Where Have All the Lenders Gone?: "Loan to Own Transactions" in the Current Credit Market

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“LOAN TO OWN TRANSACTIONS” IN THE CURRENT CREDIT MARKET

STEPHANIE A. NADLER

Abstract

Credit is not readily available in current markets. While distressed firms are in dire need of capital contributions, traditional lenders are not willing to make risky loans. Distressed firms have turned to hedge funds as lenders for much-needed capital. Thus, hedge funds engage in “loan to own” transactions, a lending technique that has recently drawn much criticism. In a loan to own transaction, the hedge fund makes a loan to a distressed company, while also taking an equity stake in the company. Pursuant to such activity, the hedge fund will generally gain a seat on the board of directors or become a controlling shareholder. From this position, the hedge fund is well-situated to exercise influence over the company should it file for bankruptcy.

Because the distressed debt market is forecasted to balloon in 2009, it is important to establish the proper duties applicable to hedge funds in loan to own transactions. Critics fault hedge funds for breaches of fiduciary duty, allege insider trading, and call for the recharacterization of the hedge fund’s debt into equity. I propose that a duty of good faith should be imposed on hedge funds in all dealings with distressed companies and that the duty will confront those criticisms. This duty of good faith is a baseline duty that affects all of the hedge fund’s activities while it is in a loan to own transaction, and a duty that must coexist with other fiduciary duties already imposed by present law, including fiduciary duties the fund owes its investors. The duty of good faith will serve as a check on the hedge funds’ decisions to make a loan to a distressed company that may file for bankruptcy as it will require hedge funds to consider seriously the added duty of good faith that could be imposed should the distressed company file for bankruptcy. The duty of good faith will protect distressed corporations from activist and self-interested hedge funds.

Applying this broad duty of good faith in the loan to own scenario will allow hedge funds to provide liquidity in the market while also protecting the borrowing corporations, without imposing so great a burden that would cause hedge funds to not engage in the transactions at all. Plus, the loans help to “bail out” companies from bankruptcy, which benefits all corporate stakeholders.
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I. Introduction

The current economic crisis undoubtedly exposes the legal system to new financial arrangements that were unheard of a decade ago. The credit markets have undergone – and continue to undergo – fundamental changes to their structure. Today, credit is not as readily available as it was in the past, and as a result, companies in need of capital – either because they wish to expand or they hope the influx of money will save them from bankruptcy – are forced to seek less traditional lenders.

Hedge funds have become ready lenders in such a market of financial instability and, through “loan to own transactions,” will be very active in the corporate governance of distressed companies.¹ Hedge funds’ unique nature provides them with the funds and ability to lend to distressed companies. In a loan to own transaction, the hedge fund acts as a creditor and makes a loan to a distressed company, while simultaneously taking an equity stake in the company. If the company files for bankruptcy, the hedge fund will be in a position to oversee the company through its reorganization. As hedge funds’ activities in this area become more prevalent, they draw increased attention from the SEC, bankruptcy courts, scholars, critics, and the media.² One

¹ Don Durfee, Meet Your New Bankers, CFO MAGAZINE, February 1, 2006 (“As commercial bankers tighten the purse strings, more and more companies are turning to a vast and volatile source of financing: hedge funds. Over the past five years, in fact, hedge funds have become a key player in capital markets, specializing in high-risk loans to the financially distressed”); Robert J. Rosenberg & Michael J. Riel, Hedge Funds: The New Masters of the Bankruptcy Universe, 17 J. BANKR. L. & PRAC. 5 ART. 7 (2008) (“hedge funds can be a reliable source of capital when more traditional lenders are unwilling to lend (particularly in the current credit markets”); Vultures Take Wing, THE ECONOMIST, April 3, 2007 (“for many distressed borrowers, hedge funds have become the last, best hope of salvation”).
of the biggest mysteries surrounding the loan to own transaction is what laws apply to the hedge fund, and whether it owes any fiduciary duty to the distressed company.

In Part II of this paper, I provide a brief background of the underregulation and investment strategies of hedge funds, the fiduciary duty and the duty of good faith, and the role of committees in Chapter 11 bankruptcy. Part III of this paper investigates the details of a loan to own transaction. In that section, I discuss the parties’ roles and also provide an explanatory case study of Radnor Holding Corporation.

In Part IV, I submit that the hedge funds should be bound by a duty of good faith when dealing with the distressed company and its shareholders. I discuss why such a duty should apply to hedge funds in particular and the interaction of the duty of good faith with other fiduciary duties the hedge fund may have. I further discuss that bankruptcy courts are in the best position to determine whether a hedge fund has acted in good faith. In Part V, I confront some of the strongest criticisms of loan to own transactions by applying a duty of good faith. Part VI concludes with the sentiment that, in a time of limited liquidity, hedge funds should be allowed – and perhaps in some circumstances, encouraged – to make loans to distressed companies so that they may try to avoid bankruptcy.

II. A Brief Overview of Hedge Funds, Fiduciary Duties, and Bankruptcy

This section provides background information about hedge funds, fiduciary duties, and bankruptcy law. First, I discuss the nature of hedge funds. Then, I describe fiduciary duties as generally applied and the separate duty of good faith. Finally, I discuss the role of committees in Chapter 11 Bankruptcy.
A. An Overview of Hedge Funds

A hedge fund is a private investment vehicle whose investors are high net-worth individuals and institutional investors.³ Hedge funds are generally set up as partnerships.⁴ Unlike other investment vehicles whose clients are the investors, the hedge fund is its own client,⁵ and the hedge fund owes a duty to its investors. In practice, the hedge fund’s duty to its investors “means getting the greatest return possible.”⁶ Other than these similarities, there are two important characteristics that nearly all hedge funds share: lack of regulation and diverse investment strategies.⁷ I consider these characteristics below.

³ See Alon Brav, Wei Jang, Randall S. Thomas, Frank Partnoy, Hedge Fund Activism, Corporate Governance, and Financial Performance 8 (European Corporate Governance Institute Finance Working Paper No. 139/2006; and Vanderbilt University Law & Economics Research Paper No. 07-28), available at http://ssrn.com/abstract=948907 (contending that hedge funds are: “hedge funds are usually identified by four characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements”).

⁴ In most cases, the “general partner is responsible for managing the hedge fund, and the limited investors do not participate in the management.” The compensation structure is also unique to hedge funds – the “investment advisers typically receive…a management fee based on the amount of assets under management, plus a share of the capital gains or of some other allocation based on the fund’s investment performance. The so-called ‘2-and-20’ compensation arrangement (i.e., 2% of assets under management and 20% of profits above a predetermined benchmark) is typical.” Rosenberg & Riela supra note 1.

⁵ See Jonathan R. Macey, Corporate Governance: Promises Kept, Promises Broken 244 (2008); Goldstein v. Securities and Exchange Commission, 451 F.3d 873, 883 (D.C. Cir. 2006) (holding that the hedge fund’s client is the hedge fund itself; the fund’s investors are not clients). Such a distinction is a relevant reason why hedge funds are not governed by the Investment Advisers’ Act of 1940, discussed below.


⁷ See Macey, supra note 5, at 268 (explaining that hedge funds are “highly diverse” and “[t]here are more than ten thousand hedge funds and no two are identical”).
1. **Lack of Regulation**

Because of the small size of hedge funds and the relative sophistication of their investors, hedge funds are largely exempt from regulatory regimes.\(^8\) Hedge funds are not regulated by the Securities Act of 1933,\(^9\) the Investment Company Act of 1940,\(^10\) or the Investment Advisers Act of 1940.\(^11\) Whereas hedge funds are not regulated by these laws, more traditional lenders – such as banks and mutual funds – are governed by these laws or similar laws that ultimately impose restrictions on their lending strategies and require disclosures.\(^12\)

As part of the Securities Exchange Act of 1934, the Williams Act purports to regulate hedge funds.\(^13\) The Act requires investors who gain more than 5% ownership of a public

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\(^8\) Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and In the Future: An Overview and Insolvency Prospective*, 29 Cal. Bankr. J. 213 (2007). (explaining that hedge funds are exempt from the disclosure and oversight requirements to which other traditional investment vehicles are subject); see 15 U.S.C. § 80a-3(c) (2007).


\(^10\) Hedge funds are further not regulated under the Investment Company Act of 1940, either because they have too few investors, they offer their securities to a private selection of individuals or institutional investors, or their investors are “qualified.” Rosenberg & Riela, supra note 1, at; see 15 U.S.C. § 80a-3(c) (2007). A “qualified” client under these rules generally translates into “institutional investors, and high net-worth or wealthy individuals.” Cumming & Johan, *Regulation*, supra note 2 at 3 (2008); Investment Company Act of 1940 § 3(c)(1).

\(^11\) The SEC regulates “investment advisers” – “those who are compensated for advising others about the value of securities or the advisability of investing” – under the Investment Advisers Act of 1940, but exempts from registration those advisers who have “fewer than fifteen clients who did not hold themselves out to the public as an investment adviser.” Macey, supra note 5, at 243. Hedge funds fly under the radar of coverage of the Investment Advisers Act by keeping a low client-base – by having 14 or fewer clients. Rosenberg & Riela, supra note 1. In contrast, the Investment Advisers Act of 1940 and the Investment Company Act of 1940 governs mutual funds. *Id.*

\(^12\) See also Cumming & Johan, *Regulation*, supra note 2, at 6 (explaining that restrictions on banks’ activities were heightened following the imposition of the Sarbanes-Oxley Act of 2002).

\(^13\) 15 USC § 78a et seq.; see also Macey, supra note 5, at 270.
company and hedge fund managers that own over $100 million of public company securities to
disclose certain information to the SEC.\textsuperscript{14} Given these rules, hedge funds are very careful not to
reach those caps so they do not have to disclose information. Not only are the disclosures costly
for the hedge funds, disclosing investment strategies may make hedge funds vulnerable to
copycat investors who may try to implement the same strategies.\textsuperscript{15}

The underregulation of hedge funds has not gone unnoticed. There are cries for
regulation of hedge funds in the United States and abroad.\textsuperscript{16} The SEC has attempted to exercise
more power over hedge funds by making them report information. But courts have rejected that
attempted regulation.\textsuperscript{17} While hedge funds in the United States remain largely unregulated, some
of the largest UK hedge funds consented to more “voluntary disclosure standards” in early
2008.\textsuperscript{18}

\textsuperscript{15} Macey, supra note 5, at 269 (explaining that “from an economic perspective, the absence of
hedge fund regulation both increases wealth by protecting hedge funds’ property rights in
information and eliminates systemic risk by preventing other investors from rushing like
lemmings to copy the investment strategies developed by hedge fund managers”).
\textsuperscript{16} See, e.g., Cumming & Johan, Regulation, supra note 2 at 6 (“[g]iven the significant scope for
potential agency problems, regulators in many countries are calling for increased hedge fund
regulation”). See Cumming & Johan’s articles, supra notes 2 and 9, for a comparison of
regulation of hedge funds by country.
\textsuperscript{17} See, e.g. Goldstein, 451 F.3d at 833 (refusing to apply the Investment Advisers Act to hedge
funds).
\textsuperscript{18} Cumming & Johan, Regulation, supra note 2, at 6. But Cumming and Johan note that the
reason the funds may have chosen greater regulation was to “mitigate the possibility of more
onerous regulatory standards…in the future.” Id.
2. **Diverse Investment Strategies**

Traditionally, most hedge funds shared a common investment strategy of short selling securities to “hedge” the fund’s risk in the market. Today, however, hedge funds’ investment strategies are varied. In Distressed Debt Outlook, a question was posed for the interviewees “How much of your fund is dedicated to short positions?” Even though the interviewees were not all hedge funds, the following table shows their answers:

<table>
<thead>
<tr>
<th>Percentage of Fund Dedicated to Short Positions</th>
<th>Number of firms responding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5%</td>
<td>53</td>
</tr>
<tr>
<td>5 – 10%</td>
<td>18</td>
</tr>
<tr>
<td>10 – 20%</td>
<td>14</td>
</tr>
<tr>
<td>21 – 50%</td>
<td>10</td>
</tr>
<tr>
<td>More than 50%</td>
<td>5</td>
</tr>
</tbody>
</table>

Because hedge funds are not subject to the same regulations as other investment vehicles, they can trade in ways in which other investment vehicles are prohibited. An investment strategy commonly employed by hedge funds is to have investments “in multiple segments of a

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19 Mark Berman, *Hedge Funds: Lessons Learned from the Radnor Decision*, AM. BANKR. INST. J., Feb. 2007 (explaining how hedge funds hedged in order to insulate the investors from “exposure to movements and equity markets”). Short selling occurs when the investor borrows shares from a broker in the hopes that the share price will drop and the buyer will return the shares and make a profit. While ordinarily an investor wants to “buy low, sell high,” when he engages in short selling, he would like to “buy high, sell low.”  
20 *Id.; see also* Cumming & Johan, *Forum Shopping*, *supra* note 9 (claiming that “hedge funds no longer primarily hedge, nor do they use uniform investment strategies or investment instruments”).  
22 *Id.*  
23 For example, hedge funds can “trade on margin and engage in derivatives trading, strategies that are not available to other institutions, such as mutual and pension funds.” Brav, Jiang, Thomas, and Partnoy, *supra* note 3, at 9.
company’s capital structure” at one time, for example taking both debt and equity positions in the same company.\textsuperscript{24}

Due to a hedge fund’s diverse investment structure, it is more likely to make a risky investment than a traditional lender.\textsuperscript{25} Investors are attracted to hedge funds because they are willing to take those risks and also because hedge funds generally invest money quickly, so that the investor may get a return sooner than with a more traditional investment.\textsuperscript{26} Also unlike traditional investment vehicles, a hedge fund can make loans to a needy company “with lightning speed.”\textsuperscript{27} Companies with an immediate need for cash may seek out a hedge fund – even though it may charge a higher interest rate – because the company cannot afford to wait for traditional financing from a bank.

\textsuperscript{24} Rosenberg & Riela, \textit{supra} note 1 (comparing hedge funds with “more traditional investors, which tend to focus on only one segment of a company’s capital structure”). This strategy in particular may draw scorn from critics when the hedge fund engages in a loan to own transaction.
\textsuperscript{25} Durfree, \textit{supra} note 1.
\textsuperscript{26} Macey, \textit{supra} note 5, at 242 (“hedge funds may need to accommodate investor withdrawal sooner than do private equity funds, hedge funds generally take shorter-term positions in more liquid assets”). All hedge funds, however, do not operate in a short term time frame. Rosenberg & Riela, \textit{supra} note 1 (recognizing that “[w]hile some hedge funds unmistakably do have long-term investment philosophies, the permissive redemption policies offered by most hedge funds require their managers to exchange in more short-term strategies to maintain sufficient fund liquidity”). Especially with the current diversification in hedge fund strategies, hedge funds no longer only make short term investments. Especially in loan to own transactions, hedge funds are more likely to engage in a longer-term plan.
\textsuperscript{27} Durfee, \textit{supra} note 1. Durfee uses the example of Silver Point Capital LP, a Greenwich, Connecticut-based hedge fund, that loaned DMX Music Inc. $62.5 million. DMX’s CEO said that the reason DMX borrowed from Silver Point, rather than a traditional bank, was because they needed the financing in a short time frame. \textit{See id.}
B. An Overview of Fiduciary Duty and the Duty of Good Faith

This section considers the history of the fiduciary duties of loyalty and care, as well as the less-oft applied duty of good faith. Later, in Section IV, I propose the proper standard of good faith to be applied to hedge funds engaging in loan to own transactions.

Fiduciary duties arise from the law of agency and are applied to a company’s board of directors and management. A fiduciary duty generally is divided into two separate duties – the duty of loyalty and the duty of care.28 Directors and managers owe a duty of care to the corporation and to its shareholders. Basically, the duty of care protects the corporation from the board and management’s negligent actions.29 The duty of care does not have much bite, especially because the directors and managers are further protected by the business judgment rule.30 The business judgment rule was famously applied in Smith v. Van Gorkom and presumes that “in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”31 So, in order to prevail on a claim of breach of the duty of care, a plaintiff must show

29 Id.
30 See, e.g. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), citing Zapata Corp. v. Malonado, 430 A.2d 779, 782 (Del. 1981) (stating that the “business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors”).
that the board made an “uninformed” decision.\textsuperscript{32} That burden is incredibly difficult for a plaintiff to meet.\textsuperscript{33}

The duty of loyalty, on the other hand, is a more powerful tool for shareholders. The duty of loyalty questions whether directors and management acted in the best interest of the corporation and the shareholders, rather than in the interest of the managers themselves.\textsuperscript{34} Under the duty of loyalty, the director’s self-dealing actions are forbidden.\textsuperscript{35}

The duty of good faith has been applied less explicitly than the other fiduciary duties.\textsuperscript{36} There is a split in case law regarding whether the duty of good faith is intertwined with the duties of care and loyalty, or whether it can stand on its own absent the other two duties of loyalty and care.\textsuperscript{37} In this paper, I advocate for the latter characterization.\textsuperscript{38} The burden of defining good

\begin{footnotesize}
\begin{enumerate}
\item Van Gorkom, 488 A.2d at 872.
\item See Anabtawi & Stout, supra note 26, at 1263 (explaining the difficulty for a plaintiff to prove that the board’s performance was uninformed).
\item Id.
\item Id. at 1263-64. In Delaware, the courts allow the director to show that an allegedly self-interested transaction was “approved after full disclosure by either (1) a majority of the company’s disinterested directors or (2) by a majority of the company’s disinterested shareholders. If either showing is made, the burden of demonstrating unfairness reverts to the plaintiff.” Id. at 1264-65; see Del. Code Ann. Tit. 8, § 144 (2005).
\item See Hillary A. Sale, Enron and the Future of U.S. Corporate Law and Policy, 89 Cornell L. Rev. 456, 463 (2004); see also Claire A. Hill and Brett H. McDonnell, Disney, Good Faith, and Structural Bias, 32 J. Corp. L. 833, 841 (2007) (explaining that cases are beginning to mention the duty of good faith more often)
\item The Delaware Chancery Court in In re Caremark International Inc. Derivative Action defined the duty of good faith as a separate duty not coexisting with the traditional fiduciary duties of good faith and loyalty. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996); see also Sale, supra note 36 at 469.
\item This is also the preference of contemporary case law, to consider the duty of good faith as separate from the other traditional fiduciary duties. See Sale, supra note 36 at 482. and when I reference good faith I am envisioning it as a freestanding duty. When the duty of good faith stands on its own, it is a more powerful duty. See id at 464 (“as a separate duty, good faith can attach to situations beyond those invoking loyalty concerns and can grow to address its own category of governance issues”). And when good faith is a freestanding duty, “it can apply to
\end{enumerate}
\end{footnotesize}
faith for corporate actors generally falls on the Delaware courts, but a concise definition is nearly impossible to ascertain.\textsuperscript{39} Most recently, the Delaware Chancery Court found that a company acted in good faith when it did not engage in conduct that was arbitrary or unreasonable.\textsuperscript{40} The Delaware Model Business Corporation Act extends to directors a duty of good faith, that “[e]ach member of the board of directors, when discharging the duties of a director, shall act . . . in good faith.”\textsuperscript{41} Good faith has also been elusively defined as the absence of bad faith.\textsuperscript{42} The Delaware Chancery Court stated “[b]ad faith has been defined as authorizing a transaction ‘for some situations where fiduciaries failed to adhere to basic practices or forms. It can, therefore, regulate non-conflicted but deliberately indifferent behavior and transactions, creating incentives for action rather than passivity.” Sale, \textit{supra} note 36 at 488.\textsuperscript{39} \textit{See, e.g.} Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (“Delaware Supreme Court jurisprudence is developing along the general approach that implying obligations based on the covenant of good faith and fair dealing is a cautious enterprise.”). The Delaware Supreme Court in \textit{Brehm v. Eisner} characterized irrational decisions, including waste, by the directors would not be decisions made in good faith. Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000). Black’s Law Dictionary defines “good faith” as “[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.” Black’s Law Dictionary 701 (7th ed. 1999). Others have described the duty of good faith in corporate law as “comprised of a general baseline...of four elements: subjective honesty, or sincerity; nonviolation of generally accepted standards of decency applicable to the conduct of business; nonviolation of generally accepted basic corporate norms; and fidelity to office.” Melvin A. Eisenberg, \textit{The Duty of Good Faith in Corporate Law}, 31 \textit{Del. J. Corp. L.} 1, 1 (2006).\textsuperscript{40} Bay Center Apartments Owner vs. Emery Bay PKI, Case No. 3658-VCS (Ch. Del. April 20, 2009); \textit{Dunlap v. State Farm Fire & Cas. Co.}, 878 A.2d 434, 442 (Del. 2005).\textsuperscript{41} \textit{MODEL BUS. CORP. ACT} § 8.30(a) (2005).\textsuperscript{42} A 1969 article proposed that “good faith was best understood as an excluder – that is, ‘a phrase which has no general meaning...of its own, but which serves to exclude many heterogeneous forms of bad faith.”’ \textit{Id} at 21; \textit{citing} Robert S. Summers, \textit{“Good Faith” in General Contract Law and the Sales Provisions of the Uniform Commercial Code}, 54 \textit{Va. L. Rev.} 195, 196 (1968); \textit{see also} See, \textit{e.g.} Eisenberg, \textit{supra} note 39, at 20 n.58 (explaining that in his article, he would use the terms “lacks good faith” and “in bad faith” interchangeably).
purpose other than a genuine attempt to advance corporate welfare or [when the transaction] is known to constitute a violation of applicable positive law."  

C. An Overview of Committees in Chapter 11 Bankruptcy

It is now necessary to include a brief discussion of some of the basics of Chapter 11 Bankruptcy. Chapter 11 bankruptcy is an option for companies who wish to continue operating their businesses – rather than liquidating under Chapter 7, for example. Some of notable features of Chapter 11 bankruptcy are the formation of committees and creation of a bankruptcy plan. In this section, I discuss committees.

A creditor committee is formed in Chapter 11 bankruptcy pursuant to Section 1102 of the Bankruptcy Code. The committee is comprised “of persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee.” The official committee is endowed with the power to hire “attorneys, accountants, or other agents, to represent or perform services for [the] committee,” and those costs are paid out of the estate. The official committee receives confidential information about the debtor and helps the bankrupt company come up with its plan of reorganization. While the debtor ultimately drafts the plan of reorganization, the committee is intimately involved in the drafting process.

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46 11 U.S.C. § 1102(b)(1) (2007); see also Harner, Empirical, supra note 6, at 99 (asserting that the creditor’s committee is composed of the failing company’s unsecured creditors).
47 11 U.S.C. § 1103(a) (2007). The attorneys or accountants appointed by the official committee are forbidden to representing another client whose interests are adverse in the case. 11 U.S.C. § 1103(b) (2007).
The committee is also given special powers through the Bankruptcy Code. Most notably for our purposes, there is a fiduciary duty that is imposed on creditors who sit on the official committee toward the other creditors not on the committee. The official committee gains the benefit that the courts will more likely be more receptive to their concerns than to those of creditors not serving on the committee.

Before the debtor files for bankruptcy, creditors may form unofficial, or “ad hoc,” committees under § 1109 of the Bankruptcy Code. Ad hoc committees are comprised of members who have chosen to join together voluntarily. The ad hoc committee generally does

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48 See 11 U.S.C. § 1103(c) (2007) (describing the actions a committee may take, including consultation with the debtor; investigation of the debtor’s activities, assets, and liabilities; participation in drafting the plan; requesting an examiner, etc.).

49 Rosenberg & Riela, supra note 1; see e.g. In re Realty Associates Securities Corp., 56 F. Supp. 1008, 1009 (E.D.N.Y. 1944). These powers and the fiduciary duty imposed on members of the committee may give rise to potential insider trader claims and breach of fiduciary duty claims. The theory behind the committee is that the members will “act as fiduciaries for all unsecured creditors,” however “[i]n practice, members of the creditors’ committee may act as fiduciaries, but they also obtain valuable information regarding the debtor and its restructuring process and a useful platform to further their own investment agendas.” Harner, Empirical, supra note 6, at 99. See Part V where I discuss claims of breach of fiduciary duty and insider trading.

50 See Rosenberg & Riela, supra note 1; see also Harner, Empirical, supra note 6, at 100 (“An appointment to the creditors’ committee can enhance the controlling creditor’s involvement in the debtor’s restructuring. The creditor can recommend and vote on professionals to serve as the committee’s counsel and financial advisers. It typically receives non-public information regarding the debtor and its restructuring process.”)

51 11 U.S.C. § 1109(b) (2007) (“A party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under [Chapter 11 of the Bankruptcy Code].”). Alternatively, a party in interest “is generally understood to include all persons whose pecuniary interests are directly affected by the bankruptcy proceedings.” In re Cummings, 371 B.R. 565, 568 (Bankr. S.D. Fla. 2007)

52 See Rosenberg & Riela, supra note 1.
not receive confidential information of the borrower, but it can object to the official committee’s reorganization plan.

### III. Loan to Own Transactions

Due to the light regulation of hedge funds and their unique investment strategies, hedge funds have been able to find a niche as lenders in a market where credit is not readily available. Companies who cannot obtain loans through traditional lenders are turning more frequently to hedge funds as a source of capital. Historically, banks constituted the majority of lenders in the market, but, more recently, hedge funds have become increasingly popular lenders. Because hedge funds’ general investment strategies expose them to risk, they do not bat an eye at lending

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53 Fisher & Buck, supra note 2, at 87, 88 (explaining that creditors who sit on an ad hoc committee do not receive the benefits that the Bankruptcy Code allows members of the official committee – such as not having to pay to hire experts or receiving confidential information).


55 See Durfee supra note 1 (giving examples of companies that have borrowed from hedge funds when they could not get financing from banks: Calpine, Krispy Kreme, and Goodyear); see also Michelle M. Harner, The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing, 77 FORDHAM L. REV. 703, 765 (2008) (“[d]istressed debt investing is not a new investment strategy. It is, however, becoming more prominent.”).

56 Harvey Miller noted the growth of hedge funds as investors: “In 1995, banks represented over 70% of the investors in loans. [In 2007,] that number stands at 13%. Conversely, in 1995, collateralized loan obligations (“CLOs”), hedge funds, and other such funds represented just over 16% of the investors in loans. [In 2007,] that number stands at over 77%.” Harvey R. Miller, Chapter 11 in Transition – From Boom to Bust and Into the Future, 81 Am. Bankr. L.J. 375, 379 (2007); see also The Vultures Take Wing, supra note 1 (“17 percent of senior, unsecured junk-bond issues are on the lowest possible rung, compared with 2 percent in 1990;” “non-banks such as hedge funds now make roughly half of all high-yielding leveraged loans and hold the lion’s share of the secondary market”).
to these distressed companies.\textsuperscript{57} A loan to own opportunity can be a win-win situation: the hedge funds invest in distressed companies with hopes of earning above market returns, while, at the same time, distressed companies seek out hedge funds when more traditional lending institutions are nowhere to be found.

### A. Distressed Debt, the Changing Economic Climate, and Increased Presence of Hedge Funds as Lenders

Distressed debt “is the debt of companies that have either already filed for bankruptcy or are likely to do so in the near future.”\textsuperscript{58} Companies with distressed debt are attractive investments for hedge funds because if the company files for bankruptcy, the hedge fund may be in a position to exercise a lot of influence over decisions in bankruptcy. The hedge fund has the potential to earn high returns on its investment in distressed debt.\textsuperscript{59}

In her influential book “The Vulture Investors,” Hillary Rosenberg termed those investing in distressed debts as “vulture investors.” She explained:

> Vultures are so named because they have a predilection for businesses that are dead or dying. Whether a company is in bankruptcy, close to bankruptcy, or heading down a road toward liquidation, it has potential appeal for vultures. Such desperate situations present opportunities to buy stock, bonds, bank debt, and other obligations at frighteningly low prices and to collect handsome profits later

\textsuperscript{57} Durfee, \textit{supra} note 1 (explaining how traditional banks have become more “risk-adverse,” allowing hedge funds to lend in that market; discussing how hedge funds are taking the place of traditional banks in “the high-risk loan market”). The loan to own transaction further differentiates hedge funds and traditional lenders. Traditional lenders take measures to avert becoming the owner of the borrower, while hedge funds, through loan to own transactions, hope to own the borrower. Futter & Wells, \textit{supra} note 8, at 229


\textsuperscript{59} \textit{Id.} at 1415
on when the company distributes assets to creditors and shareholders in its reorganization or liquidation.\textsuperscript{60}

The distressed debt market has increased in size over the past several years, and hedge funds are now becoming key players in the market for distressed debt.\textsuperscript{61} The changing economic climate brings with it more opportunities for hedge funds to become ready lenders when traditional lenders no longer give credit. In 2007, more funds were investing in distressed corporations than at any time in the past.\textsuperscript{62} And such activities are projected to be on the rise, despite the disappointing returns in the last two quarters of 2008.\textsuperscript{63} Some scholars have termed the 2009 debt market a “candy shop” for distressed debt investors.\textsuperscript{64}

In their “North America Debt Market Outlook 2009,” DebtWire North America conducted a study where 100 hedge fund managers and other investment managers were interviewed and questioned about their forecasts for the distressed debt market in 2009.\textsuperscript{65} Of the

\textsuperscript{60} Hillary Rosenberg, \textit{The Vulture Investors, Revised and Updated}, 26 (Wiley 2000).
\textsuperscript{61} Harner, \textit{Empirical}, supra note 6, at 76.
\textsuperscript{62} \textit{The Vultures Take Wing}, supra note 1 (estimating, in 2007, “170 institutions that invest primarily in distress[ed companies], more than ever before”; those institutions “include[] hedge funds, private equity, and commodities”).
\textsuperscript{63} From September to December 2008, distressed debt investors lost 22.54%. But investors remain optimistic and forecasting higher returns – 85% of the investors surveyed expected at least a 15% return in 2009, while 56% of investors anticipate over 20% returns in 2009. \textit{Market Outlook}, supra note 21, at 3.
\textsuperscript{64} \textit{Id.} at 39 (explaining that “[f]ollowing an extremely unique period where credit was seemingly unavailable anywhere and to anyone, and where distressed investors were sidelined while default rates hovered near zero, corporate defaults are now soaring, bankruptcies are rising and there are more bank loans trading at distressed levels than at any point in history”).
\textsuperscript{65} \textit{Id.} at 2. The interviews were conducted in November and December 2008. Of the 100 firms surveyed, 52% were hedge funds, 11% were institutional investors, 11% were investment bank or trading desks, 6% were commercial banks or financing companies, while the remaining 20% classified themselves as “other.” \textit{Id.} at 4.
institutions surveyed, 61% classified their core investment strategy as distressed debt. Table 2 shows the firm’s percentage of overall assets dedicated to distressed debt. 66% of the firms said that they planned to invest a greater percentage of its assets into distressed debt in 2009. Of that 66% that said they planned to increase distressed debt investing in 2009, 79% reported plans to make those investments in the first and second quarter of 2009. There is little doubt that if these firms follow through with their predictions, there will be a substantial increase in the trading of distressed debts.

<table>
<thead>
<tr>
<th>Table 2&lt;sup&gt;69&lt;/sup&gt;</th>
<th>Amount of firm’s overall assets dedicated to distressed debt</th>
<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1%</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>1 – 20%</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>21 – 40%</td>
<td>16</td>
<td></td>
</tr>
<tr>
<td>41 – 60%</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>61 – 80%</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>81 – 100%</td>
<td>20</td>
<td></td>
</tr>
</tbody>
</table>

The Distressed Debt Outlook polled the firms and asked if they sought equity control of companies using a “loan to own” approach. Table 3 shows their results.

<table>
<thead>
<tr>
<th>Table 3&lt;sup&gt;70&lt;/sup&gt;</th>
<th>Does your firm use a loan to own strategy?</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, as part of our core strategy</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Yes, but on an exceptional basis</td>
<td>45</td>
<td></td>
</tr>
<tr>
<td>No, although we are interested in acquiring non-control positions via debt-for-equity swaps</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>Never</td>
<td>19</td>
<td></td>
</tr>
</tbody>
</table>

<sup>66</sup> Market Outlook, supra note 21, at 4. The others’ core investment strategies were event-driven (20%), high yield (14%), relative value arbitrage (3%), and long-short equity (2%). Id.<br>67 Id.<br>68 Id. at 5.<br>69 Id. at 4.<br>70 Market Outlook, supra note 21, at 18
B. Loan to Own Transactions: An Overview

In typical loan to own scenarios, the players are borrowers (“distressed companies” or “target companies”) and lenders (hedge funds). Keep in mind, however, that a loan to own transaction is rarely “typical.” Just as investment strategies vary among different hedge funds, loan to own transactions are similarly varied.\(^71\) I describe the following situations as an example of the way a hedge fund may engage in a loan to own transaction, although such a transaction may certainly occur in a different sequence or take other turns not explicitly discussed here.

1. The Hedge Fund’s Loan

Typically, in a loan to own transaction, the hedge fund will seek poorly performing companies as “target companies.”\(^72\) Particularly attractive to hedge funds are distressed companies that are either “overleveraged,”\(^73\) or companies where the hedge fund can purchase debt at a discount.\(^74\) In their paper *Hedge Fund Activism, Corporate Governance, and Firm Performance*, the authors Brav, Jiang, Thomas, and Partnoy conduct an empirical study of loan to own transactions.\(^75\) The authors studied the characteristics of the distressed firms that were most likely targets for loan to own transactions, and found that: “target firms spend significantly

\(^71\) Also note that the other institutions engage in loan to own transactions as well, although I have chosen to focus on hedge funds.
\(^72\) *See* Macey, *supra* note 5, at 247 (describing distressed companies as “investment opportunities” for hedge funds).
\(^74\) Macey, *supra* note 5, at 248 (explaining that a hedge fund seeks to “purchase the debt at a fraction of the principal amount due upon maturity”).
\(^75\) Brav, Jiang, Thomas, and Partnoy, *supra* note 3. The authors’ data included hedge funds from the years 2001 through 2006 and considered 1,059 events. *Id.* at 1, 41.
less than their peers on research and development...[and] tend to have slightly more takeover
defenses...have significantly higher institutional ownership and analyst coverage."\textsuperscript{76} They found
that “in about two-thirds of our cases, the hedge fund explicitly states that it believes the target is
overvalued.”\textsuperscript{77}

The hedge fund will simultaneously make a loan to a distressed company and take an
equity stake in it.\textsuperscript{78} In many instances, the hedge fund will choose to purchase much less than
50\% of the voting shares so as not to gain voting control.\textsuperscript{79} Brav, Jiang, Thomas and Partnoy
found hedge funds take a median of 6.3\% stake in the distressed company, and the median cost
for a stake is $11.9 million.\textsuperscript{80} The lack of voting control, however, will not harm the hedge
fund’s opportunity to influence the corporation. Instead, the hedge fund will forge a close
relationship with the board members so that it gains some measure of control over the
company.\textsuperscript{81}

The contract between the hedge fund and the distressed company controls the
transaction.\textsuperscript{82} So, the hedge fund may write a provision into the contract providing that pursuant
to the fund’s equity investment, the hedge fund will be offered a seat on the board of directors.\textsuperscript{83}
Or, if the hedge fund anticipates that the distressed company will file for bankruptcy, the fund

\textsuperscript{76} Id. at 22-23.
\textsuperscript{77} Id. at 22.
\textsuperscript{78} Landers, supra note 73, at 1.
\textsuperscript{79} Id. (describing that the hedge fund’s “equity interests tend to be in the 25 percent range”).
\textsuperscript{80} Brav, Jiang, Thomas, and Partnoy, supra note 3, at 19.
\textsuperscript{81} Landers, supra note 73, at 44.
\textsuperscript{82} Berman, supra note 19 (describing that hedge funds are governed by the contracts of particular
deals).
\textsuperscript{83} Harner, Policy, supra note 55, at 752, 753. Distressed companies wield little bargaining power
in such negotiations. See id.
may have the distressed company consent to the hedge fund’s position on the creditor’s committee in bankruptcy.

2. The Hedge Fund’s Role in Reorganization

Either just before or right after the distressed company has filed for bankruptcy, the hedge fund has great incentives to restructure the company as quickly as possible in order to reduce the possibility of disputes.\textsuperscript{84} There is nearly an endless variety of ways the hedge fund can go about the reorganization of the distressed company. By exercising control and direction over the distressed company, the hedge fund is able to exert influence that may allow both the hedge fund and target company to profit and succeed.

In the reorganization, the hedge fund is often able to choose who will sit on the board in the reorganized company.\textsuperscript{85} The hedge fund may choose to keep the old board. In that case, the hedge fund will take the hard line with the managers, demanding that the management “shape up the company’s performance” or the hedge fund will threaten to appoint new management.\textsuperscript{86} This threat is a valuable weapon that the hedge fund can wield in its control over the reorganization of the company.

\textsuperscript{84} Landers, \textit{supra} note 73, at 44 (describing how a quick restructure will minimize “opposition, competition, and expense;” explaining how if the reorganization is fast, conflict will be minimized).

\textsuperscript{85} Macey, \textit{supra} note 5, at 250, 272 (“hedge fund…managers have the resources, the expertise, and the incentives to improve the way their portfolio companies are run”). Note that parties in interest may object to the hedge fund’s participation in the reorganization, as in \textit{Radnor} discussed below. I argue that as long as the hedge fund is acting in good faith toward the company that the parties in interest should not prevail on their objection to the hedge fund’s activity.

\textsuperscript{86} Macey, \textit{supra} note 5, at 248.
But the relationship between the hedge fund and the distressed firm may be “tense” or “hostile” and the hedge fund may decide to bring in new management. Sometimes this option may be the best course of action if the existing management insists on following its own goals rather than listening to the hedge fund. In cases where the hedge fund replaces existing management, it may be worthwhile to offer to pay the existing management a considerable sum so that the management leaves quietly, without a fight.

Yet another choice is for the hedge fund to appoint a partner of the hedge fund to the distressed company’s board of directors. This action allows the hedge fund to be vocal and to exercise control over the decisions of the company. Another avenue is for the hedge fund to become the controlling shareholder by exchanging its debt interests for equity interests. By offering to forgive some of the debt owed by the distressed company, the hedge fund puts itself in a great bargaining position. In that position, without sitting on the board, the hedge fund can

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87 Id.
88 See Harner, Policy, supra note 55, at 750 (describing that most hedge funds replace the CEO and CEO during the reorganization).
89 Id. at 751 (citing that “management may disagree with a debt investor’s restructuring goals or timeline for the company”).
90 Landers, supra note 73, at 1, 44.
91 Harner, Policy, supra note 55, at 751; see also The Official Committee of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC, 353 B.R. 820 (D. Del. 2006) (in Radnor, the hedge fund Tennenbaum sought a seat for itself on Radnor’s board of directors). Hillary Rosenberg named this type of “activist vulture investor” a “Committeeman” whose “modus operandi is to get on the creditors’ committee in a distressed situation either before or after a bankruptcy filing.”
92 Harner, Policy, supra note 55, at 752; Landers, supra note 73, at 1, 44. But, Harner explains that in the United States, large public companies cannot easily swap their debt for equity out of court. Id.
93 See Macey, supra note 5, at 248 (explaining how the hedge fund may gain equity in the distressed company by “forgiving at least part of the debt that is owed them in exchange for equity”).
exercise its voice. Even if the hedge fund does not want to become the controlling shareholder, it might still swap some debt for equity.

Besides influence through the board of directors, another avenue through which the hedge fund can influence the bankrupt company is through its role on a committee. If the hedge fund is one of the distressed company’s largest creditors, it will get a seat in the creditor’s committee upon bankruptcy.\(^94\) Or, the hedge fund may serve on an unofficial committee where it will avoid learning confidential information about the target.

C. **Case Study: Radnor Holding Corporation**

An example of a loan to own transaction might help to conceptualize the process. Here, I describe the background of the loan to own transaction between Radnor Holding Corporation ("Radnor") and its hedge fund-lender Tennenbaum Capital Partners LLC ("Tennenbaum").

Radnor, a U.S. manufacturer of foam cups and chemicals,\(^95\) was considering its financing options to counteract increasing prices of materials, smaller margins, and a "liquidity crunch."\(^96\) Radnor consulted Lehman Brothers ("Lehman") who suggested that Radnor raise both debt and equity. Lehman compiled a list of about 40 potential lenders while Radnor’s board considered its different options.\(^97\) Radnor’s board ruled out liquidating in Chapter 7 Bankruptcy in favor of

\(^{96}\) Feliciano, supra note 95.
\(^{97}\) Radnor, 353 B.R. at 827-28.
continuing the operation of the company because it would be more profitable, and selected Tennenbaum as its creditor.\(^98\)

Tennenbaum purchased $25 million worth of preferred stock from Radnor and made a loan of $95 million of secured debt in October 2005.\(^99\) Radnor used the proceeds from this loan to refinance senior secured loans, to repay millions of dollars owed on equipment loans, and to reinvest in potential growth products.\(^100\) Along with Tennenbaum’s purchase of the preferred stock, Tennenbaum received the right to appoint one member to Radnor’s four-person board of directors. Tennenbaum appointed one of its partners, Mr. Feliciano, to the board.\(^101\) Mr. Feliciano abstained whenever the rest of the board voted on issues that involved Tennenbaum,\(^102\) so as not to create a conflict of interest.\(^103\)

The company, however, fell prey to an economic downturn in Spring of 2006 and faced a vast increase in the price of raw materials due to the Golf Coast hurricanes that struck the United

\(^{98}\) *Id.* at 828.

\(^{99}\) *Id.* at 827-29; *see also* Berman, *supra* note 19, at 65. This simultaneous purchase of equity and loan is common among loan to own transactions, however it is important that the hedge fund treats the loans as such or else it could risk recharacterization by the court.


\(^{101}\) *Radnor*, 353 B.R. at 829.

\(^{102}\) *See id.* at 833 (describing how Mr. Feliciano sat out of a vote regarding Tennenbaum’s second loan to Radnor). In *Radnor* there were claims against Mr. Feliciano for breach of duty of loyalty. But the court found that there was no proof that Mr. Feliciano “was interested in any transaction and voted in favor of it due to his outside financial interests rather than voting in the best interests of Radnor.” *Radnor*, 353 B.R. at 844-45.

\(^{103}\) There is further evidence that “Mr. Feliciano was a valuable member of the Radnor board and consistently acted in the best interest of Radnor,” and Radnor board members “testified that he was a productive and valuable member of the board who made helpful suggestions and was interested in the welfare of Radnor.” *Id.* at 834.
States in the preceding year. Neither Tennenbaum nor Radnor expected these price increases.\textsuperscript{104}

In a final effort to keep Radnor from filing for bankruptcy, Tennenbaum advanced another loan of $23.5 million to Radnor,\textsuperscript{105} and Tennenbaum became Radnor’s largest secured creditor.\textsuperscript{106}

But this influx of cash was not enough. Radnor’s other lenders ceased their funding, forcing Radnor to consider bankruptcy.\textsuperscript{107} When it became clear that Radnor would have to file for bankruptcy, Radnor requested that Tennenbaum bid on Radnor’s assets, fearing that if they didn’t, Radnor would be forced to file Chapter 7 Bankruptcy.\textsuperscript{108} At Radnor’s request, Tennenbaum proposed an Asset Purchase Agreement to Radnor in August 2006.\textsuperscript{109} Pursuant to this and other agreements, Tennenbaum acquired Radnor’s assets and exercised control over the operation of the company.

The creditor’s committee filed suit contesting Tennenbaum’s involvement in Radnor’s bankruptcy reorganization,\textsuperscript{110} but the Delaware Bankruptcy Court upheld the loan to own transaction. The three main claims of the creditor’s committee were (1) equitable subordination, (2) recharacterization of debt into equity, and (3) breach of fiduciary duty. First, the plaintiffs

\begin{footnotes}
\item[104] Id. at 832.
\item[105] Id. This loan, in fact, benefitted Radnor’s other creditors – Radnor used this loan to partially pay the debt owed to other creditors, and used the rest toward the business. Id. at 833.
\item[106] Feliciano, supra note 95.
\item[107] Radnor, 353 B.R. at 835.
\item[108] Id. This type of bid is known as a “stalking horse bid.”
\item[109] Id. At this point, Mr. Feliciano had already resigned from Radnor’s board of directors. Id.; Feliciano, supra note 95.
\item[110] The creditor’s committee had standing to file suit because under the Bankruptcy Code, “a party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in any case under [Chapter 11].” 11 U.S.C. § 1109(b). Bankruptcy courts have construed party in interest broadly. See, e.g. In re Marcus Hook Development Park, Inc., 153 B.R. 693 (Bankr. W.D. Pa. 1993); Unofficial Committee of Zero Coupon Noteholders v. Grand Union Co., 179 B.R. 56 (D. Del. 1995) (including bondholders as a party in interest).
\end{footnotes}
called for the subordination of Tennenbaum’s debt, but the court found that the plaintiffs did not prove their burden of showing (1) that Tennenbaum’s conduct was inequitable, (2) the plaintiffs and other creditors were injured by Tennenbaum’s misconduct, and (3) that equitable subordination this case would have been consistent with the Bankruptcy Code. The court found that Tennenbaum was not in charge of the daily control of Radnor, which would be necessary for Tennenbaum to have been an “insider” for equitable subordination purposes. The fact that Tennenbaum had oversight over Radnor’s business decisions and was present at Radnor’s board meetings was not sufficient to make Tennenbaum an insider in this context. The court concluded that Tennenbaum “at all times acted in good faith with a view to maximize Radnor’s value to all constituents.”

Second, the plaintiffs called for the recharacterization of Tennenbaum’s debt holdings into equity because the plaintiffs thought that Radnor actually held an equity stake that was wrongfully characterized as debt. The court however concluded, based on the intent of Radnor and Tennenbaum for the holdings to be true debt, and findings that there was no evidence that the parties intended otherwise, that it would uphold that intent.

111 Radnor, 353 B.R. at 840.
112 Radnor, 353 B.R. at 840-41.
113 Radnor, 353 B.R. at 840-41; see also Schubert v. Lucent Techs. Inc., 348 B.R. 234, 279 (Bankr. D. Del. 2005 (“[t]here must be day-to-day control, rather than some monitoring or exertion of influence regarding financial transactions in which the creditor has a direct stake”).
114 Radnor, 353 B.R. at 841 (emphasis added).
115 Radnor, 353 B.R. at 838-39. In making this decision, the court relied on an earlier third circuit case that held “intent may be inferred from what the parties say in their contracts, form what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case.” Cohen v. KB Mezzanine Fund II, 432 F.3d 448, 456 (3d. Cir. 2006).
Third, the other creditors alleged various breaches of fiduciary duty by the Radnor board, Tennenbaum, and Mr. Feliciano. The court held that Tennenbaum did not aid and abet a breach of fiduciary duty to Radnor,\textsuperscript{116} and that “the Radnor board did not act disloyally in entering into the transactions with Tennenbaum.”\textsuperscript{117} The court also held that Mr. Feliciano also did not breach any duty of loyalty owed to Radnor, as the plaintiffs did not establish that Mr. Feliciano voted in a self-interested way that favored the interests of himself or Tennenbaum over the interests of Radnor.\textsuperscript{118}

IV. Applying a Duty of Good Faith to Hedge Funds in Loan to Own Transactions

Given the forecast for an increased number of hedge funds investing in distressed companies, there is a need for a uniform standard that should apply to hedge funds in loan to own transactions. I argue that a duty of good faith should apply to hedge funds engaged in loan to own transactions. Such a duty should act as a check on the hedge fund considering whether to invest in distressed debt. The parameters of the duty of good faith are not conclusively defined – rather they are to be determined by bankruptcy courts using a facts and circumstances test on a

\textsuperscript{116} In order to prove a claim of aiding and abetting a breach of fiduciary duty, the plaintiff would have to show “(1) the existence of a fiduciary relationship, (2) a reach of the fiduciary’s duty and (3) a knowing participation in the breach by the non-fiduciary defendant.” Cantor Fitzgerald, L.P. v. Cantor, 724 A.2d 571, 584 (Del. Ch. 1998). The court in Radnor found that the plaintiffs did not prove these three elements. Radnor, 353 B.R. at 843.

\textsuperscript{117} Radnor, 353 B.R. at 843.

\textsuperscript{118} Radnor, 353 B.R. at 844-45 (“[t]he Committee has failed to prove that Mr. Feliciano was interested in any transaction and voted in favor of it due to his outside financial interests rather than voting in the best interests of Radnor”). The court was satisfied that Mr. Feliciano’s abstention from voting in matters that involved Tennenbaum was sufficient in showing that he did not breach his duty to Radnor. Radnor, 853 B.R. at 845.
case-by-case basis. Finally, the duty of good faith is flexible so that it may coexist and overlap with other duties that may be imposed on a hedge fund when it, or its representative, takes on a position on the board of directors or the bankruptcy committee.

A. My Proposal: Duty of Good Faith

I propose that the duty of good faith applied to hedge funds in loan to own transactions, should apply to all actions the hedge fund takes with regard to the distressed company. Unlike some applications of the duty of good faith, my proposal calls for good faith to be applied to a hedge fund regardless of whether it has any other duties toward the distressed company.

In Radnor the court concluded that Tennenbaum “at all times acted in good faith with a view to maximize Radnor’s value to all constituents.” A hedge fund should be found to have acted in good faith when it had intentions to “pursue[ ] a business strategy that it believes will increase the [distressed] corporation’s value.” Good faith may include situations where the hedge fund profits, as long as the hedge fund considered the best interests of the distressed corporation. But situations where the interests of the hedge fund and the target company diverge, where the hedge fund stands to gain while the target company simultaneously loses, should be investigated thoroughly for an abuse of the duty of good faith and possible finding of bad faith. Bad faith behavior goes beyond the hard negotiation tactics generally employed by hedge funds. Bad faith is the reprehensible behavior by the hedge funds that puts its own

119 Radnor, 353 B.R. at 841 (emphasis added).
120 Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006), judgment aff’d, 931 A.2d 438 (Del. 2007).
interests above those of the distressed company, to the peril of the distressed company.\textsuperscript{121} I discuss the judicial determination of good faith in Part VI(B).

The precise time when the duty of good faith applies to the company is difficult to determine. The duty cannot attach as soon as the hedge fund makes a loan, because then the duty would be too harsh and would apply to investors outside the loan to own scenario. It could even scare away willing investors. The duty should also not apply once the distressed company files for bankruptcy. As we saw in \textit{Radnor}, the hedge fund and the distressed company had engaged in a multitude of decisions and discussions long before the company filed for bankruptcy. Rather, the duty should apply as soon as the hedge fund considers itself, or reasonably should consider itself, involved in the company’s reorganization.

1. A Check on Hedge Fund Activity

The duty of good faith should act as a check on the activities of hedge funds. Before investing in distressed debt, the hedge fund should determine that would be capable of balancing its fiduciary duty to its investors with the duty of good faith that would be owed to the distressed company if it considers bankruptcy.\textsuperscript{122} It is important that the duty of good faith is not so

\textsuperscript{121} But the acts of bad faith must be punished “without threatening the overwhelming majority of hedge funds that respect the rules of the bankruptcy system.” Fisher & Buck, \textit{supra} note 2, at 88; \textit{see also} 11 U.S.C. 510(c) (2007), 1126(e) (2007). That is to say, when hedge funds act pursuant to their duty of good faith with respect to a distressed company in general, and then with a heightened fiduciary duty when the fund is actively involved in the reorganization process, courts must recognize the legality of the loan to own transaction. \textit{See} Harner, \textit{Empirical, supra} note 6, at 104 (“The law should not penalize distressed debt investors for pursuing, within the bounds of the law, what is in the best interests of their partners.”).

\textsuperscript{122} This suggestion seems to be on point with Sale’s discussion of fiduciary duty in general where she says that the company’s officers are obligated to “set up appropriate systems within the company to ensure its proper governance and share what they find with the directors.” Sale,
onerous that hedge funds will be dissuaded from engaging in these types of transactions at all. But, good faith should serve to dissuade some hedge funds that intend to act in bad faith in a loan to own transaction from engaging in such activity at all.

2. The Distressed Company’s Implied Consent

For the purposes of a loan to own transaction, the distressed company impliedly consents to the hedge fund’s possible engagement in a loan to own transaction when it allows the hedge fund to take a debt stake in the company. However, such consent does not guarantee that the hedge fund will be later insulated from disapproval or perhaps a lawsuit by the company or other creditors should the distressed company file for bankruptcy. Radnor presents an example of a distressed company that not only impliedly consented to the hedge fund’s participation in bankruptcy, but it also expressly consented with its request of a stalking horse bid. But Radnor demonstrates that even if the distressed company expressly consents to the hedge fund’s participation in bankruptcy, the hedge fund may not be insulated from later suit, in that case from the other creditors.123

123 Case law has shown that in cases where the target company is in favor of the hedge fund’s loan and participation in reorganization, then those hedge funds are successful if a lawsuit is brought against them by any other corporate actor. A fantastic example of the target company’s consent is in the case of Radnor where Radnor requested Tennenbaum to make a stalking horse bid. Radnor demonstrates that when the distressed company agrees to the hedge fund’s influence in reorganization, it only adds to the overall success of the loan to own process.

supra note 36 at 485. In the same vein, the hedge fund should be compelled to set up its own system of governance that conforms with the fiduciary duties discussed in this paper.
3. Why Hedge Funds?

Many different institutions can, and do, engage in loan to own transactions, but it appears that hedge funds’ activities in this area draw the most criticism. While it seems that most of the hostility toward hedge funds is unfounded, what is clear is that hedge funds are villianized in many circumstances. Take for example the recent classification of “hedge-fund managers…in the bad-guy category” in the Chrysler bankruptcy situation,\footnote{Julianna Goldman, Obama Criticizes Chrysler Hedge Funds That “Held Out” (Update 2), Bloomberg.com, April 30, 2009. While the Chrysler situation is certainly unique, especially given that it carries political undertones and affects the country as a whole (as opposed to many other bankruptcy reorganizations that are on a much smaller scale), the Chrysler bankruptcy situation highlights the importance and prominence of hedge fund involvement in bankruptcy reorganizations.} and President Obama’s own criticism of hedge funds.\footnote{See Joseph Checkler, Obama Takes Aim at Hedge Funds Amid Chrysler Bankruptcy, Wall Street Journal Online, April 30, 2009. Hedge funds have responded to the criticism claiming that they hold secured debt that is entitled to a priority under the Bankruptcy laws. Goldman, supra note 124.} While there is no plain reason why hedge funds should bear the brunt of so much criticism, I hypothesize that the mysticism of hedge funds coupled with their general lack of regulation causes some critics to believe that merely because hedge funds have the ability to act in bad faith, that they must act in bad faith.

Thus the duty of good faith should apply to hedge funds rather than other institutions that may engage in similar transactions.\footnote{Of course, since the duty is flexible it could be translated to apply to other groups that engage in loan to own transactions, such as banks and mutual funds. The duty may need to be tweaked in order to apply to banks, for example, as there are a multitude of other laws that govern banks and they may be subject to other duties to other constituents.} The first reason to apply the duty of good faith only to hedge funds is that it appears that hedge funds are more poised to engage in this type of risky transaction. That reality coupled with the fact that hedge funds tend to draw more scorn from
critics provide a situation in which it is necessary for a duty of good faith to attach. The second reason that the duty of good faith should apply to hedge funds is because hedge funds are not regulated by other laws. Whereas banks are regulated by institutions such as the Federal Deposit Investment Corporation, and mutual funds are regulated by federal securities laws, hedge funds largely escape regulation.

To counterbalance the criticism of hedge funds, my proposal of a duty of good faith on hedge funds should be satisfactory to both the hedge funds themselves and the critics. As hedge funds generally structure their investments in a manner that avoids regulation by many laws, their preference for deregulation is apparent. Hedge funds will appreciate a judicially imposed standard rather than legislation. Federal or state laws that attempt to govern loan to own transactions would be unnecessarily burdensome, very costly, and probably detrimental to the good that the hedge funds can do by providing liquidity in the market. As such, the application of a duty of good faith is a less severe, yet still effective, manner of policing the activities of the hedge funds in loan to own transactions. Hedge funds will prefer the lesser of two evils in this case, as the application of a duty of good faith is much more bearable than compliance with legislation.

The duty of good faith that I propose provides a flexible standard without the need for imposing new laws.127 Bankruptcy courts are well-suited for determining whether the hedge fund has acted in accordance with its duties of good faith.128 Although “good faith” is not a term defined in the bankruptcy code, bankruptcy courts should apply a facts and circumstances test to determine on the facts of the individual case whether the hedge fund engaged in good faith. This test is similar to the facts and circumstances tests that the bankruptcy courts apply in other situations, such as the determination of whether a bankruptcy petition was filed in good faith.129 Courts have the power to impose equitable damages on hedge funds that act in bad faith. Thus, claims of breach of the duty of good faith provide a substantive ground for liability.130

As stated by the Enron court, “[t]he courts do not define ‘good faith,’ given that ‘[t]he unpredictable circumstances in which the courts may find its presence or absence render any

127 See also Harner, Policy, supra note 55, at 770 (footnotes omitted) (emphasis added) (“Do these changes warrant or require any type of legislative response? The answer depends largely on the goals of the underlying insolvency regime. If the goal is to rehabilitate troubled companies and to let management control the rehabilitation process, then legislative change might be needed. If the goal is to ensure equitable distributions to junior creditors and shareholders, then legislative change might also be needed. If the goal is to maximize corporate value and utility, however, then arguably legislative change is not required.”).

128 Although the following examples are unrelated to the finding of good faith in the context of a loan to own transaction, it is worth noting that bankruptcy courts are required to make good faith inquiries into other issues of a company filing for Chapter 11, such as whether the filing itself was made in good faith. See generally, In re Nancant Inc., 8 B.R. 1005 (Bankr. D. Mass. 1981) (finding that the company did not file a Chapter 11 petition in good faith; rather the company filed the petition for tax purposes).

129 See generally Colonia Daytona Ltd. Partnership v. American Sav. Of Fla., 152 B.R. 996, 1001 (M.D. Fla. 1993) (describing the test the court applies in determining if a petition for bankruptcy was filed in good faith: “[t]here is no particular test for determining whether a debtor has filed its petition in bad faith, although several circumstantial factors occurring together may be indicative of bad faith filing”).

Drafting a static list of activities that qualify as bad faith is impractical, as it would only prompt hedge funds to design transactions that do not meet the letter of those prohibited transactions. Plus, the nature of hedge funds is such that their investment strategies constantly change. To define a certain activity that is outside the duty of good faith today may waste time and effort because the funds could be engaging in varied strategies tomorrow.

Examples of bad faith may include some situations where the hedge fund stands to profit at the expense of the distressed company, such as when the fund engages in arbitrage activities that could make the price of the borrower’s stock fall, short sells the borrower’s stock, or engages in a credit default swap that separates the hedge fund’s interests from those of the distressed company. Even these activities, though, do not constitute per se bad faith. For example, credit default swaps may not put the creditor at odds with the borrower in all circumstances. Also, short selling may not in all cases be found to be bad faith. If, by virtue of the hedge fund’s engagement in short selling the distressed company’s stock, the interests of

132 See Durfee, supra note 1.
133 When a hedge fund engages simultaneously in a short sale while carrying out a loan to own transaction, a conflict of interest is created between the interests of the hedge fund and that of the shareholders. Rosenberg & Riela, supra note 1.
134 Credit default swaps are “private third party transactions” that “allow a distressed investor to hold a net short position while at the same time hiding the investor’s financial incentives from all other parties in the bankruptcy case.” Coco, supra note 54, at 622. “Empty voting” is also a concern among critics of the loan to own transaction. Empty voting occurs when hedge funds “acquire voting rights that are divergent from their ownership interests, and thereby vote in a way that is counter to the interests of the other shareholders and solely at a financial gain to the fund.” Cumming & Johan, supra note 2, at 5.
135 For example, if the lender lends $100 but only hedges $50, the lender’s net exposure is still $50. The lender would find himself in the same situation if he had only lent $50.
the hedge fund and the distressed company are opposed, then such an action should be looked at carefully to determine if it was bad faith. However, if the hedge fund’s involvement with the company is only as a lender, and bankruptcy is not being considered by the company, then the short selling should not be classified as bad faith.

1. Good Faith’s Interaction with other Pre-Existing Duties

I intend for the duty of good faith to coexist with other duties that presently exist for hedge funds under present laws, such as the fiduciary duties a hedge fund owes its investors. Under my proposal, the hedge fund’s duty of good faith to the target corporation rises to the same level as the fiduciary duty the hedge fund owes its investors. The purpose for a duty of good faith in the loan to own scenario is imposed to protect the distressed company from self-interested activities of the hedge fund. Ordinarily, the hedge fund’s primary purpose is to make money for its investors, but the added fiduciary duty toward the distressed corporation forces the hedge fund to recognize that, while it can still make money for its investors, its activities will be qualified by a duty of good faith to the distressed corporation.

There may be situations where the hedge fund assumes another role in bankruptcy that imposes further fiduciary duties on the hedge fund, such as when a hedge fund partner becomes a director or a member of a bankruptcy committee. In these situations, the hedge fund must balance the duty of good faith to the company, the fiduciary duty owed to its investors, and whatever other duty is imposed preexisting law.

If it is impossible for the hedge fund to maintain both the duty of good faith and the other fiduciary duties imposed on it in whatever position it has *voluntarily chosen* to take, then the hedge fund could be vulnerable to legal action (by for example the distressed corporation, its shareholders, other creditors, and perhaps its own investors) and its actions may be found to be a violation of the duty of good faith.

When the hedge fund appoints one of its partners to the board of directors of the distressed company the partner who is a director takes on the traditional fiduciary duties of loyalty and care owed to the company by reason of his appointment to the board of directors. My proposed duty of good faith will still exist as a blanket duty to guide the hedge fund and that partner in all its dealings with the distressed company. This director’s decisions will require an extra delicacy that the other board members do not have to apply, but is only fair because the hedge fund has chosen to assume this dual role, with a high risk for conflict. In bankruptcy, directors owe *Revlon* duties to the shareholders, meaning that the hedge fund representative to the board of directors – and by extension the hedge fund – has a duty to maximize the distressed company’s value for the shareholders.\^137 Such a duty must coexist with the good faith duty the hedge fund owes the distressed company.

When a partner of the hedge fund sits on an unofficial committee in bankruptcy, it has a fiduciary duty to other creditors, while at the same time it has a duty of good faith to the company. In such a situation, there may be a difficult balance of the various duties, and if the hedge fund does not believe that it can honor those duties, then it should decline to sit on that committee. Finally, when the hedge fund takes a position in a loan to own transaction only as a

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shareholder, the duty of good faith should apply to the hedge fund’s actions with regard to the company.\textsuperscript{138}

2. A Brief Consideration of the Chrysler Situation

With the Chrysler bankruptcy reorganization now making headlines, it is difficult to determine whether the hedge funds are acting in good faith. The outcry over hedge funds in the Chrysler situation focuses on the hedge fund’s refusal to agree with the bankruptcy plan\textsuperscript{139} and the duty of good faith should apply. As long as the hedge funds are not acting in purely for their own self-interest – that is to say, that they are taking into account the financial well-being of Chrysler – then their actions should conform to the duty of good faith.

V. Response to Critics of Loan to Own Transactions

This section investigates the common criticisms of loan to own transactions. I confront these criticisms with my proposal that a duty of good faith will attach to all activities of the hedge fund regarding the target company.

\textsuperscript{138} In this context, it may appear that because the hedge fund is only a shareholder, its position falls outside of the loan to own transaction. As a shareholder, however, the hedge fund does have standing to serve as a party in interest in bankruptcy, and so for that limited activity. \textit{See} 11 U.S.C. § 1109(b). Since the possibility exists for the hedge fund to be actively engaged in the reorganization of the distressed company, I include a hedge fund who is a shareholder as applicable to loan to own transactions. 

\textsuperscript{139} Checkler, \textit{supra} note 125.
A. Claims of Insider Trading

When a hedge fund is involved in the reorganization of a distressed company, there is a possibility that there will be charges of insider trading. Because the hedge fund may act as a creditor or sit on the board of directors, it may be in a position to learn confidential information from the company, thus opening it up to accusations of insider trading. I discuss a variety of instances in which the hedge fund may receive confidential information that could potentially be used for insider trading purposes and how the duty of good faith and fiduciary duty apply.

To begin, traditional banks often find themselves in the same position as hedge funds when it comes to keeping confidential information private during a lending relationship and ensuing bankruptcy process. A common practice among banks is to separate the information the bank uses for trading and lending, as well as restrict the people who have access to the information to ensure no one has access to both. It is more difficult, however, for hedge funds to mimic this approach, as there are fewer people working for the hedge fund. In hedge funds, the portfolio companies’ confidential information is held by only a few people. While the bank may keep the information separate between divisions that may operate on different floors of a large building, the hedge fund operators may be right next door. Some hedge funds are

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140 Insider trading is the “illegal use of price-sensitive, nonpublic information to buy and sell securities and other financial instruments.” Insider Trading: Global Developments and Analysis, ix (Paul U. Ali & Greg N. Gregoriou, eds., 2008).
142 Id. (explaining that hedge funds “tend to be smaller than banks and have fewer information barriers”).
143 Id.
capable of separating the information – for example, Silver Point Capital LP ensures that people who have confidential information about the client are separated physically from others. In the event that nonpublic information is leaked within the hedge fund, Silver Point has a policy of halting trading for that company. Other hedge funds seek the approval of their screening mechanisms from a supervising court. If the court approves of such mechanism and the hedge fund adheres to the screening procedure, then the hedge fund will not be found to have violated the fiduciary duties owed to the committees’ constituents.

The application of the duty of good faith should calm critics who claim that the hedge fund will use insider information to benefit its investors at the peril of the distressed corporation. Critics fear that the hedge fund will learn the company’s confidential information and then engage in transactions that actually harm the target company while earning more money for the hedge fund itself. Such activity is barred by the duty of good faith.

The duty of good faith’s application should cause the hedge fund appointee, if he serves on the board, to not vote on matters involving the hedge fund and the reorganizing company. This method was effectively used by Tennenbaum in *Radnor*. Tennenbaum’s appointed board member, Mr. Feliciano, would abstain from voting on matters that concerned Tennenbaum. The court found that this precaution “was a significant factor in protecting that director from a

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144 *Id.* (“[a]t some funds, the person trading loans, who may have access to confidential information, often sits next to the person trading the bonds – or, in some cases, may be the same person”).
145 *Id.* A Silver Point spokesman stated that Silver’s Point’s method of keeping information separate is a “sophisticated information barrier.” *Id.*
146 *Id.*
147 See Rosenberg & Riela, *supra* note 1 (“committees (or individual members thereof) often request court approval of ‘screening walls’ and other procedures”).
finding that he breached his duty of loyalty to Radnor.” This example shows the overlapping of the duty of good faith, applied to the hedge fund representative, and the duty of loyalty, applied to directors.

The SEC does not sit idly by in situations of possible insider trading in a loan to own transaction. For example, Blue River Capital was fined for using nonpublic information it had gained from sitting the creditor’s committee in bankruptcy. Blue River was accused of using that nonpublic information in conjunction with trading the shares of Adelphia, Globalstar, and WorldCom in 2004. Ultimately, while Blue River was not charged with insider trading, the SEC “accused Blue River Capital of failing to have information barriers in place to prevent the misuse of such information.” Blue River was fined $150,000 and was prohibited from trading for six months.

B. Shareholders Claim that the Hedge Fund Breached its Fiduciary Duties

Shareholders may criticize the hedge fund for having a conflict of interest and breaching its fiduciary duty to the shareholders. But, it is more probable that the hedge fund activity in the loan to own transaction actually helps shareholders. To use Jonathan Macey’s concept, hedge funds are the “new sheriffs of the boardroom” because of the potential power they exert.

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149 Berman, supra note 19, at 67.
150 See also id. (“the SEC sued Van D. Greenfield and his fund, Blue River Capital, accusing them of using fake trades to secure a position on the WorldCom creditors committee. That position enabled him to get inside information while his fund continued to trade in the securities of the company.”).
151 Id.
152 Durfee, supra note 1.
153 Futter & Wells, supra note 8, at 229; see also Cumming & Johan, supra note 9 (conflicts of interest may arise from the investor base, from fees and investment by hedge fund managers, from lack of regulatory oversight, from strategies and leverage).
over management of publicly held companies. Acting in this role, hedge funds oversee the boards of directors and management and ensure that they do not engage in self-serving activities. Plus, the hedge fund will want to govern the distressed company in the best possible manner so it maintains a positive reputation and potential investors will see that the fund successfully is a successful manager of distressed firms.

The hedge fund wants to make money and succeed so that it does not disappoint its own investors, and so that its reputation is not marred so that it can attract investors in the future. As long as the hedge fund is cognizant of the duty of good faith that it owes to the distressed corporation, and in turn to the shareholders, it should be insulated from such claims of breach of fiduciary duty from the shareholders.

In Radnor, the creditors committee brought suit complaining that both Radnor and Tennenbaum breached fiduciary duties. In finding that Mr. Feliciano did not breach his duties to Randor, Judge Walsh pointedly stated:

As a matter of law, there is no *per se* breach of fiduciary duty for an insider making a bid to purchase a company or its assets. Were it otherwise, every management led leveraged buyout would be a *per se* breach of fiduciary duty, yet the Delaware courts have held otherwise...Therefore there can be no breach of

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154 Macey, *supra* note 5, at 245. And, because “companies that want to avoid being the target of an activist hedge fund can only do this by improving corporate governance extensively so that there are no longer any arbitrage possibilities that allow fund managers to take a position in the target company and then start agitating for reform.” *Id.* at 250.

155 Macey, *supra* note 5, at 247.

156 *Id.* at 248, 249 (“Because their compensation is inexorably tied to performance...hedge funds often use a very hands-on approach to ensuring that their portfolio companies perform as well as possible.”).

157 See Harner, *Empirical, supra* note 6, at 103 (discussing how these incentives cause hedge funds to “maximize the return on their investment” in the distressed company).

158 Such a claim brings up interesting issues, such as whether the claim could stand even if the Tennenbaum did not have a freestanding duty to the shareholders that loan to own transaction.
Since the judge found that the bid helped Radnor, Mr. Feliciano can be considered to have acted in good faith. It is also worth noting that even if the bid had not helped Radnor but had chosen a course of action with the intent of benefitting the distressed corporation, or at least that was not at odds with the corporation’s well-being, that such action would be considered good faith.

C. Cries to Recharacterize the Hedge Fund’s Debt as Equity

Some argue that the hedge fund’s loan to a distressed company should be recharacterized as equity, as the creditors committee argued in Radnor.\textsuperscript{160} There is no sound legal reason, however, that the debt should be recharacterized simply because of the nature of the hedge fund who owns the debt.\textsuperscript{161} Plus, courts are reluctant to recharacterize loans outside of the fact pattern involving people on the inside of corporations (generally in closely held corporations), and controlling shareholders.\textsuperscript{162} The case law states that as long as the parties manifest an intent for

\textsuperscript{159}Radnor, 353 B.R. at 845 (citations omitted).
\textsuperscript{160}The typical case for recharacterization of a loan is when a “lender” gives money to a corporation, but it looks more like the purchase of stock (purchasing an equity interest) rather than a creditor. Perhaps the “lender” will take such action in hopes of beneficial tax treatment. A court may choose to recharacterize what the parties had been calling a “loan” for what it really is, an equity stake.
\textsuperscript{161}Landers, \textit{supra} note 73, at 46 (explaining that it is not sufficient to say that debt should be recharacterized as equity just because the hedge fund holds both).
\textsuperscript{162}Berman described some of the factors the court looked to in order to decide the intent of the parties: “[t]he transaction documents referred to the obligations as debt; [t]he parties consistently referred to the obligations as ‘loans’ or indebtedness; [t]he debt instruments contained a fixed maturity date; [t]he hedge fund lender was given the right to enforce the payment of principal and interest; [t]he transaction documents did not contain voting rights; [t]he loans were treated as priority debt instruments and the proceeds were used for working capital and to replace and/or pay down existing debt; and [t]he transaction documents provided the
the interest to be debt, the court will be reluctant to recharacterize it as equity. As long as the hedge fund and the distressed company enter into a transaction in good faith that classifies the interest as debt, such a decision should be upheld by the bankruptcy court.

In *Radnor*, the plaintiffs made a case for recharacterizing Tennenbaum’s debt as equity. The judge chose to focus instead on the intent of the parties when they entered into the loan agreement. Because the intent of the parties’ at the time the agreement was entered into was to be a loan, the court refused to recharacterize the debt.

VI. Conclusion

This paper has demonstrated the benefits of loan to own transactions. It has highlighted hedge funds’ ability to provide liquidity in current markets where there is a credit shortage. Loan to own transactions benefit many parties: the distressed company and its stakeholders, and possibly other creditors. The distressed company benefits because it is able to get a loan from the hedge fund, which may help the company avoid filing for bankruptcy. Employees benefit because they can keep their jobs. The shareholders get a second chance for the company to be a lender with a security interest given priority in a liquidation or insolvency.” Berman, *supra* note 19, at 67.

163 *Id.* (explaining that if the hedge fund is “careful to act like a ‘lender’ by monitoring the loan, documenting and enforcing defaults, insisting on timely payment of interest, principal, and other amounts due…” then the court should not recharacterize the hedge fund’s debt as equity).

164 Rosenberg & Riela, *supra* note 1; see also Rosenberg & Riela, *supra* note 1 (“[e]ven in the current tight credit market, a number of hedge funds continue to provide substantial returns to their investors (and managers)”; Don Durfee “Meet your New Bankers” (“hedge-fund money may fit neatly into a company’s capital structure at a crucial moment, providing a bridge to the next stage of development”).

165 Landers, *supra* note 73, at 46.
successful in the future. Management may be asked to stay on board, or could get a sizeable severance package.

The hedge fund is able to use its industry expertise to take the reins of the distressed company and make it profitable again. Whether the company ultimately fails or succeeds, the fact that the hedge fund was able to give it a loan is valuable. Even if the hedge fund is not successful in keeping the target company from filing for bankruptcy, the added opportunity that the distressed company received to attempt to overcome bankruptcy gives incentives for current management to keep their companies thriving. And a robust loan to own market increases liquidity and allows hedge funds to compete – which lowers transaction costs for the borrowers.

In this paper, I have proposed that in a loan to own transaction, the hedge fund should act at all times under a duty of good faith toward the company and its shareholders. While the parameters of the duty are not absolute, bankruptcy courts have the task of determining what activities qualify as good faith using a facts and circumstances test. The duty of good faith should serve as a check on hedge funds considering making a loan to a distressed company. As long as hedge funds enter into loan to own transactions knowing that the duty of good faith will

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166 See, generally, Macey, supra note 5, at 250, 272 (“hedge fund…managers have the resources, the expertise, and the incentives to improve the way their portfolio companies are run”)
167 Id. at 246 (explaining that the possibility of a loan to own transaction establishes a “positive externality for all investors: the mere threat of intervention by activist investors creates strong incentives for managers of companies to act in the interest of shareholders in order to avoid losing autonomy and control, not to mention their jobs”).
168 See Fisher & Buck, supra note 2, at 86; Rosenberg & Riela, supra note 1; see also Adam Levitin, Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron, Colum. Bus. L. Rev. 83, 87-88 (2007). Harner’s empirical study found that “[a]n active distressed debt market can lead to a lower cost of capital for potentially troubled companies” and the “competition in the distressed lending market may reduce the cost of financing, including debtor in possession financing.” Harner, Empirical, supra note 6, at 98.
apply, and as long as those hedge funds act under the duty of good faith, loan to own transactions should be encouraged.