Corporate restructuring: The impact of credit derivatives and distressed debt investing

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Derivatives markets have attracted considerable attention recently, in the context of both the global financial crisis and equity derivative use in merger and acquisition activity. Yet limited consideration, especially in Australia, has been afforded to how the use of credit derivatives by lenders may affect the ability of a distressed borrower to restructure its debt. Against a background of increased corporate distress in 2007-2010, this article demonstrates that lenders benefiting from credit derivative protection may act in ways that are not conducive to restructuring. The separation of credit risk from legal ownership of debt increases the likelihood of distressed borrower liquidation and contributes to systemic risk. Although a regulatory response is possible, a commercial approach that does not prejudice the interests of market participants is preferable. Distressed debt investors, far from being "vulture funds", act to restore the concentration of debt ownership reduced by changes to traditional relationship banking. They also restore the economic incentive to restructuring removed by credit derivative use. Australian restructuring and insolvency practice must facilitate the potential benefits of such investment.

INTRODUCTION

Consider the following two scenarios.

Scenario 1: A prudent creditor

In September 2008, the world's largest insurer, American International Group Inc (AIG), suffered a liquidity crisis, following a credit rating downgrade that increased its collateral posting obligations to counterparties,[1] amidst volatile equity and debt markets that were dislocated by the Lehman Brothers bankruptcy filing of 15 September. On 16 September, the United States Federal Reserve organised a "bail out" of AIG, establishing a credit facility of up to US$85 billion to prevent the company defaulting on its obligations to financial counterparties. One such counterparty was Goldman Sachs, which was one of AIG's largest creditors, being owed money as the beneficiary of insurance agreements and under various trading positions.[2] Indeed, AIG eventually made payments to Goldman Sachs in satisfaction of some obligations. However, at all times Goldman Sachs insisted that it had "no material exposure" to AIG,[3] with the following reason offered by the investment bank's chief financial officer in a conference call on 20 March 2009:

> As we do with many other counterparty relationships, we limited our overall credit exposure to AIG through a combination of collateral and market hedges in order to protect ourselves against the potential inability of AIG to make good on its commitment … We held roughly [US]$7.5 billion in collateral.

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[1] AIG was itself involved in selling credit derivatives and insuring other financial contracts, but for the purposes of this article, this line of business is to be distinguished from AIG's position as a *corporate debtor* – to investment bank counterparties and beneficiaries of insurance contracts.

[2] See, eg Son H and Teitelbaum R, "AIG Trading Partners Squeeze Insurer Before Bailout", *Bloomberg News* (22 June 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=atPG852RVX3Y viewed 18 October 2009.

[3] See, eg "Goldman Sachs Faults NY Times Story on AIG Risk", *Financial Times* (28 September 2008), http://www.reuters.com/article/newsOne/idUSTRE48R2Y820080928 viewed 17 September 2009. See also Hu H, "Empty Creditors and the Crisis: How Goldman's $7 Billion was 'Not Material'", *The Wall Street Journal* (9 April 2009), http://www.online.wsj.com/article/SB123933166470307811.html viewed 21 September 2009.

> The remainder was fully covered through hedges we purchased primarily through CDS [credit default swaps]. Again, as we have said before, we had no material economic exposure to AIG.[4]

There is nothing untoward in the use of credit default swaps (CDS). On the contrary, the actions of Goldman Sachs in limiting its exposure via the use of such financial instruments, thereby acting in its own best interests and those of its shareholders, are to be admired as an example of prudent risk management. But they illustrate, indirectly, that to some extent Goldman Sachs was an "empty creditor" of AIG. At the point when the insurer was in financial difficulty, Goldman Sachs was nominally owed large amounts at law but, contingent on AIG's default, stood to benefit from offsetting payments under credit derivative agreements made with third parties.[5] The investment bank had thus separated (decoupled) its legal rights to the debts from any net financial loss caused by an AIG default.

Scenario 2: An effective corporate restructuring

On 22 January 2002, Kmart Corporation filed for Ch 11 protection in the United States,[6] subsequently acknowledging mismanagement and generating a US$17 billion bankruptcy that attracted monthly fees of US$10-12 million payable to bankruptcy and restructuring advisors.[7] Shortly after, ESL Investments Inc and Third Avenue Management LLC, two distressed debt investors (DDIs) or hedge funds, started purchasing Kmart's debt, ultimately acquiring over US$480 million of bank debt, $US1.2 billion of bond debt and US$140 million in trade debt, to emerge as the largest creditors by value.[8] In September 2002, ESL and Third Avenue were appointed to Kmart's creditors' committee and sought influence over the restructuring, attempting to expedite the Ch 11 process and minimise transaction costs.[9] By January 2003, with ESL and Third Avenue in control of the restructuring and having negotiated an agreement with the other financial and trade creditors, the retailer filed a reorganisation plan with the court, appointed a new chief executive officer and detailed a new post-bankruptcy board of directors, largely nominated by the two investors, with the founder of ESL appointed as chairman. Kmart also entered into an investment agreement with ESL and Third Avenue, whereby the investors' debt claims would be converted into a majority equity stake, with additional investment scheduled as required.

ESL continues to play an active role in managing Kmart, having streamlined operations and secured a merger with Sears, Roebuck & Co. The investor owns more than 50% of the merged company and, despite subsequent operational challenges,[10] Kmart's restructuring delivered a substantial return to some pre-petition creditors, with common stock soaring from US$15 to US$109 per share after Kmart's emergence from Ch 11 protection. The 15-month bankruptcy period, although seemingly extensive compared with the provisions of voluntary administration in Australia under the *Corporations Act 2001* (Cth), in fact reflected a speedy exit from bankruptcy protection, given the timeframe of Ch 11 processes and Kmart's size and complexity.

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[4] Conference call by David Viniar (Goldman Sachs Chief Financial Officer). Transcript available at http://www.scribd.com/doc/13465855/Preliminary-GS-Conference-Call-Transcript viewed 5 October 2009.

[5] Assuming these third parties were themselves creditworthy.

[6] Now a subsidiary of Sears Holdings Corporation (NASDAQ: SHLD). See Harner M, "The Corporate Governance and Public Policy Implications of Activist Debt Investing" (2008) 77 Fordham L Rev 703 at 725-726. For media commentary, see "Kmart Files Chapter 11", *CNN News* (22 January 2002), http://www.money.cnn.com/2002/01/22companies/kmart viewed 15 July 2009; Kerwin K, "Creditors Take on Kmart's 'Frat Boys'", *BusinessWeek* (21 November 2003), http://www.businessweek.com/bwdaily/dnflash/nov2003/nf20031121_5491_db035.htm viewed 15 July 2009.

[7] Goldschmid P, "More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganisation Process" [2005] Colum Bus L Rev 191 at 213. See also Mather B, "Kmart Comes Out Of Bankruptcy", *CBS News* (6 May 2003), http://www.cbsnews.com/stories/2003/11/20/national/main584618.shtml viewed 4 October 2009.

[8] Harner, n 6 at 726-727.

[9] See, eg Pacelle M, "Salvage Operation: Behind Kmart Exit from Chapter 11", *The Wall Street Journal* (6 May 2003).

[10] See, eg Kavilanz P, "Sears Holdings Profit Drop", *CNN Money* (30 August 2007), http://www.money.cnn.com/2007/08/30/news/companies/sears/index.htm viewed 16 July 2009.

Derivatives markets

The global credit derivatives market has grown exponentially during the last decade, with the estimated notional value of outstanding CDS alone increasing from US$632 billion in 2001 to over US$30 trillion as at end-2009, having peaked at $US62 trillion at end-2007.[11] This growth has vastly outpaced that in equity derivatives;[12] equally, these amounts are many multiples higher than underlying debt outstanding.[13] All these estimates are of notional exposure rather than net exposure between counterparties, with the recent fall in swaps outstanding principally resulting from trade compression (the unwinding of redundant positions between counterparties);[14] but even mark-to-market value is conservatively estimated at over US$5.5 trillion.[15]

It is therefore not surprising that this market has received considerable publicity and attention from lawyers, regulators and academics. Yet in examining the ramifications of credit derivatives, attention has largely focused on regulating these derivatives, which are generally unregulated over-the-counter (OTC) products, leading to the establishment of a CDS clearing house in the United States. Publicity has also highlighted the "interconnectedness" and speculative potential of credit derivatives, emphasising that these "time bombs"[16] pose systemic risk of market failure if a single large debtor or counterparty defaults. Considerable attention has also been given to the need for disclosure of *equity* derivative agreements, principally in the context of public market merger and acquisition (M&A) activity.

A nexus?

By contrast, little consideration has been given, especially in Australia, to how credit derivatives may impact corporate restructuring.[17] In the context of changed economic conditions and an increase in the number of corporations seeking to restructure their debt or filing for insolvency, this article demonstrates that a lender's use of credit derivatives to hedge risk, akin to Goldman Sachs' actions with respect to AIG, can have profound consequences for the debtor company. The presence of protection tends to alter creditors' behaviour, producing unexpected incentives. Where a debtor may have expected a creditor to have a keen interest in seeing the company restructured and restored to financial health, an "empty creditor" may be passive, indifferent or unwilling to participate in a pre-insolvency "work-out". A hedged creditor may prefer the company to file for insolvency, simply so that a "credit event" occurs as defined in the derivative agreement. And credit derivatives may result in "new creditors", hitherto unknown to the debtor, emerging at work-out negotiations or in insolvency administration.

[11] International Swaps and Derivative Association Inc (ISDA), *Market Survey*, http://www.isda.org/statistics viewed 15 August 2010. The survey was first conducted in relation to credit default swaps (CDS) in 2001. See also surveys conducted by the Bank of International Settlements, http://www.bis.org/statistics/otcder/dt21.pdf viewed 12 October 2009.

[12] ISDA, n 11. Equity derivatives outstanding were estimated at US$2.3 trillion as at end-2001 and at $8.8 trillion as at mid-2009.

[13] ISDA, n 11.

[14] See below for a discussion of CDS settlement procedures.

[15] Statistics in respect of Australian entities are not available, but the largest Australian commercial banks are estimated to have more than A$80 billion in CDS exposure: see West M, "Credit Default Swaps – No Central Exchange, No Regulator and No Reserving", *The Age* (14 October 2008), http://www.business.theage.com.au/business/credit-default-swaps--no-central-exchange-no-regulator-and-no-reserving-20081013-4zx5.html viewed 16 August 2009.

[16] Buffett W, "Letter to Berkshire Hathaway Shareholders 2002", http://www.berkshirehathaway.com/letters/2002pdf.pdf viewed 22 October 2009. Citing "interconnectedness" and speculation as a concern, in mid-2010 some European Union governments implemented or considered proposals curtailing use of CDS referencing sovereign debt: see, eg Ewing J, "Germany Set to Widen Crisis Restrictions", *The Australian Financial Review* (27 May 2010).

[17] The author is aware of only one analysis published in Australia: Green J, "The Impact of Credit Derivatives on Corporate Debt Restructuring" (2008) 19 JBFLP 97. See also Hu H, "'Decoupling', Governance and the World Financial Crisis" (Speech delivered at the Ross Parsons Address in Commercial, Corporate and Taxation Law, Sydney Law School, 12 June 2009), http://www.law.usyd.edu.au/parsons/events/parsons_address.shtml viewed 18 October 2009.

This article examines these concerns against the goals of corporate restructuring[18] and suggests that, apart from the need for revised regulation and insolvency law, there may be a commercial approach to resolving problems produced by credit derivatives. DDIs have certain advantages over traditional lenders in corporate restructuring, and Australia's regulatory regime should evolve to encourage and balance this potential against the unique risks that may originate from distressed debt investment. Thus the two scenarios, Goldman-AIG and ESL-Kmart, each emblematic of seemingly disparate developments in law and finance, are in fact linked, if distressed debt investing is seen as a market-based solution to creditor passivity and incentive misalignment.

CREDIT DERIVATIVES AND "WORK-OUTS" DEFINED

A derivative is a contract whose value depends on (derives) from the value of an underlying asset, reference rate or index.[19] Depending on the nature of this "underlying", a derivative may be an equity(-linked) derivative, an interest rate, a commodity, currency or a credit derivative, or a combination of these categories.

Credit derivatives are instruments whose payoff is linked to a change in the credit quality of an entity or an entity's debt (the underlying). They are thus used to transfer credit risk from one party to another. These instruments range from single-name CDS, whose function is similar to that of a guarantee; to "index" or "basket" CDS; and to total-return-swaps, which transfer interest rates as well as credit risks, and other highly structured contracts.

Transfer of credit risk is also closely related to securitisation, that is, the creation of collateralised debt obligations (CDOs). A traditional "funded" securitisation (otherwise known as a cash flow or asset-backed securitisation) functions as a complete transfer of a debt obligation, somewhat like an extended loan syndication. But a synthetic securitisation based on selling a basket of CDS is a true derivative.[20]

This article is principally concerned with the simplest of all these instruments, the single-name CDS, for two reasons: it is the most commonly used credit derivative;[21] and its potential effects on corporate restructuring may be readily perceived.

CDS

Commercial structure

A CDS is a bilateral agreement between a buyer and a seller of protection, the protection being provided in respect of a third party (the reference entity), with payoff contingent on the occurrence of a prescribed "credit event" – commonly the reference entity's default, insolvency or debt restructuring.[22] The seller agrees to provide a specified amount of protection in return for a regular fee (the CDS spread or price, commercially similar to an insurance premium), payable by the buyer until the credit event occurs or the CDS expires. CDS agreements are generally between one and five years in duration. The parties also specify a "reference obligation" of the reference entity, such as a traded

[18] For the purposes of this article, the term "corporate restructuring" is used interchangeably with "corporate debt restructuring" and is intended to refer to the reorganisation of companies in financial difficulty, not to restructuring of non-distressed companies, which may occur by way of demerger or other corporate action.

[19] Mallesons Stephen Jaques, *Australian Finance Law* (6th ed, Lawbook Co., 2008) p 76.

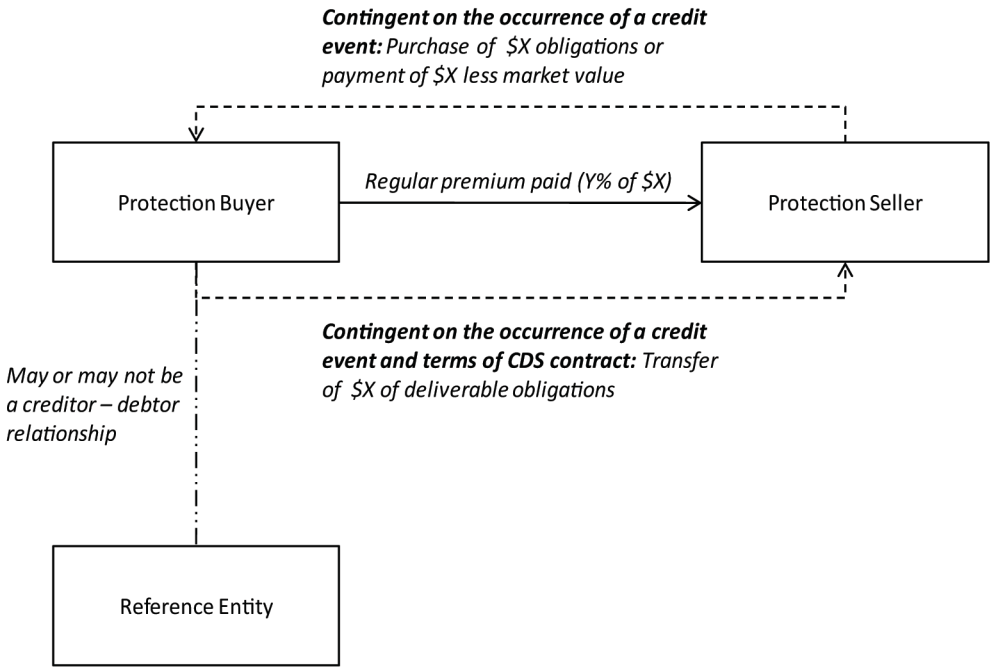
[20] For a description of synthetic securitisation, see, eg Duffie D, "Credit Risk Transfer: Implications for Financial Efficiency and Stability" (Speech delivered at the Bank for International Settlements workshop, "Stress Testing of Credit Risk Portfolios: The Link Between Macro and Micro", De Nederlandsche Bank, Amsterdam, 7 March 2008), http://www.bis.org/bcbs/events/rtf08duffie.pdf viewed 12 October 2009.

[21] More than 65% of outstanding CDS are single-name instruments (as measured on both a notional exposure and net market value basis). See n 11.

[22] Mallesons, n 19, p 82; Green, n 17 at 98.

bond, for the purposes of determining any settlement if the credit event occurs. The CDS contract functions independently of any relationship the buyer (or seller) may have with the third party reference entity.[23]

CDS are either cash-settled or physically-settled. If cash-settled, the seller agrees to pay the buyer the difference between the nominal protection sold and the market price of the reference obligations subsequent to a credit event.[24] If physically-settled, the seller agrees to buy from the buyer "deliverable obligations" at face value, after the occurrence of a credit event. In a physically-settled CDS, payoff is thus dependent on the buyer assigning an appropriate obligation to the seller. If a buyer does not hold such an obligation,[25] it must either acquire the deliverable obligations to secure a payout or the parties may mutually agree to cash settle the CDS. The structure of a CDS may be illustrated as follows:



Legal characterisation: A contract of insurance?

Although a CDS demonstrates many of the commercial characteristics of an insurance contract, the derivative agreement as drafted is not a true contract of insurance. Thus, unlike an insurance contract, the buyer of protection is not obliged to have an underlying legal or equitable interest that is being insured and does not need to prove actual loss – hence CDS can be bought for speculative purposes. The CDS contract is not uberrimae fidei[26] and is not subject to laws relating to selling of insurance products. And the seller's obligation is only a secondary one, contingent on the occurrence of a credit event, differing from a primary obligation or indemnity against loss. The distinct legal characterisation of CDS has been supported by United States case law.[27]

[23] The reference entity is not privy to the CDS contract.

[24] If a company has defaulted on its obligations or is distressed, the price or valuation of reference obligations and bonds will fall. The payout is then the difference between the face value of the obligations and the lower market price or valuation.

[25] For example, if a buyer has entered the CDS for purposes of speculation rather than hedging.

[26] Of "utmost good faith". See, eg Tyree A, *Banking Law in Australia* (6th ed, LexisNexis, 2008) p 512.

[27] See *Aon Financial Products Inc v Societe Generale* 476 F 3d 90 (2007); *Eternity Global Master Fund Ltd v Morgan Guaranty Trust Co of New York* 375 F 3d 168 (2004).

Documentation

A CDS transaction is an OTC contract commonly entered into under a standard master agreement developed by the International Swaps and Derivatives Association Inc (ISDA), the most recent version of which is the 2002 ISDA Master Agreement. The master agreement specifies the essential terms that are intended to apply to all transactions entered into by the parties. The master agreement is supported by a schedule containing terms specific to the parties, such as counterparty details and any customised terms.

The commercial terms of a particular transaction (such as the reference entity or the premium payable) are then specified in a short-form confirmation, made under the terms of the master agreement (an umbrella contract), and incorporate a booklet of credit derivative definitions also developed by the ISDA.[28] This documentation is designed to facilitate concise and timely confirmation of transactions, while taking advantage of the benefits of the master agreement, specifically the application of "netting" or "set-off" to all mutual transactions in the event of one party's default or insolvency. This latter feature is designed to prevent "cherry-picking" by administrators or liquidators and has proven legally contentious in the United States and Australia.[29]

The "work-out": Is restructuring a credit event?

The definition of "credit event" within the documentation is crucial for the potential impact of a derivative agreement on a corporate restructuring.

A corporate restructuring often does not equate to a debtor's insolvency, or even a failure to pay, but may take the form of a negotiation or "work-out" between the company and its main creditors. A work-out frequently results in the postponement of loan maturity dates, a waiver of breached debt covenants or the advance of further funds, and thereby avoids debt enforcement and insolvency. A work-out is initiated by a company's directors where a company is still solvent and succeeds where the company is perceived by its creditors to be economically viable. Any agreement is typically settled with a company's primary creditors, with the company then seeking a formal scheme of arrangement under Pt 5.1 of the *Corporations Act* to bind all creditors.[30] The work-out has been described as "one of the great strengths of the financial intermediation process", with appropriate industry guidelines developed to facilitate negotiations that are productive and conducted in good faith by both sides.[31]

Although the ISDA Credit Derivative Definitions include restructuring as a credit event, this was seen as a "soft" credit event not necessarily involving default. Consequently, the definitions have placed some limitations on the meaning of "restructuring" to prevent buyers of CDS opportunistically demanding payouts at the first instance of a change in a reference entity's debt arrangements.[32] In 1999, ISDA introduced "modified restructuring", seeking to prevent CDS buyers from having a "cheapest to deliver" option when sourcing the "deliverable obligations" under a physically-settled CDS. Modified restructuring limited the nature of obligations that the buyer can deliver under the

[28] For example, the 2003 ISDA Credit Derivative Definitions. See https://www.isdadocs.org/conf/index.html viewed 24 October 2009; Mallesons, n 19, p 92.

[29] "Cherry-picking" involves administrators or liquidators repudiating (or disclaiming) unprofitable derivative positions but seeking to enforce profitable ones: see Mallesons, n 19, p 796. The collapse of Enron resulted in a number of Australian cases on the ISDA Master Agreement, including *Sims v TXU Electricity Ltd* (2005) 53 ACSR 295; *Yallourn Energy Ltd v Enron Australia Finance Pty Ltd* [2005] NSWCA 326: see Ientile T, Vandepol M and Harris G, "The Enron Effect: How the Fall of Enron is Changing the ISDA Landscape in Australia" (2006) 17 JBFLP 34. More recently, the collapse of Lehman Brothers raised issues of cherry-picking: see Ientile T, Mak S and Harris G, "Derivative Contracts and The Lehman Brothers Bankruptcy: Counterparty Rights and US Bankruptcy Law" (2009) 20 JBFLP 58.

[30] Green, n 17 at 105.

[31] Green, n 17 at 103.

[32] Green, n 17 at 100.

derivative – certain subordinated, long-dated and non-transferable obligations are precluded from delivery.[33] These restrictions have been accepted by American and Australian reference entities.[34]

The effect of all this is that the restructuring of a reference entity outside an insolvency regime may not qualify as a credit event under a given CDS, preventing the buyer from receiving a payout. If the CDS buyer is also a creditor of the reference entity, a clear incentive is created for the creditor to avoid a restructuring and urge a formal insolvency filing, so as to trigger a credit event and receive a payoff. As CDS are private contracts, such a reference entity may find its creditor acts in a seemingly inexplicable way, denying a work-out or behaving contrary to established practice and commercial expectations during negotiations.

Use of CDS

Prevalence and pricing

The size of the CDS market has been described above. In general, CDS are bought to hedge or speculate, and are sold by parties seeking to derive regular income. Lenders have increasingly hedged their exposure to their clients, taking advantage of the efficient transfer of credit risks at low transaction costs and without the knowledge of the borrower, thereby disguising their seeming distrust of a client's ability to repay debts. CDS are also used to alleviate regulatory capital requirements.[35] A prominent example of use, apart from Goldman-AIG, relates to the insolvency of Enron in 2001, where lenders bought protection over an approximate $US8 billion of US$10 billion of Enron debt, with protection sellers consequently reporting the majority of associated losses.[36] In Australia, the largest commercial banks have considerable involvement in the CDS market, and globally CDS are written on more than 70 of Australia's largest corporations (as reference entities).[37]

Although CDS are private contracts, the frequency of transactions in respect of large reference entities has led to indicative CDS pricing being provided by Markit Group Ltd.[38] The price of a CDS is the cost of protection for a certain amount of debt to be insured,[39] with movements in price interpreted by market participants as a measure of a reference entity's credit risk, isolated from other sources of risk. This price signal is an informational benefit of CDS.

Clearing and settlement

The indicative price assumes that the seller of protection is creditworthy and will pay once the obligation is triggered. Given the size of the market, the unrestricted entry of participants and nascent collateralisation practices,[40] there has been considerable uncertainty regarding CDS settlement failure. Substantial government and regulatory attention has resulted in reform, with a clearing house for CDS

[33] Prices of different bonds may change in different magnitudes following events of default or insolvency, depending on bond maturity and other factors such as the term structure of interest rates. This may allow the buyer to source the "cheapest-to-deliver" bond for settlement, prejudicing the interests of the CDS seller.

[34] European markets have sought to relax the restrictions of "modified restructuring", adopting a more relaxed "modified modified restructuring": see Green, n 17 at 102. Parties to a CDS can now elect to adopt either "modified" (more restrictive) or "modified modified" (less restrictive) definitions of restructuring as a possible credit event.

[35] See below for a discussion of prudential regulation and regulatory capital requirements.

[36] Partnoy F and Skeel D, "The Promise and Perils of Credit Derivatives" (2007) 75 U Cin L Rev 1021.

[37] Remolona EM and Shim I, "Credit Derivatives and Structured Credit: The Nascent Markets of Asia and the Pacific" in Bank for International Settlements, *BIS Quarterly Review* (June 2008) p 57, http://www.bis.org/publ/qtrpdf/r_qt0806.htm viewed 12 October 2009.

[38] Indicative prices are the consensus of quotes supplied by market-makers (dealers) in CDS on a given day: see http://www.markit.com/en/products/data/cds-pricing/cds-pricing.page? viewed 5 October 2009. See also ISDA's website, "CDS Marketplace" (launched in August 2009) that collates available CDS information (including pricing), http://www.isdacdsmarketplace.com viewed 17 October 2009.

[39] Typically US$10 million of debt (at face value).

[40] See Neagle A, "Collateral Retrieval in Derivatives Transactions: A Collateral Provider's Perspective on Posting Collateral" (2007) 18 JBFLP 217.

established in the United States and operated by the IntercontinentalExchange.[41] Australia does not appear to have a need for a separate arrangement, although regulators have encouraged parties to OTC derivatives contracts to ensure appropriate settlement and administration.[42]

As the total nominal protection sold over a reference entity is often larger than all underlying debt obligations, a buyer of CDS may be unable to deliver the requisite obligation to the seller on the occurrence of a credit event, thus qualifying only for a reduced payout. The settlement of CDS is therefore often determined in a post-credit event auction conducted by the ISDA. ISDA recently formalised the incorporation of auction settlement terms into standard CDS documentation following the occurrence of a credit event (including the restructuring credit event) by implementing the "Big Bang" and "Small Bang" protocols.[43] Thus netting of offsetting CDS positions between counterparties, together with the auction, occasioned the exchange of US$5 billion after the Lehman Brothers bankruptcy, despite a referenced amount of US$72 billion.[44] Nevertheless, CDS do protect effectively from default, especially with the advent of a clearing house that minimises inter-party risk.

DEBT DECOUPLING: EFFECT OF CDS ON CORPORATE RESTRUCTURING

Awareness of (equity) decoupling

In relation to any asset, the separation of economic interest and risk from legal ownership and rights may be termed "decoupling".[45] The concept is not new. For instance, legal title to assets vests in a trustee, but the trustee does not enjoy beneficial ownership and does not bear risk in relation to assets. The recognition of such duality of title is a hallmark of the common law. More strikingly, where a third party surety gives a guarantee to a creditor in respect of a principal debtor's obligation, the creditor's economic risk has been decoupled from legal rights relating to the debt which the creditor retains.[46]

More recently, the occurrence of "equity decoupling" has attracted regulatory attention and commentary.[47] Equity derivatives such as equity swaps, options and contracts-for-difference (CFDs) can give rise to two different situations. First, a party may attempt to gain legal equity rights in excess of its economic interest, hedging any excess economic interest gained. For instance, consider the issue of corporate "vote-hiring" at shareholders' meetings, exemplified by Coles Myer voting in 2002.[48] This practice has been the subject of substantial analysis in Australia and abroad.[49]

[41] The InterContinentalExchange Inc (ICE) gained United States government approval to create and operate a clearing house: see https://www.theice.com/ice_trust.jhtml viewed 22 July 2009. See, eg Kingsbury K, "ICE Opens CDS Clearinghouse", *The Wall Street Journal* (10 March 2009). This ICE clearing house represents progress on previous arrangements, where only a fraction of CDS were cleared by the Depositary Trust and Clearing Corporation: see Mengle D, *ISDA Research Notes*, No 1 (2009) p 5, http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes1.pdf viewed 18 October 2009.

[42] See the joint report by the Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA), *Survey of the OTC Derivatives Market in Australia* (May 2009), http://www.rba.gov.au/payments-system/clearing-settlement/survey-otc-deriv-mkts/index.html viewed 5 October 2009.

[43] See ISDA, "ISDA Announces Successful Implementation of 'Big Bang' CDS Protocol", Press Release (8 April 2009), http://www.isda.org/press/press040809.html viewed 25 October 2009; ISDA, "ISDA Launches 'Small Bang Protocol' and Restructuring Supplement", Press Release (14 July 2009), http://www.isda.org/press/press071409.html viewed 25 October 2009.

[44] Pickel R (ISDA Chief Executive Officer), "Testimony before the House Committee on Agriculture" (15 October 2008), http://www.agriculture.house.gov/testimony/110/h81015/Pickel.pdf viewed 18 July 2009.

[45] A term first introduced by Professors Hu and Black: see Hu H and Black B, "Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications" (2008) 14 Eur Fin Mgmt 663.

[46] See below for a comparison of CDS and traditional contracts of guarantee.

[47] See especially the research of Professors Hu and Black: Hu H and Black B, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications and Reforms" (2006) 61 Bus Law 1011; Hu H and Black B, "The New Vote Buying" (2006) 79 S Cal L Rev 811; and an overview of research in Hu H and Black B, "Empty Voting and Hidden Ownership" [February 2007] *M&A Lawyer* 6.

[48] In 2002, Solomon Lew, a substantial shareholder and director of Coles Myer, effectively "hired votes" for the purpose of voting at a shareholder meeting, borrowing shares and using put options to hedge excess economic exposure: see, eg Wood L, "Lew Puts Money Where Mouth Is", *The Age* (18 October 2002), http://www.theage.com.au/articles/2002/10/18/1034561308555.html viewed 18 July 2009. Compare this with voting in 2009 in Brisbane Connections, where a subsidiary of

But the reverse is also possible – by using equity derivatives, a party can gain economic interest in shares without legal ownership. The most striking example is disguised equity ownership by bidders in public-market M&A activity, which has produced substantial case law in Australia. Indeed, the *Glencore* cases on equity swaps, and the subsequent issuance of Guidance Note 20 by the Takeovers Panel,[50] have aimed to curtail the use of equity derivatives in the market for corporate control, recommending disclosure and focusing on *economic* ownership.[51] The Commonwealth government responded to this matter in June 2009, proposing to legislate to require disclosure of equity derivative positions in this context.[52] Similar efforts have been made in the United Kingdom, following the outcome of the Turner Review, completed by the Financial Services Authority in March 2009.[53]

The potential effects of *credit* derivatives on the corporate landscape seem to be comparatively neglected in extant regulatory attention and commentary.

THE TRADITIONAL BANKER-CUSTOMER RELATIONSHIP

> Creditors are likely to have interests going well beyond payment of the debts owing to them. For example, they will wish to continue to conduct business with the company.[54]

The traditional relationship between a lender (typically a bank) and a borrower (the bank's client) requires little description. Banks have always been averse to downside risk and have always been concerned that a client pays its debts.

But pragmatism, as well as social effects, resulted in the development of lenders' qualified "incentive to negotiate", triggered when companies encountered financial difficulty. Depending on how far a debt was "under water",[55] lenders had an economic interest in keeping a firm "afloat", as this could maximise the eventual recovery rate. Lenders were also influenced by past and expected future relationships. A company that encountered temporary financial difficulty could recover and continue to be a valuable client – not only for a trade creditor but also for a lender (financial creditor). Moreover, if a lender unreasonably refused to participate in a work-out, its reputation was hurt amongst corporate borrowers, especially where the borrower managed to obtain refinancing elsewhere. This overall "incentive to negotiate" was qualified because where the debt was not far "under water", it would often be in the lender's interests for the company to file for insolvency, rather than bearing the risk of a re-arrangement that offered little upside.

Leighton Holdings purchased votes from Nicholas Bolton, a substantial shareholder, for the purpose of voting at an extraordinary unitholders meeting, but did not acquire economic exposure and did not use derivatives in the transaction, simply taking advantage of a flexible legal regime in relation to shareholder voting: see, eg Battersby L, "'White Knight' Rejects Accusations He's a 'Greenmailer'", *The Age* (15 April 2009), http://www.business.theage.com.au/business/white-knight-rejects-accusations-hes-a-greenmailer-20090414-a6b4.html viewed 18 July 2009.

[49] See, eg Kahan M, "The Hanging Chads of Corporate Voting" (2008) 96 Geo LJ 1227, http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1007065 viewed 18 July 2009.

[50] The *Glencore* cases related to the takeover of Austral Coal Ltd in 2005: see *Glencore International AG v Takeovers Panel* (2005) 54 ACSR 708; *Re Austral Coal Ltd 02* [2005] ATP 13; *Re Austral Coal Ltd 02(R)* [2005] ATP 16; *Re Austral Coal Ltd 02(RR)* [2005] ATP 20. See also Takeovers Panel, *Equity Derivatives*, Guidance Note 20 (11 April 2008), http://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=guidance_notes/current/020.htm&pageID=&Year viewed 24 October 2009. The Guidance Note outlines where equity derivative use may result in "unacceptable circumstances" within the meaning of s 657A of the *Corporations Act 2001* (Cth). The Takeovers Panel's authority derives from the *Corporations Act*, Pt 6.1 (Div 2).

[51] Numerous papers have been published on the effect of *Glencore* and the Guidance Note: see, eg Lee Y and Bentvelzen L, "Case Closed on Equity Swaps? The Glencore Decisions" (2006) 24 C&S LJ 323.

[52] See Commonwealth Treasury, *Improving Australia's Framework for Disclosure of Equity Derivative Products* (June 2009), http://www.treasury.gov.au/documents/1556/PDF/Equity_Derivatives_Assessment_IP.pdf viewed 24 October 2009.

[53] The Financial Services Authority (FSA) in the United Kingdom conducted a wide-ranging survey relating to bank regulation from October 2008 to March 2009 led by Lord Turner as Chairman: see *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), http://www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml viewed 19 September 2009.

[54] Ford H, Austin and Ramsay I, *Ford's Principles of Corporations Law* (13th ed, Butterworths, 2007) p 1342.

[55] A debt is "under water" where even in liquidation the debt would not be repaid fully or the realisable value of assets over which the creditor holds security is less than the amount of the debt.

Lenders' traditional incentives corresponded to the premise of legal regimes for corporate restructuring, including Australia's voluntary administration regime. Stated simply, this premise is: companies that are economically viable, having long-term value as a going concern greater than liquidation value but are suffering financial difficulties or have been prone to mismanagement, should be given an opportunity to restructure and avoid liquidation. Preserving a viable business is important, hence the legal stay on proceedings granted in voluntary administration.[56] However, companies that are not economically viable should be liquidated expeditiously and efficiently, maximising returns to creditors and shareholders.

Debt decoupling: Complications in the relationship

Hedged creditors

> How can you strike a "deal" when the chairs will be filled with many different people after your "credit event"?[57]

Both lenders' incentives and restructuring law developed in the context of presumed *coupling* – linked legal rights and economic interest relating to debt. The ability to hedge credit risk means that modern reality runs contrary to this presumption:

> The operation of Chapter 11 is premised on a perception of ownership that no longer exists, or at least is threatened by the expansion of credit derivatives.[58]

Where lenders hedge their exposure to large corporate borrowers, they effectively become "empty creditors", as termed by Hu and Black, or hedged creditors. The rights relating to payment of the debt and enforcement in the case of default or insolvency are retained, but "unbundled" from the risk of loss.[59] Hedged creditors naturally seek to maximise the *overall* value of their loan and CDS position, possibly creating perverse incentives. Thus as mentioned, creditors may be unwilling to consent to work-outs:

> A creditor's willingness to participate in a negotiated restructuring … could be described as being negatively correlated with the extent to which it has been able to lay-off its exposure to the debtor under a CDS.[60]

Even where such work-outs do take place, a lender is likely to impose conditions on a work-out that trigger payoff under the CDS. Thus a hedged creditor may be unwilling to waive rights relating to default or breach of covenant, where an unhedged creditor ordinarily would.

Alternatively, a hedged creditor may be unwilling to serve on a creditors' committee, an organ of less influence in voluntary administration than under Ch 11[61] but one that is nevertheless important to administering insolvency in Australia. This unwillingness stems from members of creditors' committees frequently being subject to contractual standstill agreements that prevent the trading or assignment of debt interests. Such standstill agreements are aimed at ensuring stable ownership during the period of restructure, but may possibly hinder a creditor's desire to effect a CDS payoff. In the

[56] *Corporations Act 2001* (Cth), s 440D.

[57] Farquhar RM, "The Next Wave: Why You Should Care About Credit Default Swaps" (2005) 24 Am Bankr Inst J 18 at 2-3, as cited in Green, n 17 at 109.

[58] Lubben S, "Credit Derivatives and the Future of Chapter 11" (2007) 81 Am Bankr LJ 405 at 416.

[59] See generally Hu and Black, n 45.

[60] Green, n 17 at 106.

[61] The role of creditors' committees in Australia's regime of voluntary administration is different to that in United States Ch 11 bankruptcy. In Australia, the directors of a corporation no longer exercise control over the company after the appointment of an external administrator; in the United States, the directors retain managerial control, so that the debtor is "in possession". Under the *Corporations Act 2001* (Cth), ss 436E-436G, a creditors' committee may be appointed at the first creditors' meeting and continue operating during voluntary administration, but its powers are relatively limited, chiefly relating to consulting with the administrator, considering the administrator's reports and approving fees. But under Ch 11, a creditors' committee may move for the appointment of a court trustee so that directors and management lose control, with this threat accounting for much of the committee's influence.

United States, committee members may also be required to disclose derivative positions referencing the distressed company; a hedged creditor will usually be unwilling to provide such disclosure and so may avoid creditor committee membership.[62]

The lender may also place artificial time limits on the duration of negotiations – perhaps because most CDS are of limited duration and may be approaching expiry, with the creditor aiming to secure a payout resulting from a credit event before the "insurance policy" expires worthless. Where agreement to a work-out may cause a lender to lose CDS protection but continue to bear risk of default arising from the borrower's financial difficulty, the economically rational decision is apparent.

Ultimately, hedged creditors do control one of the credit events prescribed in a CDS, in that they may file a petition or notice of default to trigger involuntary administration which, if accepted, will almost definitely qualify as a credit event. The fact that a lender may thereby contribute to the occurrence of a credit event is unlikely to preclude its entitlement to the CDS payout – prevention of moral hazard is a feature only of true contracts of insurance that are uberrimae fidei.

Admittedly, there are limitations on perverse behaviour by empty creditors. Reputation risk applies in two ways. Perverse behaviour will diminish the lender's standing amongst corporate borrowers and will also damage the lender's reputation as a CDS counterparty – being an OTC market, a lender that has acted to generate a credit event may subsequently find it difficult to obtain CDS protection as counterparties perceive the risk of moral hazard, even if this is not recognised by law. Also, a payout on a CDS may in fact be less than expected,[63] so that the creditor is imperfectly hedged and wishes to maximise the value of the debt itself.

But lenders' overall reduced motivation to participate in a work-out and contribute to reorganisation is apparent. To the extent that this unwillingness forces a borrower to rely on *new* lenders in the event of financial difficulty, a new element of restructuring risk is introduced – for refinancing may be unavailable during occasional credit market volatility and illiquidity.[64]

Lenders monitoring borrowers, and inter-creditor relationships

Traditional "coupled" loans entailed concentrated debt ownership, with a large stake held by a particular bank, which monitored a debtor's operations and financial position. This monitoring operated to the benefit of the bank, the debtor and other creditors of the debtor. The bank was perceived to be prudent and potentially privy to information unavailable to other creditors or employees, and thereby in a position to provide oversight.

But the use of credit derivatives by the bank may result in "informational muddling" of the bank's actions.[65] The bank is still likely to be prudent, but now simply focuses on hedging risk rather than monitoring the borrower. Credit risk transfer will be preferred to monitoring where it is relatively less expensive. Although banks were never ultimately involved in managing their borrowers' businesses, the lack of bank monitoring can be detrimental to preventing financial distress, as observed in the case of Enron:

> They appeared to have provided very little oversight, either while Enron was thought to be healthy or after its fortunes began to deteriorate. There no doubt were many reasons that the banks were missing in action, but surely one of them was credit derivatives. The banks that financed Enron had used massive amounts of credit derivatives to limit their exposure in the event Enron defaulted … The banks would

[62] Rule 2019(a) of the United States *Bankruptcy Code* requires disclosures by committee members of direct holdings of company equity and debt: see Coco K, "Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases" [2008] Colum Bus L Rev 610. See also Goldschmid, n 7 at 208. The rule applies to ad hoc creditors' committees but not to "official" committees, and has been enforced in respect of derivative holdings in at least one instance: see *Re Northwest Airlines Corp* (2007) 363 BR 701.

[63] See the above discussion of CDS settlement.

[64] Hu and Black, n 45 at 692.

[65] Partnoy and Skeel, n 36 at 1036.

> have preferred that Enron survive, even after buying all this protection. After all, a healthy Enron meant the ability to keep making loans and to continue pocketing fees. But the prospect of Enron's decline meant much less.[66]

Similar "informational muddling" occurs where a party advances funds secured by a second charge or mortgage, and relies on assumptions of the behaviour of the senior creditor with priority, unaware that the creditor may be hedged and therefore more liberal in approving the corporation's (chargee's) use of the asset. The expectations of parties to inter-creditor agreements may in general be frustrated where one or more, but not all, creditors are hedged.[67]

Short selling debt?

The use of credit derivatives can also give rise to negative net economic exposure to debt, so that a party *profits* from a fall in the trading value of the debt or an event of default. The payoff is as if one short sells debt. The situation may arise either from speculation or where a lender buys CDS protection over a nominally larger amount than the amount lent.

In the latter case, misalignment of creditors' incentives is acute and has come to the attention of bankruptcy practitioners in the United States.[68] In the former case, debt speculators will exhibit motivations identical to short sellers of equity securities, and as such may increase the risks of "rumourtrage".[69] Yet their economic positions remain undisclosed and are not regulated by comparison with short selling in the equity market.

New faces at the table

Finally, the advent of credit derivatives has increased the incidence of a company dealing with unknown parties upon restructuring or insolvency. Where a creditor assigns a "deliverable obligation"[70] as part of claiming payment on a physically-settled CDS, the seller of protection instantly becomes a creditor of the corporation. This may have an adverse or positive impact on the work-out or administration. If the new creditor has less experience or differing motivations from a traditional commercial bank, a restructuring may be hindered. For instance, the new creditor may decide to exercise security unhindered by reputation cost or the possibility of future business with the company – the motivation is simply to minimise loss. Indeed, a "known and static pool of creditors" is desirable in corporate restructuring, and certainly a manageable number of creditors is crucial – where many participants sell CDS protection over small amounts of an entity's debt, the "morphing of one holder into five or 10 other holders" is clearly undesirable.[71]

Yet if the new lender has requisite experience and a genuine economic interest, the resultant behaviour may be more conducive to a successful restructuring than that of the original empty creditor, and may provide a market solution to the problem of creditor passivity.[72]

In either instance, it is evident that credit derivatives may give rise to unexpected behaviour and outcomes:

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[66] Partnoy and Skeel, n 36 at 1033. See also Mora N and Sowerbutts R, "The Paradox of Liquid Loans" (Paper presented by Mora at the Bank for International Settlements workshop, "Risk Transfer Mechanisms and Financial Stability", Basel, Switzerland, 30 May 2008), http://www.bis.org/bcbs/events/rtf08rtmfs/mora.pdf viewed 19 July 2009.

[67] Inter-creditor agreements are made between individual lenders, for instance, first and subsequent chargees or within a loan syndicate. For an analysis of inter-creditor relations and agreements, see Dembo T, "The Tensions Between Lenders and Swap Providers" (2009) 20 JBFLP 140.

[68] Hu and Black, n 45 at 732.

[69] See n 79 below.

[70] Depending on the contractual terms of the debt, the lender may be required to give notice to the debtor of this assignment, but this is not always the case.

[71] Green, n 17 at 104, 109.

[72] See the discussion below on the benefits of distressed debt investing. Consider Alinta Energy's (ASX: AEJ) creditor group, which market speculation notes has increased from 11 parties to more than 30 parties as a consequence of secondary debt trading, but with distressed debt investor groups subsequently emerging with concentrated ownership: see Range J, "Buzzards Pick Over Alinta", *The Australian Financial Review* (28 July 2010); Clegg B, "TPG Fund Considers Debt-For-Equity Plan to Save Struggling Alinta", *The Australian* (13 August 2010).

> Credit default swaps make bankruptcy discontinuous. It is an event that fundamentally alters the payouts and identities of the investors.[73]

Old news? A comparison of credit derivatives to contracts of guarantee

Extant analyses of credit derivatives have not included a comparison with traditional contracts of guarantee.[74] The similarities between a CDS and a contract of guarantee are striking. Both involve the assumption of a secondary (contingent) obligation by a third party surety (seller of CDS protection), triggered on the default of the principal debtor (the reference entity). The economic interest of the creditor is reduced while legal rights remain unaffected, at least until the debt is extinguished and the surety's right of subrogation arises (compare the effect of a possible assignment of the reference obligation under a CDS). On this basis, a guarantee results in an unbundling of debt rights, and one could argue that lender incentive misalignment is hardly a new phenomenon.

Several points of distinction must be noted in response. First, contracts of guarantee are not as pervasive as CDS, such that any decoupling effects are less frequent. Secondly, third party sureties usually have a pre-existing relationship with the principal debtor, accounting for the willingness to provide a guarantee – an obvious example is guarantees within a corporate group.[75] In this situation, although the lender's incentives relating to the particular borrowing entity may be altered, incentives with respect to the broader corporate group are unchanged. The benefit of the guarantee diminishes if the group (and the surety as part of the group) encounters financial difficulty and creditworthiness diminishes. Thirdly, if a surety was related to the principal debtor, the impact of rights of subrogation was more muted than the effect of a transfer of the reference obligation underlying a physically-settled CDS. The surety was not a "new face at the table" and would be less prepared to act in a manner detrimental to the borrower.[76]

Admittedly, where the surety merely engages in a commercial "insurance" transaction, undertaking a guarantee in return for a fee payable by the debtor (or by the creditor), the effects of debt decoupling apply similarly. But the occurrence of this type of transaction was insignificant relative to the situations where guarantees were provided and especially infrequent relative to the prevalence of CDS.[77]

IMPLICATIONS OF CREDIT DERIVATIVES FOR CORPORATE LAW AND FINANCIAL REGULATION

Premises of corporate law and financial regulation

The law currently provides for the arrangement of a work-out or restructuring, with success depending on the commercial circumstances of the company and the strength of its relationships with its bankers. Fundamental to current practice is freedom of corporate restructuring: a solvent company and its creditors may negotiate freely; or an insolvent company may enter voluntary administration where there is flexibility for creditors to approve a deed of company arrangement. The court inspects and may seek to balance creditors' different interests, but does not generally involve itself in making business judgments. Although the Ch 11 approach in the United States involves greater judicial intervention, the philosophy is equivalent. If these processes fail, an insolvent company is liquidated.

[73] Baird D and Rasmussen R, "Anti-Bankruptcy", Working Paper No 470 (University of Chicago Law and Economics, 2009) p 37 http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1396827 viewed 18 July 2009.

[74] For a formal definition of a contract of guarantee and discussion of the instrument's development in Australian and English law, see, eg Everett A and McCracken S, *Banking and Financial Institutions Law* (6th ed, Lawbook Co., 2004) or Mallesons, n 19, p 608.

[75] Usually a guarantee is provided for little direct consideration, with consideration typically the provision of continuing financial accommodation to the principal debtor.

[76] The comparison to guarantees also gives rise to issues such as whether a right of subrogation should automatically extend to the seller of CDS protection, even where the CDS settlement does not require assignment of the debt, but this issue is beyond the scope of this article.

[77] For an example of a guarantee given purely as a commercial transaction, see the facts of *Winterton Constructions Pty Ltd v Hambros Australia Ltd* (1992) 39 FCR 97.

Yet freedom of corporate restructuring, like freedom of contract, is based on the assumption that parties act commercially and in good faith – an assumption that may be mistaken given the effect of credit derivatives.

Disclosure of credit derivative positions?

Bringing debt regulation in line with equity regulation

As discussed above, courts and regulators have increasingly mandated the disclosure of equity derivative positions, in addition to general requirements for the disclosure of significant shareholdings of listed companies.[78]

Short selling of shares has also been the subject of much attention. In Australia, class orders issued by the Australian Securities and Investments Commission (ASIC) variously restricted short selling, and in December 2008 the Commonwealth government passed the *Corporations Amendment (Short Selling) Act 2008* (Cth).[79] The Act modifies prior legislation, banning naked short selling and mandating disclosure of covered short sales.[80] Again, similar regulatory attention has arisen in the United Kingdom.[81] By comparison, there is no requirement to disclose debt interests and credit derivative positions, nor any limitation on assuming negative net economic exposure to debt.

The traditional equity: Debt distinction

This disparate regulation seems to be founded on a conceived distinction between debt and equity. Equity is publicly traded, with dispersed ownership of listed companies and the interests of passive (especially retail) shareholders requiring protection, particularly during changes of corporate control. Debt, however, was concentrated in the hands of a few large sophisticated institutions who could negotiate with and monitor the company, if necessary, receiving non-public information on a confidential basis rather than relying solely on the disclosure requirements imposed on listed Australian companies.[82]

But this distinction is problematic, not only because of the effects of credit derivatives but also given changes in lending practices resulting in increasingly dispersed ownership of debt. The fluidity of credit derivatives, the existence of hybrid securities in a debt-equity continuum and the increasing ability to tailor risk-return profiles using cross-market hedging all suggest that:

> A regime of disclosure on the equity side, yet nondisclosure on the debt side, makes increasingly little sense.[83]

Increasing transparency

Compulsory disclosure of beneficial credit derivative positions (that is, where the holder has bought protection, a "long" position) held by creditors has been suggested, in order to minimise information asymmetries arising from the existence, but non-disclosure of, such interests.[84] The need for disclosure could arise as soon as a company enters voluntary administration, as this seems more

[78] Disclosure of substantial shareholdings in listed companies (holdings in excess of 5% of issued shares) is mandated by the *Corporations Act 2001* (Cth), s 671B, with tracing of beneficial ownership possible under s 672A.

[79] See, eg ASIC, *Covered Short Sales*, ASIC Class Order [CO 08/751] (19 September 2008). For a detailed discussion of equity short selling ramifications and Australian regulation, see Terrett A and Poisel T, "Transparency and Disclosure: Implications of the Bear Raid on ABC Learning Centres" (2009) 27 C&SLJ 139.

[80] See Terrett and Poisel, n 79 at 159-160 for discussions of the legal reforms, and at 152 for a general discussion of short selling regulation in Australia.

[81] See n 53.

[82] Continuous disclosure of material information is compulsory for listed companies, pursuant to the *Corporations Act 2001* (Cth), Ch 6CA and associated Australian Securities Exchange (ASX) Listing Rules (Ch 3; Ch 4 provides for periodic disclosure).

[83] See Hu and Black, n 45 at 688-690 for a discussion of "hybrid decoupling" (with creditor behaviour during the Bear Stearns sale to JPMorgan in March 2008 an example of such techniques), and for a general discussion of hedging using instruments trading in different markets (cross-market hedging).

[84] Hu and Black generally, nn 45, 47; Partnoy and Skeel, n 36 at 1047; Coco, n 62 at 654.

equitable than mandating early disclosure, at the point when a CDS agreement is completed. Although the latter requirement would further reduce the impact of debt decoupling, mandatory early disclosure may be damaging to banks' reputations, discouraging the use of credit derivatives and negating any benefits associated with such use.[85] Such early disclosure may also prompt the creation of more complex instruments that circumvent disclosure requirements.

However, where entry into insolvency is involuntary, as where a creditor files a notice of default or petition, any such filing should necessitate contemporaneous disclosure of related credit derivative interests, allowing the court to assess the creditor's true incentives and whether it merely wishes to secure a CDS payout. Disclosure could take place via ASIC. Exceptions to a statutory regime of disclosure could be made for minimal hedging and where the credit derivative position is held by the entity for dealing (market-making) purposes rather than for hedging purposes.[86]

Disclosure of a creditor's "hidden *non*-interest" in a debt, resulting from a long derivative position, would engender increased transparency.[87] The company, an external administrator and associated stakeholders would gain awareness of a creditor's economic interest and likely motivations. When exercising discretion, a court would presumably place greater emphasis on the views of creditors with real economic interests than those of hedged creditors. Disclosure would also give companies forewarning of likely "new faces at the table" to emerge after the settlement of a CDS.[88]

Creditor voting

Associated with the disclosure of "hidden non-interest" is the basis for creditor voting, which ought to be prescribed by statute and considered by the courts when overseeing external administration. Arguably, voting in insolvency should be conducted on the basis of a creditor's net (positive) *economic* interest instead of gross (nominal) debt ownership:

> Ascertaining *economic* interests is crucial to assessing bankruptcy policy. Investments come with both cash flow rights and control rights. As a general matter, cash flow rights and control rights work in tandem. We normally assume that an investor exercising a control right granted by a financial instrument is acting so as to maximise the value of that investment. Credit default swaps have rendered this assumption obsolete.[89]

Such a basis for voting seems somewhat inequitable to the creditor who has prudently sought and paid for protection from the risk of default. But the provision would resolve many of the difficulties associated with creditor passivity, as well as more reprehensible attempts to force a company to file for insolvency in order to secure a CDS payout. The legislative change would not so much impinge on a "freedom to hedge", but rather modify insolvency processes while providing for the certainty of the hedged creditor's net economic position. For example, a creditor that has nominally fully hedged its exposure using a CDS, but does not receive the expected payment due to the default of the CDS seller or a reduced settlement price, would retain full voting rights in respect of the residual debt interest.[90] Legal and regulatory reform is not aimed at, and must not have the effect of, prejudicing the legitimate financial interests of a hedged creditor. The intention is rather to facilitate an optimal restructuring outcome.

Creditor voting rests on the same assumption as shareholder voting – one vote for every share or dollar of value held. The regulation of creditor voting needs to recognise the importance of assessing net economic interests, just as the courts and regulators have come to realise in the context of M&A activity and equity decoupling.

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[85] For a discussion of the potential benefits of credit derivative use, see nn 96-98 below.

[86] Compare the exception usually granted to equity market-makers with respect to equity derivative disclosure and short selling: see Guidance Note 20, n 50; ASIC Class Order, n 79; *Corporations Amendment (Short Selling) Act 2008* (Cth).

[87] See Hu and Black's expanded work, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions" (2008) 156 U Pa L Rev 625 at 628.

[88] Whether the law should require general disclosure by *sellers* of CDS protection (holders of "short" interests) or by *speculative* buyers with no direct interest in the debtor, is a more complex issue and beyond the scope of this article.

[89] Baird and Rasmussen, n 73, p 33.

[90] See the discussion above for an explanation of why the buyer of a CDS may be imperfectly hedged.

Contractual solutions?

Contracts between creditors and debtors offer potential ways of addressing the effects of credit derivatives. As work-outs are privately negotiated without judicial oversight, perhaps disclosure requirements ought to be required under creditor-debtor contracts or incorporated in industry work-out guidelines. Similarly, inter-creditor agreements should preclude a particular creditor's ability to act with conflicting interests. And a general prohibition on creditor voting in the absence of genuine economic interest, could be incorporated into company constitutions.[91]

There is also potential in the very terms of CDS contracts. Ironically, a tendency has developed where CDS contracts require the buyer, if also a creditor of the reference entity, to act in the interests of other creditors of the reference entity, implying that a buyer may not necessarily do so as a matter of course.[92] This evidences some market awareness of the effects of credit derivatives on corporate restructuring and is to be encouraged.

But all the above measures depend on some level of disclosure for enforcement and effectiveness. Parties not aware of the existence of a CDS, let alone privy to its contractual terms, cannot seek adherence to such terms by the creditor.

Legislative solutions and Pt 5.3A

A legislative solution for solvent companies outside statutory insolvency regimes is not immediately apparent. As Green notes, a solvent but distressed Australian company seeking to restructure its debt has only one conceivable alternative to a work-out or refinancing – filing for voluntary administration.[93] Voluntary administration requires that directors believe in the likely insolvency of the company and are prepared to cede managerial control, and entails adverse publicity and costs. As such, voluntary administration does not in fact present a viable alternative to a work-out. Yet the 2004 Corporations and Markets Advisory Committee (CAMAC) report on large scale corporate restructuring, and the resulting *Corporations Amendment (Insolvency) Act 2007* (Cth), did not address this lack of alternatives.[94] It is submitted that an initial desirable measure would be to refer the matter to CAMAC for consideration and public consultation.

In respect of insolvent companies, Pt 5.3A of the *Corporations Act* should be amended in respect of disclosure of long CDS positions and the basis of creditor voting, as described above. Further, it would seem appropriate to give ASIC enhanced powers of supervision and investigation into alleged inappropriate behaviour by creditors. Again, it is time for CAMAC to consider how insolvency law should be amended to address the growth of credit derivatives, following on from its general 1997 report on derivative regulation.[95]

Broader implications

Benefits of credit derivatives

This article should not be construed as a criticism of credit derivatives and financial innovation. On the contrary, credit derivatives may offer considerable benefits by reducing the cost of debt for some corporate issuers;[96] allowing banks to optimally structure their capital, in turn facilitating greater

[91] Or as a replaceable rule under the *Corporations Act 2001* (Cth).

[92] Hu and Black, n 45 at 733.

[93] Green, n 17 at 110.

[94] Companies and Securities Advisory Committee (CAMAC), *Rehabilitating Large and Complex Enterprises in Financial Difficulty* (September 2003), http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/Large_Enterprises_Discussion_Paper.pdf viewed 19 October 2009. See also Green, n 17 at 112.

[95] CAMAC, *Regulation of On-exchange and OTC Derivatives Markets* (June 1997), http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+1997 viewed October 2009.

[96] See, eg Ashcraft A and Santos J, "Has the CDS Market Lowered the Cost of Debt?" (Paper presented at the Bank for International Settlements workshop, "Risk Transfer Mechanisms and Financial Stability", Basel, Switzerland, 30 May 2008), http://www.bis.org/bcbs/events/rtf08rtmfs/santos.pdf viewed 24 August 2009.

lending and economic activity;[97] assisting price discovery in other markets;[98] and enhancing capital allocation by opening a new asset class. The relative lack of CDS market transparency may be explained simply by the needs of its participants, including creditors seeking confidential protection.

However, these factors need to be assessed against the impact of credit derivatives on corporate restructuring, not only at the "firm level" but also in terms of broader economic effect.

Systemic mispricing of risk and light covenants

Credit derivatives discourage not only bank monitoring but also accurate loan pricing, covenant specification and assessment of risk by lenders. A hedged creditor that underestimates the risk of default, or does not include an appropriate covenant as a means of lender protection, will at worst bear the cost of buying CDS protection, but otherwise will receive a payout; an unhedged creditor will suffer significant loss. As in securitisation, credit risk transfer encourages banks to originate a larger number of loans, absorbing fees related to each loan and its ongoing "servicing", but otherwise disposing of credit risk and relaxing lending standards: "The banks are no longer eating their own cooking, as it were."[99]

Although the CDS market is itself a means of pricing credit risk, it remains a widespread market where many participants do not have a direct relationship with the borrower. As such, the market as a whole is arguably less well placed to price credit risk than a traditional lender specifically analysing the borrower's credit prospects. In either case, like all public markets, the CDS market is prone to irrationality, occasional high volatility and illiquidity, and long-term mispricing – more so than most conservative lenders.

Systemic restructuring risk

If the use of CDS for hedging can impede an isolated corporate restructuring, then by extension CDS can threaten the soundness of the regulatory framework for rehabilitating corporations. Externalities arising from the unbundling of rights extend beyond isolated instances of corporate restructuring.

When applying to many loans and borrowers, lender inflexibility in conducting work-outs and a possible willingness to urge formal insolvency poses systemic risk. Such behaviour is tantamount to declaring a lack of confidence in the borrower's capacity to survive and repay, discouraging trading partners, signalling a withdrawing of credit from the market, and forcing companies to bear the considerable financial and reputation costs associated with voluntary administration and liquidation. Creditor inflexibility increases a viable but troubled corporation's reliance on refinancing, magnifying the ramifications of temporary illiquidity in credit markets. The cumulative effect is considerable in economic downturns.

Evaluation

There is evidently a basis for calling for increased legislative, regulatory and academic attention to the issues described in this article. The key question to ask is whether the law as it stands now provides an adequate framework within which large-scale viable companies may attempt a work-out or be restructured within voluntary administration to drive the optimal collective outcome. The answer appears to be negative, as the legal framework has remained constant while financial innovation has continued during the last decade. Credit derivative use poses impediments to negotiation, the "lifeblood" of corporate reorganisation, with increased probability of outcomes that are beneficial to certain creditors but otherwise suboptimal.

[97] See, eg Cerasi V and Rochet JC, "Solvency Regulation and Credit Risk Transfer" (Paper presented at the Bank for International Settlements workshop, "Risk Transfer Mechanisms and Financial Stability", Basel, Switzerland, 30 May 2008), http://www.bis.org/bcbs/events/rtf08rtmfs/cerasirochet.pdf, viewed 24 August 2009.

[98] See Mengle, n 41 at 7. Mengle notes the difficulties in pricing credit risk solely from corporate bond prices, as these prices impound risks relating to interest rates in addition to default risk, unlike CDS which indicate default risk only.

[99] Hu and Black, n 47 (2007) at 7.

The law must evolve to address such concerns, even while corporate finance theory is being reassessed in light of the global financial crisis and economic downturn,[100] so that the goals of corporate restructuring continue to be fulfilled.

DISTRESSED DEBT INVESTING: OPPORTUNITIES AND CHALLENGES

A market-based solution?

There is likely to be substantial opposition by lenders to law reform concerning increased disclosure requirements and creditor voting. Lenders are likely to be concerned about the harm to their relationships with borrowers, inconsistencies in disclosing long credit derivative interests compared with non-disclosure of other risk transfer mechanisms such as contracts of insurance, and that disclosure may cause breach of contractual terms of a CDS.

Yet maintenance of the status quo seems unacceptable. A market-based solution to deal with the impediments posed to corporate restructuring is preferable. Such a solution may be found in the developing practice of distressed debt investing.

Distressed debt activity

A DDI is a party that purchases the debt of a financially troubled company at a discount to face value,[101] often in addition to injecting new capital into the company in return for a new debt, equity or hybrid interest. The debt may be purchased either from trade creditors (such as a company's suppliers) or from the company's lenders, with the latter transactions commonly referred to as non-performing loan (NPL) deals. A DDI seeks to profit on the investment by converting the purchased debt into an equity position in the reorganised debtor, thus gaining voting power and equity upside, by obtaining an eventual recovery on the debt in excess of the purchase price or by reselling the debt at a higher price.[102]

Distressed debt investment developed in the United States in the 1970s and 1980s as part of the development of private equity. More recently, DDIs were active in, though ultimately did not gain influence over, the WorldCom-MCI bankruptcy in 2002-2004.[103] Growth in distressed debt investment is negatively correlated with general market conditions. There are a greater number of opportunities in an economic downturn, where depressed trading conditions prompt work-outs and/or insolvency filings. And less liquid credit markets, which render re-financing more difficult and costly, generate opportunities for DDIs.

Activity in Australia

Sources of and uses for distressed debt investment capital in Australia also require definition. The Australian landscape is currently witnessing substantial levels of corporate distress with high-profile collapses of over-leveraged corporations,[104] accompanied by the collapse or distress of entire industries,[105] offering opportunities for DDI capital use.

In terms of sources of capital, the industry has been less active in Australia than in the United States and Europe, reflecting the size of the local market and Australia's continued prosperity. Most

[100] It has been observed generally that the law evolves to fulfil common goals amongst changed circumstances, in line with changed markets but independently of uncertainty in broader finance theory: see Walker G, "Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy" (2006) 36 HKLJ 481, http://www.ssrn.com/abstract=1099512 viewed 14 September 2009. Uncertainty about the broader role of credit derivatives and their "interconnectedness" should not preclude or defer regulatory reform.

[101] Distressed companies may be defined as ones where issued debt trades at (or is valued at) less than 80% of face value or are priced at a 10% (or greater) premium to government bond yields.

[102] Harner, n 6 at 716-717.

[103] Goldschmid, n 7 at 195.

[104] Including the collapse of Babcock and Brown, ABC Learning, Centro, Allco and MFS.

[105] Most obviously the real estate investment sector (A-REITS): see Yik A, Koster B and Lumsden A, "A-REITS: Impact of the Global Financial Crisis" (2009), http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1392041 viewed 24 July 2009. In 2009, the agricultural managed investment scheme (MIS) sector saw the collapse of Great Southern Plantations and Timbercorp.

DDIs operate globally, with offices in Australia, or more commonly in the Asia Pacific. A local DDI industry is slowly developing out of the operations of private equity firms.[106] The 2009 economic downturn and changed market conditions appear to have produced greater interest in distressed Australian companies on the part of international and local DDIs. A survey of DDIs found that Australia is considered a leading country in terms of investment opportunities.[107] Indeed, for foreign investors, Australia offers not only opportunities but also political stability and well-settled recognition of property interests at law. Media commentary in 2009 noted the growing interest of DDIs in Australia.[108]

Distressed debt activity has come to prominence in 2010, with DDIs emerging as key participants in the complex restructuring of Alinta Energy and Centro Properties, as well as acquiring debt of PBL Media in a secondary loan market that has witnessed transactions of record size, including portfolio trades.[109]

DDIs typically raise funds with which to pursue opportunities. The economic downturn is an ideal period for distressed fundraising, with clients willing to make substantial commitments to this "alternative" asset class, in view of diminished, negative or highly volatile returns from traditional public market asset classes.[110] Therefore distressed debt activity has increased as the economic downturn cycle plays out.

Why do creditors sell distressed debt?

Trade creditors

Distressed debt investment relies on purchasing debt claims when the issuer becomes distressed or insolvent. Traditionally, the main vendors of such claims were trade creditors. Their motivations to sell were clear: trade creditors were ordinarily unsecured and therefore at a disadvantage to secured creditors in the insolvency process; they were frequently inexperienced in recovering via insolvency and lacked the information and resources to investigate ways of maximising return; and issues such as security valuation stood outside their core competencies.[111]

Thus a DDI, by bidding for the debt claim, offered liquidity – albeit at a considerable discount to the nominal claim. The trade creditor could sell the claim, usually deriving a tax benefit[112] and extricating itself from a lengthy and complex insolvency process. A DDI would then seek to accumulate a substantial amount of debt in order to gain influence over the restructuring process.

Financial creditors

However, DDIs can attain limited influence if the only vendors of debt are trade creditors, as typically most debt claims against a company are held by lenders.

[106] See Blake Dawson and PricewaterhouseCoopers, *Distressed Investing in Australia: A Guide for Buyers and Sellers* (March 2009) p 13, http://www.blakedawson.com/Templates/Publications/x_publication_content_page.aspx?id=54667 viewed 24 June 2009.

[107] Blake Dawson and Pricewaterhouse Coopers, n 106, p 14.

[108] See, eg McIntyre D, "Distressed Debt Funds are Eyeing Australian Firms", *The Australian* (18 April 2009), http://www.theaustralian.news.com.au/business/story/0,28124,25347477-36418,00.html viewed 29 September 2009; Buhrer K, "Distressed Debt Seen as a Fertile Field", *The Australian Financial Review* (9 October 2009); Boyd T, "Debt Buyers See Billions of Opportunities", *The Australian Financial Review* (22 December 2009). For commentary on distressed debt investor (DDI) interest in Asia, see Desai H, "Distressed Debt Investors Prepared to Pounce in Asia", *The New York Times* (3 April 2008), http://www.nytimes.com/2008/04/09/business/worldbusiness/09iht-rtrdeal10.1.11804078.html viewed 29 September 2009.

[109] See, eg Shapiro J, "All Distressed With Somewhere To Go", *The Australian Financial Review* (9 August 2010); Harcourt T, "RBS Sells its Centro Exposure", *The Australian Financial Review* (26 July 2010).

[110] Most clients of DDIs are institutional or "sophisticated" investors, such as pension funds and high net worth individuals. Principals and employees of DDIs also usually invest in their funds. Most clients seek exposure to distressed debt investment as a means of investment diversification, given the low correlation of this asset class to the performance of other asset classes, and as a means of providing a target absolute (not benchmarked) return.

[111] Goldschmid, n 7 at 206.

[112] See below for a discussion of potential tax benefits to be gained from sales of debt claims.

Traditionally, Australian banks have not sold NPLs for several reasons, including that there have been a small number of NPLs in Australia, reflecting buoyant economic conditions and relatively conservative lending practices; the development of work-out teams, signifying a preference to deal with customers internally rather than admitting mistakes in lending; and valuation. NPL valuation often was determinative: the lack of a distressed debt market and active buyers of distressed debt resulted in a wide "bid-ask differential", so that banks could obtain a better return by dealing with the NPL than by selling it.

However, increasing defaults and growing NPL portfolios (Australia's major banks now carry at least A$11 billion in defaulted loans),[113] together with other developments during the last few years, have altered the traditional unwillingness to sell distressed debt. Vendors in recent NPL transactions have included not only Australian banks but also foreign banks (with Australian loan portfolios), the latter often unwinding offshore positions given commercial and funding pressures.

Prudential regulation and opportunity cost of capital

In Australia, lenders are usually authorised deposit-taking institutions (ADIs) and therefore subject to prudential regulation by the Australian Prudential Regulation Authority (APRA).[114] Prudential regulation mandates that banks hold adequate regulatory capital, categorised into tiers with Tier 1 capital of highest "quality" and liquidity and Tier 2 of lower quality.[115] Regulatory capital acts as a reserve, an equity buffer or "cushion" in the event that the bank's assets (its loan portfolios) are impaired, in which case the bank's shareholders bear the loss. Impairment occurs where loans are marked down in value due to a lower probability of recovery (an increased default rate), a lower likely recovery rate or deferred recovery. Prudential regulation thus functions to limit the amount of money a bank can lend, as equity reserves are limited and are more costly than debt capital.[116]

Since the late 1990s, international attempts to harmonise capital adequacy regimes in different jurisdictions led to the Basel I, and subsequently Basel II, framework. APRA's standards are grounded within this framework, with Basel II adopted in Australia in January 2008.

Basel II's impact on distressed debt sales is profound. Capital adequacy requirements in respect of NPLs have been substantially increased under Basel II, so that large amounts of expensive Tier 1 capital must be held to cover the possibility of losses. However, capital adequacy requirements for *performing* loans and low-risk customers are lower relative to Basel I. This reflects the general "hard-wired procyclicality"[117] of Basel II, meaning that Basel II encourages lending in buoyant conditions but discourages lending in economic downturns. Thus while A$25 million in Tier 1 capital may be required to support a NPL (even if a substantial amount of the loan is expected to be eventually recovered), the same A$25 million could support up to A$460 million of low-risk loans.[118] Such low-risk loans cumulatively would generate greater income than a portfolio of high-yield but distressed loans, thereby improving the bank's shareholder returns (return on equity).

Hence the new prudential standards encourage banks to sell distressed debt, increasing the opportunity cost of retaining substantial NPLs. In 2009, Australian banks conducted large equity raisings, mostly to boost regulatory capital amidst loan portfolio mark-downs. But there is definitely a

[113] Blake Dawson and Pricewaterhouse Coopers, n 106, p 80 (the estimate is based on A$6.7 billion of defaulted corporate loans and A$4.3 billion of defaulted consumer loans).

[114] Pursuant to the *Australian Prudent Regulation Authority Act 1998* (Cth). APRA regulates by issuing prudential standards that prescribe requirements for, and the constitution of, regulatory capital. For example, see APRA, *Capital Adequacy*, Prudential Standard APS 110 (January 2008), http://www.apra.gov.au/ADI/upload/Final-APS-110-November-2007.pdf viewed 15 August 2010.

[115] Essentially only cash and short-term money-market securities qualify as Tier 1 capital.

[116] A bank cannot lend monies that must be kept as reserves, increasing the overall cost of capital and the required return on any loans that are made.

[117] See the discussion of procyclicality in *The Turner Review*, n 53, pp 59-68. In the Australian context, see Sweeney S, "Enron's Legacy Lives on: Australia's Adoption of Basel II's Securitisation Framework'" (2007) 25 C&SLJ 527; Sweeney S, "Basel II's Effect on the Australian Market" (2006) 34 ABLR 284.

[118] Blake Dawson and Pricewaterhouse Coopers, n 106, p 37.

tipping point at which diluting shareholders is less attractive than selling NPLs at a discount to face value. Basel II has moved this tipping point closer.

Tax benefits

Under Australian tax law, Australian banks cannot realise a benefit from an NPL until either the entire loan is written off (generally the case only for extremely distressed borrowers) or the bank partly recovers the loan and crystallises the loss.[119] Therefore any tax benefit gained by retaining an NPL and claiming a "bad debt" is deferred – banks continue to pay tax on their nominal profit, as if the loans were performing. By comparison, selling a NPL allows the immediate realisation of the tax benefit, as the loss is crystallised.

The decline of traditional banking practice

Finally, banks have increased incentives to sell debt as a result of broad changes in the banking model. The reduction in concentrated exposure to a particular borrower stems not only from the increase in credit derivatives during the last decade, but the advent of loan syndication and securitisation which arose in the 1970s and 1980s, with securitisation employed in Australia in large-scale issuance of residential mortgage-backed securities (RMBS) until mid-2007.[120] Both loan syndication and securitisation disperse ownership, substituting a group of banks or hundreds of investors in place of one lender. The resultant "shadow banking" system decreases the possibility of work-outs generally, with each investor having comparatively low exposure and little incentive to invest resources in a work-out.[121]

With dispersed ownership, banks increased their focus on originating and "servicing" debt and decreased the size of work-out teams. These teams are now overwhelmed with the level of NPLs. Indeed, loan syndication is now more commonly accepted by debtors, with less expectation of an exclusive relationship and greater contractual provision for transferability.[122]

All this is not to say that traditional banking has come to an end or that work-outs are impossible regardless of whether credit derivatives are present. It simply goes towards establishing lenders' increased willingness to sell distressed debt. Even excluding the cost of maintaining work-out teams, the combined cost of regulatory capital, deferred recovery and deferred tax benefits have been estimated to reduce the value of a NPL-carried on-balance sheet by up to 23% of the gross loan value.[123] If a DDI is prepared to pay a price that allows the bank to bear a loss less than 23%, the bid-ask differential is satisfied and a transaction can occur. The recent NPL transactions noted above indicate that asset price stabilisation, and enhanced price discovery, have contributed to the narrowing of the bid-ask differential.

The "residual actor" problem

Asymmetric risk-return profiles in corporate restructuring

Corporate insolvency, and corporate distress bordering on insolvency, is characterised by what has been termed the "residual actor" problem.[124] A "residual actor" is one whose investment "will reap the marginal dollar of a firm's gain or suffer a marginal dollar of its loss, and one who has influence over the firm's operation".[125] The risk-return profile is *symmetric*. When a company is successful, its

[119] Blake Dawson and Pricewaterhouse Coopers, n 106, p 37.

[120] The securitisation market has revived somewhat following improvement in credit market liquidity, with Australian RMBS issuance commencing again in late 2009.

[121] For a discussion of shadow banking, see Hannoun H, "Financial Deepening Without Financial Excess" (Speech delivered at the 43rd SEACEN Governers' Conference, Jakarta, 21 March 2008), http://www.bis.org/speeches/sp080403.pdf viewed 18 September 2009.

[122] Lubben, n 58 at 426.

[123] Blake Dawson and Pricewaterhouse Coopers, n 106, p 38.

[124] For a detailed discussion of the "residual actor" problem, see Goldschmid, n 7 at 192, 196-200.

[125] Goldschmid, n 7 at 196.

shareholders are the residual actors, receiving the benefit of any upside once the firm pays its debts and incurring loss if a firm is not profitable. They also have the power to *act*, voting to elect the board of directors, which appoints management. Shareholders are the primary decision-makers and are able to shape the company to be long-term economically viable.[126]

But in the case of insolvency or near-insolvency, the risk-return profiles of the decision-makers are *asymmetric* and there is no obvious residual actor. Although shareholders remain "residual claimants" as long as the company exists, they are no longer "residual actors", having little decision-making power. The decision-makers are rather creditors, whose interests may be divergent as a result of pari passu distribution. Junior creditors are likely to be well "under water" and therefore are likely to favour a riskier approach that may increase their otherwise low recovery rate: there is little to be lost and much to be gained. Senior and secured creditors demonstrate the reverse *asymmetry*: their interests will be generally "above water" or just below, with limited upside and considerable downside. Such creditors will therefore prefer less risky outcomes that preserve the value of their interests and do not delay realisation of security. The divergence between creditors is magnified where a large creditor is protected by CDS and acts in an unexpected way.

The lack of a residual actor may frustrate the fundamental purpose of corporate restructuring – that viable but troubled companies are re-organised and preserved as a going concern, whereas non-viable companies are efficiently liquidated. The ideal collective outcome may not be achieved given individual motivations. The problem is intrinsic in insolvency. This article does not offer a resolution, but submits that certain DDIs may be appropriate residual actors, serving to increase the probability of an optimal collective outcome.

New faces at the table can be beneficial: The role of DDIs

A symmetric risk-return profile: Equity-for-debt swaps

It has been relatively rare for anything positive to be written about DDIs. DDIs are frequently referred to as "vulture funds", "preying" on companies in distress or "swooping" on the "carcasses" of such companies.[127] This view reflects the emotions typically accompanying significant corporate distress, experienced by owners, managers and employees, as well as the fact that some distressed debt "investors" have acted contrary to the interests of the company and other stakeholders. Much of this antagonism derives from the fact that a DDI, unlike other creditors and shareholders, may actually profit from its involvement with the company.

But an analysis of distressed debt investing in the context of corporate restructuring, including restructuring affected by the use of credit derivatives, shows that DDIs may be properly incentivised to drive the optimal outcome. By accumulating debt holdings and converting these to equity, as ESL and Third Avenue did in relation to Kmart, a DDI stands to gain or lose *equally* from how the company subsequently performs. The risk-return profile is equity-like and therefore *symmetric*: either the investment will be lost as performance deteriorates or a return on invested capital will be earned if the company recovers. So a DDI becomes a "residual claimant" like pre-existing shareholders but, unlike other shareholders, it is initially a *creditor* and is involved in decision-making, and may therefore be a "residual actor".

Higher level of acceptable risk: Entrepreneurialism and regulatory differences

As described, a large senior (and probably secured) creditor may be unwilling to consider riskier reorganisation plans or advance further funds even where this would be in the best interests of a company. However, DDIs are far more entrepreneurial than commercial banks, aiming to share in any upside and seeking a significant absolute return[128] rather than merely recovering the value of a loan.

[126] Excluding the effect of agency problems.

[127] Goldschmid, n 7 at 194.

[128] Typically a return above 20% or 25% per annum. A DDI's managers usually obtain performance fees to the extent the investments achieve such a required level of return, commonly referred to as a "high watermark".

DDIs often make new advances in the form of convertible debt, which preserves seniority (and security if the convertible debt is secured) but retains equity upside.[129] DDIs' willingness to accept greater risk and exercise control usually results in an equity-for-debt swap in respect of purchased claims and any new advances made. The reduction in financial pressure effected by an equity-debt swap can be crucial to corporate restructuring, as indicated by the successful restructuring of AMF Bowling in 2002 where a DDI emerged with a controlling equity stake in return for advances made while the company was in Ch 11 bankruptcy protection, and which allowed the company to exit from that process.[130]

The willingness to swap debt for equity is a characteristic typical of DDIs but atypical of commercial banks. This contrast stems partly from regulatory differences between DDIs and traditional creditors. As described, banks are regulated as ADIs, with prescribed regulatory capital requirements and established financial reporting. Thus a bank will be less willing to agree to an equity-for-debt swap simply because this will trigger a loss on the loan and attendant Basel II requirements. If such swaps are entered into on a large scale, the bank's own investors may grow concerned about the quality of its loan portfolio. If a bank is listed, its shareholders may act on a short-term view, selling down the bank's shares. In terms of accounting, banks are reluctant to swap debt, usually accounted for as a held-to-maturity investment, for listed equity, the accounting for which usually involves periodic mark-to-market adjustments that increase volatility of reported profit.

By contrast, DDIs are largely unregulated and accountable solely to their private investors who usually view projects on a medium- to long-term investment horizon, assessing the DDI managers on the return achieved rather than the form of security by which it is achieved.

Admittedly, DDIs may also choose to use credit derivatives to hedge their debt interests or equity derivatives to hedge subsequently acquired equity. Either action would render the return asymmetric and perpetuate the impediments to corporate restructuring posed by hedged creditors. But the basic approach of a DDI is *activist* – to derive gain by restructuring and managing the company in a more effective way. Hence equity, to the extent it passes voting control and allows the company to exit from external administration or Ch 11, is desirable for the DDI but represents a loss of seniority and security for a bank lender.

Expediting the insolvency process

The activist approach undertaken by DDIs often results in benefits at the procedural level of insolvency. In the United States, a Ch 11 bankruptcy is often lengthy and costly, as reflected in the monthly advisory fees paid by Kmart. Expediting the process and minimising transaction costs is not only directly beneficial to the company, but also mitigates the extent to which the insolvency process distracts management (pre-existing or new management) from effectively running the company:

> The biggest risk to chapter 11 comes from the risk that the debtor's business will decline beyond the point of rescue while the parties debate, and litigate, the issues.[131]

A DDI's ability and focus on negotiating a settlement between all creditors so as to generate *upside* from which it will benefit, rather than focusing exclusively on *recouping* its invested capital, proved crucial in the Kmart reorganisation:

> The Kmart restructuring turned largely on the ability of ESL and Third Avenue to broker a settlement among the prepetition facility lenders, prepetition bondholders, and the trade creditors.[132]

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[129] Conversion is usually at the option of the holder, but may be exercised by the issuer or automatically on the occurrence of a prescribed event.

[130] AMF Bowling filed for Ch 11 protection in July 2001. DDIs (Farallon Capital Management, Oak Tree Capital, Satellite Holdings and Angelo Gordon) then gained control, allowing the company to exit Ch 11 and reduce its debt, and later on-selling the firm to private equity management: see Sorkin A, "AMF, Bowling Giant, is Said to Seek Buyer", *The New York Times* (7 February 2003); Securities and Exchange Commission, *AMF Bowling Worldwide Inc*, File No 22-22601 (26 February 2002), http://www.secinfo.com/dRe2b.356.htm viewed 25 October 2009.

[131] Lubben, n 58 at 428.

[132] Harner, n 6 at 763-764.

Although Australia's voluntary administration regime usually operates on a considerably shorter timeframe than Ch 11,[133] the benefit of management focus is invaluable, preventing industry competitors from gaining at the distressed company's expense. Expedited insolvency administration also reduces the deleterious impact of key employees leaving and trading partners terminating contracts, as well as brand name fallout.

A strategic approach and operational focus

A DDI seeks to bring its skills – financial and managerial skills – to bring to bear on a restructuring situation:

> The distressed debt investment is an informed wager that the company is worth more if taken out of the control of management, and run by operations-minded strategic investors.[134]

The strategic approach to managing the distressed company may be compared with the "private equity model" of operating, as traditionally applied to non-distressed companies. The salient features of such an approach are a three-year or greater time horizon in which to drive improvements, and to replace underperforming managers with new managers overseen by the DDI principals. But unlike private equity-led leveraged buyouts (LBOs), distressed debt investment usually reduces a company's gearing. And DDIs tend to use unlevered capital, with investment return driven by the steep initial discount to face value and subsequent operational improvement, rather than financial leverage.[135]

In a work-out, where a distressed company is still controlled by directors, operationally focused DDIs seek representation on the board of directors and demand effective company management. By contrast, banks may be influenced by pre-existing relationships with a company's management, and will often be wary of exercising too much control in a work-out, lest the company ultimately fails and liability is triggered, for instance by a court finding the bank acted as a shadow director.[136]

DDIs and banks also differ in terms of an expected timeframe. Although DDIs may expedite the insolvency process itself, recovery of invested capital is often deferred by years as a result of the restructuring. By contrast, a bank holding such distressed debt bears an ongoing capital adequacy cost. Bank-led reorganisations, even given a genuine "incentive to negotiate", tend to result in a relatively quick binary outcome – of either recovery or liquidation. As discussed, a senior creditor's asymmetric risk-return profile produces a bias *in favour of* liquidation and taking a small loss, rather than advancing further funds or forgiving debt (agreeing to a "haircut"). In many cases, a longer timeframe is required to reorganise operations, reduce debt and restore profitability. DDIs have a bias *against* liquidation, except in cases where liquidation value is greater than going concern value.[137]

Not every corporate restructuring led by a DDI will be as successful as the Kmart restructuring. For instance, consider the failed investment of Cerberus Capital Management in Chrysler Inc.[138] DDIs themselves tend to hold a portfolio of investments in distressed companies, expecting an overall positive return but not necessarily a positive return from every investment. Overall, however, it is evident that DDIs offer a strategic "deep value" approach – they perceive value in a distressed company or its assets in excess of price, and are willing to act and wait to realise this value.

The differences between the approaches of DDIs and of banks and other creditors ultimately signify underlying psychological differences. The DDI is the only substantial decision-maker in

[133] Court-granted extensions of time relating to the second creditors' meeting may result in complex administrations of longer duration.

[134] Goldschmid, n 7 at 264.

[135] Jeffrey A, "Signs of Life Appearing in the Distressed Debt Industry", Press Release (14 March 2009), http://www.bluestone.com.au/news.aspx?c=2&id=24 viewed 28 September 2009.

[136] Austin RP, "Hip-pocket Injuries in Workouts: Accessory Liability for Bankers and Advisers" (2007) 15 Insolv LJ 6. See also the definition of "director" in the *Corporations Act 2001* (Cth), s 9, and the application of this definition in *Standard Chartered Bank of Australia Ltd v Antico [Nos 1 & 2]* (1995) 38 NSWLR 290.

[137] Largely where businesses have no goodwill.

[138] See, eg "Running the Numbers on Cerberus's Chrysler Debacle", *The New York Times DealBook* (4 May 2009), http://www.dealbook.blogs.nytimes.com/2009/05/04/cerberuss-chrysler-deal-was-bad-but-maybe-not-the-worst viewed 17 July 2009.

corporate restructuring that stands to *benefit* – all other creditors can, at best, stand to recover the value of their investment and aim to mitigate loss. The more positive attitude brought to the negotiating table by DDI "new faces" is to be welcomed:

> The beauty of distressed debt investment, handled correctly, is that everyone benefits: the banks have a new, viable customer; the management team works with a fresh and experienced partner; new capital is provided to expand the business; suppliers are assured of payment and ongoing business; and many employees will stay on and share in the growth of the company.[139]

Limitations and new risks arising from distressed debt investment

Risks in DDI involvement

DDIs will often be more sophisticated than many creditors, especially trade creditors, and may exploit this position to secure debt claims at an advantageous price. Indeed, the trading of debt claims may be very opaque.[140] This problem is compounded where a DDI, by virtue of an already substantial interest in the company, gains inside information by being a member of the board of directors or a creditors' committee and trades in the company's debt on the basis of such information.[141]

A DDI's quest for a return on investment may also manifest itself in "asset stripping", where a DDI attempts to secure the "crown jewels" at a discounted price, in exchange for debt forgiveness, leaving the remnants of the company's assets for other creditors and stakeholders.[142] Further, an equity-for-debt swap that gives a DDI control of the company is highly dilutive for all other shareholders. Finally, some DDIs have little true managerial experience or operational focus, instead merely "window-dressing" the company to achieve a sale at a higher price (a public listing or trade sale) without creating value.[143]

Debt trading

> There are some people who are just in there to trade the debt and make a few cents, but therea re other funds who are genuinely interested in promoting a longer term restructuring of the balance sheet.[144]

Some DDIs are in fact "DDTs" – distressed debt traders. These funds operate by purchasing and then attempting to sell debt claims at a higher price quite quickly, usually within a few weeks of purchase. A higher price may be forthcoming because the company's prospects during restructuring or insolvency have improved, a company has managed to refinance or extend the maturity on due debt, or a DDI has entered the process, increasing the likelihood of reorganisation and improvement.

Variations on such strategies are possible[145] and could be collectively termed "distressed debt arbitrage", as a form of risk arbitrage. A meaningful comparison may be made with "merger arbitrage",[146] as applies to (usually non-distressed) companies involved in M&A activity. Much like merger arbitrageurs, "DDTs" are largely passive with respect to the actual corporate restructuring, relying on the role taken by creditors or a DDI. And DDTs purchase smaller non-controlling stakes and are far more diversified than DDIs – compare the number of portfolio holdings of merger arbitrageurs and private equity investors.

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[139] Dunstone N, "Opening the Door for Distressed Debt Funds", *Money Management* (1 June 2009), http://www.moneymanagement.com.au/article/Opening-the-door-for-distressed-debt-funds/482584.aspx viewed 22 August 2009.

[140] Baird and Rasmussen, n 73, pp 16-19.

[141] Hu and Black, n 45 at 685.

[142] See the discussion of the Tower Automotive Inc bankruptcy in "Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play", *The Wall Street Journal* (18 July 2005).

[143] Goldschmid, n 8 at 265-267.

[144] See Low H, "Options for Firms Facing Insolvency Risks", *The Australian Financial Review* (27 July 2010).

[145] For descriptions of such strategies, see, eg Baird and Rasmussen, n 73, p 43.

[146] Merger arbitrage involves taking positions in the equity (or other securities) of a target company, usually in anticipation that a higher price for these securities can be obtained if a bid succeeds (due to the control premium offered) or the bid is increased by the original or a subsequent competing bidder. In the case of a scrip bid, merger arbitrage typically involves buying (taking a "long" position) in the shares of a target company and short selling the shares of the purported acquirer.

Distressed debt arbitrage is not reprehensible – in fact, it provides debt market liquidity and contributes to market efficiency. But it may pose difficulties for corporate restructuring, including the effects of rumourtrage and a frequently shifting base of creditors with which the company attempts to negotiate.

Management conflicts

Much like private equity buyouts, DDI investment may bring into focus potential conflicts of interest for the directors and managers of the target company. Where directors remain in control (as in a work-out in Australia or in Ch 11 bankruptcy where the debtor remains in possession), conflict may arise if directors or managers are offered employment or other collateral benefits by a DDI seeking to gain control:

> The solvency of the company may still be in question, and both creditors junior to the distressed debt investors and existing shareholders may still have some interest in the company … Management must fulfil its fiduciary duties, which may still be owed exclusively or at least partially to the company's shareholders. Yet management is facing demands from a controlling debtholder that may end up owning the company at the end of the restructuring.
>
> Conflicts between management, the controlling debtholder, other debtholders, and existing shareholders can be value destructive.[147]

A conflict of interest may result in directors and management behaving to encourage other creditors and shareholders to cede control of the company for insufficient compensation, or otherwise behaving contrary to the interests of stakeholders. This concern does not apply if a DDI does not seek management support or intends to replace company management.

Beyond "vultures"

It is time that DDIs are acknowledged for their potential beneficial impact on corporate restructuring and are not simply termed "vulture investors". It is vital to make a distinction between types of funds that buy distressed debt. Distressed debt traders engage in various forms of arbitrage on a short-term basis, purchasing smaller stakes and displaying a passive approach that relies on other actors.

True distressed investors, however, re-install the traditional work-out situation that has changed following widespread credit risk transfer by lenders, as DDI involvement results in ownership concentration and a strong incentive to participate in restructuring. Again, compare the incentives of many CDO holders to that of a single fund that buys most outstanding CDO instruments and emerges as a significant creditor. Moreover, DDIs add to the traditional work-out, where a DDI's interest is converted into equity, partially resolving the "residual actor" problem that has long characterised insolvency. Such investors should be "tentatively applauded" rather than publicly loathed, so that more corporate restructurings can go the way of Kmart Corporation:

> Distressed debt investing, while "vulture-like" to many, is better described as a phoenix. Rising from the ashes of bankruptcy are revitalized firms, thanks to the determination of investors who immolate short-run destructive behaviours in favour of long-run value maximisation.[148]

The link to credit derivatives and incentive misalignment

The relative advantages of DDIs over bank lenders in corporate restructuring are most apparent where lenders are hedged by means of credit derivatives. A hedged creditor has even less incentive to participate in a reorganisation than lenders holding small stakes. A hedged bank lender may have an even greater incentive to sell an NPL as it may reap a windfall, receiving both a payout from a credit derivative and the value of the NPL.[149]

The idea of hedged lenders selling their debt claims is not necessarily inconsistent with the function of a CDS. Although a physically-settled CDS may require the transfer of a deliverable

[147] Harner, n 6 at 756.

[148] Goldschmid, n 7 at 273. DDIs were prevented by regulators from taking an active role in the WorldCom-MCI bankruptcy, on the basis of suspicion that they would act in a "short-termist" and subversive manner.

[149] Where such a windfall is possible, an upfront sum that finalises the bank's involvement is, for reasons stated above, likely more attractive than a postponement of debt maturity or an equity-debt swap.

obligation, this obligation need not be equivalent to the NPL held by the lender. "Modified restructuring" only places partial restrictions on a hedged creditor's ability to purchase a cheaper obligation of the reference entity/debtor, transfer it to receive the CDS payout, and then separately retain or sell the NPL. Cash-settled CDS do not require transfer of a deliverable obligation as a pre-condition to settlement – unlike a true contract of insurance, rights of subrogation do not necessarily arise for the seller of the protection.

DDIs proffer a market-based solution to the creditor passivity and incentive misalignment that has resulted from changes to traditional banking practice and credit derivative use. Although still a developing practice, distressed debt investing is of benefit in achieving a long-standing goal – that an economically viable company is restructured, with the restructure delivering the optimal collective outcome for the company and its stakeholders.

Maximising the benefits for corporate restructuring

Scope of benefit

The potential benefit of distressed debt investment for corporate restructuring is restricted to work-outs or insolvencies of medium-large organisations, which offer sufficient size and return to be potential targets for DDIs. Distressed debt investment applies equally in respect of financially distressed companies and companies with operational difficulties in addition to financial distress.

Regulatory implications: A market for distressed debt investment in Australia?

The aggregation of ownership in the hands of a long-term oriented owner that acts as a residual actor is beneficial, and Australian insolvency processes should encourage such investment.

The DDI approach relies on debt claims being transferable. Australia now has a nascent secondary loan market, with NPL sales slowly becoming more frequent. It is suggested that the Australian market and regulators should act to enhance the transferability of debt claims in Australia, possibly with a view to promoting a more active secondary debt market. There are natural constraints on establishing a secondary debt market in Australia – much debt issued in Australia is not intended to be publicly traded.[150] But private transfers of debt may be negotiated, facilitating DDI-led corporate restructuring, provided transferability is underpinned by judicial recognition.

Rule 3001(e)(2) of the United States *Bankruptcy Code* enhances the transferability of claims in Ch 11 bankruptcy by giving standing to object to a transfer only to the transferor and by eliminating the need for a court order to effect a transfer.[151] An equivalent provision should perhaps be enacted in respect of transfers in Australia's system of voluntary administration. Indeed, a court should not necessarily seek to intervene in the transfer of a debt, provided the transaction is commercial (at arm's length), for the fact that the sale of a debt claim occurs suggests a synergy of sorts: the DDI's offer is at a premium to what the claim is worth in the seller's hands, but still less than the true value perceived by the DDI.

Regulators and the judiciary should certainly be cognisant of unique risks arising from the increased transferability of debt claims and the presence of DDIs seeking control. For instance, as part of a negotiated deal with the distressed company, a DDI should be expected to enter into a standstill agreement, preventing sell-down of its stake for a specified period, to signify its presence as a cornerstone investor with strategic interest in the company's prospects.

But these risks should be set against a background of growing recognition and acceptance of DDI activity in Australia. For example, in terms of work-outs, the requirements for parties dealing with distressed companies were formulated in *The Bell Group Ltd (in liq) v Westpac Banking Corp*

[150] Recent public debt issues such as the Tabcorp Retail Bond issue (listed on the ASX since May 2009) are exceptions to generally unlisted Australian corporate debt. For discussion of the Tabcorp issue and a potential increase in public debt issuance, see Cerche P and Darcy J, "What is Old is New Again: The Return of the Australian Domestic Retail Bond Market" (2009) 20 JBFLP 170.

[151] Goldschmid, n 7 at 206.

(No 9).[152] The test places an onus on the external party to satisfy itself that a transaction is to the corporate benefit of the distressed company. These preconditions should be applied carefully in respect of distressed debt investment, noting the potential for DDIs to take advantage of the company and other stakeholders, but also that a likely alternative for a company that cannot structure a DDI deal is liquidation. The Takeovers Panel will also need to come to terms with any competing offers for control of a distressed entity and assess possible objections to a DDI seeking control.[153]

As mentioned, the Australian distressed debt market remains in "price discovery" mode, with sellers of distressed debt continuing to adjust and gradually accepting the benefits of selling NPLs to DDIs:

> Market participants are beginning to see a closing of bid-offer spreads and a growing recognition by vendors that bad debt disposal will be an important ingredient in an eventual recovery.[154]

This level of market development has been compared with the United Kingdom in the late 1990s, when United States distressed debt funds began to invest in distressed technology and resource companies, leading to a move away from a "traditional lender enforcement approach to a more value enhancing, restructuring approach".[155] Once the "bid-ask differential" narrows in Australia, it is important that the legal and regulatory frameworks facilitate debt transfer and effective corporate restructuring, ultimately allowing cleansing of bank balance sheets and efficient "recycling" of debt capital.

Thus a market for distressed investment, founded in a broader secondary debt market, is gradually developing in Australia. Such a market offers primary and secondary liquidity to distressed companies and is of benefit to Australian banks and the capital markets generally. Law and regulation should evolve in response to the growth of distressed debt investment, acknowledging that it offers a potential market solution to impediments to corporate restructuring arising from changes in traditional banking practice and the use of credit derivatives.

CONCLUSION

> The use of a growing array of derivatives and the related application of more sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions, which was so evident during the credit cycle of 2001-2 and which seems to have persisted. Derivatives have permitted the unbundling of financial risks.[156]

Although derivatives have ultimately not underpinned the resilience of large financial institutions, global growth in derivatives markets has indeed permitted increasing unbundling of risks – of economic interest from legal rights in respect of both debt and equity. The Goldman Sachs-AIG scenario is symbolic of such developments.

Using the CDS instrument as an example, this article has demonstrated that hedged creditors often behave in unexpected ways that are not conducive to effective corporate restructuring, rendering negotiation difficult and possibly increasing the incidence of insolvency filings. One response to information asymmetries resulting from undisclosed credit derivative use is to mandate disclosure of beneficial long CDS positions held by creditors where a company files for insolvency, with associated modifications to creditor voting. Recognition of debt decoupling effects must follow recent appreciation of equity decoupling, but without prejudicing the legitimate financial interests of a hedged creditor or other market participant.

Contractual and market-based solutions are therefore desirable. Following recent development, distressed debt investment is expected to increase in Australia during the next several years and offers

[152] *The Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1 (Owen J).

[153] See generally Philip R, "Rights Issues and Control Party Underwritings – Be Afraid, be very Afraid" (2005) 23 C&SLJ 426.

[154] Jeffrey, n 135; Blake Dawson and Pricewaterhouse Coopers, n 106, p 11.

[155] Dunstone, n 139.

[156] Greenspan A, "Risk Transfer and Financial Stability" (Speech delivered at the Federal Reserve Bank of Chicago's 41st Annual Conference on Bank Structure, Chicago, Illinois, 5 May 2005), as cited in Mallesons Stephen Jaques, n 19, p 75.

a commercial approach to resolving restructuring impediments. This method of investment restores the concentration of debt ownership reduced by changes to traditional relationship banking. It also restores the economic incentive reduced by credit derivative use. As shown by the successful Kmart restructuring, the result can be striking. In addressing creditor incentive misalignment, Australia's work-out and insolvency practices should move beyond a traditional lender enforcement approach to include specialist DDIs as key players in large-scale corporate restructuring, while acknowledging new risks posed by such investment.

The corporate restructuring process is one of the great strengths of Australia's financial and legal systems. Developments in financial markets and lender practice that threaten to frustrate the aims of corporate restructuring call for attention, while new ways of achieving these aims should be – carefully – embraced.