

# **RISKS OF CLAIMS TRADING**

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## **INTRODUCTION**

Trading in claims against bankruptcy estates can be a risky business, beyond the obvious danger that the estate will not have enough assets to pay more than the purchase price of the claim. This paper discusses three other risks: (1) the danger that members of official committees will be charged with breaches of fiduciary duties if they trade in claims; (2) the potential that the purchaser of claims may be unable to vote those claims to accept or reject a plan; and (3) the possibility that a traded claim will be subject to defenses or the possibility of subordination because of the conduct of the seller.

### **I. The Survival of Defenses to Traded Claims**

Trading in claims can indeed have many risks for the buyer. There is the obvious risk that the claim may not get paid under the plan. But there are additional risks, including whether the claim may be disallowed, capped or equitably subordinated because of the seller's conduct.

Some light was shed on the risks of buying claims in Enron Corp. v. Ave. Special Situations Fund II, LLP (In re Enron Corp.).<sup>1</sup> The initial question presented to the bankruptcy court was whether claims originally owned by banks that allegedly engaged in inequitable conduct that were subsequently transferred to third parties would be subject to subordination under § 510 of the Bankruptcy Code in the hands of the transferee. Enron argued that the original claimholders, the banks, engaged in inequitable conduct and their claims should thus be equitably subordinated, even in the hands of innocent transferees.

The bankruptcy court held that a claim may be equitably subordinated even though the current claimholder did not engage in the inequitable conduct. Thus the risk of equitable subordination remains with the claim and it is therefore not immunized from subordination upon transfer. The court also found that a transferee cannot avail itself of the "good faith" defense because such transferee

knew or should have known that a bankruptcy claim would be subject to review and investigation. According to the court, "Whether the purchaser of a claim protects itself is not an issue with which the Court need be involved."<sup>2</sup>

The claimants appealed the bankruptcy court decision to the district court. In a decision that is both remarkable and troubling, the district court sought refuge in a distinction that many would say is without a difference. The court held that a claim that had been transferred by way of an assignment could be equitably subordinated, but not if it had been transferred by way of a sale. The district court distinguished between an assignee and a purchaser by stating:

With respect to assignments, '[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor.' In other words, 'an assignee of a claim takes with it whatever limitations it had in the hands of the assignor.' These principals are a corollary to the well-established doctrine of *nemo dat qui non habet*: an assignor cannot give more than he has. By contrast, these assignment law principals do not apply to sales. A purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances.<sup>3</sup>

The district court reversed and remanded the case to the bankruptcy court to determine whether the transfer of the claim was accomplished by way of a sale or assignment.

The district court also dealt with another question decided against the transferees in the bankruptcy court and held that § 502(d), which provides a defense to a claim when the holder has not returned an avoidable transfer, is not grounds for disallowance of a transferred claim. Rather, the district court held § 502(d) focuses on the actions of the claimant as opposed to the claim, and therefore the claim in the hands of a purchaser who has not committed a wrongdoing cannot be disallowed under § 502(d).

The district court decision brought some relief to purchasers of claims, but it has also raised some concerns. For instance, the opinion does not list specific criteria for lower courts to apply when determining whether a sale or assignment occurred.<sup>4</sup> "Commentators and Bankruptcy Judges alike

have indicated that the decision will be difficult to apply in light of a common perception that a sale is no different from an assignment in the claims trading arena (in fact, the terms are often used interchangeably).<sup>5</sup> Although a decision from the Southern District of New York can never be ignored, it is likely that other courts will be reluctant to follow it. The issue is, in other words, still open.

The real question is the degree to which claims should be negotiable. One author, emphasizing the considerable benefits of claims trading, suggests a federal law of negotiability for corporate bankruptcy claims so that they would be treated like negotiable instruments are treated under the Uniform Commercial Code.<sup>6</sup> This suggestion at least focuses the policy debate, which is more than can be said about the Enron court's distinction between assignments and sales. The problem is that in bankruptcy the competing interests are not between those of the debtor (that might have been able to protect itself) and the innocent transferee; they are between the innocent transferee and the equally innocent other creditors. The real issue is whether the systemic benefits of claims trading outweigh the cost to other creditors in particular cases of depriving them of a remedy for inequitable conduct that has harmed them.

The enormous size of the claims trading market makes it especially important that this issue be resolved. Nothing about the difference (if any) between an assignment and a sale helps to resolve that issue. It is unfortunate that the district court in Enron failed to address the real question but chose to retreat to arcane principles of no contemporary significance.

## **II. Claims Trading and the Reorganization Process**

The holder of a claim is entitled to cast a vote to accept or reject a plan of reorganization. 11 U.S.C. § 1126(a). As a result, claims trading can have a significant impact on the plan confirmation process. In fact, some purchasers buy claims solely to increase their voting power or to gain voting rights.<sup>7</sup> For example, someone might want to acquire a "blocking position," that is, the ability to prevent

an impaired class of creditors from accepting a plan. Such a blocking position creates leverage because at least one impaired class must accept a plan before it can be confirmed, 11 U.S.C. § 1129(a)(10), and even if that requirement is met, a plan cannot be confirmed if there is a dissenting class unless the plan satisfies the cramdown requirements of § 1129(b) of the Bankruptcy Code. 11 U.S.C. §§ 1129(a)(8), (b). Thus, a creditor with such a blocking position will have considerable power to affect the outcome of the case.

To get such a blocking position in a class of unsecured claims requires the acquisition of either more than one-third in dollar amount of the allowed claims in an impaired class or at least one-half in number of those claims. See 11 U.S.C. § 1126(c) (class of claims accepts if holders of at least one-third in amount and more than one-half in number of voted claims accept plan). Obtaining a blocking position by buying more than one-third in amount of the claims could be difficult (since the holders would likely be sophisticated and might have close relationships with the debtor) and expensive (since the claims would have to be large).<sup>8</sup> Thus, anyone wanting to alter voting dynamics would be well-advised to purchase many small claims. A creditor in the Ninth Circuit did just that.

In In re Figter, Ltd., a secured creditor seeking to block a cramdown plan purchased 21 unsecured claims in the only other impaired creditor class and voted those claims against confirmation.<sup>9</sup> If those votes were counted, no impaired class would have accepted the plan and it could not be confirmed. The debtor argued that the claims were purchased in bad faith and that the votes should therefore be disqualified. The debtor alternatively argued that the purchaser should be limited to one vote for its 21 claims.

Section 1126(e) of the Bankruptcy Code provides that "[o]n request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of [a] plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions

of this title."<sup>10</sup> Thus, if a court finds that the claimholder's acceptance or rejection of the plan was in bad faith, Bankruptcy Code § 1126(e) authorizes the court to disqualify those votes.<sup>11</sup> The debtor in Figter argued that the secured creditor's votes of the 21 purchased claims were in bad faith because the creditor obtained those claims solely to block the plan. Consequently, the court was required to consider the parameters of good faith, and its antonym, bad faith, under § 1126(e).

The court said that a creditor acts in bad faith when it seeks to gain an advantage for an "ulterior motive." That led the court to consider what motives are "ulterior." The court had a realistic perspective:

But that does not mean that creditors are expected to approach reorganization plan votes with a high degree of altruism and with the desire to help the debtor and their fellow creditors. Far from it.

If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster. On the other hand, pure malice, "strikes" and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.

Under this standard, it was not bad faith for the secured creditor to act in its "enlightened self interest" by buying claims for the purpose of blocking confirmation of the cramdown plan. The secured creditor was only protecting its own interests as a creditor, and trying to obtain what it thought was fair treatment.

On the other hand a purchaser of claims might be found to have ulterior motives if it attempts to use the purchased claims to destroy the debtor's business to further its own competing business, or if it was not a preexisting creditor and purchased a claim for the sole purpose of blocking an action against it. Similarly, a non-creditor insider who buys claims in order to gerrymander class voting to obtain confirmation, or, conversely, a non-creditor proponent of a competing plan who buys claims for the purpose of blocking confirmation may have ulterior motives that will result in the disqualification of their

votes.<sup>12</sup> But it is not bad faith to buy the claims for the purpose of blocking a plan that would harm the purchaser's interest as a creditor in obtaining a better outcome.

It was additionally held in In re Figter, Ltd. that each claim is entitled to one vote. The court opined, "If allowed claims are to be counted, they must be counted regardless of whose hands they happen to be in."<sup>13</sup> But what if a purchaser only bought a portion of the claim? That issue appears to be unresolved. It was noted, "Of course, that is not to say that a creditor can get away with splitting one claim into many, but that is not what happened here."<sup>14</sup> Based on the reasoning of Figter that one proof of claim counts as one vote, it appears as though each purchaser would not be entitled to vote on the plan.

### **III. Claims Trading and Protective Orders**

The Bankruptcy Abuse and Prevention and Consumer Protection Act of 2005 (BAPCPA) added Section 1102(b)(3) to the Bankruptcy Code. This new section mandates that appointed committee members provide "access to information" to creditors holding claims of the kind represented by the committee but who do not sit on the committee and that the appointed committee members "solicit and receive comments" from the creditors that it was appointed to represent.<sup>15</sup> This new provision concerns many committee members as it does not specify: (1) the type of information to be made available, (2) whether creditors are entitled to non-public, confidential and privileged information received by the committee, (3) whether the committee must actually provide the information rather than only make the information accessible, (4) the extent of detailed information to be made available, (5) whether certain creditors are excluded from this provision, (6) the consequences of a committee member's failure to provide such information, and (7) the process of soliciting and receiving comments.<sup>16</sup>

In response to this new requirement, some committees have sought protective orders defining and limiting their responsibility to provide information and to solicit and receive comments. Additionally, because many committee members seek to trade claims, they seek the entry of a "trade order" or "comfort order" essentially seeking permission from the court to trade claims of the debtor. Commentators have questioned whether these orders actually provide protection to committee members. Furthermore, some question whether such orders are even necessary if the committee members seeking to trade claims are not in possession of non-public information. Under new § 1102(b)(3), the distinction between public and non-public information may be harder to maintain.

While there is not a specific Bankruptcy Code provision prohibiting claims trading by committee members, committee members have fiduciary duties to the creditors or equity holders they represent.<sup>17</sup> Committee members that possess information that is both material and non-public, cannot trade claims. Often times, however, committee members are not in possession of such information. In those cases, some argue that the committee members should be permitted to trade claims as limiting claims trading discourages investors from participating in the committee process, which could potentially hurt creditors.

Prior to BAPCPA, some courts approved information-blocking procedures to allow committee members to trade claims against the debtor. In In re Federated Department Stores, Inc., a member of the Official Bondholders' Committee of Allied Stores Corporation, Fidelity Management & Research Company ("Fidelity"), sought an order determining that it would not be violating its duties as a committee member and would not be subjecting its claims to possible disallowance, subordination or other adverse treatment by trading in securities of the debtor during the pendency of the case if it established procedures to prevent the misuse of non-public information obtained through its role as a committee member.<sup>18</sup>

The court entered an order providing the committee member "will not be violating its fiduciary duties as a committee member and will not be subjecting its claims to possible disallowance, subordination or other adverse treatment by trading securities . . . provided that Fidelity employs an appropriate information blocking device or 'Chinese Wall.'"<sup>19</sup> The order further provided that the "Chinese Wall" procedures to be employed shall include the following information blocking procedures: (1) all personnel with access to non-public information in the bankruptcy shall execute a letter acknowledging that they may receive non-public information and are aware of the "Chinese Wall" procedures, (2) committee personnel will share non-public committee information with no other employees, (3) all files containing non-public information generated from committee activities shall be in cabinets inaccessible to other employees, (4) committee personnel will receive no information regarding current securities trades, except that committee personnel may receive reports of ownership of securities, and (5) Fidelity's compliance department personnel shall review Fidelity's trades in securities of the debtors to confirm such trades were made in compliance with the "Chinese Wall" procedures.

The court in In re House of Fabrics, Inc. issued a similar order.<sup>20</sup> The court entered an order specifying that members of the equity committee who engage in the trading of securities will not be violating their fiduciary duties as committee members by trading securities of the debtor during the pendency of the case provided the committee members institute appropriate and effective information blocking procedures. The court, however, also noted the following:

Trading on inside information is against the law. The SEC is the enforcement agency with responsibility to monitor activity and prosecute violations of federal securities laws. The SEC supports the granting of a trading order as well as full disclosure by the parties seeking or obtaining a trading order of procedures to be instituted by such member to guard against improper activity. However, the SEC and the opponents to this motion, if such is granted, discourage the court from giving its approval of any

specific procedures which might serve as a defense against actual violations. This court agrees.<sup>21</sup>

Based on the above, it is unclear whether the House of Fabrics order can be characterized as a "comfort" order.

In In re Spiegel, members of the creditors' committee sought a judicial determination that they could permissibly engage in trading of debtor's stock.<sup>22</sup> To support such a determination, the committee members referred the court to a similar order it entered in In re Iridium Operation, LLC, Case No. 99 B 45005 (CB). The court explained that the Iridium application established that a "screening wall" had been established, and described the committee member's business, its fiduciary duties to its clients, and the harm that would follow should the committee member not receive the protections requested by the committee.

The Spiegel court, however, found no such factual record. The court therefore denied the request by the creditors' committee. The court noted, "[I]t appears that the Committee in this case seeks approval of a general scheme now, with affidavits from applicable members to follow, 'as evidence of [the member's] implementation of the procedures detailed [in the Application].'"<sup>23</sup> The Spiegel court concluded that even if it had been presented with an adequate factual record, it would not have been inclined to grant the requested relief. It provided the following to illustrate one of its concerns: "This Court is further concerned that the Application was made by proposed counsel for the Committee, on behalf of the committee, where the relief requested benefits a limited number of committee members to the potential detriment of the unsecured body as a whole."<sup>24</sup> The court also noted that "[h]indsight is always 20/20, and this Court rues the day it opened the Pandora's Box in Iridium."<sup>25</sup> Spiegel suggests that such protective orders may be less readily obtainable than they once were.

Nevertheless, it is likely that committee members will continue to seek protective orders to reconcile their obligation to provide access to information to other creditors and the desire of certain members to trade in securities of or claims against the debtor with the need for protection and preservation of confidential non-public information. With the enactment of § 1103(b)(3), orders implementing procedures for information sharing and blocking may provide committee members with the comfort that, if they follow an approved protocol, their risk of being penalized for breaching their fiduciary duty as a committee member may be limited. Those orders are not likely to provide protection against the SEC or others making claims based on the use of non-public information.

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1 379 B.R. 425 (S.D.N.Y. 2007).

2 Enron Corp. v. Special Situations Fund II, LP (In re Enron Corp.), 333 B.R. 205, 211 (Bankr. S.D.N.Y. 2005).

3 79 B.R. at 435-36.

4 George B. South III and Stefanie Birbrower Greer, Should the buyer of a bankruptcy claim be infected by the bad acts of the seller?, Financial Word, December 2007.

5 Id.

6 Adam J. Levitin, Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron, 2007 Colum. Bus. L. Rev. 83, 171 (2007).

7 Kenneth N. Klee & Matthew C. Heyn, Disclosure Statements, Solicitation and Lock-Up Agreements: The Shifting Dynamics of Plan Voting, ALI-ABI Course of Study, 344 (March 29-31, 2007).

8 Id.

9 Figter, Ltd. v. Teachers Ins. and Annuity Ass'n (In re Figter, Ltd.), 118 F.3d 635, 639-40 (9th Cir. 1997).

10 11 U.S.C. § 1126(e).

11 Kenneth N. Klee & Matthew C. Heyn, Disclosure Statements, Solicitation and Lock-Up Agreements: The Shifting Dynamics of Plan Voting, at 346.

12 See In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990); In re Machne Menachem, Inc., 233 Fed. Appx. 119, 2007 WL 1157015 (3rd Cir. 2007); In re Applegate Prop., Ltd., 133 B.R. 827 (Bankr. W.D. Tex. 1991).

13 Id. at 640.

14 Id.

15 11 U.S.C. § 1102(b)(3).

16 David S. Kupetz, Creditors' Committees Are More Frequently Seeking Comfort Orders Since Recent Bankruptcy Law Changes Increased Their Disclosure Duties, 30 APR L.A. Law. 22 (2007).

17 Woods v. City Nat. Bank & Trust of Chicago, 312 U.S. 262 (1941); Westmoreland Human Opportunities, Inc. v. Walsh et al., 246 F.3d 233, 256 (3rd Cir. 2001).

18 In re Federated Dept. Stores, Inc., No. 1-90-00130, 1991 WL 79143 (Bankr. S.D. Ohio March 7, 1991).