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Claims Trading Promotes Ownership Concentration

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Claims trading is a pervasive component of modern chapter 11 restructurings. The identities of claimants holding relatively liquid equity, bonds and senior bank claims can change hands multiple times in the months leading up to a filing. By the time a company files, trading can open across the entire capital structure as investors put into play just about any eligible claim against the debtor, including trade claims, rejected leases, tax liens, and insurance and tort claims. The acquirers of these claims are often sophisticated “distressed debt” investors, well-versed in the workings of chapter 11 and in the strategies available to affect chapter 11 outcomes.



Prof. David C. Smith

Reactions to the development of claims-trading markets have ranged from consternation to measured praise. On the one side, distressed-debt investors are blamed for behaving opportunistically against the interests of other parties, for burdening the court with undo litigation and for acting as “vultures” picking over the carcasses of dying companies. On the other side, distressed-debt investors are viewed as adding needed liquidity to claims markets, as supplying a competitive force to drive recoveries higher for all claimants, and as a “phoenix” that

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revives burned-out companies so they can thrive once again.¹

Yet little is known empirically about the ownership structure of bankrupt claims, much less the influence that claims trading and ownership have on the outcome of a chapter 11 case, because the actions of distressed-debt investors are notoriously hard to observe.² In this article, results from a new study that helps fill this gap in our knowledge will be summa-

rized. The study used a novel data set for identifying investors holding chapter 11 claims to examine the role these investors play in affecting chapter 11 outcomes.³

Specifically, the study identified the owner of claims at two points during the chapter 11 cases: (1) at the filing of the debtor's schedule of assets and liabilities, supplemented with entries into the credit register; and (2) at the tabulation of votes on the debtors' plans of reorganization. In total, the study covers claims filed by 71,358 different claimants in 136 large debtors from 1998 to 2009. For a subset of

the claims, the study also observed actual trades by investors during the chapter 11 case. The initial claims data were collected with the help of four claims-management companies—BMC Group, Donlin Recano & Company, Epiq Systems Inc. and Kurtzman Carson Consultants, who provided the publicly available information in electronic format.

Much of the value added to the data by the researchers comes in the form of classifying all claims owners by “investor type.” The authors used a variety of computer and hand-matching methods to classify each of the roughly 70,000 claimants according to whether they were financial investors, including whether they were banks (commercial or investment), custodians for bondholders, hedge funds, private-equity funds, other asset management firms, insurance companies or real estate companies, or nonfinancial investors, divided into intercompany

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claimants, individuals, corporations, and government entities and tax authorities. The strategy for identifying claimants works through subsidiary and separate funds, including collateralized debt and loan obligation (CDO and CLO) structures, up to the parent investors/managers. The investors' ownership share (percentage of claims held) and concentration (percentage of shares held controlling for the size and distribution of ownership of other claimants) across entire capital structures were also tracked and recorded. How both the ownership structures and concentrations of claimants related to the evolution and outcome of a case, and how trading of claims influences the concentration of creditors in the capital structure, were also studied.

To our knowledge, this is the first study to provide a comprehensive examination of the ownership structure of debt

¹ Adam J. Levitin, “Bankruptcy Markets: Making Sense of Claims Trading,” 4 *Brook J. Corp. Fin. & Com. L.* 64-109 (2010), provides a nice overview of the controversies and debate surrounding claims trading.

² See *op. cit.* 1 (stating at 73, “[t]he debate over claims trading operates on a limited evidentiary base. Arguments about claims trading are based on theory, common sense, and anecdote, but not data. Empirically, we know relatively little about claims trading”).

³ Victoria Ivashina, Benjamin Iverson, David C. Smith and Per Strömberg, “The Ownership and Trading of Debt Claims in Chapter 11 Restructurings,” unpublished Harvard Business School and University of Virginia manuscript (2010).

claims of financially distressed firms. This article presents some of the interesting summary statistics from the study and documents its key findings.

A First Look at the Data

Table 1 shows the 136 filings for which claimant holdings were obtained. The table is constructed from data on chapter 11 filings collected from debtor disclosure statements and *The Deal Pipeline's* bankruptcy database, and provides a nice snapshot of the characteristics of large filers from 1998 to 2009.

The debtors studied were relatively large, with median assets of \$250 million, that had mostly filed in either Delaware or the Southern District of New York and spent about one year in chapter 11. Roughly 20 percent of the sample debtors filed a prepackaged or prearranged chapter 11, which speeds up the resolution process (the median prepackaged/prearranged filer exits within five months of the petition date) but is associated with lower recovery rates. Forty-five percent of the debtors in the sample exited as going-concerns via traditional reorganizations, 21 percent were sold as going-concerns through 363 sales, and 33 percent were liquidated piecemeal. Traditional reorganizations were associated with the highest recovery rates (54 percent), although sales to financial buyers recovered nearly as much (52 percent) and considerably more than sales to strategic buyers (46 percent). Median recoveries in liquidations were 32 percent of face value.

Claimants in the “middle” of the capital structure most often received new equity in a reorganization, with pre-petition lender claimants gaining controlling equity in 31 percent of the cases.

Table 2 provides a summary from the study of claims holdings by investor type across the 136 debtor firms. For brevity, the table reports holdings only at the time of that vote tabulation. Thus, the statistics reported in Table 2 are calculated on the subset of claimants that are eligible—and willing—to vote on plans. The first column shows that the largest two claims-holders in chapter 11 cases tended to be banks and nonfinancial corporations. Together these two investor groups held 47.8 percent of all voting claims. By comparison, asset-management firms, hedge funds and private-equity funds—investor groups that are likely to include sophisticated distressed-debt investors—held only 15 percent of the total voting claims, but the picture changes when focusing only on cases in which the groups of sophisticated investors held at least one claim, as reported in the third column of the table. Asset-management firms, hedge funds and private-equity funds together held about one-third of all voting claims in firms in which they chose to invest. These holdings increase to about 45 percent of all claims if it is assumed that bonds held through custodial relationships were also owned by these investors.⁴ The distressed-debt

investors were also selective about cases in which they invested, as fully 60 percent of the sample firms had no identified hedge-fund involvement and 70 percent had no private-equity investors.

Claims Trading and Ownership Concentration

While Table 2 provides a snapshot of the ownership and concentration of claims holdings among investor groups voting on a plan, it tells little about how *claims trading* prior to the vote affected that distribution. Table 3 presents some interesting statistics related to claims trading during a case—specifically, the proportion of claims purchased and sold by each of the investor groupings during the chapter 11 case based on observed assignments reported as proofs of transfer under Bankruptcy Rule 3001(e). The transfers primarily involved bilateral claims, such as trade claims, rejected leases, tax claims and tort claims that are not tracked separately by a trustee, custodian or agent. If trading in these claims is correlated with claims trading across other parts of the capital structure, then observing the frequency of these transfers can tell something about the impact of trading on claims ownership in general.

Table 3 shows that the largest sellers of these claims during chapter 11 were banks and nonfinancial corporations, while the largest purchasers of the claims were banks, asset-management firms and hedge funds. The transfers observed by

⁴ Registered bondholders are permitted to remain anonymous for the purposes of voting on a plan and can opt for their brokerage firm or some other custodian to vote on their behalf.

Table 1: Descriptive Statistics on 136 Large Debtors Filing During 1998-2009

Year of filing	% of all filings	Characteristics of debtor at filing		Filing type and outcome	Median % of all filings	Mean % of all filings	Median recovery rate
		Median	Mean				
1998	0.7%	Assets (\$ in millions)	\$250	\$1,929	Type		
1999	0.0%	Liabilities (\$ in millions)	\$375	\$1,818	Prepack/prearranged filing	19%	45%
2000	0.7%				Non prepack/prearranged filing	78%	49%
2001	5.8%				Outcome		
2002	9.4%	Filing court			Reorganized	45%	54%
2003	12.2%	Delaware	41%		Sold to a financial buyer	9%	52%
2004	7.2%	Southern District NY	22%		Sold to a strategic buyer	12%	46%
2005	11.5%	Other	37%		Liquidated	33%	32%
2006	13.7%						
2007	9.4%	Time in Chapter 11 (Months)			equity interest in reorganized firm at exit	% of all reorgs	
2008	23.7%	Median	12.4		DIP lenders	8%	
2009	5.8%	Mean	14.4		Prepetition lenders	31%	
2010	0.0%				Notes/bondholders	24%	
					General unsecured creditors	19%	
					Subordinated debtholders	3%	
					Equity interests	15%	

banks, which are both large sellers and buyers of claims, likely reflect the different roles played by large banking institutions. As pre-petition lenders wishing to liquefy their exposure to a bankrupt client, banks will be willing sellers. At the same time, proprietary trading desks at

large banks that specialize in distressed-debt trading will be willing buyers of distressed-debt firms. Thus, net trading by banks is only slightly negative. In general, financial institutions are net buyers during bankruptcy, while nonfinancial institutions are net sellers.

Table 2: Holdings of Voting Claims, by Investor Type

	Holdings as % of all claims, average across all cases	Proportion of cases in which investor is present	Holdings as % of all claims, average across cases in which investor is present
<u>Financial institutions</u>			
Bank	21.7%	72.4%	30.0%
Custodial bond holdings	4.2%	34.5%	12.2%
Asset management firm	9.1%	62.9%	14.5%
Private equity fund	3.5%	30.2%	11.7%
Hedge fund	2.3%	38.8%	6.0%
Insurance	1.9%	34.5%	5.5%
Real Estate	0.8%	25.9%	3.1%
Potentially Financial	7.5%	87.1%	8.6%
Other Financial	1.8%	22.4%	7.9%
<u>Non-Financial Institutions</u>			
Corporation	26.1%	95.7%	27.2%
Government/tax entity	4.4%	39.7%	11.0%
Individual	12.2%	82.8%	14.7%
Intercompany/Insider	2.2%	11.2%	19.5%
Identity unknown	2.4%	65.5%	3.6%

Table 3: Claims Transfers by Investor Type

	% of all sellers	% of all buyers	% of all net buyers
<u>Financial institutions</u>			
Bank	42.92	40.48	-2.45
Custodial bond holdings	7.08	1.79	-5.29
Asset management firm	1.04	17.28	16.24
Private equity fund	0	4.72	4.72
Hedge fund	0.19	14.72	14.54
Insurance	8.86	1.74	-7.12
Real Estate	0.18	0.06	-0.12
Potentially Financial	2.08	1.19	-0.9
Other Financial	0.1	0.79	0.69
All financial institutions	62.46	82.78	20.31
<u>Non-financial institutions</u>			
Corporation	33.86	6.46	-27.4
Government/tax entity	0.19	0.08	-0.11
Individual	2.08	0.36	-1.73
Intercompany/Insider	1.05	6.47	5.42
Identity unknown	0.36	3.85	3.49
All non-financial institutions	37.54	17.22	-20.31

The study presents several other key results relating claims trading to the distribution of claims ownership. First, claims trading leads to more concentrated capital structures. Across debtors, those cases experiencing more intense claims trading ended up with relatively fewer claims-holders owning a greater share of the claims. As explained below, this concentration in the capital structure can have important consequences. The study shows that this relationship holds more directly by using 26 debtors that are clients of BMC Group in which individual claims—and the identity of the claims-holders—are tracked from the filing of schedules through to the tabulation of votes. Across these 26 firms, there is a strong relationship between trading in debtor claims and eventual concentration of claims at voting. Relatively dispersedly held claims held by corporations and banks were sold to relatively fewer financial buyers, which concentrated the claims holdings for voting purposes.

Claims Ownership and Chapter 11 Outcomes

The big question central to the debate on claims trading is: How does claims trading affect chapter 11 outcomes? Is the debtor estate made worse or better because of claims trading? While the study does not provide a direct answer to this question, it does show a distinct relationship between concentration in claims ownership structures and chapter 11 outcomes.

Both economic theorists and legal scholars conjecture that concentration within debt structures aids in lowering the costs of restructuring and improving the efficiency of the process. Simply put, having fewer creditors around to bargain with the debtor makes it easier and less costly to complete the restructuring.⁵ Creditors can better coordinate their actions and are less likely to be plagued by individual creditor hold-outs. The data collected for the study addressed these conjectures and estimated the impact of ownership concentration on the events of the case.

While it is relatively straightforward to estimate a relationship between claims ownership concentration and bankruptcy outcomes, it is more difficult to determine *causality* in the

⁵ For economic theory papers, see Robert Gertner and David Scharfstein, "A Theory of Workouts and the Effects of Reorganization Law," *J. Fin.* 46, 1189-1221, and Patrick Bolton and David Scharfstein, "Optimal Debt Structure and the Number of Creditors," *J. Pol. Ec.* 104, 1-25. For legal scholarship on the subject, see Thomas H. Jackson, "The Logic and Limits of Bankruptcy Law," *Baird & Rasmussen op. cit.* 1, and Levitin, *op. cit.* 2.

observed relationships because it is difficult to discern potentially complex joint relationships between the variables. For instance, if more claims trading leads to more concentrated claims-ownership structures, and more concentrated claims are, in turn, observed to correlate with lower recovery rates, then one *could* interpret this as suggesting that claims trading leads to lower overall recovery rates in bankruptcy. An equally valid interpretation of this finding is that claims traders seek cases in which valuations are low at the outset because there is more upside potential from these investments. This potential “upside” is missed in the straight regressions of recovery rates on concentration.

Against this background, the study’s primary findings can be summarized as follows. First, higher creditor concentration *at the outset of the case* (as measured by the concentration of claims ownership at the filing of the schedules of assets and liabilities) is associated with a higher likelihood of observing prepackaged/prearranged filing and a shorter time in bankruptcy. Part of the increased speed through chapter 11 is due to the fact that prepacks/prearranged deals move much faster, but setting prepacks/prearranged deals aside, the study finds that a one standard deviation increase in creditor concentration is still associated with a two- to three-month decrease in the time spent in chapter 11. Second, more highly concentrated claims-ownership structures at vote tabulation are associated with a higher probability of observing a going-concern sale of debtor assets during chapter 11. Third, higher creditor concentration at vote tabulation is associated with lower overall recovery rates. The findings on this dimension are fairly strong—a one standard deviation increase in the level of claims concentration is associated with a 13 percentage point decrease in recovery rates to creditors.

What do these results imply about the efficacy of claims trading? It is probably too early to draw any hard conclusions. The study finds that claims trading leads, in part, to more concentrated claims ownership and that distressed-debt investors—asset-management firms, hedge funds and private-equity funds, as well as banks—are the most active claims buyers during the chapter 11 case. The study also finds that higher creditor concentration is associated with more prepack/prearranged deals, faster restructurings and more going-concern sales. To the extent that a goal of an effective

restructuring is to rehabilitate a firm as a going-concern in as short a time as possible, the results suggest that observed claims trading by sophisticated investors can improve restructuring efficiency. On the other hand, such traders might simply be good at finding those cases that move faster through restructuring anyway and therefore do not *cause* the cases to move more efficiently.

Moreover, more concentrated claims structures are associated with lower recovery rates to creditors as a group. This result, taken by itself, would suggest that the involvement of claims traders reduces the size of the “pie” available to creditors and therefore works against more efficient outcomes, but such inferences are invalid without first accounting for the forces that impact recovery rates independent of claims trading. Current work by researchers involves putting in place the controls that will allow for more causative statements to be made about the relationship observed above, including explicit “instruments” that net out other factors influencing outcomes and recovery rates. Those results will be forthcoming in an updated version of the study. ■

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