

♪ WELCOME TO THE JUNGLE [OF CLAIMS TRADING IN BANKRUPTCY]♪

Eric B. Terry¹
Autumn Smith²
Haynes and Boone LLP

I. Introduction

As a result of a growing number of investors interested in corporate takeovers, bankruptcy developed as a hot spot for mergers and acquisitions in the 1990s.³ This interest in acquiring claims against, or acquiring control of, distressed companies has resulted in the creation of a large market for the trading of claims against bankruptcy debtors.⁴

The Bankruptcy Code defines a claim broadly to include any right to payment or any right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to payment or equitable remedy are “reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured,” or any right to an equitable remedy for breach of performance if such breach gives rise to a right to payment.⁵ The use of the term “claim” throughout the Bankruptcy Code contemplates that “all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case.”⁶ In keeping with the Bankruptcy Code’s broad definition of claim, the market in trading claims has generally included many different types of claims against debtors, including debentures, notes, and trade claims.

The most important forms of bankruptcy relief, for claims-trading purposes, are chapters 11 and 13. Chapter 11 permits a debtor (usually a corporation or an individual whose debts exceed chapter 13 debt limitations) to operate under an automatic stay while it negotiates a consensual plan of reorganization with its creditors. The purpose of chapter 11 is to rehabilitate the debtor. In a similar vein, chapter 13 permits an individual with regular income to keep his

¹ Eric B. Terry, Haynes and Boone LLP, 112 East Pecan St., Ste. 900, San Antonio, TX 78205, eric.terry@haynesboone.com.

² Autumn Smith, Haynes and Boone LLP, 901 Main Street, Ste 3100, Dallas TX 75202, autumn.smith@haynesboone.com.

³ Joy Flowers Conti et al., *Claims Trafficking in Chapter 11—Has the Pendulum Swung Too Far?*, 9 Bankr. Dev. J. 281, 281 (1992); see Ross Kaufman, *Redress Distress by Trading the Debt; Activity in Secondary Market Increases*, N.Y.L.J., Oct. 12, 1993, at 11 (estimating claims trading at \$13 billion in 1993 alone).

⁴ Conti, *supra* n.3, at 282.

⁵ 11 U.S.C. § 101(5).

⁶ H.R. No. 95-595, 95th Cong., 1st Sess. 309 (1977); S. Rep. No. 95-989, 95th Cong. 2d Sess. 21 (1978).

assets and pay his creditors through a wage earner plan lasting up to five (5) years. Creditors entitled to distributions or payments in a chapter 11 or 13 case will usually wait far longer to receive their money than they would have in a chapter 7 case, where the debtor's nonexempt assets are sold by the trustee and distributed to creditors. One of the potentially most frustrating parts of a chapter 11 or chapter 13 bankruptcy case is the amount of time it takes for creditors to see any payment for their claims against a debtor.⁷ Creditors of a bankrupt company are often more than willing to sell their claims at a discounted price in order to avoid the delay inherent in chapters 11 and 13 and to satisfy their need for liquidity in their own business or for other reasons.⁸

II. Potential Motivations to Purchase Claims

When a debtor has insufficient assets to satisfy all of its liabilities, the ability to take control of a debtor generally belongs to a debtor's creditors in a bankruptcy case.⁹ Therefore, a large portion of investors purchasing claims in the trading market do so in the hopes of acquiring enough of the claims against the debtor to gain a substantial equity stake in the post-bankruptcy, reorganized entity.¹⁰ These investors often take an active role in a bankruptcy case to avoid losing their investment as a result of a debtor's potential proposal of a reinvestment or "non-equity" plan of reorganization.¹¹ There are some potential pitfalls for this type of investor. For example, it is often hard for an entity that acquires claims post-petition to secure a position on a creditors' committee, as creditors' committees are most often formed at the beginning of a bankruptcy case.¹² Second, creditors' committee members owe fiduciary duties to the unsecured creditors, and as a fiduciary, committee members are entitled to confidential information.¹³ Therefore, an investor that trades in the debtors' securities must be careful to avoid a potential breach of fiduciary duty by serving on a committee.¹⁴

⁷ See Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 Colum. Bus. L. Rev. 83, 87 (2007) ("Creditors can wait for years to receive a payout in a large Chapter 11 case and the expected payout at the end is highly speculative. The ability to sell bankruptcy claims provides an exit opportunity for creditors who do not wish to incur the hassle and expense of the reorganization process.")

⁸ Conti, *supra* n.3, at 297; Frederick Tung, *Confirmation and Claims Trading*, 90 Nw. Univ. L. Rev. 1684, 1701 (Summer 1996).

⁹ Conti, *supra* n.3, at 284.

¹⁰ Carianne Basler & Michelle Campbell, *Claims Chat: Savvy Claims Purchasers must Avoid Pitfalls*, 25-5 ABIJ 26, 26 (June 2006).

¹¹ *Id.* at 26.

¹² *Id.* at 26.

¹³ *Id.*

¹⁴ *Id.*

There are other reasons to purchase claims in a bankruptcy beyond efforts to gain control of a debtor. Perhaps the most obvious reason to purchase a claim is to make an easy profit.¹⁵ The purchaser of a claim can pay a discounted price for a claim, and then enforce that claim at full face value in a debtor's bankruptcy case.¹⁶ This type of investor often purchases enough claims in a particular class to ensure voting control over the class, specifically on half (1/2) in number and two-thirds (2/3) in amount of the allowed claims in the class.¹⁷

Other entities might purchase claims to facilitate standing as a party-in-interest in particular proceedings in the bankruptcy case, such as asset sales.¹⁸ This type of entity would likely purchase small blocks of trade debt.¹⁹

Both entities that purchase claims to increase their return and those that purchase claims to ensure standing must be careful to complete appropriate due diligence to uncover any potential problems with the claims purchased.²⁰ Claims can be subject to "disallowance, subordination, or reduction based on the existence of an avoidable transfer."²¹ Examples of red flag claims include, among others: (i) claims that are not included on a debtor's schedules or that are listed as disputed, contingent or unliquidated; (ii) claims held by an entity that committed misconduct related to or unrelated to the claim²²; (iii) claims held by an entity that received an avoidable pre-petition transfer for the debtor; and (iv) "protective" rejection-damages claims based on an executory contract.²³

III. Regulation of Claims Trading

Before the 1991 Amendments to Federal Rule of Civil Procedure 3001(e), which governs the assignments of claims, courts routinely established procedures for determining whether a claims trade should be honored, despite the fact that Rule 3001(e) seemed to only give courts the

¹⁵ Conti, *supra* n.3, at 297.

¹⁶ Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 Cardozo L. Rev. 1, 13-14 (1990) ("[A] claim purchased at a discount may be enforced by the purchaser at par. Thus, a fifty cent plan with distribute fifty cents on account of a one dollar claim, even if the claim is held by a postpetition investor who paid twenty cents for it.").

¹⁷ Basler & Campbell, *supra* n.10, at 27.

¹⁸ *Id.* at 26.

¹⁹ *Id.* at 27.

²⁰ *Id.* at 27.

²¹ *Id.*; Fortgang & Mayer, *supra* n.16, at 14 ("If the debtor had a defense to the claim when it was held by the original creditors, the debtor still has the defense to the claim when it is transferred to a purchaser.").

²² See *infra* discussion regarding equitable subordination and *In re Enron* in Section IV.C.

²³ Basler & Campbell, *supra* n.10, at 27, 73.

ministerial responsibility to record transfers.²⁴ As the Advisory Committee note makes clear, the 1991 Amendments to Rule 3001(e) intended to reject the courts attempts to regulate claims trading and make clear that a court's responsibility is limited to simply determining disputes raised by the parties themselves.²⁵

The current version of Rule 3001(e) provides:

(e) Transferred Claim

(1) *Transfer of Claim Other Than for Security Before Proof Filed.* If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.

(2) *Transfer of Claim Other Than for Security After Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If the alleged transferor files a timely objection and the court finds, after notice and a hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.

(3) *Transfer of Claim for Security Before Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer. If either the transferor or the transferee files a proof of claim, the clerk shall immediately notify the other by mail of the right to join in the filed claim. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.

(4) *Transfer of Claim for Security After Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security after the proof of claim has been filed, evidence of the terms of the

²⁴ Kaufman, *supra* n.3, at 101-02.

²⁵ *Id.* at 102; Fed. R. Bankr. P. 3001 (advisory committee note).

transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If a timely objection is filed by the alleged transferor, the court, after notice and a hearing, shall determine whether the claim has been transferred for security. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.

(5) *Service of Objection or Motion; Notice of Hearing.* A copy of an objection filed pursuant to paragraph (2) or (4) or a motion filed pursuant to paragraph (3) or (4) of this subdivision together with a notice of a hearing shall be mailed or otherwise delivered to the transferor or transferee, whichever is appropriate, at least 30 days prior to the hearing.²⁶

Under the amended Rule, only the transferor has standing to object to the transfer of the claim. If that entity files no objection, the transfer will automatically be noted “without the need for court approval.” Third parties, i.e. the debtor, and other creditors are intended to be barred from delaying court approval of the transfer of the claim. The amendment deletes the requirement that terms of the transfer be set forth if the transfer is made after proof is filed. In this respect all transfers are treated similarly to transfers of publicly traded debt securities, and Rule 3001(e) seemingly helps to promote the market for claims trading and avoid the potential chill that judicial regulation could create.²⁷

IV. Hot Topics in Claims Trading

A. Tax Implications in Chapter 11 – Net Operating Losses

A chapter 11 debtor corporation is likely to have accumulated large net operating losses, or NOLs, from losses suffered in the years prior to filing for bankruptcy.²⁸ These NOLs permit a debtor to earn future income largely free of income tax.²⁹ A chapter 11 debtor may run into complications under federal income tax law in utilizing its NOLs, because a chapter 11 plan of reorganization often results in a change of ownership of the debtor’s stock.

Tax law imposes restrictions on the use of NOLs by a corporation after a transaction or series of transactions that result in a fifty (50) percent change in the ownership of that

²⁶ Fed. R. Bankr. P. 3001(e).

²⁷ Kaufman, *supra* n.3, at 102.

²⁸ Fortgang & Mayer, *supra* n.16, at 111.

²⁹ *Id.*

corporation's stock over a three(3)-year period, known as an "ownership change."³⁰ Section 382 of the Internal Revenue Code provides that upon an ownership change, a debtor may use only a specified fraction of its NOL carryforwards to shelter income in any given year.³¹ However, to protect chapter 11 bankruptcy debtors from what could be a severe sanction, Congress created a special exemption to section 382, which provides that as long as enough of the stock after the ownership change is owned by creditors that have held claims for at least eighteen (18) months prior to the filing of the bankruptcy petition,³² and there is not another ownership change within the two (2) years following the bankruptcy reorganization, the debtor will not be limited in the use of its NOLs by the general provisions of section 382.³³

Clearly, claims trading can jeopardize a debtor in bankruptcy's ability to preserve its NOLs under section 382(l)(5), and the use of NOLs can be critical to a debtor's successful reorganization.³⁴ As a commentator explained:

A postpetition investor who is purchasing claims for the purpose of acquiring control in the reorganization would, if successful, virtually preclude a debtor corporation from using the IRC section 382(l)(5) exception. Accordingly, by its very purchase, such an investor may be destroying a large part of the value of the corporation which he seeks to control.³⁵

In an attempt to preserve its NOLs, a debtor may request limitations on claims trading for their large debtholders. Courts are often willing to establish procedures to monitor ownership changes in a case or to issue claims-trading injunctions to protect a debtor's NOL carryforwards.³⁶

On July 22, 1991, Ames Department Stores, a chapter 11 debtor, moved for, and was granted, an order subjecting all claims trading, other than publicly-traded debt securities, to a procedure which gave the debtor an opportunity to have notice of and an opportunity to object to each trade.³⁷ On September 24, 1991, Pam Am Corporation sought an order regulating all claims trading, including trading on public markets.³⁸ Pam Am Corporation received its order,

³⁰ *Id.*

³¹ 26 U.S.C. § 382.

³² Certain qualifying trade debt will also apply in this exemption.

³³ 26 U.S.C. § 382(l)(5).

³⁴ Kaufman, *supra* n.3, at 102.

³⁵ Fortgang & Mayer, *supra* n.16, at 113.

³⁶ Basler & Campbell, *supra* n.10, at 26.

³⁷ *In re Ames Dep't Stores*, No. 90 B 11233 (Bankr. S.D.N.Y. July 31, 1991); Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 *Corodozo L. Rev.* 733, 752-53 (1993) [hereinafter *Developments*].

³⁸ *In re Pan Am Corp.*, No. 91 B 10080 (Bankr. S.D.N.Y. 1991); *Developments*, *supra* n.37, at 753, 757.

although there were no substantive objections, and despite the fact that Federal Rule of Bankruptcy Procedure 3001(e)(2) specifically exempts publicly traded bonds, notes, and debentures from its scope.³⁹

Subsequently, in *In re First Merchants Acceptance Corp.*,⁴⁰ the debtor filed a motion to establish notification and approval procedures for the sale of certain unsecured claims and equity interests.⁴¹ The debtor requested notice of any transfers of certain claims and an opportunity to object to trades that placed the debtor's NOLs in jeopardy.⁴² The court granted the debtor's motion providing the debtor thirty (30) days to object to a proposed transfer after receiving notice of the transfer, and the transfer would not be effective until approved by order of the court.⁴³

The authority for these attempts is based on *In re Prudential Lines, Inc.*'s holding that NOLs are property of a debtor's estate, and acts to destroy NOLs violate the automatic stay.⁴⁴ *In re Prudential Lines* provides that the bankruptcy courts have the power to enjoin a parent company from taking a fatal deduction under both the automatic stay in section 362(a) of the Bankruptcy Code and the bankruptcy courts' equitable powers under section 105 of the Bankruptcy Code.⁴⁵

B. Purchased Votes Cast in Bad Faith – 11 U.S.C. § 1126(e)

The fundamental purpose of bankruptcy law is to ensure that similarly situated creditors are treated equally.⁴⁶ At certain times, claims trading can threaten this principal. One commentator explained:

The fundamental tenant of bankruptcy law may be violated when a claims purchaser intends to obtain control over the debtor. Any purchaser of claims who wishes to obtain control of the debtor clearly intends to vote those claims in order to obtain such control. This self-interest will motivate the claimant to attempt to provide less value to other claimants in order to increase the value of the

³⁹ *In re Pan Am Corp.*, No. 91 B 10080 (Bankr. S.D.N.Y. 1991); Fed. R. Bankr. P. 3001(e)(2); *Developments, supra* n.37, at 758.

⁴⁰ No. 97-1500, 1998 Bankr. LEXIS 1816 (Bankr. D. Del. Jan. 20, 1998).

⁴¹ *Id.* at *1-2.

⁴² *Id.* at *3-5.

⁴³ *Id.* at *4.

⁴⁴ *Developments, supra* n.37, at 758.

⁴⁵ *Official Comm. Of Unsecured Creditors v. PSS Steamship Co., Inc. (In re Prudential Lines, Inc.)*, 928 F.2d 565, 574 (2d Cir. 1991); *Developments, supra* n.37, at 758-59.

⁴⁶ *Begier v. IRS*, 496 U.S. 53, 58 (1990); *Clarke v. Rogers*, 228 U.S. 534, 544 (1913).

ownership interest it will obtain after the plan of reorganization is effected. To ignore the intent of this type of claim buyer when assessing the impact of its conduct on the tenet of equality of treatment is naive⁴⁷

Some investors vote to block a particular plan of reorganization with purchased claims to try and ensure a chance to structure their own reorganization plan.⁴⁸ As one commentator explained, “[i]t is one thing to acquire a blocking position. It is another to exercise it.”⁴⁹ Section 1126(e) of the Bankruptcy Code allows the disqualification of any vote not cast in good faith.⁵⁰ Although neither section 1126(e), nor its legislative history, specifically address blocking votes, the history of how section 1126(e) has been applied by the courts supports its application in these cases.⁵¹

Several courts have utilized section 1126(e) for the purpose of preventing claims traders from manipulating the plan process.⁵² Generally, in these cases, bad faith will not be found where a creditor votes against a plan that the creditor does not believe is in the best interests of its class, but will be found where the creditor vote against a plan to extort more favorable terms for itself or to propose a competing plan designed to result in the acquisition of the debtor.⁵³

In *In re Allegheny International, Inc.*,⁵⁴ the bankruptcy court granted a debtor’s motion under section 1126(e) to designate and disqualify votes of the claims and interests of Japonica Partners.⁵⁵ The debtor explained to the court that Japonica Partners had purchased “only enough claims . . . [to obtain] a blocking position in the two highest classes which were impaired, ensuring that the debtor could not confirm its plan of reorganization.”⁵⁶ The court determined

⁴⁷ Conti, *supra* n.3, at 309

⁴⁸ Fortgang & Mayer, *supra* n.16, at 91.

⁴⁹ *Id.* at 92.

⁵⁰ 11 U.S.C. § 1126(e) (“[T]he court may designate any entity whose acceptance or rejection of such plan was not in good faith . . .”).

⁵¹ Fortgang & Mayer, *supra* n.16, at 93-94.

⁵² Other courts, however, have rejected this application of Section 1126(e), at least under the circumstances of the case in front of them, and held that acting in one’s own economic self-interest should not be construed as bad faith. *See generally Figter Ltd. v. Teachers Ins. & Annuity Assoc. of Am. (In re Figter Ltd.)*, 118 F.3d 635 (9th Cir. 1997) (taking into consideration the fact that the secured creditor was not a lender, was not a competing business owner, was not the proponent of a competing plan and had not purchased a small number of claims to block the plan, but had purchased all the claims in a class).

⁵³ William L. Wallander & Clayton T. Huff, *Claims Trading in Distress: Clearing an Imperfect Market*, 5 State Bar of Texas Bank. L. Section Newsletter 13 (Summer 2007).

⁵⁴ 118 B.R. 282 (Bankr. W.D. Pa. 1990).

⁵⁵ *Id.* at 290.

⁵⁶ *Id.*

that Japonica Partners had an ulterior purpose in purchasing votes, to assert veto control over the plan process and determined that these actions were in bad faith. The court designated Japonica Partners' votes pursuant to section 1126(e).⁵⁷

Similarly, in *In re MacLeod*,⁵⁸ a debtor brought motion requesting that named individuals be designated as persons whose rejection of the debtor's chapter 11 plan was not in good faith.⁵⁹ The bankruptcy court held that the rejection of debtor's plan was "not in good faith, but rather was for the ulterior purpose of destroying or injuring [the] debtor in its business so that the interests of the competing business with which the named individuals were associated, could be further."⁶⁰ Therefore, the court designated the named individuals' votes.

It is clear that, under appropriate circumstances, courts are willing to designate votes for bad faith. However, at least one commentator has suggested that the designation of votes for bad faith is, at best, a partial solution.⁶¹ The commentator explains:

Disqualification of votes after solicitation, balloting, and a contested confirmation hearing is inherently retrospective. By the time the votes are designated and the outcome of the hearing known, the parties have already incurred the costs of inhibited cooperation throughout the case. In addition, the bankruptcy investor's entry forces the parties to reinvest in new relationships and to incur the costs of ultimately unsuccessful negotiations that precede the contested confirmation. Finally, the parties – including the bankruptcy investor – are forced to expend scarce resources on a confirmation fight that is ultimately mooted by the designation of votes. But this is not the most efficient way to preserve the integrity of the confirmation process. . . . [T]his retrospective remedy does nothing to avoid or recover the costs actually incurred as a result of claims trading.⁶²

Ultimately, perhaps equitable relief may be more effective to avoid the potentially adverse effects of claims trading on the confirmation process and its costs to third-parties.⁶³

⁵⁷ *Id.* at 289.

⁵⁸ 63 B.R. 654 (Bankr. S.D. Ohio 1986).

⁵⁹ *Id.* at 654.

⁶⁰ *Id.* at 656.

⁶¹ Tung, *supra* n.8, at 1748.

⁶² *Id.*

⁶³ *Id.* at 1748-54 (suggesting that trading injunctions regulating the timing and scope of claims trading might be an effective option to limit potential negative consequences of claims trading).

C. Equitable Subordination – *In re Enron*

“Investors purchase claims and interests in bankrupt corporations relying on a basic legal principle: a claim or interest in the hands of a purchaser has the same rights and disabilities as it did in the hands of the original claimant or shareholder.”⁶⁴ When considering this principle alone, one would conclude that if a claim in the hands of its original owner would be subject to equitable subordination under section 510(c) of the Bankruptcy Code⁶⁵, that same claim would be subject to disability as equitably subordinated in the hands of a subsequent purchaser or assignee.

As a result of this principle, and prior to the recent developments in *In re Enron*, many post-petition investors in illiquid trade claims or bank claims attempted to protect themselves by requiring certain specific representations, warranties, and indemnities from selling creditors.⁶⁶ The post-petition investor is often negotiating for protection from damages or loss caused by potential legal weaknesses in the claim, including the potential for equitable subordination.⁶⁷ The failure to agree on these representations, warranties, and indemnities had destroyed a large number of deals, despite agreement on economic terms.⁶⁸ After the bankruptcy court decision, these protections seemed more important than ever before.

In the *In re Enron* bankruptcy case, the bankruptcy court, in several widely publicized decisions rejected several arguments made by claims traders in support of their argument that their claims should not be equitably subordinated to other creditors’ claims. In a nutshell, these rulings arose out of a suit by Enron against distressed-debt traders who acquired bank-facility claims from banks that allegedly committed inequitable conduct or received avoidable transfers in connection with transactions unrelated to the credit facility. Certain of those traders filed motions to dismiss, arguing that their claims were not subject to subordination or disallowance because the traders did not act inequitably or receive avoidable transfers. The bankruptcy court determined that equitable subordination travels with a claim,⁶⁹ and that a claim may be

⁶⁴ Fortgang & Mayer, *supra* n.16, at 13.

⁶⁵ Section 510(c) of the Bankruptcy Code provides, in pertinent part, that:

[A]fter notice and a hearing, the court may—

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest or all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c)

⁶⁶ Fortgang & Mayer, *supra* n.16, at 18.

⁶⁷ *Id.*

⁶⁸ *Id.* at 19.

⁶⁹ *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

disallowed based on the conduct of a transferor even when a transferee did not engage in misconduct and did not know of the transferor's misconduct.⁷⁰

The bankruptcy court decision caused ripples throughout the claims trading world. A good example of the impact of the decision was seen in the Refco Group Ltd., LLC ("Refco") bankruptcy. Prior to Refco's bankruptcy, Refco debt was widely traded. In the months leading up to Refco's bankruptcy, rumors began to circulate regarding one of Refco's primary lenders, and a holder of a substantial amount of Refco debt, and post-petition Refco's creditors filed suit against the lender. In light of the *In re Enron* bankruptcy court decision, trading in claims that had been held by this lender virtually ceased and trading in all other Refco debt significantly decreased.⁷¹

The District Court for the Southern District of New York granted the right to appeal the bankruptcy court's decisions, and on August 27, 2007, the district court issued its ruling overturning the bankruptcy court's ruling on equitable subordination and claims disallowance.⁷² The district court ruling proposes to provide protection to good-faith "purchasers" of claims in bankruptcy cases, but the ruling also leaves several pitfalls for those unwary of the details.

According to the district court, while some priorities become fixed and immutable on the petition date, claims of equitable subordination and disallowance do not. Equitable subordination under section 510(c) is not fixed as of the bankruptcy petition date because the remedy (a) requires court action; (b) is permissive, not mandatory; (c) may be based on post-petition conduct; and (d) is not available to creditors who have suffered no injury, so creditors who acquired their claims post-petition, after the alleged misconduct, may not be entitled to the remedy.

Similarly, according to the district court, claim disallowance under section 502(d) is not fixed as of the petition date because (a) again, court action is required; (b) disallowance is contingent on the refusal or failure to return the recipient's avoidable transfer; and (c) disallowance could be premised upon receipt of an unauthorized postpetition transfer under Bankruptcy Code section 549.

Next, the district court concluded that equitable subordination under section 510(c) and disallowance under section 502(d) are personal disabilities. Congress intended equitable subordination to be specific to the individual who acted inequitably. "Congress did not intend 510(c) to be applied to the transferee of the claim—who has not acted inequitably—merely

⁷⁰ *In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006). More specifically, in these two decisions, the bankruptcy court determined that equitable subordination under section 510(c) and disallowance under section 502(d) can be applied, as a matter of law, to claims acquired by a transferee based solely on the alleged bad actions of the seller—claims held by a "tainted" seller who committed bad acts or received avoidable transfers are fixed as of the bankruptcy petition date and cannot be "cleansed" by transferring the claims to a new holder.

⁷¹ See Levitin, *supra* n.7, at 161-64.

⁷² *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 2007 U.S. Dist. LEXIS 63129, 48 B.C.D. 213 (S.D.N.Y. August 27, 2007).

because that claim was transferred, directly or indirectly, by a bad actor.” Likewise, the plain language of section 502(d) focuses on the claimant rather than the claim, and the purpose of section 502(d) is to coerce the return of assets obtained by an avoidable transfer. The purpose would not be served where the claimant never received the avoidable transfer.

The court reasoned that because subordination and disallowance are both personal disabilities of the seller, the determination of whether a transferred claim would be equitably subordinated or disallowed depends on whether the transferee received the claim by way of sale, or by assignment. According to the district court, “[s]ales and assignments can have very different consequences for the transferee.” The assignee stands in the shoes of the assignor and is subject “to all equities against the assignor.” The “assignee of a claim takes with it whatever limitations it had in the hands of the assignor” because “an assignor cannot give more than he has.” On the other hand, the principles of assignment law do not apply to sales. The purchaser does not stand in the shoes of the seller and may, under certain circumstances (such as when the purchaser is a holder in due course), obtain more than the transferor had.

To the district court, this distinction was especially important in the distressed debt market, where, it stated, sellers are often anonymous and purchasers have no way of knowing whether that seller has acted inequitably and no amount of due diligence would reveal the information. In contrast, the court stated that parties to “true assignments” can easily contract around the risk of equitable subordination by executing indemnity agreements. The district court therefore remanded the case back to the bankruptcy court so it could determine, among other things, whether the transfer in question was a sale or an assignment.

While the court’s analysis should protect good-faith purchasers without knowledge of a seller’s inequitable conduct⁷³, other purchasers may not be so fortunate: “Indeed, purchasers of claims with actual notice of the inequitable conduct of the seller may be subject to equitable subordination based on their own misconduct.” The district court gives little guidance on what level of knowledge is sufficient to constitute misconduct. The impact of this lack of direction will be increased litigation, especially since the factual nature of the inquiry will eliminate the availability of pre-trial summary resolution.

In the future, bankruptcy courts will also have to grapple with the question of whether a transfer is a sale or a “true assignment.” The district court does not directly address what is required for a true assignment or a sale, but the court suggests the following potentially distinguishing factors: (i) whether there is a fully negotiated contract containing representations, warranties and/or indemnities provided by the assignor, or instead whether there is a plain-vanilla agreement without such bells and whistles; (ii) whether there is an anonymous seller and a purchaser who has no opportunity to conduct due diligence, or instead whether there are face-to-face negotiations and lots of due diligence; and (iii) whether there is a potentially insolvent or financially troubled assignor. It is unclear whether any of these factors are controlling, whether there are other factors, or what the outcome would be if a transfer was a hybrid of a sale and a “true” assignment.

⁷³ At least one commentator, however, questions whether a bankruptcy claim can ever be purchased “in good faith.” See Levitin, *supra* n.7, at 141-48.

As mentioned above, post-petition investors have been very diligent in attempting to negotiate for protections from the risk of equitable subordination. A reasoned reading of the district court's opinion, however, suggests that this act of negotiation and due diligence may cease to be a characteristic of claims that could potentially be equitably subordinated, and instead become part of the cause of such equitable subordination. There is no doubt that the standard practices and forms used to trade post-petition claims will be modified in an attempt to adapt to the district court's decision, the issue of substance over form will continue to be litigated.

Finally, even if there is a true assignment, the district court suggests that the assignee still might take the claim free of the seller's personal disabilities under certain circumstances, such as when the assignee is a holder in due course or when controlling state law provides the doctrine of third-party latent equities. Here again, the need for a knowledge based inquiry will increase litigation.

In short, the district court opinion provides protection to good-faith "purchasers" of claims in bankruptcy cases, but is less than clear regarding what constitutes a protected transaction. The only sure outcome of the district court's decision will be an increase in litigation.

D. Bankruptcy Rule 2019 Disclosure Issues

Federal Rule of Bankruptcy Procedure 2019 provides that in a chapter 9 or 11 case under the Bankruptcy Code, an entity or committee that represents more than one creditor or security holder must file a verified statement with the court making certain disclosures.⁷⁴ These disclosures include information that is often considered confidential by claims traders, including the time each committee member's claims were acquired, the amount paid for the claims, and any subsequent sales or dispositions of the claims.⁷⁵

Investors in distressed claims often form unofficial or *ad hoc* committees in chapter 11 bankruptcy cases.⁷⁶ Customarily, counsel for these *ad hoc* committees files a disclosure identifying its members and the aggregate holdings of the committee, but not individual holdings or trading histories.⁷⁷ In *In re Northwest Airlines Corp.*,⁷⁸ however, the United States Bankruptcy Court for the Southern District of New York held that an unofficial committee

⁷⁴ Wallander & Huff, *supra* n.53, at 14

⁷⁵ *Id.*

⁷⁶ Evan D. Flaschen & Kurt A. Mayer, *Bankruptcy Rule 2019 and the Unwarranted Attach of Hedge Funds*, ABI Journal pg. 16 (Sept. 2007).

⁷⁷ *Id.*

⁷⁸ *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

comprised of a group of hedge funds was required to make the full required disclosures under Rule 2019.⁷⁹

The potential that members of *ad hoc* committees would be required to make the disclosures required by Rule 2019 “is the anathema to hedge funds, as the disclosure of detailed trading histories could reveal the proprietary and highly confidential methodologies of their investment strategies.”⁸⁰

The only other bankruptcy court to consider the issue of Rule 2019 disclosure as to an *ad hoc* committee, however, disagreed with the *Northwest Airlines* court. In *In re Scotia Dev., LLC*,⁸¹ the Bankruptcy Court for the Southern District of Texas declined to force an unofficial committee of noteholders to make Rule 2019 disclosures.⁸²

At the heart of the disagreement between these two courts is interpretation of the terms “committee” and “entity” as used in Rule 2019.⁸³ The *Scotia* court concluded that the term “committee” in Rule 2019 “does not include informal groups that do not purport to represent anyone other than themselves.”⁸⁴ The *Northwest* court, on the other hand, concluded that Rule 2019 “applies to any collective action where the committee seeks to be ‘taken seriously’ in the bankruptcy process.”⁸⁵

In light of this complete disagreement between the courts over the requirements of Rule 2019, claim holders should consider the potential impact such disclosures might have when purchasing claims.⁸⁶

⁷⁹ *Id.* at 703-04.

⁸⁰ Flaschen & Mayer, *supra* n.76, at 16.

⁸¹ *In re Scotia Dev., LLC*, Case No. 07-20027, Docket No. 659 (Bankr. S.D.Tex 2007).

⁸² *Id.*

⁸³ Flaschen & Mayer, *supra* n.76, at 16.

⁸⁴ *Id.* at 16, 46.

⁸⁵ *Id.* at 16.

⁸⁶ Wallander & Huff, *supra* n.53, at 14.