

PROCEDURES FOR CLAIMS TRADING IN CHAPTER 11:
ORDERLY SYSTEM OR UNREGULATED WILD CARD¹

I. Introduction

Claims trading, or the purchase of distressed debt in a chapter 11 bankruptcy,ⁱ is big business. Some estimates put the value of the market for distressed debt at as much as \$500 billion a year,ⁱⁱ but that figure appears to be speculative.ⁱⁱⁱ The difficulty in valuing the market for distressed debt in chapter 11 cases is that claims trading is largely unregulated.^{iv} The Bankruptcy Code does not expressly regulate claims trading;^v the procedures for claims trading are outlined in Rule 3001(e) Fed. R. Bankr. P.^{vi} In addition to the limited disclosures required by Rule 3001(e), two huge categories of claims — bank loans and bond debt — go largely unreported because the beneficial interest in such claims can be traded without transferring legal title.^{vii} Claims trading serves an important function in the bankruptcy process, which may spillover to the primary capital markets,^{viii} but the lack of regulation continues to create uncertainty in those markets.

These materials discuss three issues: First, what proof is required of “the evidence of transfer” which is required to be filed with the Clerk under Rule 3001(e)(2)? Second, under Rule 3001(e) and Section 1109(b) of the Bankruptcy Code who can object to a transfer? Third, what authority, if any, do bankruptcy courts have to regulate claims trading?

II. History of Rule 3001(e) and Procedure for Claims Trading

Individuals buy and sell claims in a chapter 11 bankruptcy for a number of reasons. Sellers, whether they be sophisticated financial institutions or small claimants,^{ix} are generally seeking liquidity and to insulate themselves from the risks that inhere in bankruptcy — risks that

a claim will be disallowed or that any payout under the plan of reorganization may be small or non-existent.^x

Buyers' motivations are more varied. Speculators are passive investors seeking to capture the spread between what they paid for the claim and what they think they can recover under the plan of reorganization.^{xi} Active investors may be seeking to influence or control the reorganized company by acquiring "fulcrum security"; may be seeking information in order to purchase assets from the bankruptcy estate or for a competitive advantage; or may be seeking a blocking position in order to extract more favorable treatment of their claims.^{xii} This latter class of buyers are called as "greenmailers",^{xiii} or "vultures", uncomplimentary names for those who swoop in and seek to slice the economic pie for their own benefit and bar other players from having a role in the reorganization. Others might just call them buyers investors.

Commentators disagree about the effect of claims trading on the reorganization process. On the one hand are those who argue that claims trading consolidates claims in the hands of sophisticated investors and, therefore, makes the negotiation of a plan more "efficient".^{xiv} Others argue that claims trading decreases "efficiency" insofar as the debtor in possession ("trustee") may have to renegotiate the settlement of a claim if that claim changes hands.^{xv} Like so many concepts in life and the law, the value of efficiency lies in the eye of the beholder who benefits from it.

Commentators point to the leveraged buy-out (LBO) frenzy of the 1980s and the subsequent increase in chapter 11 bankruptcy filings as the beginning of widespread claims trading as a new investment vehicle.^{xvi} Under Bankruptcy Rules adopted in 1983, bankruptcy

¹ Prepared by Anders J. Watson, Law Clerk to the Honorable Jack B. Schmetterer, Bankruptcy Judge for the Northern District of Illinois, for the American Bankruptcy Institute Central States Bankruptcy Workshop in Traverse City, Michigan, June 12-15, 2008.

courts exercised significant discretion over claims trading. According to the version of Rule 3001(e) adopted at that time:

(1) Unconditional Transfer Before Proof Filed. If a claim other than one based on a bond or debenture has been unconditionally transferred before proof of the claim has been filed, the proof of claim may be filed only by the transferee. *If the claim has been transferred after the filing of the petition, the proof of claim shall be supported by (A) a statement of the transferor acknowledging the transfer and stating the consideration therefore or (B) a statement of the transferee setting forth the consideration for the transfer and why the transferee is unable to obtain the statement from the transferor.*

(2) Unconditional Transfer After Proof Filed. If a claim other than one based on a bond or debenture has been unconditionally transferred after the proof of claim has been filed, *evidence of the terms of the transfer shall be filed by the transferee.* The clerk shall immediately notify the original claimant by mail of the filing of the evidence of the transfer and that objection thereto, if any, must be filed with the clerk within 20 days of the mailing of the notice or within any additional time allowed by the court. If the court finds, *after a hearing on notice*, that the claim has been unconditionally transferred, it shall enter and order substituting the transferee for the original claimant, otherwise the court shall enter such order as may be appropriate.

Fed. R. Bankr. Rule 3001(e)(1)-(2) (1983) (repealed Aug. 1, 1991) (emphasis added). Some commentators criticized any court oversight of claims trading that was not specifically authorized by the Code itself.^{xvii} The authority for such regulation came from pre-Code Supreme Court precedent, which, it was argued, was not superceded by Congress enacting the Code.^{xviii} Therefore, according to the 1983 Advisory Committee Note:

The interests of sound administration are served by requiring the post-petition transferee to file with the proof of claim a statement of the transferor acknowledging the transfer and the consideration for the transfer. Such a disclosure will assist the court in dealing with evils that may arise out of post-bankruptcy traffic in claims against an estate.

Critics argued that the lack of uniformity in bankruptcy court decisions approving or disapproving of transfers was creating uncertainty and dampening the claims trading market. Of

particular concern was the issue as to whether bankruptcy courts had authority and discretion to review the adequacy of consideration paid for a claim.^{xix}

Rule 3001 was amended in 1991 to limit discretion of bankruptcy judges in regulating claims trading. According to the new Rule 3001(e)(2):

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.

Thus, the 1991 amendment to Rule 3001(e)(2) removed the requirement that “*terms* of the transfer” be filed, and only requires “*evidence* of the transfer.” In addition, “a hearing on notice” is only required if there is a timely objection. According to the 1991 Advisory Committee

Notes:

Subdivision (e) is amended to limit the court's role to the adjudication of disputes regarding transfers of claims.... If a claim has been transferred other than for security after a proof of claim has been filed, the transferee is substituted for the transferor in the absence of a timely objection by the alleged transferor. In that event, the clerk should note the transfer without the need for court approval. If a timely objection is filed, the court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law. This rule is not intended either to encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.

Despite these changes, the precedent in the area of claims trading has not evolved much from the case-by-case, fact specific inquiries that were being made prior to the 1991 amendment as judges sought to identify applicable standards to be applied.

What interests was the new Rule 3001(e)(2) designed to protect? Is the purpose of the Rule to provide the trustee with notice of where to send distributions from the estate?^{xx} Is it to give creditors due process notice in order to object to a purported transfer?^{xxi} Is it to make sure that unsophisticated trade creditors are not being taken advantage of by investors seeking to benefit from the spread between the offered amount and likely dividend?^{xxii}

III. What is “evidence of the transfer”?

There is at least anecdotal evidence that some claims purchasers have been mailing creditors checks along with letters saying that if the creditor cashes the check it is accepting the purchaser’s offer to buy the claim. If nothing else, this raises an interesting question: What is “evidence of the transfer” that must be “filed by the transferee” under rule 3001(e)(2)?

Under the 1983 version of the Rule, transferors were required to list the consideration paid for the claim. This would allow even an unsophisticated trade creditor with access to the docket some meaningful information about how claims purchasers were valuing claims in a particular bankruptcy. Because the word “terms” was eliminated from the 1991 amendments, purchasers are no longer required to list the consideration paid for a claim. This change enabled claims purchasers to keep their transactions secret from potential sellers. Thus, it is unlikely that the drafters of the Rule were concerned about an unsophisticated trade creditor being taken advantage of in bankruptcy. For example, in *Viking Assocs., L.L.C. v. Drewes (In re Olson)*,^{xxiii} the claims purchaser acquired all the unsecured claims with a face value of \$525,000 for \$67,000. The bankruptcy court found that the purchaser “obtained many of the claims from the creditors by providing them with false, misleading, and incomplete information.”^{xxiv} The bankruptcy and district court equitably subordinated the purchaser’s claims and limited those claims to the amount paid for them.^{xxv} However, on appeal the Circuit panel held that because

no transferor made a timely objection, the bankruptcy court had no discretion to review the transfer under Rule 3001(e)(2). According to *Viking Assocs.*, “If a timely objection is not filed by the alleged transferor, the transferee *shall* be substituted for the transferor.”^{xxvi}

Even if the claims purchaser does not have to disclose publicly what consideration was paid for the claim, what “evidence” does it have to show in order to establish that the claim was actually transferred? According to the opinion in *In re Oxford Royal Mushroom Prods., Inc.*,^{xxvii} the answer to that question is vague:

Rule 3001(e)(2) does not give guidance as to what evidence would tend to prove the terms of the transfer.... The evidence should, however, provide sufficient information so that the duties imposed by Rule 3001(e) may be carried out. Thus, the evidence should identify the transferor, the transferee and the claim; it should reflect whether a proof of claim has been filed and whether the transfer is unconditional or for security purposes.

This information suggested for a transfer of claim has been incorporated in Official Form 210A. That form does not require the transferor’s signature or any document verifying that the claim was actually assigned to the transferee. Indeed, the form itself is clearly intended to be the only “evidence” submitted to the Clerk, and it merely asserts that the identified creditor has transferred its claim to the transferee.

IV. Who has standing to object to a transfer under Rule 3001(e)(2)?

According to Rule 3001(e)(2), “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.” Since only the alleged transferor is to be noticed, some courts have held that to mean that only the transferor has standing to object to a claim transfer under Rule 3001(e).^{xxviii}

However, this conclusion conflicts with 11 U.S.C. 1109(b), which states, “A party in interest, including the debtor, the trustee, a creditors’ committee, a creditor, an equity security

holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.” Any conflict between the Bankruptcy Code and the Bankruptcy Rules must be settled in favor of the Code.^{xxxix} In *In re Kreisler*,^{xxx} the bankruptcy court held that a chapter 7 trustee had standing to object to a transfer of claim under Rule 3001(e)(2) by virtue of the “party in interest” language contained in 11 U.S.C. § 502. According to *Kreisler*, “Courts have interpreted the term ‘party in interest’ broadly, finding that it includes ‘all persons whose pecuniary interests are directly affected by the bankruptcy proceedings.’”^{xxxi} Thus, under the “party in interest” test it would appear that standing is not necessarily limited to the alleged claim transferor.

However, one must ask what the nature of any possible substantive objection to a claim transfer under Rule 3001(e) is if such objection is made by someone other than the transferor. According to the 1991 Advisory Committee Note, “If a timely objection is filed, the court’s role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law.”^{xxxii} When viewed in the context of nonbankruptcy law, it could be argued that only the alleged transferor would have standing to assert nonbankruptcy defenses to the transfer, such as misrepresentation or fraud. For example, in *In re Nw. Airlines Corp.*,^{xxxiii} the creditor objected to the alleged transfer outside the twenty-day objection period on the basis that employee who executed the Assignment Agreement did not have authority to do so. The bankruptcy court overruled the objection, and denied the creditor’s later Motion for reconsideration, because the filing was tardy and refusing to allow the creditor to file a late objection did not prejudice its nonbankruptcy state law rights.^{xxxiv} According to the opinion, “the issue of claim ownership is a ‘contractual dispute’ unrelated to the claim’s validity or priority.”^{xxxv}

However, imaginative counsel seeking to block large claims investors from influencing the reorganization have come up with objections based on other provisions of the Code.

V. Do bankruptcy courts have authority to regulate claims trading?

In *Keisler*, the remedy for the claims purchaser's failure to comply with Rule 3001(e)(2) was not to void the transfer, but to equitably subordinate the claim.^{xxxvi} The court did not specifically mention 11 U.S.C. § 510(c) as its basis for doing so, but other courts have done so.^{xxxvii} Courts have also used 11 U.S.C. § 1126(e) to regulate claims trading. According to the court in *Lynn*, "the Court has the power under various sections of the Bankruptcy Code to regulate *attributes* of an assigned claim if the assignee uses the claim improperly."^{xxxviii}

In addition to trying to capture the spread between purchase price and plan dividend, active investors purchase claims to increase the number of votes they can cast for or against a particular plan of reorganization. According to 11 U.S.C. § 1126(e), "On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." "Designate" is a term for disqualification of those votes.^{xxxix} The Code does not define good faith. However, the Supreme Court has defined bad faith in the context of plan voting as those who "by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages from the other stockholders who are cooperating."^{xl} This standard has been applied beyond equity holders to investors engaged in claims trading generally.^{xli} That leaves to lower courts the task of deciding exactly when an advantage is "undue."

In dealing with this question, bankruptcy judges have tried to discern whether a claims purchaser has an “ulterior motive.”^{xlii} On the other hand, in the real world no one would likely purchase claims if they were not allowed to vote their self interest.^{xliii}

Precedent gives little guidance. One opinion held that it is significant evidence of good faith where the claims purchaser offered to buy all unsecured claims for 100 cents on the dollar.^{xliv} This provides an unsatisfying rationale for good faith; why should a claims purchaser not be allowed to benefit from the spread as well as increased voting power? Another opinion held that the test for determining good faith is: “*As long as a creditor acts to preserve what he reasonably perceives as his fair share of the debtor's estate*, bad faith will not be attributed to his purchase of claims to control a class vote.”^{xlv} Of course, determining what is “fair” also requires a subjective determination. Moreover, that implies a creditor who tries to expand that creditor’s voice in voting and leverage over plan negotiations is not playing according to someone’s concept of “fair” play. This entire concept of bad faith seems to be one advanced by secured creditors and debtor-in-possession principals who want to control the plan process and terms. It also implies that non-creditors are foreclosed from buying up claims when no such prohibition is found in the rules or statutes.

VI. Conclusion

In short, the concept of good faith is a fluid one, and no single factor can be said to inexorably demand an ultimate result, nor must a single set of factors be considered. It is always necessary to keep in mind the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest. Prior cases can offer guidance, but, when all is said and done, the bankruptcy court must simply approach each good faith

determination with a perspicacity derived from the data of its informed practical experience in dealing with bankrupts and their creditors.^{xlvi}

And what exactly does that mean?

-
- ⁱ As commonly used within the secondary market for bank debt, “distressed” generally refers to debt that is sold for less than \$0.90 on the \$1.00. Anne Marrs Huber & Thomas H. Young, *The Trading of Bank Debt in and Out of Chapter 11*, 15 J. BANK. L. & PRAC. 1, at 15, 31 n.1 (2006). The Loan Syndication & Trading Association (LSTA) is “a not-for-profit trade association [founded] to develop standard settlement and operational procedures, market practices, and other mechanisms to improve secondary market liquidity.” Allison A. Taylor & Ruth Yang, *The Evolution of the Corporate Loan Asset Class* (LSTA, <http://www.lsta.org/content.aspx?id=274> (last visited Mar. 21, 2008)), at 2. The LSTA *Code of Conduct* defines distressed debt as, “a loan which the parties to the transaction designate as a ‘distressed loan’ at the time of trade.” Huber, *supra*, at 31 n.1 (quoting LSTA *Code of Conduct*, at 7 (May 5, 1998) at <http://www.lsta.org>)).
- ⁱⁱ ‘Little spotlight’ sheds light on opaque claims trading market, 49 BANKR. CT. DECISIONS 10 (LRP Publications, West Palm Beach, Fla.), Feb. 12, 2008, at 1 [hereinafter ‘Little spotlight’].
- ⁱⁱⁱ See *id.* at 4 (estimating the value of claims trading in chapter 11 cases for 2007 somewhere between \$4 billion and \$5 billion). See also Huber, *supra* note 1, at 15 (estimating the total market for distressed debt for 2001 at \$41.7 billion).
- ^{iv} ‘Little spotlight’, *supra* note 2, at 1.
- ^v See Huber, *supra* note 1, at 18; Michael H. Whitaker, Note, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL’Y 303, 314 (1994).
- ^{vi} FED. R. BANKR. P. 3001(e); Huber, *supra* note 1, at 18.
- ^{vii} Adam Levitin, *Bankruptcy Claims Trading: Part I*, CREDIT SLIPS, Sept. 20, 2007, available at <http://www.creditslips.org/creditslips/2007/09/bankruptcy-clai.html#more> [hereinafter *Levitin I*].
- ^{viii} Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 100-03 (2007); Whitaker, *supra* note 5, at 304.
- ^{ix} See ‘Little spotlight’, *supra* note 2, at 5 (referring to the ubiquitous \$40 exterminator or rug cleaner as examples of trade creditors seeking liquidity and to avoid risk).
- ^x Adam Levitin, *Bankruptcy Claims Trading: Part II*, CREDIT SLIPS, Oct. 1, 2007, available at <http://www.creditslips.org/creditslips/2007/10/bankruptcy-clai.html#more> [hereinafter *Levitin II*].
- ^{xi} See *Levitin I*.
- ^{xii} *Id.*
- ^{xiii} *Id.*
- ^{xiv} *Id.*
- ^{xv} *Id.*
- ^{xvi} Michael H. Whitaker, Note, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL’Y 303, 303 (1994).
- ^{xvii} *Id.* at 316 n.77 (citing Barbara Franklin, *Trading Creditors’ Claims: Bar Challenges Bankruptcy Courts’ Role in Deals*, N.Y.L.J., Oct. 4, 1990, at 5; Joy Flowers Conti et al., *Claims Trafficking in Chapter 11—Has the Pendulum Swung Too Far?*, 9 BANKR. DEV. J. 281, 298 (1992)).
- ^{xviii} *Id.* at 316-17 n.78-79 (citing *In re Pleasant Hill Partners*, 163 B.R. 388, 391 (Bankr. N.D. Ga. 1994) (citing *American United Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138 (1940))).

-
- xix See Barbara Franklin, *Trading Creditors' Claims: Bar Challenges Bankruptcy Courts' Role in Deals*, N.Y.L.J., Oct. 4, 1990, at 5.
- xx *In re Keisler*, 331 B.R. 364, 376 (Bankr. N.D. Ill. 2005) (“Such evidence puts the trustee on notice that the original holder of the claim against the estate is no longer an interested party with respect to that claim.”).
- xxi *In re Crosscreek Apartments, Ltd.*, 211 B.R. 641, 646 (Bankr. E.D. Tenn. 1997) (“Compliance with Rule 3001(e) appears designed primarily to meet the due process requirement that a creditor be given notice and an opportunity to object to any purported transfer of its claims against the estate.”).
- xxii *In re Allegheny Intern., Inc.*, 100 B.R. 241, 242 (Bankr. W.D. Pa. 1988) (“This court ... feared that creditors were selling their claims at extraordinary discounts, without understanding their rights.”).
- xxiii 120 F.3d 98, 100 (8th Cir. 1997).
- xxiv *Id.* at 101.
- xxv *Id.* at 102.
- xxvi *Id.* (emphasis added).
- xxvii 93 B.R. 390, 396 (Bankr. E.D. Pa. 1988).
- xxviii *In re Lynn*, 285 B.R. 858, 862 (Bankr. S.D.N.Y. 2002) (“Given Bankruptcy Rule 3001(e)(2)’s plain language, as confirmed by the Advisory Committee Note, third parties, including the Debtor, do not have standing to object to a claim assignment itself.”) (citing *Viking Assocs. L.L.C. v. Drewes (In re Olson)*, 120 F.3d 98, 102 (8th Cir. 1997)). See also *S. Pac. Transp. Co. v. Voluntary Purchasing Groups, Inc.*, 229 B.R. 119, 121 (E.D. Tex. 1999) (*dicta*); *In re Crosscreek Apartments, Ltd.*, 211 B.R. 641, 646 (Bankr. E.D. Tenn. 1997) (*dicta*).
- xxix *In re Pacific Atlantic Trading Co.*, 33 F.3d 1064, 1066 (9th Cir. 1994) (citing *Cisneros v. United States (In re Cisneros)*, 994 F.2d 1462, 1465 (9th Cir.1993)).
- xxx 331 B.R. 364, 375 (Bankr. N.D. Ill. 2005).
- xxxi *Id.* (quoting *In re Hutchinson*, F.3d 750, 756 (4th Cir. 1993) (additional citations omitted).
- xxxii See also *In re Altman Nursing, Inc.*, 299 B.R. 813, 819 (Bankr. N.D. Tex. 2003) (citing *In re Infiltrator Systems, Inc.*, 251 B.R. 773, 776 (Bankr. D. Conn. 2000)).
- xxxiii No. 05-17930, 2007 WL 498285 at *1 (Bankr. S.D.N.Y. Feb. 9, 2007).
- xxxiv *Id.* at *4.
- xxxv *Id.* at *2 (citing *Viking Assocs.*, 120 F.3d at 100)).
- xxxvi 331 B.R. at 377.
- xxxvii See *In re Lynn*, 285 B.R. 858, 862 (Bankr. S.D.N.Y. 2002) (citations omitted).
- xxxviii *Id.*
- xxxix See *Figter, Ltd. v. Teachers Ins. and Annuity Ass’n (In re Figter)*, 118 F.3d 635, 638 (9th Cir. 1997).
- xl *Young v. Higbee*, 324 U.S. 204, 211 n.10 (1945).
- xli See *Figter*, 118 F.3d at 638-40.
- xlii See *In re Marin Town Ctr.*, 142 B.R. 374, 378-79 (N.D.Cal.1992).
- xliii See *Figter*, 118 F.3d at 639 (compiling what the Circuit panel felt were examples of both good and bad faith).
- xliv See *255 Park Plaza Assoc. Ltd. P’ship v. Conn. Gen. Life Ins. Co. (In re 255 Park Plaza Assoc. Ltd. P’ship)*, 100 F.3d 1214, 1219 (6th Cir. 1996); *In re Crosscreek*, 211 B.R. at 646.

xliv *In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989) (emphasis added).
xlvi *Figter*, 118 F.3d at 640.