



Claims Trading *Opportunities and Pitfalls*

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The Trading Market in Debt

- Rapidly growing market – less than \$10 billion in 1990 to more than \$200 billion by 2007.
- Distressed Debt – A growing portion of all debt traded – now accounting for more than a third of all debt traded.
- “Distressed Debt” usually defined as debt instruments selling for less than 90 cents per \$1 dollar.
- Trend is for banks to dispose rather than hold distressed debt.
 - clean up balance sheet
 - facilitate meeting Federal Reserve requirements
 - avoid bankruptcy related delays and uncertainties
- Result is increasing liquidity in Debt Trading Market.

Trading Debt of Entities in Bankruptcy

- Emergence of private equity and hedge funds as major purchasers of debt.
- Reasons for purchasing debt.
 - passive investment to obtain return
 - debt to equity swaps to gain control of entity upon emergence
 - purchases to obtain a blocking position in plan process
 - facilitate “pre-packaged” bankruptcy by concentrating players



Buyers' Strategies

- Purchasing Secured Debt
 - most likely to be repaid in full or at least the greatest opportunity to recover investment
 - smaller number of sellers makes it easier to obtain a blocking position
 - difficult to “cram down” under § 1129(b)
- Purchasing Unsecured Debt
 - usually able to purchase at a steep discount
 - because of the deep discount the economic risk in obtaining a blocking position is lessened due to the smaller investment
 - most likely to be converted to equity

Purpose of Rule 3001(e)

- Advisory Committee on Rules and Procedures of Judicial Conference explained purpose of Rule:
- “Subdivision (e) is amended to limit the court’s role to the adjudication of disputes regarding transfers of claims...The court’s role is to determine whether a transfer has been made that is enforceable under non-bankruptcy law. This Rule is not intended either to encourage or discourage post petition transfer of claims...”

Trading Claims in Bankruptcy

- Rule 3001(e) sets forth procedural requirements but Bankruptcy Rules evidence policy of free transferability of debt:
 - no requirement to provide disclosure of consideration paid
 - no requirement to notify debtor of transfer
 - when claim trade prior to filing of proof of claim, Rule only requires that the transferee file proof of claim
 - when claim filed after proof of claim filing transferor is given 20 days after clerk of court mails notice to object to transfer -- if no objection transferee is automatically substituted for transferor
 - Rule 3001 (e) does not apply to transfer of claims “based on a publicly traded note, bond, or debenture which are governed by the federal securities laws

Limitations on Rule 3001 (e) Transferability

- Bankruptcy court has blocked certain trading where purchases or sales may result in “change of control” under the Internal Revenue Code and loss of Net Operating Losses. (“NOL’s”)
- NOL’s are considered property of the Debtor’s estate under § 541
- Most NOL orders require notification of Debtor and Committees prior to transfer of specified large claims and opportunity to object
- The Bond Market Association and the Loan Syndications and Trading Association (“LSTA”) have developed a Model NOL order which allows unrestricted trading prior to the filing of a Plan but would require transferees to divest purchases after order is entered if such purchases would endanger NOL’s

Bankruptcy Law Relating to Purchased Claims

- Buyer generally has same rights as any other creditor in a case including voting on any Plan, objecting to motions or even filing a Plan if exclusivity has lapsed
- Purchased claims subject to any defenses Debtor has against original owner including right of set-off
- Each claim purchased is separately counted for purpose of meeting numerosity standard
- If transferor or transferee is a member of Creditors Committee trading may be restricted by fiduciary obligations; establishment of so-called “Chinese walls” may obviate such restrictions

Standard for “bad faith” held by one court as follows:

“[Creditors are not] 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”.

Figter Ltd. v Teachers Ins. and Annuity Ass’n 118 F3d 635, 639-40 (9th Cir. 1997)

Bankruptcy Law Relating to Purchased Claims (cont'd)

- Circumstances where courts have approved “Chinese walls” and procedures to obtain approval of “Chinese wall” procedures
- Claims purchased in “bad faith” may be prevented from voting under § 1126(e) but purchasing claims to obtain a “blocking position” or Plan influence is not usually considered “bad faith”. “Bad Faith” includes purchasing claims to destroy competitor, blackmail and similar motives. Subjective test used to judge “bad faith”.
- Buying claims to increase voting power or block a plan is not considered bad faith in absence of other factors.

Trading in Chapter 7 Claims

1. Permissible under the same terms as Chapter 11 claims
2. However, unsecured Chapter 7 claims are usually of little or no value
3. Above statement may be modified if there are large contingent claims such as litigations that may result in distributions to unsecured Chapter 7 claims
4. Purchasing secured Chapter 7 claims may be used to credit bids for assets Chapter 7 trustee is offering for sale
5. In credit bidding secured claims can be bid on a dollar for dollar basis even if vastly under secured

Trading Claims – Obligations of Creditor Committee Members

- Members of a Committee are fiduciaries as to all creditors and interest holders
- Pursuant to Fed. R. Bank 2019 members must disclose their holdings and may be required to disclose changes in such holdings
- Committee may obtain order from Court allowing member institutions to trade if protections are in place preventing trading claims on confidential and inside information
- Fact that a Disclosure Statement has been approved in case does not relax requirements since Committee member may have additional non-public information not contained in Disclosure Statement or revealed in Court documents

Enron Claims Transfer Decision

- Bankruptcy Courts in New York have held:
- Transferee of claim is subject to equitable subordination for both conduct by transferor:
 - Related to claim
 - Unrelated to claim



Enron Claims Transfer Decision (cont'd)

- Holdings in Enron:
 - “transfer of claim subject to a §502(d) or [§510(c)] disallowance in the hands of transferor remains subject to disallowance in hands of transferee”
 - “A claim in the hands of a transferee, either as an initial transferee or a subsequent transferee, remains subject to disallowance, just as if such claim still held by the transferor”
 - “Good faith defense” contained in §550” not available to transferee of claim subject to §502(d) or [§510(c)] disallowance.” Possible exception if trading documentation evidences a sale rather than an agency relationship

Enron Claims Transfer Decision (cont'd)

- The Court Specifically Held:
 - 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.
 - The Court also 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.

Loan Syndications and Trading Association (“LSTA”)

- Founded in 1995 by major financial institutions to facilitate an efficient market for trading debt
- LSTA has developed a Code of Conduct and standardized procedures and forms for use by market participants
- Use of forms not mandatory but widely accepted
- Parties free to vary forms as conditions dictate



Anatomy of Typical Trade of Institutional Debt

- LSTA has established a Code of Conduct and Standard Form Documents to Evidence Trades.
- Elements of Trade Include:
 - confidentiality agreement if applicable
 - telephonic trade which is made on recorded call
 - execution by transferee of trade ticket
 - exchange of documents
 - obtaining consents if applicable
 - execution of Assumption and Assignment documents if applicable
 - execution of the standard LSTA Agreement for distressed debt trades
 - settlement

LSTA Agreement

- Representations that transferor is legal and beneficial owner of claim.
- Claim free and clear of any adverse claim.
- Transferee must disclose whether it is an insider under the Bankruptcy Code or is or was a member of any Creditors' Committee.
- Transferee represents that it is a sophisticated purchaser and has received or possesses adequate information about Debtor so as to be aware of inherent risks of transaction.
- Transferee acknowledges that seller may have certain confidential material information and agrees to hold seller harmless by reason of the non-disclosure of such information.

LSTA Agreement (cont'd)

- Parties agree not to disclose contents of the agreement or the price without mutual written consent.
- Transferee represents that it is not purchasing with a view towards sale or distribution which is in violation of the Securities Act of 1933.
- Transferee agrees to file Rule 3001(e) statement and requires transferor to co-operate and not object to filing.
- All representations, warranties, covenants and indemnities are enforceable by successor and assigns.
- Depending on transferor posting of letter of credit or other security to enforce remedies for breach.

Thank You

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