Been down so long, it looks up to me
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Bankrupt auto parts giant Delphi Corp.'s maneuverings through Chapter 11 are drawing scrutiny, and not just from union workers, pensioners, lenders and trade creditors. In addition, it looks as though two hedge funds - Harbinger Capital Partners Master Fund I Ltd. and Appaloosa Management LP - will have a say in shaping Delphi's future, despite sitting near the bottom of the company's creditor hierarchy.

Harbinger, no stranger to bankrupt investments, had bought up Delphi stock to a point that it was told by the company and Judge Robert Drain of the U.S. Bankruptcy Court for the Southern District of New York in Manhattan to reduce its stake below 26.5 million shares, based on stock-trading rules established earlier in the case. Harbinger has since joined with Appaloosa - Delphi's largest shareholder with some 9.3% - to begin talks regarding a "negotiated business arrangement" that could shape Delphi's eventual emergence from bankruptcy.

These aren't the only hedge funds playing big bankruptcy roles through their equity positions. Sigma Capital Management LLC and funds such as Goldman Sachs Credit Partners LP began to buy up a stake in Linwood, Pa.-based Foamex International Inc. following the company's September 2005 plunge into bankruptcy. Equity holders led by stock and debtholder D.E. Shaw Laminar Portfolios LLC have since called for and withdrawn a request for an equity committee as Foamex's financial fortunes improved.
Foamex, meanwhile, scrapped its original reorganization plan, with the intention of creating one that may or may not include shareholder payouts.

Indeed, a trend that began years ago with increasing numbers of court appointments of official equity committees has strengthened of late. With some professionals suggesting debt markets are high-priced and overbought, distressed-debt investors have begun looking to the lowest rung of the ladder for returns. "A lot of these hedge funds that used to play in unsecured bonds are looking elsewhere," says John Madden, a senior vice president at Chanin Capital Partners' restructuring group. "And they're looking to equity."

The explosion of second-lien financing shows that hedge funds and other distressed investors are buying securities on every level of capital structures, with many also exerting influence in debtor-in-possession and exit financing. However, their presence has recently been felt in equity as they scoop up shares either before or during Chapter 11 filings. That has set off valuation battles and contested confirmation hearings and produced alternate reorganization proposals.

And there's an additional ingredient: Many cases increasingly struggle to cope with unquantifiable liability structures from legacy benefit costs, pending litigation or large and uncertain claims. Such uncertainties encourage equity holders to get involved in the hopes of influencing outcomes.

"I think courts are, in some cases, struggling with the proper treatment of real junior constituents," says one hedge-fund investor.

Over the past 12 months, bankruptcy courts have appointed five equity committees, with bankruptcy judges overruling U.S. trustee decisions in two of them. Trustees shot down committee requests in Delphi's and Oneida Ltd.'s bankruptcies. However, aggressive investors holding equity such as Appaloosa, Xerion Capital Partners LLC and others fought for and won official status for shareholders.

Bankrupt companies such as OCA Inc., Dana Corp., Calpine Corp. and Riverstone Networks Inc. in turn also saw their organizing shareholders win official status straight from trustees without turning to judges.

A greater sense of uncertainty about establishing valuations of bankrupt companies is driving this activity in equity committees. This murkiness blurs the picture when judges consider wiping out equity - historically a typical event in a bankruptcy. This comes even though, as Anders Maxwell, a managing director at Peter J. Solomon & Co. focusing on corporate restructuring, points out, "by definition" a company that files couldn't have material residual value for an equity committee.
However, circumstances have changed, and with much more persuasive and financially backed arguments coming from the bottom of the hierarchy, equity has a greater chance of getting a second look.

"There's not quite the same knee-jerk reaction against it," says Peter Wolfson of Sonnenschein Nath & Rosenthal LLP, who represented the Loral Space & Communications Inc. equity committee.

A few equity victories emboldened those reactions. Cases such as Kasper ASL Ltd. and Peregrine Systems Inc. marked early instances when equity committees won battles for recoveries. The most substantial victory, however, came after the longest valuation hearing in history - the 27-day epic in Mirant Corp.'s bankruptcy. In that case, Judge D. Michael Lynn of the U.S. Bankruptcy Court for the Northern District of Texas in Fort Worth ruled against several constituencies that argued there would be no value for equity. The judge told the Atlanta energy giant's financial adviser to hike its valuation by $450 million.

That represented a victory for an official committee of Mirant shareholders, the likes of which have rarely been seen in a Chapter 11 proceeding. Instead of getting wiped out, Mirant's stockholders won 3.75% of the company, in addition to warrants for 10% more - an investment that placed equity holders "almost immediately in the money,"
says Maxwell, who was the equity committee's financial adviser.

The impact of the Mirant decision is still under debate. Some view it as a watershed moment that enhanced shareholder possibilities, while others say it was merely a timing matter based on a sharp rise in gasoline prices.

"It's not as simple as 'Gas moved into our favor,' " Maxwell says. "Clearly, [we] benefited, but if you go back and look at our valuation analysis and 27 days of court hearings, there were a lot of issues that had to do with errors and biased analysis that were detrimental to the interests of the common stock holders. And the judge more or less concurred with our conclusion, and subsequently the market has borne out the efficacy of the analysis."

The arguments for the appointment of equity committees generally tend to touch on two themes: the uncertain state of the credit market, roiled by rising interest rates, and various large and amorphous claims, which may well have been the motivating factor to file in the first place. Both may raise the possibility of massive valuation swings.

Daniel Arbess, a principal at Xerion, which is involved in active equity committees in Riverstone, OCA and Oneida, says current restructurings are being shaped by a "frosty credit market" and the concept of "reallocation of liabilities," such as pension termination claims. The result is the possible unimpairment of more classes of junior creditors.
"I think the courts are taking both of these themes into consideration and recognizing that there are more scenarios than there might have been in previous cycles where equity may be the first impaired class," he says.

Arbess notes that private equity firms have paid high Ebitda multiples in recent years while, he says, "putting up very little equity." As a result, he says, "[i]n a normal bankruptcy, where the second-lien lender or senior bondholder would be the focal security, you will see much more impaired subordinated creditors coming in [with] the hope of cramming up senior creditors with new money."

Xerion teamed with D.E. Shaw to attempt such a tactic in Oneida, which filed with a prenegotiated plan to wipe out equity and hand it to senior lenders. The company's two most significant shareholders instead floated an offer to buy all the equity and pay off two tranches of secured debt and unsecured creditors, though a source close to the proceedings has said the hesitancy of the Pension Benefit Guaranty Corp. and other equity holders threw a wrench into the deal. Oneida was still awaiting a decision by Judge Allan Gropper of the U.S. Bankruptcy Court for the Southern District of New York in Manhattan on its case as of Aug. 24.

The deal is a gamble on the bankrupt flatware maker and is the kind of transaction that professionals say is representative of where some hedge funds are seeking returns. Some point out that while the most risk is at the equity level, today's market also gives it, as one lawyer says, "the most bounce." "How much gain can you make on a bond taking out at par"?

says Maxwell. "In this market, where there's so much money chasing securities, in many cases there's nowhere else to go to look for a real substantial gain [than equity]."

Robert Stark of Brown Rudnick Berlack Israels LLP attributes the shift to equity to a "dearth of large capital restructurings" such as Enron Corp. and WorldCom Inc., leading to pricier debt and forcing investors to look elsewhere for returns. "You're now seeing trading desks at the large investment banks focusing on trade claims," he says. "There's too much money driving up the traditional security market, and people aren't able to find that juicy arbitrage by focusing on bond and bank debt."

Foamex is one example of a short-term arbitrage killing. The maker of foam for bedding, furniture and other uses filed for Chapter 11 in the District of Delaware in Wilmington in September 2005 with a plan to hand over its equity to secured noteholders, but the case shifted dramatically when its Ebitda began growing the following month. Foamex eventually hired Alvarez & Marsal LLC to help formulate a new business plan.

Soon after Foamex's improved earnings were reported in April, D.E. Shaw, which already owned a large portion of the bonds, bought up a big portion of its eventual 18.8% stake. Five days later, the fund called for an equity committee, court filings show.

D.E. Shaw wasn't alone. Sigma Capital bought 9.4% of Foamex that month. And in late June, Goldman Sachs reported a 19.9% stake, immediately saying that it would work with other constituencies to help formulate a business plan. D.E. Shaw initially led the charge for an equity committee, but that request was denied by U.S. Trustee Kelly Beaudin Stapleton.

As in other cases, a motion was then sent to presiding Judge Peter Walsh in the hopes of overruling the trustee's decision. That hearing was pending for several months as Foamex reportedly huddled with several parties regarding a new reorganization plan - before D.E. Shaw withdrew the plan on Aug. 21. Meanwhile, Foamex, whose stock hung at 5 cents per share in September 2005, was trading at $3.92 a share on Aug. 18.

Foamex shows the potential boon for shareholders if equity is given a chance. Had Foamex's plan been rushed toward confirmation, shareholders might not have had a chance at any recoveries - even though objecting parties have still claimed that equity remains under water and the eventual plan may still not provide stockholders anything.

The quick swing in Foamex's results highlights how inexact projections can be. Maxwell argues that a large amount of liquidity in the market has driven corporate valuations skyward. "A rising market raises all the ships," says Maxwell. "You've got a rising tide taking all these companies' valuations up."

When valuations rise, the potential for recovery seeps down the hierarchy. When combined with investors that have a greater ability to organize, a prenegotiated plan may be harder to shove through court. "Regardless of who the investor is, if there's a realistic opportunity to make a good return on a security, somebody's going to avail themselves and pursue it," says a source.

Though Maxwell cautions that the current wave of rising valuations may be cyclical, it does offer a chance to bet on equity, even though odds of success remain long. Equity committees in the cases of Cone Mills Corp., Exide Technologies Inc., Gadzooks Inc., Loral and Intermet Corp. were appointed, but none received distributions - a fact cited in an objection against the creation of an official committee in Foamex.

Even so, courts may give equity committees more credence in cases where the risk is particularly unquantifiable. Consider Delphi, which has been hit by a multibillion-dollar unspecified, unsecured claim from former parent General Motors Corp. Though that's not Delphi's only unknown liability - there are legacy benefit costs as well - the claim affects nearly every party hoping for a distribution, particularly equity holders.

No one knows as of yet how much of that claim will be allowed by the court. "Delphi is a significant 'value in flux' situation," says Carmen Lonstein of Bell Boyd & Lloyd LLC, who has represented equity committees such as Kasper, Comdisco Inc. and, most recently, OCA.

Delphi isn't the only uncertainty. A number of asbestos bankruptcies could see significant valuation swings. The same can be said, Arbess notes, of PBGC claims, which create a reallocation scenario that can alter distributions. Often such a reallocation would take place if a debtor decides to terminate a pension plan and settle with the PBGC. Under that scenario, the agency could get a portion of its claim guaranteed and the rest subordinated somewhere else in the capital structure.

The concept of conservative valuations drives equity committees and is fueled by instances where, as Lonstein says, "the premature cut" of equity occurred to the benefit of senior creditors. These valuations are based on what some charge is the "tendency" of senior creditors to "undervalue these companies."

"The debtor generally likes to be fairly conservative - they want to manage expectations and don't want to overstate their projections," says Chanin's Madden, who advises the equity committee in the Owens Corning Inc. case. "[An equity committee's valuation] is looking for conservative spots in the projections. You question management and try to come to a more realistic set of projections."

"I think there is somewhat more of an inclination - and each case is different - but I think U.S. trustees and judges are still sensitive to allegations that are often made in connection with the appointment of [an equity] committee," says Douglas Bartner of Shearman & Sterling LLP.

Those sensitivities may go back to cases such as Kmart Corp. and National Gypsum Co., which several attorneys cite as arguments for equity committee formations. In both, returns to junior creditors were minimal, while senior creditors later ended up with a windfall. "At the time [in Kmart], everyone said there was no value. But there was so much value, even though equity got nothing," says Lonstein. "That is the best example of what can happen when equity gets cut off prematurely."

Currently, it's still difficult to win official standing as an equity committee. Shareholders of companies such as Refco Inc., Seracare Life Sciences Inc., AAIPharma Inc. and Metabolife International Inc. all recently have been denied official status. But the number of battles is increasing.

Some argue that isn't such a bad thing, even if there's no recovery. Particularly in cases that are large enough where the drain on the estate becomes minimal, an equity committee's appointment means that a more comprehensive reason can be given for wiping out old equity, says Wolfson.

In Loral, for example, an equity committee was appointed late in the case after both the trustee and the court rejected one, Wolfson says. However, even though the committee didn't win distributions, the case featured a "strong process" and a "full-blown evidentiary hearing" the court could use. "The court wasn't just wiping out equity because the debtor told it to," he says.

Bell Boyd's Lonstein concurs, saying, "At the end of the day, at least there will be no appearance that a single party is driving the case."

Such a reason was cited for the formation of a committee in Oneida. Equity holders thought they were being squeezed out through the prenegotiated plan and that, since unsecured creditors were slated for full recoveries anyway, the case needed a counterbalance.

Though Gropper declined to rule on the valuation, he did acquiesce to the need for another voice and overruled trustee Diana Adams' decision against a committee's formation, citing "unusual circumstances ... [that] warranted an official committee."

Oneida's proceedings have been heated, but it isn't the only case where protesting shareholders have stirred the pot.

OCA, which provides business services to dental practices, has faced its own share of conflict. The company filed hoping to hand its stock over to lender Silver Point Capital LP through a debt-for-equity swap, but that plan has been under fire by a feisty equity committee, which has challenged the debtor's valuation and is hoping to refinance the company's secured debt and continue business. Not surprisingly, OCA's banks, led by Bank of America NA, rallied against the equity committee, calling it a drain on the estate, and even took the unusual tactic of calling for the judge to reverse the trustee's decision and disband the committee. The trustee appointed the committee, feeling that the book

value of OCA left valuation at least up in the air enough that a distribution was possible.

In Delphi, Appaloosa, the company's largest shareholder, led the charge for an equity committee that formed only after Drain ruled that such a committee was necessary to provide a voice in key labor issues. Appaloosa itself wasn't granted status on that committee. So in conjunction with Harbinger and a few other hedge funds, Appaloosa formed an ad hoc equity committee, which is now working with the official committee. However, in early August, Appaloosa and Harbinger hired UBS Securities LLC and Merrill Lynch & Co. to advise on a "potential restructuring transaction" after the company gave the funds access to confidential financial information.

"It's not clear what claim certain parties are entitled to [in Delphi],"
says a source, who calls the decision by the U.S. trustee to form an equity committee in the Dana case "less complicated but similar" to Delphi. "If you can normalize the earnings power of that business [Dana], there should be value to the equity," the source says.

Riverstone Networks' case was also reshaped through equity holders, who were not happy with the Ethernet router maker's initial decision to sell itself for $170 million to Lucent Technologies Inc. Shareholders were initially slated to be wiped out under a proposed sale and liquidation plan. However, an equity committee was formed "to pressure the company to fully entertain more bids," according to a source. The auction process yielded a competing offer from Ericsson Inc. that led to a $207 million final price for the company paid by Lucent. Shareholders would now see distributions under the company's current liquidation plan.

And in SeraCare's bankruptcy, an ad hoc equity committee, whose request for official standing was denied, has proposed its own plan for the company in an objection to exclusivity. On Aug. 24, it was seeking to file a plan that incorporated a rights offering, arguing that the company's misfortunes were more of a result of accounting misstatements than operational problems.

All these cases represent examples of the increased aggressiveness of shareholders, even without assurances of distributions. When a public company goes bust, it's no longer a foregone conclusion that shareholders will be swiftly wiped out. "The type of investors in [distressed] equity now are pretty active, and they want to have a say in the process," says Chanin's Madden.

It looks like they'll get it.