Institutional Investor

Hedge Funds Profit from Trade Claims Against Bankrupt Firms

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Chicago-based commodities broker-dealer Refco went bankrupt in late 2005 after it emerged that CEO Phillip Bennett had hidden $430 million in bad debt, a move that earned him a 16-year jail sentence. The bankruptcy also took down a small hedge fund manager named PlusFunds Group and its SPhinX funds. Founded by Refco alumnus Christopher Sugrue, New York–based PlusFunds was an early effort to develop an investable hedge fund index; Refco was the $2.5 billion SPhinX funds' brokerage.

SPhinX had $312 million with Refco, and Sugrue demanded it back. Bennett complied, but the bankruptcy court later ruled that the money had to be returned. SPhinX coughed up $263 million and abandoned its claim to the rest. When SPhinX ended up in liquidation and PlusFunds filed for Chapter 11, Sugrue left the U.S. Investors in SPhinX have yet to see their money.

Not everyone with an outstanding bankruptcy claim can wait around to collect whatever cash or collateral is owed to them. Many creditors sell their so-called trade claims on the secondary market to a bank or a hedge fund manager. The seller will settle for less than the claim's paper value, often through an agreement that gives the buyer recourse if the claim isn't paid in full or the agreed-upon amount.

In 2010, Greenwich, Connecticut–based hedge fund firm Contrarian Capital Management began buying the trade claims against SPhinX. (Contrarian had held a small position in SPhinX in 2007.) The $3.4 billion firm is now the only trade claims creditor to SPhinX that wasn't an original investor. SPhinX is still in liquidation in Grand Cayman, which operates under U.K. law. With fellow creditor Deutsche Bank,

Contrarian recently proposed a scheme of arrangement for repayment that won more than 95 percent approval from investors.

Buying trade claims can be lucrative, but it requires expertise to analyze each one, assess its position in the capital structure and gauge the chance of recovering money. Bankruptcies that have seen significant investment activity around trade claims in recent years include those of U.S. broker-dealers Lehman Brothers Holdings and MF Global, whose former CEO Jon Corzine was recently charged by the Securities and Exchange Commission in relation to the misuse of almost $1 billion in client funds.

Major banks — in particular, Barclays, Deutsche and Jefferies — dominate the $41 billion trade claims business. Hedge funds like Contrarian that specialize in distressed debt also participate, especially in larger bankruptcies. New York–based Avenue Capital Group has invested in trade claims, as has Greenwich-based Silver Point Capital. But few firms make them as much of a specialty as Contrarian has. Its expertise has been a big driver behind annualized returns of about 12.5 percent since inception in 1995. "I started in the business in 1982; it was 1983 when I bought my first trade claim," says CEO and CIO Jon Bauer, who has invested in them for 30 years.

Bauer launched Contrarian with Janice Stanton and Gil Tenzer, having worked with them at New York–based investment bank Oppenheimer & Co. Stanton was Bauer's first senior hire after he joined Oppenheimer from Bear Stearns Cos. in 1986; together they built the bank's trade claims operation. The Contrarian team has chosen to remain smaller than some of its distressed-debt competitors, enabling trade claims to stay a major part of its business. The 48-employee firm, which has a desk of ten dedicated to trade claims, finds and analyzes deals directly. "The barriers to entry in this business are very high," says president and portfolio manager Stanton.

In the case of Lehman, the claimants were hedge funds, banks and other counterparties that had assets trapped with the broker-dealer, which went into bankruptcy in September 2008 under CEO Richard Fuld. Contrarian was one of the first trade claim investors willing to buy contracts on a nonrecourse basis, which prevents the buyer from returning to the seller for more capital if the contract isn't later made whole. This arrangement allowed investors such as hedge funds that had assets tied up in Lehman's U.K. entity to sell and move on. Contrarian was able to buy as low as 12 to 16 cents on the dollar; the firm expects to make back par plus accrued interest.

As for SPhinX, if the Cayman courts approve Contrarian and Deutsche's proposal, investors could get their money back soon. Meanwhile, online evidence suggests that as recently as 2011, PlusFunds' Sugrue was living in the Los Angeles area, enjoying surfing and travel. Litigation over his defunct firm is still winding through the U.S. legal system. • •

Pictured (from left): Refco's Bennett, Lehman's Fuld and MF Global's Corzine