds with the cash liquidity to meet the requirement to redeem shares. To frame this issue for the commission mutual funds and exchange-traded funds currently hold over $80 billion of sub-investment grade senior loans. These funds will be forced to liquidate or cease operations if secondary markets were not able to help these funds meet redemption needs.

In short, bankruptcy reform will not affect bankruptcy alone. Weakening the protections available to secured creditors, reducing the recovery of holders of debt bought on the secondary market, will have a profound and a negative effect on the availability and price of credit, particularly extended to non-investment grade companies. Such companies could see their access to capital markets vanish, and see their ability to continue to run and grow their businesses vanish with it. That means fewer businesses, fewer jobs, something that we can ill afford in these especially difficult times.

Thank you.

Keach: Thank you. We are going to take questions from the Commission. The Chair recognizes Ms. Whyte.

Bettina Whyte:

Thank you. Mr. Shaiman, Ms. Murphy, we appreciate your papers and your thoughts, certainly well done, but I think there is some confusion. I don’t believe that the Commission is suggesting or recommending in any way that the reforms being instigated would curtail the rights of secured lenders and holders of debt purchased in the secondary markets. That’s number one.

Nor are we recommending diluting the protections that secured credit rights and bankruptcy, and that seems to be a premise of both of your papers, and that is not recommended. I think those not being recommended, and is not the purpose. I think there may be some confusion because of the way the mission statement of the Commission has been written, and I want to try to clarify that. What is says is that "The use of secured credit, the growth of distressed debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code will be studied."

We are not saying that there should be any curtailment of it, that there should be any curtailment of the credit capabilities or rights of the secured creditor, we are saying that this is not … these kinds of debts and the kinds of situations we see in bankruptcy today are very different than what we saw when the code was written originally.

I want to try to make that clear, and if there is any other Commissioners who'd like to add on to what I say or correct me if they think I'm wrong, but I don’t think that’s … at least my opinion, I do not believe that’s what we are trying to do, is curtail your rights.

Keach: Before I recognize the point, yeah, I would summarize this way. We are not actually considering any specific reforms at the moment. The title of this Commission is important; it's a Commission to study things. This is one of the first days of study, and we are anxious to take in this information. We are, frankly, very appreciative of the connections you’ve made between what we might do as a Commission, or we might recommend as a Commission on a broader market because those are important considerations.

I wouldn’t go so far as to say that we are not going to do any specific thing about anything. I can only tell you we haven’t considered anything yet. We are entirely in the information-gathering mode and that’s why we are here today. To the extent there's any belief, in general, that we have pre-decided anything, I can tell you we haven’t. I can tell you that the interest of secured credit has some very strong advocates on the Commission, so you shouldn’t feel as if you're not well represented. We are going to take all those issues into consideration, but at this point we haven’t chosen to do, or to not do anything. I would put it probably more generally than Bettina has, but I would make that point.

With that, let me recognize Mr. Brandt.

Brandt: Thank you, Mr. Keach. I can't help but think you’ve confused us with the debtors lobby. (laughter). I for one, apart from the work I do on this Commission, am starting my third term as the Chair of the Illinois Finance Authority, the nation's largest State-sponsored bond issuing agency.

I note, when you gave your presentation, and when Mr. Keach and others who had spoken earlier that, when the code was created in 1978 we didn’t have computers, we didn’t have cell phones. Many of the markets you're describing didn’t even exist until the 1990s. We like to joke among ourselves who are in the bankruptcy business that Rule 3001, when it was changed in 1991 to allow for the simplified exchange to claim information, has spawned a market that none of us could have envisioned.

For the same reason, here we are 40 years on, you have a variety of capital markets that we think are terribly important to this country. I for one, at the IFA, deal with them every day. I issue up to $30 billion of bonds a year for the IFA. You’ve got a wide variation and representation of people on this Commission but there is an issue about balancing the equities.

One of the things that drives our thought process, and we are here to study only, is the fact that commercial credit markets are radically changed since the 1978 Code was introduced. The process of reorganization and preserving jobs and doing the rest of it, seems to have changed as well, and most of us, as we say in the trade today, appear to be doing nothing more most days than moving the mettle. That is a quick 360 sale which does preserve jobs in the business and I'm the first one to agree with that; but it defeats the long-term proposition of what many of us originally considered was a reorganization.

One of the things I think we are here to do, is not at all to dissuade or defer or diminish the capacity of the capital markets to do something that was unheard of in 1978, and that is to contribute to a vibrant economy. We do need to look at the equities. I was once told that the essence of bankruptcy was a process of balancing the equities.

To some of us the equity seems a bit imbalanced at this point, that does not mean that the rule of law will be violated which is, Ms. Murphy, I assume what you mean when you discussed "bad countries," there has to be predictability in the system, we get it; the Bankruptcy Code offers predictability. All we are here to do at this point is to study should that predictability and the structure within it be updated some 40 years on.

Keach: The Chair recognizes Mr. Miller.

Miller: With that background and that information … about what the Commission is doing or intends to do, I would be interested in, what is your recommendation, you and your clients, as to what the Bankruptcy Law should provide with respect to secured creditors?

The arguments that you make are very familiar to the same arguments that were made in connection with derivatives, and the liquidity of that market and how important that market was to the economy, and the consequence is essentially those are exempted from bankruptcy jurisdiction.

Is that something that you are endorsing?

Shaiman: Are you asking if we are endorsing putting limits or restrictions on…?

Miller: -- how the bankruptcy court deals with secured debt. Maybe a secured debt should not be dealt with in the bankruptcy court. Maybe the balance of the equities that Bill is referring to is no longer a prevailing principle. The world has changed a lot. Businesses are conducted in different ways. What would you recommend that this Commission consider adopting or recommending?

Murphy: I think what I would say is, we are most focused on, and we did not mean to address any particular outlines, set of points, because we didn’t think that there were any either. What we are trying to point out is that what makes the secured markets as broad and deep and accessible as they are right now we think is, in large part, a shared belief amongst lenders that they have a pretty good sense of how the process is going to play out. I think they think they know going into an investment what the rules will be, what rights they're buying effectively through a process, and there's a predictability that they're able to count on as to how they'll be treated.

We would advocate a set of … if in fact you were to rewrite the Code, not to have a particularly weaker set of rights afforded to those lenders, because we do think that the size and depth of these markets are in large part a function of them feeling as protected as they are now. We think an non-intended consequence of changing the protections, I understand the balance of equity, certainly, but I do think the particular balance that it is right now, we could agree or disagree on who it's weighted toward, is a very direct input into the size of the market that is available to these types of issuers. I'm not sure that that’s a specific recommendation, but…

Miller: Are you satisfied that there is certainty under the current version of the law?

Murphy: I am not and I will say … and everyone in this entire room, nobody knows less about bankruptcy than me; for the sake of clarity. (laughter)

Miller: No, Jack is here, no need to worry.

(Laughter)

Lee S: There could be more certainty in the process. In terms of reform, I think issues to bring even greater certainty to the process is important, and I think as you develop those ideas, and I don’t have any number of specific recommendations or guidelines or guardrails, but they should avoid these potential unintended consequences.

They should also not take the consideration of a small number of companies that end up in a process to have an enormous impact on lots of other thriving businesses who benefit greatly from more open capital markets. The availability of capital, the availability of relatively inexpensive capital, when you think about it, versus the risks that are available, that are taken on by lenders who don’t have an equity stake, or only get principal and an interest when due as a good outcome, and then as a bad outcome they lose money.

Miller: Your recommendation is this Commission should consider even strengthening the rights of secured creditors and in aid of predictability to protect this market?

Shaiman: I think the Commission should consider any reforms or changes that make the system very clear, understandable and predictable for investors or lenders who are making decisions on the front end, so that they have clarity as to what the decision tree may be and it helps price that debt.

Murphy: Transparency, I think, is probably a common, shared goal here, and an ability to have a sense of how this would in fact play out, because from my seat where we are putting together a debt package it gets a lot harder when we start doing a lot of guess work on how certain types provisions would be treated in a bankruptcy court. Obviously we are on the way frontend, but we know that our investors are going to be focused on, how would that situation play out? How would that term play out? This particular package, the way it's written, the inter-creditor.

There's a lot of guesswork involved, so I think we would say there is plenty that could be done to enhance clarity and to enhance predictability, because that’s the basis that people make decisions to invest on, and how to price risks. We are very much in favor of things that make that all the more clear and prescribed. I understand that’s a very difficult job, but I do think that it's a major premise of investors when they go in, and we see it firsthand all the time when we are selling debt.

People are trying to guess where something ends, and that’s the basis for how they put terms together and price, and the years of maturity, and all that sort of thing. The more we can do to take the guesswork out of it, it can only mean more efficient and fairly-priced markets.

Keach: Thank you. Mr. Butler.

Butler: Thank you. First an observation and back to some of the questions that I had earlier that I'd like to get some more of your views on.

First; and I think it's important, that we emphasize, because I think it was actually presented a little bit differently in your testimony. That the Commission views its mission through a dual prism, which is to balance the effective reorganization of business debtors, which would include job preservation and expansion of jobs, with the maximization and realization of asset values for all creditors and stakeholders. It's a dual objective, mission, that we have here.

I think it would be a mistake to assume that the Commission is focused on one and not the other. I think we are focused on both, and I think that means that over the next several years we are engaged in a discussion, and I can say how appreciative I am of getting this feedback and input. Of having a discussion about how to balance those two issues; and not in just a balancing of the equities, as Mr. Brandt talks about, because that can be less predictable. Actually in a system that is more predictable, because I presume that if it is predictable people can price it and decide whether they want to be involved in it.

Murphy: Exactly.

Butler: The question is, as we think about that, how do we think about … and I'm trying to understand how you think about what's evolved over the 25 to 30 years. Starting off there, would you agree with Chairman Keach's observation? That the use of secured credit over the last 25 years has increased, not decreased? Would you agree with that in terms of … about the use of secured credit?

Murphy: Yeah.

Shaiman: The use of debt financing overall has increased and the markets have increased to provide that, but …

Murphy: The leverage markets exist in a way now that they didn’t exist 25 years ago, so as I mentioned earlier, if we look at loans that are issued for corporates across the country, it's only the non-investment grade guys who use secured credit. I don’t think the access to the markets … even if you go back to the late '90s, the non-investment grade bond market was $50 billion, this year it will be 300s, and we are on such a different scale that we look at it a little bit more in percentages of leveraged debt rates, but it's hard to compare … There's a market, to the point I made, I think with Mr. Brandt earlier, that there's a market that exists now that didn’t used to exist. By definition secured creditors is used far more, but we are probably focusing a little bit on some of the shifts on how it's used in probably the last 10 years, more so than, I think, I think the 30 before that are all the same and it wasn't used a lot.

Butler: Let's focus on that then, because I think our focus for the moment in this conversation is non-investment grade companies.

Murphy: Right.

Butler: So let's look at that part of the market, and in that portion of the market, would you agree that there has been a transfer, or an increased use of secured debt versus high-yield unsecured debt, say, over the last 10 years?

Murphy: I don’t know that I would, I would not agree with that, because I think…

Shaiman: If you look at capital structures 10 years back and the ratios of senior secured debt to subordinated debt I would suspect that, in general, that those capital structures are not dramatically different.

Murphy: That’s right. If I think about the kind of … let's call the time since 2001, because that’s when things really took off, I think, in the leverage markets. I would say that as the CLO formation picked up in that '02, '03, '04, '05 heading into '06 timeframe, that was probably when you had the most availability to the lowest cost and most flexible secured debt, that really fell off meaningfully when you hit the crisis time.

What I would say is, we've definitely seen an increase in percentages of debt raised in the high-yield bond that’s secured, so you're probably talking about 25% of the high-yield bond market having any kind of security around it back in '06. Today you're in the low 30s, and we peaked about 34-35% number, so it definitely picked up by about 10% during that period of time, and it was noticeable because the debt overall in the bond market was down then, so it felt like there were so many bond issuers in there, and there were because that was how you raised capital.

I would I would say that the other side of that equation was there was no loans being issued for the most part, so the secured bonds in no way filled the hole that was left behind by the loans that were not being raised. The loan market has been recovering pretty steadily, more or less, for the last three years now, but I don’t know that we are back to where we were in that Golden Day of the CLO. Now CLOs in the past six months have ramped up meaningfully, but still a long way to go before we are where we were. What you have now is a lot more cross-ownership between the asset classes, unsecured and secured, and that’s its own whole topic, obviously, but I don’t think that the lenders are lending more secured debt as a proportion to where they were than they were 10 years ago, in a meaningful fashion.

Butler: How do you see things over the next, say, three to five years looking forward from your seats? In terms of having investors in the high-yield bonds having learned that they can get high-yield bond with security. I think we'd all agree 10 years ago wasn’t the norm, and they did it during the high-stressed period of the last four or five years. Having now learned that approach and having that now in your toolkit. As you look forward over the next five years, do you see the markets normalizing back to the way they used to be, so that percentage would come down? Or do you expect the fact that there's a new normal here in terms of the use of high yields per debt?

Murphy: It's been coming down, it's been coming down. It's a tool in the toolkit for sure that people didn’t think about pre-crisis, but at the end of the day most issuers that I deal with want to, especially in this interest rate environment, and that’s a big component here to be sure, but most guys would like to go as far out as they can on an attractive base, but with the most flexibility.

A lot of issuers are … the percentages of secured debt as the markets improved have, in fact, gone done. Senior unsecured loans are meaningfully more flexible in terms of what you're able to do in the future, so in a good interest rate environment most issuers, and I can't say all, but most issuers would say, because even senior unsecured rates are pretty attractive right now, the differential of what I'm going to save, which we could probably call 150 basis points to go secured, is not worthwhile, because I do think, going back to the previous question, that secured debt is finite in terms of the capacity in your capital structure. How much markets, overall, are going to lend to you, whether it's bond or bank on a secured basis, it's capped.

It's capped on the bank loan agreements that exist, it's capped in other bonds in the structure and it's capped in with what the market is willing to do, so because that that, trading off the giving of security to buy down your rate, we don’t see it that much. People tend to use it more when they need to buy down their rate for covenants, or because their rates are very high, or because it's their only way they can access capital. In a good market it's a tool that you use when you need it, very few issuers do it just because it saves them money, we don’t see that very often.

Shaiman: I also think that AJ made, it was a subtle but a very important point, and I think some of what brings us to the forefront right now is we are in an interest rate environment, the absolute term structure of interest rates is so low, it's the lowest in any of our lifetimes, even Mr. Miller's lifetime.

(Laughter)

Shaiman: We have not … and this is causing companies, corporate managements of your corporate treasurer, if you don’t fix out in this interest rate environment to the extent that you have a need for long-term debt in your capital structure, you're an idiot because rates are so low. Part of that is, rather … and I think AJ said it earlier, and I completely agree with this point, to some degree, these are substitutable asset classes, if you will.

There is an absolute level of security that is available whether the market determines that in a given situation, in a given company. Or whether … there is an absolute level at which you can give security above which the security is worthless and it dilutes the value of the security. Today corporate treasurers are saying, "I'm in this for the long term," maybe it's not an LBO where they're looking to foot the company in two, three, four years, "I want a 10-year fixed rate, 5.5% coupon debt, and I'm willing to give security for that because I don’t need that security for my banks."

Corporate treasurers and corporate managements are making those decisions and those tradeoffs every day, and I think, tell me where interest rates are going to be in three years and I'll … my suspicion is they will be higher than they are, then you will see this phenomena start to fall away and it will return more and more…

Murphy: We are saying that.

Shaiman: … a normal bank loan market. We look at, and those of us again, you talk about right here, those of us who've around a while, there was a phenomenon of first mortgage bonds.

You rarely see first mortgage bonds anymore, but that was secured lending, and it was because in the very high interest rate environment that we had in the Reagan Administration when Volcker wrung out at inflation. A lot of companies do buy down rate; they did first mortgage bonds to reduce the coupon. You see these techniques, they're not new; they come back from time to time. It depends on the conditions in the marketplace.

Butler: One last follow-up question, we are short on time.

Keach: Real quick because we've got to move on.

Butler: The last question I had about this is to come back to the first question I'd asked earlier which is, if you assume for a moment that most … it's just assume for the moment, that most midcap companies that show in Chapter 11 have no equity value and no value in their unsecured debt, they are claims on security. If you assume that, a much larger percentage of larger cap companies have the same phenomenon, that’s what's showing in bankruptcy court these days.

How should the Commission think about that change from … because that is a change over the last 10, 20, 30, 40 years; how should the Commission think about that as it relates to all of the other stakeholders? By other stakeholders I'll mention the ones I mentioned earlier; trade debt, landlords, employees, pension plans and other categories and classes of unsecured debt. How should the Commission think about that, if at all, in terms of what recommendations or thoughts that you have? Should funded debt just have that preference period, or do think there should be some…?

Murphy: The question you asked a tad earlier was; is it better to be a secured lender than an unsecured lender. That’s…

Butler: No, Mr. Miller asked that question. I asked this question.

Murphy: I think the answer is … the way that I see this when you think about various classes of debt within the structure, whether it's trade claims, et cetera, and some of those people willingly enter their spots and some ended up there obviously. The way that I think about that is, when a company decides … to some previous point, that they're going to go out and they're going to issue secured debt because they have to, or because they want to, or because it's the most attractive form of debt out there, they're going to put security against it and buy down their interest rate by many hundreds of basis points.

They're going to do away with call protection so that they call it out for free anytime, versus paying big make wholes. They're going to have a different set of conditions around that. It's hard to say that companies can do that and get all those things which are very, very borrower-friendly, and things that they want, and then have them end up in a … Later we are actually looking at everybody, maybe they don’t want to give those guys that kind of preference. I don’t know how you get around that, you make some promises, and offer some things out in order to get something back. You have to, I think, be thinking about all of those other stakeholders when you're doing it and the consequences that may come subsequently.

Shaiman: It really goes to Mr. Brandt's point, which is that brings the equity question into it, and that makes your job extraordinarily difficult, because when the company has come to us as secured lenders they’ve given security, they’ve made a bargain at a price that presumes that we have much less risk and in fact, the option to abrogate that debt or abrogate those claims against the assets of the company that render them unenforceable.

Where's the equity to us as lenders? We've lost our money, we've lost our claims, the company has used the money, the company has used the money, they may have made mistakes with it, obviously the equity is going to suffer, but other constituents have also benefited during pendency of that borrowing period.

Keach: We will agree with you there, the job is difficult. One of the difficult parts is we now have to go onto the next panel, but we thank you very much for your thoughtful papers…

Shaiman: Thank you.

Keach: …and your testimony. Thank you.

Keach: We are going to skip the break because we are running so late, and when you're done, if you need [COE 01:28:28] remember to sign up again; or if you’ve come in late, to sign.

Keach: We are going to continue on with no break, so stay tuned. We are now going to hear from Professors Altman and Hotchkiss. Thank you. Without further delay Professors Altman and Hotchkiss.

Ed Altman: Thank you. Thank you very much. I was told that I have five minutes for my testimony, and I've been timing some of the others, and my wife can attest to the fact that I practiced good and hard to get it down to five minutes and 23 seconds. I'm going to try to keep to that rather read the whole testimony, and hopefully, the essence of what we've said comes through.

First of all, I'm Ed Altman and I'm the Max L. Heine Professor of Finance at the NYU Stern School of Business, where I've been on the Finance Faculty for 47 years.

During these almost five decades I've been a student, a researcher, consultant on U.S. Corporate Bankruptcy Process and the Associated Financial Markets, including the high-yield bond market and the distressed debt markets, and had the privilege of testifying before the Congressional Bankruptcy Commissions for the 1978 and the 2005 Revisions.

It's an honor for me to testify again before this distinguished ABI Commission today. I'm pleased to discuss with you the scope and importance of the development of the distressed debt market and to summarize several scholarly publications that I and others have contributed to the better understanding of these markets, and the importance that they have played in our financial economic system.

I was fortunate to have been commissioned to prepare a series of white papers on the distressed debt market in 1990 and 1992. That provided the original analysis to the development of the Altman-Kuehne Indexes, one of the most well-known and respected benchmarks of these securities. I have some tables that are not that important really to show on the screen, but they just show the growth of that index over time.

I estimate that there are, today, well over 200 financial institutions investing between $350 and $400 billion in a distressed debt market in the United States. Interestingly, it has been observed that the corporate bond market becomes more liquid and volume increases as the firm becomes distressed and especially at the time that it defaults and soon thereafter.

Figure three in my testimony shows the calculations of the annual amounts of bankruptcy liabilities for Chapter 11 filings, from 1989 to 2012, and I think you have that in my testimony, so again we don’t need to see it, I guess, directly.

These filings and the liabilities thereof total a staggering $3 trillion approximately over that period of time, requiring substantial efforts on the part of debtors and creditors and their advisors to be restructured so that the debtor can attempt to emerge from the process as a going concern.

In my opinion, the combined efforts of the bankruptcy law profession and the restructuring specialist along with the coincident growth of institutional investors and broker dealers have enabled this enormous amount of debt and defaulted debt to be restructured reasonably effectively.

All parties involved can now continuously and clearly observe the market's assessment of the debtors' liabilities, so as to determine whether to sell or retain their interests. Those prices also provide important benchmarks for negotiations. This enhanced price discovery and easy transfers, compared to the pre-1991 experience, helped to provide a more liquid market for the debt as the debtor worked its way through the restructuring.

Price discovery also makes markets more efficient and provides important benchmarks for the future recovery value of those securities, and also of the debtor.

In one of my studies we found that bank loan prices provide an even earlier warning that a firm is likely to default on corporate bonds, enabling creditors to monetize their holdings before values decrease even further, and to motivate restructuring efforts earlier than would be the case if those markets were less developed.

Figure four in the testimony, shows our estimate of the size of the defaulted and distressed debt market from 1990 to 2012. Data includes public and private debt, both market and face values. As far as I know, we are the only analyst providing these statistics. These amounts have totaled close to $1 trillion each year since 2000 and more than that figure since 2008. I want to make that clear, that’s not $1 trillion new debt each year, but the total amount outstanding.

These dynamics have provided the incentive for a special breed of investors experienced in distressed investing, as mentioned earlier, providing a potential outlet for original investors to monetize their troubled assets over a period that can stress from a year or more before bankruptcy filing, lasting throughout the duration of the bankruptcy process.

This liquidity is crucial to other investors who do not have the resources or expertise to hold their claims through the resolution of the reorganization. Very briefly, Hotchkiss and Mooradian, Edie Hotchkiss is going to be testifying next, investigated the role of distressed investors and the governance and reorganization of a sample of 288 firms that defaulted on their public debt. I think Edie will summarize her findings. My own observations and experience tend to support these findings, although I didn’t do a formal study like she has.

We also conducted the first study on the performance of new equity in the post-reorganization period. We analyzed the stock return performance of 131 firms emerging from Chapter 11 over the period 1980 to 1993 for 200 days post emergence, we found consistent evidence of significant abnormal excess returns averaging about 28% excess return. Results from such of these studies helped to motivate distressed investors to provide needed financing to the firms exiting Chapter 11. I don’t think we discussed exit financing very much at this point, and I think it's an important issue to discuss.

In summary, in my opinion the role of capital markets and that of the distressed investors had an important and generally positive impact on the U.S. bankruptcy reorganization process. Thank you very much.

Keach: Thank you. Professor Hotchkiss?

Edith Hotchkiss:

My name is Edie Hotchkiss and I'm a Finance Professor in the Carroll School of Management at Boston College, and as much as I hate to admit it, I've been working in various aspects of debt markets since the early 1980s, and since the early 1990s have been working as an Academic Researcher in this area. A lot of my work has had to do with attempting to measure the efficiency of the Chapter 11 process.

First of all, I'm very honored to be able speak with you today and also, equally honored to be sitting here next to Ed Altman, I think this is the first time since I was a graduate student at NYU that this has actually happened, so that’s an honor as well.

Altman: Me too.

Hotchkiss: Thanks. My objective today, and I had laid out in the written testimony four key points that I think academic evidence can speak to and I'm going to try and summarize those for you today. It's bit of a daunting task to try and summarize kind of detailed data analysis for you in this way, but I'll give it my best shot.

These are all issues that I think the academic evidence can help us move from the anecdotes that you'll hear on either side to the broader large sample empirical evidence that will give you perhaps a better view of the bigger picture of things. Overall, my reading of my own work in the related literature is that the secondary market which, trading claims of distressed companies, the role of secured financing and so on, has a very positive role in the bankruptcy process especially when we start to look at measures of efficiency, of outcomes, which I'll get in a little bit, oversight of the process, impact on corporate governance, and so on.

I'm going to step you through each of these four points and I do have them on slides so I'll try and describe them as best as I can. The first line of research I'd like to point out, it's at the issue and documents for you the extreme consolidation of claims that occurs through the claims trading process and bankruptcy. That consolidation of claims we can empirically associate with improved measures of efficiency or improved outcomes.

My first entry into looking at those aspects of the market was really motivated by the growth in the secondary market, trading that started in the early 1990s and what we did was a comprehensive study of all firms that had defaulted on public debt up to that point and try to characterize the activities of the investors, the distressed debt investors at that point.

Just very roughly, what we were finding was that these distressed debt investors at that point would invest in all levels of the capital structure, frequently would show up having at least one-third of a particular claim showing their influence. Very often became the equity holders of reorganized company, but overall had a significant influence on the restructuring process itself. Remember, this is back, occurring mostly in the early 1990s. To us at the time the level of activity especially related to governance was strikingly high, somewhere around 60% of the firms we looked at had this type of control activity going on.

If I fast-forward a little bit, I'll come back to some of the governance aspects, in a recent follow-on study some other colleagues have published in Journal of Finance, one of the top academic journals, they bring us up-to-date where we are today in terms of that market, but their focus is much more on the hedge fund involvement.

They found some … what I find fascinating results, the hedge fund involvement leads to higher CEO turnover, higher likelihood that you have a loss of exclusivity, and I think that points to the disciplining role that these outside investors can play in the process.

They also find that senior lenders, when they … or hedge funds, often … or actually empirically it's associated with higher recoveries for even the junior claimants. It's suggestive that this disciplining role is having a positive impact on the overall valuation of these companies as well.

Lastly, I'll point one other recent study, also funded by an ABI grant, which I think is very unique, in that the only researchers today that they work with the claims paying agents … the claims agents to be able to do this. They're the only researchers today that have been able to construct, for a large sample of firms, a snapshot of what the ownership look at the time of filing, and a snapshot of what the ownership looks like at voting on a plan. They can trace the consolidation of claims, they can see exactly who the owners are, they can document that hedge funds are the largest net buyers of these claims during the process. They take that one step further and relate to outcomes of the cases and, again, find higher likelihoods that firms will emerge as a going concern.

More incidents of pre-packs and so on so, again, point is to improve deficiency measures. I know I've described a lot of information here but I think the picture you get going from my initial study on down the line here, is that this activist investor behavior seems to be positively related to measures that we would use to indicate efficiency of the process. The likelihood the firms survives as a growing concern, pre-packs, less time in bankruptcy, recovery rates and so on. That was the first key point.

The second point I wanted to make and this is not based on my own research but is based on research of one of my colleagues, is that senior lenders have an important role in governance of companies, very, very early in the decline of our firm. There's a particularly interesting study that I've cited in the testimony that looks at what happens to companies around covenant violations. This is something that only be done with today's technology. They do searches, text searches through all the electronic filings, and basically it's the universe of all public filing companies that have ever defaulted on financial covenant.

It's very interesting in that respect to observe that, but what they find is when firms violate covenants very quickly you see reductions in CapEx, reductions in leverage, reductions in shareholders payouts, increases in the CEO turnover, which I find particularly interesting because it's, again, indicating this disciplining role of these … in this case the senior lenders.

Again, taking that further, what they show is that kind of intervention is empirically associated with improvements in operating performance, improvement in stock performance. In other words it's associated with turnarounds of these companies. That early governance influence -- it's been speculated more anecdotally by some of the legal researches -- but here it shows you in this very comprehensive way, I think the positive effects of that intervention.

The other aspects that some of this research shows, and much of this was brought up in the earlier testimony, if we look at the sources of financing as firms decline the increasing use of secured financing and, again, in some of my own work as we look at what happens when firms are renegotiating well before bankruptcy, much stricter terms being imposed on the company. You could view that as part of the necessity of continuing to extend credit to these companies as they're starting to decline. If the alternative would be terminating a credit agreement, failing to be able to provide capital to these companies as they're starting to decline, that’s probably something that very clearly would impair the firm's values.

The next point; and I'm going to step back to my original study of the role of distressed-debt investors in governance activities. The backdrop for my comments here are … I guess go back even further to my original work back when I was at NYU, where I was looking at the performance of companies that have emerged from Chapter 11. One thing, again, was very striking at the time, but I looked at a very large sample of public companies emerging from bankruptcy, and to us it was very striking that such a vast proportion of firms emerge from Chapter 11 and continue to experience operating losses.

The statistics that I had at the time were, 40% of the companies, public companies that emerge from bankruptcy by the early 1990 or so continue to experience operating losses. We know from the data that we have that the incidence of the so-called Chapter 22 cases continue beyond that, so what I found fascinating about one of our … the study I mentioned earlier that, again, Professor Altman cited. That looking at the activities of these distressed debt investors, what we were finding was the window where you did see firms that performed better after bankruptcy were the cases where the hedged funds were, at that point, distressed debt investors became active in the governance of the companies.

In contrast to the overall not so stellar-looking performance, we did see a lot of improvement there, and it does seem to be through this governance channel that the cases where you saw this better post-bankruptcy performance were the ones where these investors had taken positions on Boards, so it assumed management had controlling ownership stakes and so on. Very often they then would remain as long-term investors in these companies for several years following bankruptcy.

Going back and reviewing all of this, there's, I'll say, a broad literature outside our markets looking at the role of hedge funds and other activist investors and equity markets, and in preparing my testimony I went back and took a look at a lot of that as well. It's interesting that you see a very parallel picture there, that when you start to look at changes in firm values, stock performance and so on, these activist investors, again, seem to have a positive influence there, looking in the body of literature.

The last point that I'd like to make, I think this is really the most readily observable of the four points that I laid out in my testimony, but perhaps what academics can contribute here is we can put some percentages and statistics on these things that we see going on.

This is the fact that you see senior lenders providing other services to these companies as they become distressed. For example, there was obviously discussion earlier about provision of DIP financing, less discussed was these existing lenders to the company also providing exit financing to the companies who emerge in bankruptcy. Also providing funding for plans of reorganization, in other words, adding value to the process that probably extends beyond what you would expect based on their initial stake as you enter the organization.

Overall, I guess my take on the process, and I'll step away from testimony a little bit. I as an academic was not so motivated or aware of the specific agendas of any one party in terms of reforming a process, but if I look at how the academic, but legal and finance literatures progressed over time, early on the concern was too much control in the hands of debtor, and there was a lot of reaction to that. Then more recently we see reaction, well maybe things have gone the other direction, and it's at the top of the capital structure, the senior lenders that have too much control.

I think what's emerging from the research that we are seeing here is that you can't view it as a fixed pie, that you're balancing senior versus junior and figuring out how to divide it up. The bigger issue here is that as some of these players have gotten involved over time, it's increasing the size of the pie. Even when you have things that potentially are in the interest of senior lenders, or other claimants; if they're overall enhancing the value of the company at the same time, we also see beneficial effects to the much lower creditors, junior creditors and shareholders and so on.

That’s like a 30,000 feet view of very large academic literature. I hope I did a halfway reasonable job trying to explain that in a very short timeframe.

Keach: You did. Thanks. We are going to … we have time for a couple questions. Deb, go ahead.

Williamson: First of all, I'm trying to understand a phrase that you used, Ed. You used the phrase, "restructured reasonably effectively" , do you see that the same as "going concern"?

Altman: Do I see it as --?

Williamson: Are you using that term interchangeably with … because you also make reference to "a going concern restructuring," do you see going concern as being the equivalent of "restructured reasonably effectively"?

Altman: I think … by the way, I saw your comment on that, it's a very good one to clarify the going concern issue, and also provides some fairly deep-rooted concern I have with the bankruptcy process as it now is. That is the fact that when I mean by going concern, I really mean the long-term going concern. What I'm very concerned with also is the fact that companies come out of bankruptcy and they're able to survive but not very long, and then they go back into bankruptcy one or more times afterwards. I'm talking more the long-term going concern.

Effectively … the reason why I used the adjective "reasonably effectively" is that I think that overall the bankruptcy process in the United States Chapter 11 system is the best in the world. However, it's not perfect, and I know you're trying to think of ways to make it better and I think the efforts are really commendable and I wouldn’t say long overdue, but certainly appropriate of this time.

What I'm concerned is the fact that when I said reasonably as opposed to always effectively restructuring, is that too often firms come out of bankruptcy with too much debt, that they haven’t cured the operational problems, and they're probably operating in markets today when there's too many firms, and they shouldn’t be operating at all.

Now, I know that this is … and I've spoken about this with bankruptcy judges, and with lawyers, and it's not a very popular point of view, but I think the Chapter 22 issue is a serious one to consider, and whether or not we can solve it through judicious legislation, that’s why I used the term "reasonably" as opposed "effectively," that was my basis for that.

Keach: Let me just follow up with that for a second, because I think this goes to some degree, to both of your comments. One about the impact of certain players in the process, and secondly about whether we are using Chapter 11 effectively to fix companies in ways that don’t require repeat filings, because I think there's a tension between those two things. There certainly are aspects of the bankruptcy literature and you see this frankly in the case law much as anything, so some of the people speaking about this are judges not just academics and lawyers.

That is, that one of the reasons we have companies that are not completely fixed that need to be fixed again so quickly, is that certain players, and this is usually laid at the feet of senior secured debt, are pushing the process too rapidly. In other words, the process is filed and engineered the first time around to fix a particular balance sheet issue but not to fix the operational issues in the company.

I'm not adopting that premise, I'm telling you that’s a premise that people put there. Would you speak to that, because I think that goes to your point Professor Altman, but it also addresses, I think, your point Professor Hotchkiss, of the impact of certain players in the process?

Altman: Let me start and then it over to Edie. First of all, the Chapter 22 phenomenon is not simply the last couple of years, and it's not been since 2005. We've had recidivism … we did a study going back to 1984 and it's fairly consistent over long periods of time, and of course you’ve had more Chapter 22s in 2009, because there were so many more bankruptcies, and you had it again, large numbers, in 2001 and 2002 when we had the all-time high default rate.

I don’t think this is a modern phenomenon of the Chapter 22 process. I personally think that the decision as to whether or not a firm comes out of bankruptcy is one that is not contested by anyone if there's agreement on the part of all creditors. Maybe that’s the role of the process, I'm just saying I think that the most recent situation, particularly in industries like retailing, somewhat a function of the 2005 Code which went too far afield in the form of protecting creditors, and it's also a function of the marketplace. I think Wal-Mart is far more important as a reason for a retail firm filing Chapter 22 than any other reason although they're contributing factors.

I could be wrong about certain companies that are being forced more quickly to deal with the leases are a problem, and maybe that can be fixed and probably should be.

Keach: I'm told we've got to move on, but I want to give Professor Hotchkiss a chance to add to that personally.

Hotchkiss: I'll just point to one other thing, and like my very first study which was looking at the reasonableness of management projections ex post and then also looking at the incidences of second filings, and one of the things I saw there was that the worst offenders were the cases where management hadn't been replaced by the time the reorganization plans were proposed. I think it ties into, how do you bring oversight into the process.

You could make a … the second part of your point, you could make a similar criticism of distressed exchanges, and you could in pre-packs and their fixing balance sheet within the operations, but we also, especially recently, see a large incidents of cases where pre-packs were quick reorganizations are coupled with the change in control. There, I think you are seeing more of the substantial change in the direction of the business or the company at the same time. I don’t think you can single out just the speed of the process as the best indicator.

Keach: Okay, Harvey, quickly then.

Miller: Thank you very much, it's enlightening, but you got me totally confused. Professor Hotchkiss, you say the introduction of hedge funds and other traders, make the process more effective, more efficient and more successful. Professor Altman talks about Chapter 22s. In the last 10 to 15 years, creditors' committees have been much more powerful. Governance has changed dramatically. These companies that are coming out of Chapter 11 have plans designed by the debt holders, by the hedge funds, and the reason they have too much debt coming out, and their over-leveraged coming out, is because that’s what the creditors want. Hedge funds and other distressed debt traders are afraid there's going to be a second bankruptcy and they don’t want to be equity holders the second time.

Now people buy debt for one or two reasons. They think they're going to make money, and that means in the short term. Or, they're after the fulcrum security and they want to get control of the entity, and you would think these people would be very careful about making sure the company is not overleveraged. The fact of the matter, if you take Hostess Brands, the distressed debt traders and senior lenders wanted a lot of debt, so we have a Chapter 22.

I don’t know how you get to the conclusion that this makes it more effective and more efficient. In the pre-pack era in the '90s pre-packs were all over the place. Most of the pre-packs were overleveraged, and that’s where you ended up with the first Chapter 11. That’s what the creditors want, so in that context, I'm not sure I understand your conclusion.

Hotchkiss: The earlier study we had done where, I agree with you, there's a lot firms emerging over-levered and so on, but what we did find was the ones where one of these activists investors had gained a controlling state, they did perform better, and they did have lower incidences of subsequent filings, so…

Miller: In general … the general trend was Chapter 22s, we had 33s, I think we had a couple of 44s…

Hotchkiss: Right, so…

Miller: … and Professor Altman points out, when you get to the confirmation hearing, these creditors who are supposed to be very interested, they join hands with the debtor and sing "We shall overcome" and there's no opposition, and you can't expect the Bankruptcy Judge to come down off the bench and test the feasibility.

Altman: By the way, Harvey, there was a study done in 1990 by Gilson, Kosejohn and Lang which found the issue of unsuccessful Chapter 11s was the issuance of too much debt, even then. This has been a chronic problem…

Miller: And they were traders then also.

Altman: Sorry?

Miller: There were traders in the business then also.

Altman: Yes they were but I don’t think … I mean your comment that the secured creditors are now controlling the process, that implies that things have changed so much since the '78 Act, that it's time to do something about it. The evidence is that even in 1990 this was the case.

Miller: No. I'm not saying we should do something to rebalance it or something, maybe the solution is that Chapter 11 doesn’t work. Maybe we should just enforce contracts. What lenders want is the benefit of the bargain, and we spend a lot of money creating these long instruments, and within these instruments are whole procedures at what happens on default. Maybe that’s a better and efficient system than going through bankruptcy with … and you say bankruptcy is very expensive. I think it's relatively cheap, but that’s beside the point. Maybe that’s the solution, maybe there shouldn’t have a debtor in possession. Maybe we should have the election of trustee by creditors. Is that something that would make it more efficient?

Altman: I don’t think so, Harvey. I don’t think you can [crosstalk]…

Miller: My point of it is…

Altman: … I don’t think you can say that.

Miller: At least you can't say it to me. You can't say that distressed debt trading makes the process more effective, more efficient. It make the process a lot faster because those who buy claims want to trap that profit in, and get that profit. I don’t know if you’ve done a study, how long do they hold the claims, if they're not going after the fulcrum security?

Altman: Well they have… Go ahead.

Hotchkiss: If they're not, then we have no way to know.

Keach: With that, because I do get to say to Harvey, we have to move. We do have to move on briefly. I want to thank you very much.

Altman: Thank you.

Keach: For your thoughtful studies and your thoughtful papers. To the extent that you feel compelled to add to that, and you would like to submit it to us we would love to have you do that. If you'd like to answer these questions in writing with more time, we would love to receive it as well. We thank you very much for your time today, and for your written papers. Thank you.

I think we are now going to hear from Mr. Kamensky and Mr. Greene, if I'm not mistaken. This is the last panel, so those of you stay till the end get stars. Whenever you're ready.

John Greene:

Thanks. Members of the Commission, my name is John Greene. I'm the Managing Principal and Partner at Halcyon Asset Management, LLC, where I've focused on distressed investing for the last 10 years. Halcyon and its affiliates have over $10 billion of assets under management. We manage capital for a diverse group of investors including leading pension funds, endowments, foundations… excuse me while I reorganize myself here … and high net worth individuals throughout the world. I have more than 13 years experience in distressed investment.

Prior to joining Halcyon in 2002 I worked as a distressed analyst at J.P. Morgan Chase. On behalf of Halcyon I appreciate the opportunity to express our views on the importance of vibrant capital markets in the U.S. bankruptcy process, and the potential adverse ramifications of certain reforms to Chapter 11, that I understand could potentially be considered, and I've read in other academic literature.

The U.S. bankruptcy regime is superior to any other in the world. It offers substantially greater flexibility, transparency and certainty. These qualities result in reduced transaction and bankruptcy cost and encourage broad participation in the system. Any changes to Chapter 11 that undermine these qualities will impair the functioning of the capital markets, and the reorganization process.

Distressed investors pay an important role in the bankruptcy process by providing liquidity and capital to companies in distress, and a market for such companies' debt securities. The benefit of the stressed investor participation is not limited to providing liquidity and capital. This participation can improve enterprise value through operational, financial and governance reforms. This, in turn, proves the viability of distressed companies, and preserves jobs.

The role of distressed investors begins long before the reorganization process and continues long after. I like to call it, The Lifecycle of a Distressed Company. As you know a wide range of parties participate in capital markets, each with varying risk profiles ranging from over-secured debt to speculative equity investments.

This variety in risk appetite is beneficial to borrowers at all stages of the company's lifecycle, particularly during times of financial distress. A borrower's credit risk is typically priced in the primary market as a result of the relative value of the secondary market. However, as circumstances change and the 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 that know that a ready market exists in which they can sell their holdings. Of course, lower credit costs benefit the entire economy. In addition to varying degrees of risk tolerance, some original debt holders of distressed companies are unwilling or unable to hold defaulted securities or loans. Often banks, insurance companies or pension funds may have to sell owing to investment guidelines for regulatory reasons, or liquidity demands.

Highly-functioning liquid markets for distressed securities ensure top prices for these sellers. For distressed companies the continuing functioning of capital markets and participation of distressed investors in those markets before, during and after the commencement of the bankruptcy case is critical.

There is no bankruptcy timeout for companies' need to access the capital markets. Specifically the capital markets provide a company with debt refinancing opportunities before, during and after bankruptcy, often under circumstances where the primary markets are no longer willing to extend credit. Chief among these opportunities is debtor-in-possession financing which provides liquidity during pendency of a bankruptcy case.

Another example that is typically unique to distressed investors is their ability to offer new money equity to facilitate an exit. The result is continued operations, job preservation and the maximization of value for all stakeholders. Distressed investors can facilitate the company's restructuring by providing restructuring of a counterparty with skin in the game with which management can negotiate. Because of their familiarity with the bankruptcy process, distressed investors acting as principals generally are the ones with the appetite and willingness to make long-term investments of time and money. Upon emergence from bankruptcy, reorganized companies have newly minted securities.

The capital markets and specifically distressed investors create a market for these securities thereby both building and establishing value for the reorganized company. This backend completes the lifecycle of the distressed company. Any amendments to the Bankruptcy Code that will eliminate or weaken parties' ability to enforce their legal rights upon a company's bankruptcy filing is ill advised and will harm, not improve, the company's ability to successfully reorganize in bankruptcy.

The most disastrous form of interference in the capital markets will be to limit the free trading of claims of distressed companies. Such amendment of the Bankruptcy Code would have an immediate adverse consequence for the capital markets as a whole, and to free market economies in general. Among potential unintended consequences would be increased difficulty for regulated financial institutions to remove problem or toxic assets from their books, and deny those entities the ability to deploy their capital more efficiently and, presumably, for the benefit of the economy as a whole.

In short, the efficient functioning of capital markets is itself necessary to the success of the organizations. Actions that undermine robust claims trading will thus have an adverse consequence on the ability of distressed companies to reorganize. This will, in turn, impair the flexibility of the U.S. economy to deal with problem assets.

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 is committed to working constructively with the Commission regarding any proposed amendments to the Bankruptcy Code. Thank you.

Keach: Thank you. Dan?

Dan Kamensky:

Thank you. I'm keeping everyone from drinks, so I will try and make this brief. Members of the Commission…

Keach: I'm going to ask you some questions so we'll keep them longer.

(Laughter)

Kamensky: Members of the Commission, my name is Dan Kamensky, and I'm honored to be here. I'm a Partner at Paulson & Company, and I want to thank you for the opportunity to address you today. I'm here today in my role as Chairman of the Bankruptcy & Creditors' Rights Group, of the Managed Funds Association.

I'd like to convey our views on the importance of financial creditors to the bankruptcy process and how the Bankruptcy Code can better facilitate active involvement by those creditors.

The MFA believes that active participation by hedge funds in bankruptcy is beneficial. We believe that it leads to the successful reorganization of companies and decreases the probability of liquidation. Their participation helps maximize value for all stakeholders including creditors, shareholders, employees, and helps preserve jobs.

Specifically, hedge funds, unlike other investors, are uniquely equipped to provide debtors with the capital they may need to emerge from bankruptcy. This function is particularly important now in today's market since many commercial banks are no longer in the business of investing on a principal basis, which will be especially the case after Dodd-Frank, and many traditional investors are not set out to provide capital to a distressed company.

As investors, hedge funds are also uniquely equipped to take an active role in providing a check and balance over management, and during the bankruptcy process, and after the company emerges. Oftentimes, hedge fund members sit on post-effective date Boards of Directors and become long-term stakeholders giving them a vested interest in the company's success. At the same time, yes, investors may sell their investment. This provides liquidity; this is a benefit to the bankruptcy process because it provides price transparency and exit strategy for other creditors.

In sum, we believe that increased participation by distressed investors in the bankruptcy is a positive development that should be encouraged. I speak from personal experience having participated in 11 out of the 15 largest bankruptcies during this cycle. We have provided billions of dollars through us and our investment partners in companies to help them reorganize. We consider it a core part of our principle investing. Fundamentally we believe that steps should be taken in four discreet categories to facilitate the active engagement of financial investors.

First, creating consistent and well-defined rules of the road; second, promoting the equality of treatment among similarly-situated creditors. Third, promoting liquidity and capital investment, and fourth, increasing transparency, management and Board accountability, and improving the flow of information to creditors.

I'd like to speak briefly about one of our suggestions relating to company oversight and accountability. Commissioner Keach asked, "Why reform now?" From the perspective of investors in the marketplace, we believe that the bankruptcy process has been largely successful, and has allowed companies to reorganize successfully and avoid liquidation, particularly where the members in our group have been involved. But we believe that that bankruptcy has not evolved sufficiently to provide adequate oversight and accountability from management, and its professionals since the enactment of the modern day Chapter 11 in 1978.

We believe that this can lead to distrust by creditors, particular financial investors regarding the decisions made by management and the Board concerning the future of the company. We believe this is a particular problem since it's often these creditors that will become the new owners of the company upon its emergence in bankruptcy.

We are reminded of the debate that occurred during the 1970s prior to the enactment of the modern day Code. At that time under the old Chapter 10, trustee appointments were mandatory to protect the public investor from machinations of corporate insiders.

The 1978 amendments sought to strike a better balance between oversight under the old practice and the new debtor-in-possession model by implementing a new program to oversee the appointment of trustees while allowing management to remain in place. We believe that the blueprint for the 1978 amendments has not been followed, and that the pendulum needs to swing back to strike a better balance between oversight and management discretion.

Under the current model, prepetition management retains control of the company even if it was their poor judgment that led the company to file for bankruptcy. Management, in turn, continues to report to a prepetition Board of Directors that was elected by, generally, out-of-the-money equity. This means that decision regarding the case and the future of the company, are made by individuals who may have little or no financial stake in a reorganized company. We believe that this invites management entrenchment with the interest of the company and its professionals differing substantially from the interest of all stakeholders including creditor and employees.

In our written submission we offer a variety of suggestions. I think 20 in total that try to strike a better balance. Some that seek a greater role for creditors, some that seek to change the current dynamic of official committees, but all that seek to provide for a better reorganization process.

In conclusion, I'd like to thank the Commission on behalf of the MFA for allowing us to present our views on these matters. We are committed to working constructively with the Commission regarding the future of the bankruptcy process and we look forward to our further engagement on these matters.

Keach: Dan, thank you. I trust there are some questions, I know I have one, but let me ask it since it goes on some of your last comments, which is about governance. You referred to the debate that preceded the '78 Code and goes back even farther than that, and that is there's a fair amount of belief including some literature, I think, to back it up, that says that if you design a Bankruptcy Code where management is automatically displaced, for example, by a trustee, as is true in some non-U.S. regimes, you invent a Bankruptcy Code that nobody will voluntarily use.

In other words, management would seldom choose to file a case to displace itself. Number one, I'd like your thoughts on that premise, and number two, given that premise, how would you design a system that would take into account your concerns about governance, but would be one that people would voluntarily use?

Kamensky: We fundamentally believe in the alignment of incentives; that shareholders should not only be seen but heard. That’s true outside of bankruptcy and it's true in bankruptcy. The problem in bankruptcy is that you don’t have that alignment of incentives, so we need to come up with a system that strikes a better balance to allow for creditors to not only be seen, but heard in the bankruptcy process.

For the most part, we are very happy with the current system, we don’t advocate going back to, when you refer to the debate, going back to the 1930s. In our view, we don't say, we should go back to that time, we'd say that under the current regime there needs to be some changes, and thoughtful changes that we want the Commission to consider. With respect to the appointment of trustees, we don’t believe that the appointment of trustees has been given its due. If you look at the standards within the various circuits, it's very difficult for a trustee to be appointed.

To your point at the beginning of this hearing, we need to look at today's marketplace and at least from the perspective of our members who represent billions and billions of dollars of capital that flows into the marketplace who are continual investors in these processes. The experience of these investors is that the bankruptcy process has a number of elements that act as an element of entrenchment. We would suggest the Commission look at some of the suggestions we've made to strike a better balance to give creditors faith in that process that they can participate knowing that if they become the economic stakeholders, they'll have a voice that will be heard.

Keach: A really quick follow-up because it goes to the same point, which is the governance point, and that is, there is, I think some conventional wisdom around the idea that … and I offer this to both panelist, would like your views. There's some, I think, conventional wisdom around the idea that what's occurring more frequently is that you essentially have what amounts to an ad hoc trustee appointment by the pre-bankruptcy or immediately post-bankruptcy selection of Chief Restructuring Office, often at the behest of senior debt.

Number one, I'd like you to comment on whether or not you think that’s a phenomenon that’s as extensive as some would suggest? Secondly whether or not that is an answer to part of your problem or is that a solution to your problem, or is that part of the problem?

Kamesky: It's a little bit of both which makes, I think, the Commission's work very difficult in this area, because we discuss this among our membership, and there's certainly the cases when bringing in a CRO benefits the enterprise. However, depending on who appoints the CRO, to your question, it can be that the CRO acts as an element of entrenchment for management.

From our perspective we think there needs to be more of a neutral party that makes those decisions, and I think you'll see a theme in our written statement that we think that the role of the U.S. Trustee should be expanded in this regard. They are the ones who appoints the official committee, and if we are going to have a gate-keeper function, it goes back to the original thesis that many of you on the dias discussed going back to the 1978 Code, which is the appropriate role of the various parties in the process.

I think for the process to have credibility around issues of management entrenchment, the Commission should consider having more of a neutral party be the one that helps make those decisions.

Keach: Let me go to Mr. Seery, first because he hasn’t had a chance yet.

Seery: I think that this question can go to either of you, but it was in the MFA presentation that Mr. Kamensky set forth. It really deals with the exit and management compensation, and it was an interesting point you raised with respect to having the new Board determine management's compensation. I wonder if you'd thought about that, and aren't the creditors now involved in a sufficient way of proving management compensation? Or do you feel that that’s really part of the self-entrenchment as well?

Kamensky: Thank you for that question. One of the risks of the process that many creditors confront is that the incentives that management have may not often be aligned to maximization of value, and with respect to management compensation which has been an issue of extreme public interest, and have been subject to change in the 2005 Code, one area where our members felt that there has been abuse, and where I think many professionals have experienced this in bankruptcy cases, is that management compensation and the compensation of the post-effective date Board of Directors becomes an element within the plan negotiations that could be used as leverage to allocate value amongst different creditor classes. We think as the MFA, discussion around post-effective date management compensation, in particular, should be a matter for the post-effective date Board, to take that out of the negotiation process amongst the creditors.

We think it does not align management with maximizing value for the entire enterprise, and we think that would better serve the creditors who will be choosing under our construct who that Board will be to be responsible for determining management comp on a going forward basis.

Greene: If I could just add to that too. I think that’s one of those … one of the items that you have to do in a restructuring, and that ends up getting tagged in a sort of the eleventh hour, or very late in the process at least. From my perspective, it's not always just about reallocating among individual creditor constituencies, but from … I have some experience in seeing large amounts of value leak out from the entire enterprise system to that.

A lot of times there's not an effective check and balance to that because that whole process is squished at the end, and I think that that goes to what Dan was saying about accountability and alignment of interest.

Seery: It may not surprise you that a number of practitioners tell me it's not the last thing that management thinks of.

Kamensky: I was going to say that, to add to John's point, sometimes it's purely a gating function. We've been involved with restructurings where the first item management wants to negotiate is their ongoing compensation; and unfortunately that becomes a gating item to even get into the room to discuss with management the terms of a plan.

Our view is, we think that doesn’t help the process, so we are trying to come up with a proposal for the Commission to consider because we believe that there's no reason why management compensation necessarily has to be part of that plan negotiation.

Keach: Jack, did you have a question?

Butler: Yeah. I wanted to move to the testimony that both of you gave in your written testimony on net operating losses. Your testimony seems to acknowledge that operating losses are in fact, a viable asset of the estate and should be protected. The question is; what's the mechanism? I know, Mr. Kamensky, in your testimony on behalf of the MFA, you suggested that it could be resolved simply through dealing with an amendment to the Internal Revenue Code, which is well beyond the scope of the work of this Commission, and I don’t know if we want to leave the fate of reorganization and whatever happens to that Code.

I want to ask you if you have any insight or suggestions about whether you think, for example, the NOL protection process should be codified in the Bankruptcy Code as opposed to let … it be the law or the case, from case to case? Or if you have … maybe what you're concerned about, which is overbroad orders be entered on a case-by-case basis. Do either of you have any thoughts about how to protect the asset which in some cases is worth hundreds of millions and even more to reorganizing a company?

Kamensky: I think I'll take first stab at that question. I actually Co-Chair with the LSTA, the NOL Working Committee, I think together with Jim, back in '05 and '06, they came up with the Model Order. The problem with NOL orders is not just that they're overbroad, but even if they're properly drafted, it creates enormous uncertainty for the marketplace because they're extraordinarily complex because the rules themselves are extraordinarily complex.

The rules themselves are very difficult to tailor an NOL order to. You think about the benefits of the NOLs to the company, those should be preserved. The context of having specific provisions that would apply in bankruptcy makes perfect sense, but we don’t think that the provisions within the tax code, properly take into account how important debt trading is to the liquidity of the capital markets.

The other point that we make in our papers is that, in your hypothetical, you put aside the overbroad versions, but oftentimes, even if you need to get the consent of management to go over 5% because that’s oftentimes in the model orders, management can use that as a gating function as to who can buy or sell their securities, and that creates a double-standard between what investors are entitled to inside bankruptcy and outside of bankruptcy.

For us fundamentally we believe that in order to address those issues, again, we do think that the Commission within its broad mandate should be able to make suggestions to Congress, not only that would affect the Bankruptcy Code, but provisions specifically within the Tax Code, '05 and '05 exceptions, that are meant to address bankruptcy, and we would suggest the Senate Finance Report suggestion, in terms of the Safe Harbor, would be a better balance between the need of the capital markets for liquidity and the need for companies to preserve their NOLs.

Keach: We appreciate your confidence. I think we maybe have less chance of influencing tax policy than the two participants in last night's debate. I know the time is running a bit short, and Judge Gonzalez, you had a question?

Arthur Gonzalez

I guess there's two parts. One is an observation. In the 15 or so years I spent on the bench, that experience led me to be quite surprised by your comment that you believed the issues you raised about management entrenchment, because it seemed to me over those years that more and more of the prepetition creditor constituency as we see the debt today, has great influence on the management prior to the filing. That somewhat surprised me where I sat as a Bankruptcy Judge. The question I had is, how do you envision, or would you envision the role of the U.S. Trustee acting as a neutral in this process?

I ask that question from one, having been a U.S. Trustee, and two, feeling then and feeling now deficient in an ability to make business judgments about what goes on inside a company, as a government official that (A) doesn’t have the expertise, (B) Doesn’t have the funding to do it, and finding themselves usually being severely criticized for interjecting themselves into a process in which they have no place in the boardroom, so to speak, as the negotiations go on throughout a case. Then just to jump in the middle and make a judgment as to what should go on.

Kamensky: We do believe that, with respect to the first part of your question, Judge Gonzalez, we do think that there are enormous parts that happen in a bankruptcy case that are not apparent to judges in the courtroom. The judges don’t see what happens in terms of the tradeoffs that happen in that negotiation, they don’t see the proverbial sausage as it's being made.

I think one of benefits that our group can bring to this process is to give you our collective experiences that we bring having been the party as the economic stakeholders responsible for being involved with or excluded from some of those decisions. I want to share that as our observation as a group having discussed it and thought about our collective experience.

In terms of how the Commission weighs that experience with the recommendations it makes to the Code, what we say is that there needs to be some change in the pendulum. That the pendulum has swung too far in terms of alignment of interests. The suggestions we made, we think, are fairly tailored to accomplish that goal.

For example, the two suggestions we made, and I would I just say, in light of the fact that the other change here is that because financial creditors are oftentimes either unwilling or unable to participate on official creditor committees, that the process of who should provide that oversight function is now a bit, I think, an open question that the Commission will have to answer.

We do make suggestions about how the official committees may not have a role in certain cases given the increase in secured debt, but at the same time, the Commission has to take into account there needs to have an oversight. How we answer that question is that we say, in certain cases where there is a misalignment of interest, that there needs to be a gatekeeper function to make sure that the Board continues to be responsive to its stakeholders.

We think the U.S. Trustee is perfectly able to act in that function with input from creditors in terms of appointing additional members to the Board of Directors. Oftentimes, the major issue of the Board of Directors in bankruptcy is that it's no longer an active Board of Directors. That is not in the interest of creditors who want to see an active Board.

The second thing that we suggest is in certain cases, that the U.S. Trustee be entitled to appoint a trustee with the input of creditors. We think that the balance that was struck in 1978 was a balance that asked for more circumstances in which U.S. Trustees were appointed. We think in cases and that would be in the benefit of all creditors, that could better align the incentives, but we leave that balance to the Commission to strike.

Keach: We are way over … I'm going to take the last one.

Miller: What do you envision is the role … in your perception, what is the role of the debtor-in-possession?

Kamensky: We largely believe in the debtor-in-possession, and so what we've tried to do is tailor some specific recommendations that we think that are tailored. There are cases unfortunately, and I think we would all admit that we have experienced them working in this area for a period of time, where sometimes you don’t have an active Board. Sometimes the Board is not looking out for the interest of the stakeholders.

There's currently no mechanism because official committees may not … I understand your comment before Harvey, that they're more powerful now, but they may not themselves represent really what economics stakeholders want. What we are saying is that the Commission is part of what it should look at how to better address that issue. We do think our suggestions are fairly tailored to try and do that.

We aren't saying to go back to the old trustee mandatory appointment, we are saying that there needs to be an expansion of that role, and we do believe that the U.S. Trustee is well positioned to do that.

To Judge Gonzalez's comment, when we have had discussions with the U.S. Trustee, we actually believe that the U.S. Trustee has a very good knowledge of the marketplace, and one of the things that I think our group can play a good role in is acting as a place where the U.S. Trustee can get input from the marketplace which maybe hasn’t happened historically.

Keach: Dan, let me follow up on the governance point, and also on a comment I think you made on the way by, which is that often investors are unable or willing, usually because of a desire, I think to continue to trade to sit on statutory committees that may be restricted in that respect.

Also, given the capacity of the investors to form very effective well-funded ad hoc committees, what's your position on whether or not statutory creditors' committee should be mandatory in all cases? If they're not mandatory, as they are now, assuming willingness to serve, what standard would you substitute?

Kamensky: In our written statement we do say there are circumstances which official committee should be mandatory. The example that we provide is … one of the examples that the Commission has been very focused on is where you have a very over-levered capital structure and the committees role is simply to provide some litigation value for out of the money stakeholders. We don’t think that really serves the purpose.

With respect to your other question about getting active involvement on the official committees, and the role of ad hoc committees, again that is one of the limitations in the current construct, is that, as you’ve said at the beginning we are where we are today, which we have an active secondary market comprised of hedge funds who are primarily public investors. Those investors will be the ultimate stakeholders in the company and frankly will be the ones to provide oversight and accountability for management.

That is one reason why we think there needs to be some changes to the current system to ensure that there's alignment because of the fact that committees sometimes don’t play that role.

We have further suggestions in that regard that we've discussed within our group, and they it may make sense for us to follow up with a written statement about further ways in which the Commission should consider the role of committees.

Keach: We will invite that but…

Greene: As I mentioned, you might ask me, if I think active involvement by creditors is a good thing, and if ad hoc is a good thing, and those investors are putting their money where their mouth is. Both in terms of their principal invested and also in fees going forward paying for those cases.

Another thing that we mentioned before in terms of creditors unwilling to serve on official committees, I'd like to address that a little bit too. I think that, first of all, it's not just trading restrictions, I think it's also a fiduciary duty obligations. Those can be problematic for some people, and some people don’t want to take that role on and that’s an added liability and can create conflicts for some people. I think that the other suggestion I was going to say is I think that part of that official committee is broken, and if you had … and the whole idea is, typically when you go and have a bilateral negotiation and have it worked out, outside of the context of the official committee, you go and get restricted for some period of time. Hopefully you negotiate a deal or not, and then there's release of some useful information and then everyone goes free on the same ground and then they can move on their merry way. Hopefully there's somebody … we'll see how it goes. I think if you…

Keach: You're talking about purges of non-public information?

Greene: Correct, yes, exactly. Otherwise knows conflict provisions. I think that that could be another effective way to improve the input of creditors and have it function better than that, and actually have a better two-way flow and keep it on the same footing.

Keach: Thank you. I'm not sure we have time to explore that completely. I sometimes wonder why a debtor-in-position would ever want frankly to purge non-public info it didn’t have to purge, but that’s a question for a different day.

Greene: You have the disclosure statement then, that’s ultimately what it is. I don’t know, you're only talking about a matter of timing, because that information will come out at one point or another. At one point you're going to have to have a successful restructuring for the debtor to come out of bankruptcy, so it's really that’s same information you're going to put out anyway. I understand but…

Keach No, no. Timing could be important. Again I can get, and we probably don’t have time to do it. Ms. Williamson gets the last question.

Williamson: I think it's not a question, it's a request, we are running out of time. It's a request. One of the issues that you give the appearance and we know it's not always the case that creditors speak with a voice, and we know that the creditors can speak with multiple voices even in the same tranche of debt or the same issuance of debt. I would appreciate, and I think the rest of the Commission would as well, address the issue for us of standing of the … I'm going to call it the rouge group, and that’s not the right word.

The standing of minority holders of debt in bankruptcy cases, there are allegations that they make it more expensive. You hear words like hostage and things of that type. I'm not being pejorative, I'm just asking a question. What's the position of the MFA? What's the position on dealing with the standing of that type of sub-group of creditors in a bankruptcy case?

Kamensky: Thank you for that question.

Keach: Either in or out of the money?

Williamson: Yes, either in or out.

Kamensky: Thank you for that question, we received that in advance and we appreciate that. From the MFA's perspective and we understand there's been case law on both sides of this issue. We do believe that everyone should have a fair opportunity to be heard, and we don’t think that it's necessarily appropriate to preclude on standing grounds rather than substantively address their underlying issues.

Even though that might create an additional burden within the process, we do think that the better balance is to allow creditors to be heard, and if it's the case that their substantive grounds don’t have any merit, we'd much rather those decided on the merit rather than say, you don’t have your day in court.

Williamson: Is that for creditors in the money?

Kamensky: No, we wouldn’t make any distinction. We would say that with respect to some of the case law, and I believe Judge Chapman's recent decision, we would probably say that the Commission should probably reconsider it even though we have great respect for Judge Chapman. The reason for that is, we think that it doesn’t provide the right credibility and legitimacy in terms of the process. That from our perspective, even if it creates some additional burdens, we would argue that it's outweighed by the benefit of letting everyone be heard in terms of the process.

Williamson: Thank you.

Butler: Since that wasn’t a question, I have a last one?

Keach: As long as you promise you'll be brief.

Butler: I'll be brief. On that point two things I'm going to make it a two-part question but really quickly.

Keach: This is a really two-part question?

Butler: Correct.

Keach: Okay.

Butler: Really brief two-part. Didn't your last response to Ms. Williamson suggest that … you're suggesting that some creditors ought to have more rights in bankruptcy than they have outside, because if they’ve signed it in a credit agreement or they’ve signed a loan agreement, or they’ve signed up in an indenture, in which they have contracted their right to do things to the whole, to the agent, to a required group, to some set whatever, outside of bankruptcy. You're saying that anybody ought to be able to come up inside bankruptcy and say whatever they want. I'd like you to explain why you think that?

The second piece of it is, because I found your testimony quite compelling, but it didn’t address the issue of day traders. You talked about how the investors can make a meaningful difference, but you didn’t talk about the investors that are here for a day, not for a year or two years; who come in to influence a trading price so they can make a little money and go someplace else. Perfectly legitimate motive, but those people wouldn’t be doing some of the things that your testimony suggest they would be doing.

Keach: Pure claims arbitrage versus…?

Butler: Yeah, and so I just wanted … if you could address those two points.

Kamensky: Thank you. I think, again, those are two very good questions. First, with respect to your first question about standing, for us standing shouldn’t be used as a substantive waiver of someone's rights to be heard. It may well be in an inter-creditor agreement, a stakeholder has agreed that they will not object, they will not be heard, they will consent on certain issues.

From our perspective if that creditor wants to come into court and say to the Judge, "Judge, we object because we believe X, Y and Z," we believe that the creditor should be heard. On a substantive matter the Judge may well say, and we believe that contract should be enforced; you knowingly waived your rights.

But we don’t believe that the person shouldn’t even have a right to be heard by the court. We think the person should have right to be heard and on the substantive issue, if the person waived those rights and the contract says so, then that can be waived.

With respect to your second question about day traders, as I said in my testimony that oftentimes, not all the time, but oftentimes hedge funds are long-term investors. I can say, in my funds' own experience, in my personal experience, we are a very significant stakeholder and have helped to recapitalize some very significant large business and we view that as a core principle within our business.

At the same time we constantly, every day, look at our positions and we may decide to sell a position. Both that decision to buy and that decision to sell is critical to be able to price capital within the markets. I don’t think that the Commission can look at the question of day traders without looking at what the impact that has on the broader marketplace.

So, while I think there are probably examples that I and you can come up where that has had a bad impact on the process, we would argue that on balance, the Commission when it considers that question, should look at it in terms of each of the cases over a much broader period of time, and when we do that, in our case we believe that the liquidity the markets provide both to buy and sell, is something that the Commission should look at favorable.

Keach: Dan, thank you. With that we are going to close. Elliott we totally abused your hospitality, but thank you very much.

I want to thank all of the witnesses for their written statements, their careful testimony. This has been a great start to our information gathering process, and we thank you all.

Hearing adjourned.