

An Alternative Strategy for Institutional Investors: Using Debt Rather Than Equity to Influence Corporate Governance

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Abstract

Activist institutional investors traditionally have invested in a company's equity to try to influence change at the company. Some of these investors, however, are now purchasing a company's debt for this same purpose. They may seek to change a company's management and board personnel, operational strategies, asset holdings or capital structure. I refer to this type of activity by an investor as "activist distressed debt investing."

Allied Holdings, Inc. is a recent example of activist distressed debt investing. Allied and certain of its affiliated filed for bankruptcy under chapter 11 of the U.S. Bankruptcy Code. Yucaipa Companies, a distressed debt investor, thereafter purchased approximately 66% of Allied's outstanding general unsecured bond debt. Yucaipa used this debt position to exert significant influence over Allied's chapter 11 cases. Yucaipa emerged as Allied's majority shareholder under Allied's confirmed plan of reorganization.

Allied is not an isolated example. In 2006, distressed debt investors raised a record \$19 billion in investment funds. The research shows that some investors are using these investment funds for activist purposes. Indeed, activist distressed debt investing is on the rise in both the United States and the United Kingdom. This activism is changing the dynamics of corporate restructurings and presenting new challenges for corporate management.

In this article, I examine the practice of activist distressed debt investing and its impact on corporate restructurings in the United States and the United Kingdom. I use a combination of empirical data and selected case studies to provide support for my conclusions.

The data suggest two key findings. First, some institutional investors are strategically using distressed debt investments to influence corporate governance and, in some instances, acquire the company. Second, activist distressed debt investing is causing a slow, but noticeable, convergence of the United States and the United Kingdom corporate restructuring processes. Specifically, in both countries, distressed debt investors are increasingly taking charge of the restructuring process and placing the management of the troubled company in a secondary or supporting role. I thus characterize the prevailing restructuring process as a "management-neutral" process,

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which differs from a “management-driven” (historically associated with U.S. bankruptcy laws) or “management-displacing” (historically associated with U.K. bankruptcy laws) process.

The increasing influence of activist distressed debt investors and the development of a management-neutral restructuring process raise a new set of policy issues for U.S. and U.K. policymakers to consider. Distressed debt investors may provide much needed financing and, in some cases, operational guidance to troubled companies. Their investment goals, however, may or may not align with the goals of the company, the company’s other stakeholders and the underlying bankruptcy regime. Thus, the appropriate role of distressed debt investors in the corporate restructuring process requires thoughtful consideration. I provide research and analysis of the relevant issues here to further this discussion.