

# CLAIMS TRADING – AN OVERVIEW OF ISSUES<sup>1</sup>

JOEL BRIGHTON

CHARLES L. GLERUM

ABI NORTHEAST CONFERENCE

JULY, 2004

## I. Fiduciary Issues and Claims Trading

Self-dealing by fiduciaries with the assets they hold in trust typically is either *per se* prohibited or tightly regulated. Claims trading by bankruptcy fiduciaries is not expressly prohibited by the Bankruptcy Code or the Bankruptcy Rules; however, courts are willing to take measures to see that claims trading for profit by fiduciaries is not allowed. For example, courts have limited a fiduciary's recovery on its purchased claim to the amount it paid for the claim and have equitably subordinated fiduciaries' purchased claims. See generally American Mutual Life Insurance Co. v. City of Avon Park, 311 U.S. 138 (1940).

An example of the court's willingness to ensure that a fiduciary does not profit from buying claims at a discount can be seen in In re Papercraft Corp., 247 B.R. 625 (Bankr. W.D. Pa. 2000). In Papercraft, Citicorp Venture Capital ("CVC"), an insider, purchased claims at a discount, without disclosing its insider status. After several appeals, the Bankruptcy Court ultimately subordinated CVC's purchased claims to the extent necessary to compensate creditors for the fees and expenses incurred as a result of CVC's undisclosed claims purchasing. Id. at 631.

### a. *Fiduciaries and Insiders – Broadly Defined*

The universe of "fiduciaries" can be broad. As noted by one author:

"[C]ertain persons have clearly been recognized as fiduciaries. For example, officers and directors of corporations, affiliates and controlling shareholders are identified in § 101(31) of the Bankruptcy Code as "insiders" and have been held to be fiduciaries. Pepper v. Litton, 308 U.S. 295, 306 (1939) (controlling shareholder); Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 986-87 (3d Cir. 1998) (directors); In re Applegate Property, Ltd., 133 B.R. 827 (Bankr. W.D. Tex. 1991) (affiliates)."

Harold S. Novikoff and Barbara Kohl Gerschwer, *Selected Topics in Claims Trading*, SH054 ALI-ABA 191, 194 (2003).

---

<sup>1</sup> The authors relied heavily on Stephen H. Case, *Trading in Claims*, 1998-1999 Annual Survey of Bankruptcy Law - 45 (West 1999) and Harold S. Novikoff and Barbara Kohl Gerschwer, *Selected Topics in Claims Trading*, SH054 ALI-ABA 191 (2003), copies of which are reprinted herewith, with permission. The authors also express their thanks to Lisa E. Herrington of Choate, Hall & Stewart, who is responsible for most of what is useful in this outline and whose assistance and hard work are greatly appreciated.

Section 101(31) of the Bankruptcy Code sets forth a list of those included in the definition of “insider.” When the debtor is a corporation, this includes officers and directors, affiliates, and controlling shareholders.

However, the list does not necessarily end there. As described by one court, an insider is a party “whose relationship with the debtor is sufficiently close so as to subject the relationship to careful scrutiny.” In re Three Flint Hill L.P., 213 B.R. 292, 297-98 (D. Md. 1977)(finding that an entity whose principal was a close friend of debtor’s partners was an insider for purposes of 11 U.S.C. § 1129(a)(10)).

#### *b. Creditor Committee Members*

Members of a creditors’ committee are fiduciaries with respect to the debtor’s creditors, but not necessarily to the debtor itself. Committee members, as a matter of course, receive confidential information about the debtor. As a result, committee members ordinarily may not trade in claims against the debtor. One court has even applied the rules against claims trading by insiders to an attorney who traded in claims while simultaneously negotiating on behalf of the debtor’s trade creditors. In re Chicago, Milwaukee, St. Paul and Pacific R. Co., 840 F.2d 1308 (7<sup>th</sup> Cir. 1988).

This prohibition can be problematic for institutional investors who trade in debt in the ordinary course of their businesses. Such an investor may wish to serve on the creditors’ committee in a situation where it owns a significant amount of the debtor’s debt. In recent years, courts have been more willing to permit claims trading by committee members, so long as “Chinese” or “screening” walls or other similar mechanisms are employed to isolate trading activities from committee activities. See generally In re Federated Dep’t Stores, Inc., 1991 WL 79143 (Bankr. S.D. Ohio Mar 7, 1991). Occasionally, a prospective committee member will seek the court’s approval of a screening wall prior to accepting a seat on the committee. While some courts have refused to issue such an order because they found the “case and controversy” requirements of Article III to be missing, other courts have entered such orders. For example, orders permitting committee members to trade in claims against the debtor were entered in In re GST Telecom, Inc., Case No. 00-1982 (GMS)(Bankr. D. Del. Oct. 19, 2000) and In re Integrated Health Services, Inc., Case No. 00-0389 (MFW)(Bankr. D. Del. May 4, 2000).

## II. Oversight of Claims Trading

### A. *Bankruptcy Court Oversight*

Prior to 1991, bankruptcy cases addressed claims trading abuses “in ways that to some extent mirrored securities laws.” Hon. Robert D. Drain and Elizabeth Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 Am. Bankr. Inst. L. Rev. 569, 571 (2002) (hereinafter, “Drain”). The transfer of a claim had to be approved by the Bankruptcy Court, after notice and a hearing. Rule 3001 was revised in 1991 and now limits the Bankruptcy Court’s involvement in the oversight of claims trading. Now, Rule 3001(e) provides that a court need only approve of the transfer of a claim if the transferor objects – a reasonably unlikely scenario.

Since 1991, however, some courts have determined, in certain limited scenarios, that they can oversee the transfer of claims. For example, the First Circuit noted that it could act in the transfer process where fraud is involved. See In re SPM Mfg. Corp., 984 F.2d 1305 (1<sup>st</sup> Cir. 1993). In SPM, the Court further noted:

The circumstances in which claims transfers are expressly said to be invalid are limited. For example, the purchasing of claims by an affiliate or insider of the debtor for the sole purpose of blocking the confirmation of competing plans may constitute "bad faith" for the purposes of section 1126(e). An assigned claim may be limited if the assignment involves a breach of fiduciary duty or fraud and the breach of duty or fraud enables the assignee to acquire the claim for inadequate consideration. However, absent some effect on the administration of the estate or diminution of estate property, neither the Code nor the Rules prohibit or discourage creditors from receiving cash from nondebtors in exchange for their claims.

SPM, 984 F.2d at 1314 (*internal citations omitted*).

B. *Are Claims Subject to Federal Securities Laws?*

Despite some limited oversight by bankruptcy courts, claims trading is largely unregulated. One court has characterized the filing of a bankruptcy petition as creating a market in non-publicly traded securities. In re Allegheny Intern, Inc., 100 B.R. 241, 243 (Bankr. W.D. Pa. 1988).

While federal securities laws are designed to ensure that investors receive accurate information, the Bankruptcy Code expressly provides that the issuance or sale of securities in connection with a Chapter 11 plan is exempt from securities laws. See 11 U.S.C. § 1145. The creditor is not left with entirely unregulated information, as the Bankruptcy Court must approve the adequacy of the disclosure statement. No such approval of information is necessary in connection with individual claims trading, however, and such trading usually takes place independently of the plan confirmation process. Further, federal securities laws do not apply to bankruptcy claims unless bankruptcy claims are "securities."

The Supreme Court has set forth various tests for determining whether a particular instrument is a security and thus is subject to federal securities regulations. The most prominent tests are the "investment contract" test set forth in SEC v. W.J. Howey, 328 U.S. 293, *reh'g denied*, 329 U.S. 819 (1946) and the "resemblance" set forth in Reves v. Ernst and Young, 494 U.S. 56 (1990).

In determining that demand notes sold by a farmers' cooperative were securities, the Reves Court considered whether such notes resembled securities, and set forth four factors:

- (1) Was there an investment reason for the creation of the claim?
- (2) Is the item used as a medium for investment?

(3) Would the public reasonably expect the item to be protected by federal securities laws?

(4) Are there other considerations that lessen the need for protection under the federal securities laws, such as another regulatory scheme?

In Howey, the Supreme Court held that an instrument is an "investment contract" and within the definition of security if it is a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Howey, 328 U.S. at 299.

Analyzed under the Reves "resemblance" test, it would appear that bankruptcy claims are not securities, because, among other reasons, the public does not expect bankruptcy claims to be subject to federal securities laws and the Bankruptcy Code provides an alternative regulatory scheme that lessens the need for protection under the federal securities laws. One commentator, however, has noted that under the Howey test, the question could be decided either way:

One can apply the Howey test in favor of treating bankruptcy claims as securities because: (i) the claim purchase involves an investment of money; (ii) the claim is in a common enterprise--the bankruptcy estate; (iii) the purchase and sale is based on the reasonable expectation of profits, not a commercial transaction; and (iv) the profits are expected from the efforts of others--management or a chapter 11 trustee, official and unofficial committees, the bankruptcy court, etc. It can be argued, to the contrary, that bankruptcy claims are not securities under Howey because: (i) at least the initial claim seller's "investment" in the estate is involuntary, based on a commercial transaction upon which the debtor defaulted, and such a seller does not expect profits in the traditional sense; and (ii) most large claim purchasers at some point actively assert their rights in the bankruptcy case, and, therefore, they cannot be said to derive their profits solely from the efforts of a third party or parties such as the debtor's management.

Drain at 618. While it seems unlikely that claims trading will be determined to be subject to federal securities laws, creditors are not without some protections, as courts will intervene to prevent wrongdoing, where appropriate, and other common law based on common law fraud and misrepresentation are available. In order to establish fraud, a seller must establish that the purchaser of his claim (i) acted with intent to deceive, (ii) knowingly made a misrepresentation of a (iii) material fact (iv) on which the seller was intended to rely and did in fact reasonably rely (v) to his financial loss.

### C. *Champerty*

As New York law is frequently the governing law for indentures and corporate securities transaction, the champerty defense is of particular importance in New York law. The doctrine of champerty, as explained by the Supreme Court, "is maintaining [another's] suit in return for a financial interest in the outcome." In re Primus, 436 U.S. 412, 424 n.15, (1978).

The Second Circuit has made clear that the defense of champerty is not available where the primary purpose of the purchase was not to bring suit, but the suit was merely incidental. In re Elliot, 194 F. 3d 363, 373-74 (2<sup>nd</sup> Cir. 1999).

There is limited First Circuit case law applying or analyzing champerty in the claims trading context. It is noteworthy, however, that the Supreme Judicial Court of Massachusetts has declared that the doctrine of champerty no longer exists under Massachusetts common law. See Saladini v. Righellis, 687 N.E.2d 1224 (Mass. 1997).

### III. Claims Trading and Debtor/Reorganization Issues

Certain issues related to claims trading will be of particular importance to the chapter 11 debtor who intends to reorganize.

#### A. *Voting Concerns*

Speak broadly, the purchaser of a claim will be permitted to vote those purchased claims just like any other creditor. However, there can be some issues that arise under § 1126(e) and otherwise. While the holder of a purchased claim will generally be permitted to vote such claim, he or she must do so in good faith. Otherwise, the Bankruptcy Court may “designate,” or disqualify from voting, the holder of any claim whose vote is deemed to have been cast without good faith. Some issues that arise under § 1126(e) or otherwise are:

1. **Plan Proponents.** In some cases, claims have been purchased by the proponent of a plan. One court considering whether such conduct amounts to bad faith concluded that it does not. In In re 255 Park Plaza Associates Ltd. Partnership, 100 F.3d 1214 (6<sup>th</sup> Cir. 1996), the Court determined that the “mere fact” that a party purchases claims for the purpose of securing the approval or rejection of a plan does not alone constitute bad faith. Id. at 1219.

2. **Self Interest.** When a creditor purchases claims for the purpose of protecting its own interests, it can be determined to have acted in bad faith. For example, in In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990), a creditor filed its own plan at the hearing on the debtor’s disclosure statement. The creditor then proceeded to purchase enough claims to block approval of the debtor’s plan. The court found that the creditor’s purchase of the claims was in bad faith because the purchase of claims was to aid in a takeover attempt and not to advance the purchaser’s interests as a creditor. In In re Figter Ltd., 118 F.3d 635 (9<sup>th</sup> Cir. 1997), the court distinguished bad faith or ulterior motive from self interest. In holding that a creditor that had purchased claims to prevent the approval of a plan had not done so in bad faith, the Court explained that the disallowance provision of 11 U.S.C. § 1126(e) was “intended to apply to those who were not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled.” Id. at 638. See also In re Lehigh Valley Professional Sports Clubs, Inc., 2001 WL 1188246 (finding that where creditor acknowledged purchasing claims because proposed plan was to be funded by lawsuit against it, such motivation was insufficient to support finding of bad faith).

3. Counting Purchased Claims. Generally, a creditor will be entitled to as many votes as claims it holds, even if such creditor purchased some or all of its claims. When multiple purchasers buy portions of a single large claim, it may present a more difficult question, but it is unlikely that each purchaser would each be entitled to a single vote. See generally, In re Figster Ltd., 118 F.3d 635 (9<sup>th</sup> Cir. 1997); In re Ionosphere Clubs, Inc., 119 B.R. 440 (Bankr. S.D.N.Y. 1990).

4. Lock-up Agreements. Lock-up agreements (i.e., agreements pursuant to which creditors agree to vote their claims in favor of a certain plan) are prohibited by 11 U.S.C. § 1125(b) to the extent that such agreements were entered into prior to the approval of the disclosure statement. However, recent rulings suggest that such agreements will be let to stand if entered into prior to the petition date. For example, in In re NII Holdings Inc., No. 02-11505 (MFW) (Bankr. D. Del.) the United States Bankruptcy Court for the District of Delaware ruled from the bench that it did not have jurisdiction over a lock-up agreement that was executed prior to the petition date. See Daniel J. DeFranceschi, Delaware Bankruptcy Court Announces Bright-line Rule for Use of Lock-up Agreements in Chapter 11 Cases, 2003 ABI Jnl LEXIS 11.

#### B. *Preserving NOLs*

Often, one of a debtor's valuable "assets" is a net operating loss, or NOL, which can be carried forward to offset future taxable income produced by the reorganized company. The Second Circuit has held that an NOL is property of the bankruptcy estate. In re Prudential Lines Inc., 928 F.2d 565 (2<sup>nd</sup> Cir. 1991).

The Internal Revenue Code limits a company's ability to use an NOL when there is a change in ownership of a certain percentage of the company's stock. There is a "bankruptcy exception" to his rule, so long as the debtor's shareholders and certain qualified creditors own at least 50% of the reorganized debtor's stock. When claims are freely traded, it can be difficult to ensure that enough qualified creditors hold the debtor's stock, making it difficult to ensure that a debtor will retain a valuable NOL.

For a more detailed analysis of the issues surround NOLs and claims trading, see Michael A. Fagone, *Claims Trading Injunctions and Preservation of NOLs*, 22-Feb Am. Bankr. Inst. J. 32 (2003).

#### IV. First Day Issues and Motions

A. *NOL Orders*. As set forth above, it is not uncommon for a debtor to file a motion for an order that restricts the trading of claims against, and equity interests in, the debtor. The goal of such an order is to preserve the value of the debtor's NOLs. For a further discussion of NOL orders, see the attached guide to the model NOL order prepared by the Bond Market Association<sup>2</sup> and the Loan Syndications and Trading Association, Inc.<sup>3</sup>

---

<sup>2</sup> The Bond Market Association is the trade association representing the debt markets.

B. *Screening Wall Order.* Also common in larger chapter 11 bankruptcy cases are motions seeking the court's approval of the screening mechanisms that a creditor's committee member intends to implement to allow the committee member to trade in the debtor's stock, notes, bonds or debentures. Courts often will enter such orders, provided that the "screening wall" established is reasonably designed to prevent the committee member trading personnel from receiving any nonpublic committee information, and to prevent committee members from receiving information regarding the trading in the securities of the debtor in advance of such trades. Attached is an Order entered in the Mirant Corporation bankruptcy case (Case no. 03-46590 pending in the United States Bankruptcy Court for the Northern District of Texas) approving the establishment of a screening wall. However, not all courts agree that pre-approval of screening mechanisms is appropriate. See, e.g., In re Spiegel, 292 B.R. 748 (Bankr. S.D.N.Y. 2003) (refusing to grant and questioning the propriety of granting screening wall motions).

---

<sup>3</sup> The Loan Syndications and Trading Association, Inc. is a not-for-profit organization that seeks to promote the development of a fair, efficient, liquid and professional trading market for corporate loans originated by commercial banks and other similar private debt.