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Refco Bankruptcy Involves Sale of Futures Brokerage and Protracted Litigation over Firm's Collapse

On Monday October 17, 2005, Refco Inc. and 23 of its unregulated subsidiaries listed below ("Refco"), encompassing operations in 14 countries at 23 locations serving over 200,000 customer accounts, filed for Chapter 11 bankruptcy protection in New York. The filing of the largest independent commodities brokerage in the U.S. is the fourth largest bankruptcy in U.S. history, covering stated assets of \$48.8 billion. Its admitted liabilities total \$48.6 billion, including a \$644 million secured term loan and \$600 million in unsecured 9% subordinated notes. The largest unsecured creditors include VR Global Partners, LP, a Moscow hedge fund (\$620 million), Wells Fargo Corporate Trust Services (\$390 million), Rogers Raw Materials Fund (\$288 million), Bawag P.S.K., a bank owned by Austria's trade unions (\$234 million), and a number of other hedge funds and brokerages. Refco has retained Greenhill & Co. LLC as its financial advisor and former SEC Chairman Arthur Levitt and former Comptroller of the Currency Eugene Ludwig as "special advisors."

Sale of Futures Brokerage & Currency Trading Businesses

The Chapter 11 filing did not cover Refco's regulated subsidiaries, including its futures and commodities trading business (Refco LLC and its UK and Singapore affiliates, Refco Overseas Ltd., Refco Singapore Ltd., and related entities) and its registered broker-dealer unit (Refco Securities LLC). Bankruptcy rules do not permit stockbrokers and commodities brokers to file for Chapter 11 bankruptcy and continue operations under court protection.

An investor group led by J.C. Flowers & Co., LLC made an offer for all of the stock of the futures and commodities trading entities and the right to the "Refco" name. The purchase price offer

was 103% of the entities' net regulatory capital. However, several other bidders soon expressed interest and objected to the 2.8% break-up or topping fee sought by the Flowers group. Ultimately, Man Financial Inc. was the successful bidder, purchasing the assets for \$323 million in cash and debt assumption. The sale was restructured from a stock sale to an asset sale, due to regulatory and liability concerns raised by potential bidders. The regulated U.S. broker, Refco LLC, is retaining its regulatory capital and will file a Chapter 7 broker liquidation, in which customer claims will be resolved through the bankruptcy court while its assets (other than regulatory capital) will be sold to Man free and clear of any liabilities.

Refco also filed a motion to sell its unregulated currency trader, Refco F/X Associates, LLC, to Forex Capital Markets, L.L.C. for about \$110 million, with an auction to be held in December.

Background to the Chapter 11 Filing

The Chapter 11 filing came seven days after Refco announced that it had discovered a previously undisclosed \$430 million debt owed by an entity controlled by its CEO, Phillip Bennett, and that its financial statements since 2002 should not be relied upon. Bennett repaid the debt on the same day, but was relieved of his duties, then arrested two days later and charged with securities fraud. Refco announced on Thursday October 13 that its unregulated offshore prime broker unit, Refco Capital Markets, Ltd., would freeze its customer accounts due to insufficient liquidity and that its regulated broker-dealer unit, Refco Securities LLC, would wind down its operations. The closed businesses accounted for more than half of Refco's operating profits.

Refco Inc.'s publicly traded stock (20.8% of its issued shares) fell 72% during the same week to \$7.90 per share. The New York Stock Exchange suspended trading on October 13 (symbol: RFX) and delisted the shares by Tuesday October 18. On October 18, trading resumed over-the-counter ("pink sheets") under symbol: RFXCQ. The stock fell as low as \$0.75 per share by that afternoon, down from its initial public offering price of \$22 per share in mid-August, and its peak price of \$30.55 per share on September 7. Prices for Refco's 9% bonds also fluctuated widely, from 108 cents on the dollar on Friday October 7, to 40 cents the following Thursday (October 13), to 16 cents on Friday (October 14), then back to 57 cents by Tuesday (October 18). Press reports are that there has also been significant trading in Refco bank loans.

Issues in the Chapter 11 Bankruptcy

What assets are left? – Once the remaining regulated businesses are sold (or closed) a primary issue in the bankruptcy will be determining what assets are left for distribution to creditors (and shareholders if creditors' claims can be paid in full or compromised in an aggregate amount that leaves value for Refco's equity). The bulk of Refco's balance sheet assets are subject to regulation or special provisions of the Bankruptcy Code that make them unavailable for distribution: segregated cash and securities in customer accounts, securities subject to repurchase agreements, and receivables from broker-dealers and clearing organizations – most of which will presumably be subject to customer claims and netting with counterparties. This makes it likely that the primary assets available for distribution to remaining creditors will be: (1) the proceeds from the sale of the futures brokerage and other operating units; and (2) possible litigation recoveries against Bennett and other Refco principals, officers and directors, underwriters of the August IPO, and Refco's auditor Grant Thornton – all already the targets of several class

actions and derivative suits. It also remains unclear whether the assets of Refco's offshore prime broker, Refco Capital Markets, Ltd., will be available for distribution to creditors or will instead be distributed to its own customers, as discussed below.

Who gets them? – The lenders of the \$644 million term loan have liens on substantially all stock and assets of Refco's domestic operating subsidiaries (except assets of regulated entities). They will presumably seek payment in full from the proceeds from the brokerage sale, leaving the bondholders, other unsecured creditors and stockholders to fight over any remaining sales proceeds and litigation recoveries. This will likely lead to a hotly contested battle over "structural subordination" – i.e. over where the value of the various subsidiaries is, since creditors of the operating units will demand payment from their assets, leaving creditors and shareholders of higher-tier entities (including holding companies) with less value to pay their claims and interests. This allocation exercise will probably be complicated by the sorting out of intercompany claims, particularly since Refco's financials dating back to 2002 are now suspect. The bondholders and stockholders will probably claim that the three Refco entities issuing their securities (see attached list) are owed large receivables for all bond and IPO proceeds that were "downstreamed" to other Refco units. All will lay claim to litigation recoveries under a now familiar pattern: stockholders with little expectation of receiving meaningful distributions in the Chapter 11 will seek direct recovery from the principals, underwriters, lenders and auditors (and their insurance policies where appropriate) in competition with the bankruptcy estate which may file its own litigation against some or all of the same parties. Federal regulators might join the fray by seeking criminal forfeiture against the principals' assets, as in the Adelphia case.

The RCM “property of the estate” issue – Another hotly contested issue in the case is whether the assets of the offshore prime broker, Refco Capital Markets, Ltd. (RCM), are owned by the bankruptcy estate or are instead owned by RCM’s customers. Refco initially proposed a binding class action to determine the issue, but after numerous objections from RCM customers withdrew the proposal and agreed to provide further information to RCM customers by December 5 on what assets are left at RCM and what claims are made on those assets. Refco also agreed to freeze all transfers of RCM assets until December 8 and the bankruptcy court ordered a stay on all litigation against RCM while Refco works with the Creditors’ Committee and customer representatives on a means of centralizing the numerous suits that have been filed over the RCM “property of the estate” issue.

Conclusion

Although it is too early to meaningfully predict the amount of any recovery to creditors or shareholders, it is clear that the sale of the operating businesses will be accomplished quickly but the conclusion of the bankruptcy cases may take quite some time.

Refco entities filing for Chapter 11 protection

Holding companies

Refco Inc.¹

New Refco Group Ltd., LLC

Refco Group Ltd., LLC²

Operating subsidiaries

Refco Administration LLC

Refco Capital LLC

Refco Capital Holdings LLC

Refco Capital Management LLC

Refco Capital Markets, LTD

Refco Capital Trading LLC

Refco Finance Inc.³

Refco Financial LLC

Refco Fixed Assets Management LLC

Refco F/X Associates LLC

Refco Global Capital Management LLC

Refco Global Finance Ltd.

Refco Global Futures LLC

Refco Global Holdings LLC

Refco Information Services LLC

Refco Mortgage Securities LLC

Refco Regulated Companies LLC

Bersec International LLC

Kroeck & Associates, LLC

Marshall Metals LLC

Summit Management LLC

1. issuer of the publicly traded Refco stock

2. borrower under secured term loan; co-issuer of 9% senior subordinated notes

3. co-issuer of 9% senior subordinated notes

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Business Immigration
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Executive Compensation and Employee Benefits
Federal Marketing
Financial Institutions
Franchising
Global Trade
Government Contracts
Governmental Affairs
Health Business
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