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REGULATING CLAIMS TRADING IN CHAPTER 11 BANKRUPTCIES: A PROPOSAL FOR MANDATORY DISCLOSURE

INTRODUCTION

The increase in bankruptcy filings during the 1980s awakened a slumbering market. The fallout from the highly leveraged, debt-driven mergers and acquisitions of the 1980s breathed new life into the field of bankruptcy. This revitalization is most apparent in the recent rise in the trading of bankruptcy claims.¹ Trading in claims of bankrupt concerns has proven to be a lucrative, multi-billion dollar market.²

Claims trading benefits everyone involved. It provides investors with a new source of investment, creditors with a liquid market for their claims, and debtors with interested and motivated parties to help them through the reorganization process.³ Moreover, the concentration of claims that often results from claims trading reduces transaction costs and accelerates the bankruptcy process.⁴

Unfortunately, the Bankruptcy Reform Act of 1978⁵ ("Bankruptcy Code") does not offer clear guidance on the role of courts in the claims trading market.⁶ The resulting inconsis-

¹ Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990) [hereinafter *Trading Claims*]. Indeed, some have predicted that the bull market for claims trading may become the leveraged buyouts of the 90s. See, e.g., Sandra E. Mayerson et al., *Trading Claims: The New Bankruptcy Game, Any Number Can Play*, in BANKRUPTCY DEVELOPMENTS FOR WORKOUT OFFICERS AND LENDERS COUNSEL 1991, at 547 (PLI Com. L. & Practice Course Handbook Series No. 587, 1991); see also Herbert P. Minkel, Jr., & Cynthia A. Baker, *Claims and Control in Chapter 11 Cases: A Call for Neutrality*, 13 CARDOZO L. REV. 35 (1991) (stating that the debate over claims trading has been fueled by the growth of the market for claims).

² See Mayerson et al., *supra* note 1, at 539, 547 (citing Alison Leigh Cowan, *Bottom Fishing With R.D. Smith*, N.Y. TIMES, Mar. 29, 1991, at D1 (selling bad debt has become a \$318 billion dollar opportunity)); Matthew Schiffrin, *Sellers Beware*, FORBES, Jan. 12, 1991, at 36 (estimating market for defaulted, unsecured debt, and trade claims at \$100 billion).

³ See *Trading Claims*, *supra* note 1, at 4.

⁴ *Id.* at 6.

⁵ Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1988 & Supp. IV 1992)).

⁶ The Bankruptcy Code does not address claims trading, in part because

tent rulings and controversy among practitioners have further confused the court's role in claims trading.⁷ Much of the commentary on claims trading attempts to help practitioners deal with this uncertainty.⁸

the claims trading market was small enough to be virtually ignored when Congress passed the Bankruptcy Reform Act of 1978. Mayerson et al., *supra* note 1, at 561. Bankruptcy Rule 3001(e), promulgated in 1991 under the authority of the Bankruptcy Act, deals with claims trading expressly. See 11 U.S.C. app. Rule 3001(e) (Supp. IV 1992). As discussed *infra* in Part III.B, this rule fails to address the process adequately.

⁷ Commentary on claims trading has been both positive and negative. See Gordon Caplan, *Post-Petition Trading in Chapter 11 Claims: A Call for Augmentation of Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 58 FORDHAM L. REV. 1053 (1990) (arguing in favor of adding a disclosure requirement to Rule 3001(e)); Joy Flowers Conti et al., *Claims Trafficking in Chapter 11 — Has the Pendulum Swung Too Far?*, 9 BANKR. DEV. J. 281, 298 (1992) (arguing in favor of requiring disclosure and active monitoring of claims trading by the courts); Jeffrey S. Sabin et al., *Trading in Claims and Taking Control of the Chapter 11 Debtor: Allegheny Revisited*, in TRADING IN CLAIMS AGAINST CHAPTER 11 DEBTORS: INVESTMENT AND CONTROL ISSUES 181 (PLI Com. L. & Practice Course Handbook Series No. 569, 1991) (arguing that some regulation is required, but taking control of a debtor through claims trading should not be presumed to be bad faith); *Trading Claims*, *supra* note 1 (favoring increased regulation). *But see* Andrew Africk, Note, *Trading in Claims in Chapter 11: How Much Influence Can Be Purchased in Good Faith Under Section 1126?*, 139 U. PA. L. REV. 1393 (1991) (calling for a presumption of good faith on the part of claims purchasers).

⁸ See generally Scott K. Charles, *Trading Claims in Chapter 11 Cases: Legal Issues Confronting the Postpetition Investor*, 1991 ANN. SURV. AM. L. 261 (discussing the legal issues faced by claims traders, including applicability of securities and tax laws, valuation of claims, and the mechanics of claims trading); Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991) [hereinafter *Taking Control*] (discussing acquisition of a debtor through claims trading under the amended Rule 3001(e)); Chaim J. Fortgang & Thomas M. Mayer, *1992 Developments In Trading Claims: Participations and Disputed Claims*, in 24TH ANNUAL INSTITUTE ON SECURITIES REGULATION 475 (PLI Corp. L. & Practice Course Handbook Series No. 793, 1992) [hereinafter *1992 Developments*] (examining the amended Rule 3001(e) and the effects of claims trading on NOLs); David G. Heiman et al., *Acquisition of Interests in Chapter 11 Debtors*, in CHAPTER 11 BUSINESS REORGANIZATIONS 291 (PLI Com. L. & Practice Course Handbook Series No. 647, 1993) (discussing the mechanics of claims trading in Chapter 11); Michael S. Lurey & Thomas A. Ryan, *Issues in Trading Claims in Chapter 11 Cases*, in CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION 1991, at 745 (PLI Com. L. and Practice Course Handbook Series No. 573, 1991) (discussing the current legal ramifications of attempting to gain control of a debtor through claims trading); Mayerson et al., *supra* note 1 (discussing

Part I of this Note presents a brief overview of the bankruptcy process in the United States, for it is within this framework that claims trading occurs. Part II explains why parties engage in claims trading and some practical requirements limiting their ability to do so. Part III reviews court-created requirements for claims trading as well as those imposed by the Bankruptcy Code and rules promulgated under its authority. Part IV examines the applicability of securities laws to the claims trading process. Part V argues that the lack of guidance under the current Bankruptcy Code causes uncertainty in the business community, stifling the market and increasing transaction costs. This Note concludes that investors would be better able to plan and engage in claims trading if the Bankruptcy Code required disclosure by claims traders.

I. BANKRUPTCY LAW IN THE UNITED STATES

A. ORIGIN

The idea of bankruptcy originated in Roman law.⁹ Bankruptcy proceedings as we know them today, however, began to develop during the thirteenth and fourteenth centuries.¹⁰ The

the mechanics and strategic uses of claims trading); James E. Millstein & Shari Siegel, *Strategic Investments and Acquisitions in the Chapter 11 Context*, in 23RD ANNUAL INSTITUTE ON SECURITIES REGULATION 353 (PLI Corp. L. & Practice Course Handbook Series No. 754, 1991) (reviewing methods of gaining equity in companies currently in Chapter 11); Minkel & Baker, *supra* note 1; Sally S. Neely, *Investing in Troubled Companies and Trading in Claims and Interests in Chapter 11 Cases — A Brave New World*, in COURSE OF STUDY — FUNDAMENTALS OF CHAPTER 11 BUSINESS REORGANIZATIONS 109 (C836 ALI-ABA) (1993) (exploring how courts apply bankruptcy rules to claims trading); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992); *Trading Claims*, *supra* note 1; C. Kenneth White, *Trading Claims in Bankruptcy: Trends, Issues and Investment Opportunities*, in THE PROBLEMS OF INDENTURE TRUSTEES AND BONDHOLDERS 1991: DEFAULTED BONDS AND BANKRUPTCY 11 (PLI Real Estate L. & Practice Course Handbook Series No. 366, 1991) (discussing the mechanics of claims trading, the tax issues involved in claims trading); Peter D. Wolfson et al., *Postpetition Trading of Claims and New Rule 3001(e)*, in HIGH-YIELD BONDS 1991 RECENT TRENDS IN WORKOUTS, EXCHANGE OFFERS, AND BANKRUPTCY 201 (PLI Real Estate L. & Practice Course Handbook Series No. 367, 1991) (discussing the inadequacies of the new Rule 3001(e)).

⁹ 1 JAN H. DALHUISEN, DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY § 1.01, at 1-1 (6th ed. 1986).

¹⁰ 1 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2D

framers of the United States Constitution noted the importance of bankruptcy. James Madison wrote that a uniform bankruptcy system is "is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question."¹¹

The need for and policies behind a federal bankruptcy procedure remain true today. Bankruptcy law attempts to ensure that all similarly situated creditors are treated equally.¹² More importantly, it protects the interests of creditors as a group.¹³ Without bankruptcy law, creditors would resort to self-help measures to collect the debts owed to them. Each creditor would act in its own best interest, in the process taking or harming assets that would have accrued to other creditors.¹⁴ Bankruptcy law attempts to minimize this harmful behavior and to ensure that the value of the debtor's remaining assets is maximized for all creditors.¹⁵

Chapter 11 proceedings carry this concept a step further, recognizing that it may be in the best interests of society in general to allow the debtor to continue to operate, create a plan of reorganization, restructure its existing debt, and start "fresh."¹⁶ Chapter 11 bankruptcy law reflects the belief that the value of a business as a going concern may far exceed the value of its assets sold individually and immediately.¹⁷

B. DEVELOPMENT OF CHAPTER 11 IN THE UNITED STATES

Bankruptcy laws in the United States developed "from a creditor-based, punitive model of debt proceedings to one which

§ 1:02, at 1-3 (1986).

¹¹ THE FEDERALIST NO. 42, at 271 (James Madison) (Willmoore Kendall & George W. Carey eds., 1966).

¹² See *Begier v. IRS*, 496 U.S. 53, 58 (1990).

¹³ See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-11 (1986).

¹⁴ See *id.* at 7-19.

¹⁵ *Id.* at 14. See also Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987) (discussing the distributional rationales behind bankruptcy policy).

¹⁶ JACKSON, *supra* note 13, at 225-52.

¹⁷ *Id.* at 14.

is primarily an affirmative debtor's remedy. . . ."¹⁸ This development culminated in the Bankruptcy Reform Act of 1978.¹⁹ This Act consolidated several sections of the old Bankruptcy Code²⁰ and left separate provisions to govern liquidations,²¹ municipal bankruptcies,²² corporate reorganizations,²³ farm bankruptcies,²⁴ and individual bankruptcies.²⁵

A corporation may take two basic routes in a bankruptcy proceeding. In a Chapter 7 proceeding the debtor's estate is organized, all creditors present their claims to the court, and a trustee is appointed to oversee the liquidation of the debtor's estate. Once the estate has been liquidated, the trustee pays off the creditors according to the claims presented. The second form of bankruptcy proceeding, a Chapter 11 reorganization, allows the debtor to pay off creditors as it continues to operate and reorganize its business. In this way, Chapter 11 not only promotes the interests of creditors as a group but also ensures that similarly situated creditors are treated equally.

When a debtor files for Chapter 11 bankruptcy, the court enters an automatic stay, which prevents virtually all creditors from collecting debts or enforcing judgments against the debt-

¹⁸ NORTON, *supra* note 10, § 1:3.

¹⁹ See *id.* § 2 (reviewing the development of bankruptcy law in the United States and discussing the Bankruptcy Reform Act of 1978); see also Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953 (1981) (criticizing the Bankruptcy Reform Act of 1978 and arguing that the Act wrongly isolates the treatment of bankruptcy from the existing legal structure); Theodore Eisenberg, *Bankruptcy Law in Perspective: A Rejoinder*, 30 UCLA L. REV. 617 (1983). *But cf.* Stefen L. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. REV. 327 (1982) (stating that Eisenberg views the goals of bankruptcy law much more narrowly than the drafters of the Bankruptcy Reform Act).

²⁰ Chapter 11 of the Bankruptcy Code combines four separate chapters of the Bankruptcy Act of 1898 which addressed the reorganization of businesses: Chapter VIII which concerned railroads; Chapter X which covered corporate reorganizations; Chapter XI which concerned the arrangement of unsecured debts by corporations, partnerships, and individuals; and Chapter XII which dealt with non-corporate debtors who owned encumbered real estate. PATRICK A. MURPHY, *CREDITORS' RIGHTS IN BANKRUPTCY* § 1.04 (1987).

²¹ 11 U.S.C. §§ 701-766 (1988).

²² *Id.* §§ 901-946.

²³ *Id.* §§ 1101-1174.

²⁴ *Id.* §§ 1201-1231.

²⁵ *Id.* §§ 1301-1330.

or.²⁶ All creditors who want to participate in the bankruptcy must then present their claims to the bankruptcy court.²⁷ Chapter 11 permits the debtor to remain in control and operate the business,²⁸ unless the court orders the appointment of a trustee.²⁹ If the debtor remains in control, it has an exclusive right to file the plan of reorganization, provided that it does so within 120 days.³⁰

If the court confirms it,³¹ the reorganization plan governs the entire bankruptcy process. It describes how all outstanding debts will be satisfied, when and how much creditors will be paid, and the rights of all classes of creditors.³² The percent of recovery provided to each class determines the value of the claims of all of creditors in that class. Creditors use the amount they believe they will recover under the plan in determining whether and at what price they will trade their claims.

²⁶ See *id.* § 362 (1988 & Supp. IV 1992).

²⁷ See *id.* § 507.

²⁸ A debtor who remains in control during the bankruptcy proceeding is referred to as a debtor-in-possession.

²⁹ 11 U.S.C. § 1104(a) (1988). Section 1104 requires the appointment of a trustee if there is fraud, dishonesty, mismanagement or incompetence, or if the appointment of the trustee is in the "interests of creditors." *Id.*

³⁰ *Id.* § 1121(b).

³¹ See *id.* § 1126. Confirmation of a plan requires that two thirds of the dollar amount of each class of claims and one half of the claim holders for each class accept the plan. *Id.* § 1126(c). A court will confirm a reorganization plan only if the reorganization meets the best interest of creditors test: the debtor must show that each creditor in an impaired class will receive at least as much property under the reorganization plan as it would receive in a liquidation. See *id.* § 1129(a)(7).

³² 11 U.S.C. § 1123 (1988). In bankruptcy, creditors' claims are divided into separate categories known as classes. Each class contains similar claims. *Id.* § 1122. For example, there will be separate classes for claims that represent creditors whose debts are fully secured, partially secured, and unsecured. Further classes may be created for additional types of claims. See BENJAMIN WEINTRAUB & ALAN N. RESNICK, BANKRUPTCY LAW MANUAL ¶ 8.19[2][a], at 8-104 (3d ed. 1993).

II. BACKGROUND ON CLAIMS TRADING

A. WHY TRADE CLAIMS?

When a company declares Chapter 11 bankruptcy, any creditor³³ who wishes to participate in the bankruptcy must file a notice of claim.³⁴ A claim establishes the creditor's right against the debtor and allows the creditor to participate in the bankruptcy.³⁵ Instead of waiting for confirmation of the reorganization plan to determine the value of the claim and authorize its payment, however, the creditor may choose to sell its claim to a third party. The third party investor steps into the shoes of the creditor and obtains whatever rights the creditor has against the debtor.³⁶ The buyer of this claim may, in turn, choose to resell the claim to another purchaser.

Claims trading serves an important purpose by creating a liquid market for the claims of a bankrupt entity. Some creditors prefer immediate cash over the delay and uncertainty of a reorganization. Creditors can control the timing of the gain or loss by choosing when to sell the claim.³⁷ Others, such as

³³ A creditor is any entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor, has a community claim, or has a claim arising out of one of several specified instances. 11 U.S.C. § 101(10) (1988).

³⁴ The Bankruptcy Act defines a claim as follows: "(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right of payment. . . ." 11 U.S.C. § 101(5) (1988).

Section 501 of the Bankruptcy Code governs the filing of proofs of claims or interests. See 11 U.S.C. § 501 (1988). Allowance of claims or interests is governed by § 502. See *id.* § 502.

³⁵ A creditor may or may not wish to participate in the bankruptcy reorganization process. A Chapter 11 bankruptcy is time consuming and creates uncertainty as to how much, if any, of the claim will eventually be paid. In 1989 for example, funds investing in claims of bankrupt entities had returns ranging from a 34% gain to a 40% loss. See White, *supra* note 8, at 14.

³⁶ In *re* Dorr Pump & Mfg. Co., 125 F.2d 610, 611 (7th Cir. 1942). Due to the potential for defects, a claims purchaser should obtain some representations and warranties as to the validity of the claim.

³⁷ *Id.* The gain or loss will be determined by whether the claim is sold above or below its book value, which may have been written down when the debtor declared bankruptcy.

trade creditors, simply hope to recoup their losses through future dealings with the newly reorganized entity.³⁸ Claims trading also allows creditors to sell claims in order to gain tax or other advantages.³⁹ For example, selling claims may help a bank to remove nonperforming loans, which adversely affect the bank's capital requirements.⁴⁰ A creditor who holds a large claim (or a claim that is partially disputed) can split its claim and sell part of it if it is economically advantageous.⁴¹

Furthermore, an active claims trading market may encourage the extension of credit. A creditor will be more likely to extend credit to a risky customer if the creditor knows that an active market exists where the creditor can receive cash for its claims in the event of bankruptcy. An active claims market may also benefit less risky customers by encouraging creditors to provide more favorable terms or increased credit to them.

1. *Claims Trading as an Investment Tool*

The secondary market for trading bankruptcy claims has become a major market in which all of the large Wall Street money centers participate.⁴² Investors treat claims like stocks and other high-risk, high-yield investments.⁴³ In addition, they provide interested investors with an opportunity to become involved in the bankruptcy reorganization process. Claims investors accelerate the bankruptcy process because they are frequently more sophisticated and profit-oriented than many other creditors.⁴⁴ Although these investors primarily seek

³⁸ *Trading Claims*, *supra* note 1, at 5. Creditors may wish to avoid assuming an adversarial role against a debtor with whom they hope to have an ongoing relationship. Heiman et al., *supra* note 8, at 297.

³⁹ Heiman et al., *supra* note 8.

⁴⁰ Mayerson et al., *supra* note 1, at 571.

⁴¹ *1992 Developments*, *supra* note 8, at 512. The disputed portion of a claim may be worth more to the original creditor than to third parties because the original creditor has more familiarity with the account.

⁴² "The game of the '90s is as a creditor, not a shareholder." Ken Kohn, *The Next Wave? First Boston Proposes Buying Bonds as a Takeover Technique*, CORPORATE FINANCING WK., March 28, 1988, at 1 (quoting John Laeri, Managing Director of First Boston).

⁴³ *Id.* For example, "vulture" funds have recently developed to specifically allow investment in the claims market. Mayerson et al., *supra* note 1.

⁴⁴ *See Trading Claims*, *supra* note 1, at 6.

profit, not control, they may try to influence the reorganization plan if doing so will increase the yield of their investments.

2. *Claims Trading as a Means to Control*

Trading claims to gain control of debtors through the purchase of debt at deep discounts is more controversial and potentially harmful than claims trading for investment purposes.⁴⁵ The interested party not only obtains control of the company at a significant discount, but it also bypasses many of the securities laws designed specifically to regulate bids for control of corporations.⁴⁶

Buying claims differs from buying stock in the debtor because the claims holder exerts negative control rather than positive control. By purchasing a large enough block of any class of claims, a claims holder can obtain a "blocking position," enabling it to stop the confirmation of any reorganization plan.⁴⁷ The claims purchaser, therefore, can extract more favorable treatment for its class of claims by blocking any unfavorable plan. The claims purchaser may also be able to acquire enough claims to approve a favorable reorganization plan independently.

Past court intervention⁴⁸ demonstrates that the investor acquiring claims as a means to control must be wary of several provisions in the Bankruptcy Code. Acquiring claims with the intention of blocking could be viewed as an action in bad faith in violation of § 1126 of the Bankruptcy Code.⁴⁹ Also, some courts analogize the purchase of claims to the solicitation of

⁴⁵ See David C.L. Frauman & Stephen J. Blauner, *Bankrupt Entities Targeted: Trading Claims Can Serve as the Basis of a Takeover*, N.Y. L.J., June 4, 1990, at 5.

⁴⁶ As discussed *infra* in Part IV, a claim not based on a security is not considered a security under the Securities Act of 1933, and therefore buying claims does not trigger the reporting requirements of the Securities Act of 1933 or the Securities Exchange Act of 1934.

⁴⁷ The Bankruptcy Code requires acceptance by two-thirds in amount and more than one-half in number of the allowed claims for the court to approve the plan. 11 U.S.C. § 1126(c) (1988). Thus a claims purchaser can block a plan of reorganization by purchasing one-third of the claims in any one class.

⁴⁸ Cases involving court intervention are discussed *infra* Part III.

⁴⁹ Africk, *supra* note 7, at 1395; see 11 U.S.C. § 1126(e) (1988).

votes and therefore consider it subject to § 1125(b)'s requirement of written disclosure.⁵⁰

B. LIMITATIONS ON CLAIMS TRADING IN BANKRUPTCY

1. *Net Operating Losses*

Although there are several possible ways that a claim in bankruptcy may be limited,⁵¹ the Bankruptcy Code does not address claims trading. Case law, however, imposes several limitations on claims trading. One important example is the possibility that the debtor may lose its net operating loss ("NOL") carryforward⁵² because of claims trading. If a debtor is at risk of losing its NOL, the court may limit the claim or not recognize the transfer.

Section 382 of the Internal Revenue Code limits the use of NOL carryforwards when there has been a transaction or a series of transactions which result in an ownership change of fifty percent or more of the corporation's stock over a three year period.⁵³ Purchase of claims by post-petition investors can

⁵⁰ 11 U.S.C. § 1125(b) (1988); see *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 292 (Bankr. W.D. Pa. 1990).

⁵¹ Section 502 of the Bankruptcy Code addresses the allowance of claims or interests in bankruptcy. 11 U.S.C. § 502 (1988). It lists several limitations on the amount of claims and provides the procedure for determining the amount of the allowable claim. *Id.*

⁵² *Trading Claims*, *supra* note 1, at 111. If a business loses money in a given year, it has an NOL. An NOL carryforward allows a business that is currently making a profit, but has past NOLs, to reduce its current taxes by deducting its past NOLs. See 26 U.S.C. § 382 (1988).

⁵³ 26 U.S.C. § 382 (1988); see *Trading Claims*, *supra* note 1, at 111. Section 382(l)(5) of the Internal Revenue Code provides a special exemption for Chapter 11 reorganizations. 26 U.S.C. § 382(l)(5) (1988). Under this provision, the IRS looks at claims of both stockholders and debtholders when determining whether the ownership of the debtor has changed. A debtor who is in bankruptcy can retain at least part of its NOL if, after claims trading, the original shareholders and creditors of the corporation still end up with at least 50% of the stock of the debtor. White, *supra* note 8, at 32-33; *Trading Claims*, *supra* note 1, at 112-13.

The Internal Revenue Service alleviates the impact of this rule on small creditors by defining a creditor as any holder of a beneficial interest in less than 5% of a class of a debtor's bonds or debentures, *regardless of when such holder acquired its beneficial interest*. 26 U.S.C. §§ 382(g)(1)-(2), (k)(7) (1988). Thus a claims purchaser will be considered an original creditor for purposes of the 50% test so long as their interest does not exceed 5% of a class of a

pose a serious risk that, because the corporation's debts now have new owners, the corporation will not meet the § 382 requirements and will lose some or all of its NOL. The loss of its NOL can be a major concern to the debtor.

Because the debtor has no control over claims trading by creditors, the debtor cannot prevent the change in ownership and resulting loss of NOLs caused by claims trading.⁵⁴ There has been a recent trend of debtors attempting to control or block claims trading in order to preserve their NOLs.⁵⁵ Two recent examples of this are the *Ames Department Store* and *Pan Am Airlines* bankruptcies.⁵⁶ In *Ames*, the court, at the request of the debtor, ordered creditors to stop trading claims; in *Pan Am* the court allowed the debtor to regulate claims trading itself.⁵⁷

In both cases, the courts relied on the Second Circuit's holding in *Prudential Lines*⁵⁸ as authority for their actions.⁵⁹ In *Prudential Lines*, the court viewed the debtor's NOL as property of the estate and issued an injunction to prevent the debtor's parent company from taking action which would extinguish the NOL carryforward.⁶⁰ *Prudential Lines* provides an interesting example of how a court can use its general equitable powers under § 105 of the Bankruptcy Code in combination with some other code provision to step in and regulate claims trading activity. The potential for this type of court action causes uncertainty and unrest in the claims trading market.

debtor's bonds or debentures. This provision allows some existing creditors to sell their claims without adversely affecting the debtor's NOL.

⁵⁴ See Sandra E. Mayerson, *Debtors, Creditors Vie on Claims Trading*, NAT'L L. J., Mar. 30, 1992, at 16.

⁵⁵ See *1992 Developments*, *supra* note 8, at 509 (discussing the *Pan Am* and *Ames Department Store* bankruptcies). The *Pan Am* and *Ames* decisions are both unreported.

⁵⁶ *Id.*

⁵⁷ *Id.* at 516-17. In both cases, creditors and claims buyers did not object to the debtor's request for limits on claims trading. *Id.*

⁵⁸ *In re Prudential Lines, Inc.*, 928 F.2d 565 (2d Cir.), *cert. denied*, 112 S. Ct. 82 (1991).

⁵⁹ *1992 Developments*, *supra* note 8, at 518.

⁶⁰ The Second Circuit held that the NOL was property of the estate and that the court had the power to enjoin the parent from taking such action under both the Bankruptcy Code's automatic stay provision (§ 362(a)) and its general equitable powers (§ 105). *Prudential Lines*, 928 F.2d at 572-74; 11 U.S.C. §§ 362(a), 105 (1988).

Both *Ames* and *Pan Am* were successful in part because creditors did not strongly oppose the courts' limitations on claims trading.⁶¹ A court facing opposition from creditors might not be as willing to restrict claims trading. The statutory authority for the courts' actions against claims trading is far from clear.⁶² Aside from *Ames* and *Pan Am*, there are no known cases of a court using NOL considerations as the basis for limiting claims trading.⁶³

These cases show that courts are willing to use other code provisions to limit claims trading activity when they deem it necessary. Under the current Rule 3001(e), bankruptcy courts may be more prone to reach out to § 105 to correct perceived abuses in the claims trading process. The disclosure proposal described in Part V of this Note would prevent much of the uncertainty that now surrounds claims trading.

2. *Trading by Fiduciaries*

Another constraint on claims trading is the possibility that courts will not recognize all or part of a claim because the purchaser of is also a fiduciary.⁶⁴ In this situation, there are two classes of fiduciaries: the first are the classic "insiders," such as officers and directors;⁶⁵ the second are members of

⁶¹ 1992 *Developments*, *supra* note 8, at 516-17. In *Ames*, the objecting claims buyers settled. *Id.* In *Pan Am*, that Pan Am was headed for liquidation meant that there were few potential buyers of claims to protest. *Id.*

⁶² *See id.* Fortgang and Mayer question the application of *Prudential Lines* to claims trading. They argue that *Prudential Lines* involved a willful attempt by the parent to destroy the debtor's NOLs, while claims traders generally have no idea what the impact of trading claims would be on the debtor's NOLs. Fortgang and Mayer believe that court-imposed restraints on claims trading may unduly infringe on individuals' rights to freely alienate their property. 1992 *Developments*, *supra* note 8, at 519.

⁶³ There are, however, interesting examples of debtors taking action to protect their NOLs. For example, Munsingwear, Inc. published a notice in the Wall Street Journal, stating that they would sue any claims buyer for violating the automatic stay. WALL ST. J., July 30, 1991, at B11 (legal notice).

⁶⁴ *See, e.g.,* *Manufacturers Trust Co. v. Becker*, 338 U.S. 304, 310 (1949) (fiduciaries who trade in claims may have their claims rejected in whole or in part if honoring the claim "would not be fair or equitable to other creditors."); *Pepper v. Litton*, 308 U.S. 295, 308-09 (1939).

⁶⁵ *See* *Minkel & Baker*, *supra* note 1, at 56. "Insiders" include officers and directors of a corporation as well as persons in control of the debtor, partnerships in which the debtor is a general partner, general partners of the debtor,

official creditor committees.⁶⁶ Courts carefully scrutinize any claims trading transactions by either of these groups.⁶⁷

In the *Allegheny* bankruptcy,⁶⁸ the court expanded its definition of an "insider" to include claims purchasers who put forth a plan.⁶⁹ However, the court's finding that a proponent of a plan becomes an insider due to its position lacks support in the Bankruptcy Code.⁷⁰ This finding indicates the extent to which courts will involve themselves when examining claims trading.

One difficulty with strictly regulating claims trading by fiduciaries is that some of the largest creditors are often asked to sit on creditor committees. Large creditors are often very important to the bankruptcy process and should be represented on creditor committees. But these creditors may also want to trade claims or at least reserve the right to trade claims should the need arise. Some commentators would settle this dilemma through the use of a fire wall.⁷¹ The fire wall would restrict interaction between representatives of the creditor who have a fiduciary duty to the debtor, and representatives of the fiduciary who are engaged in claims trading.⁷²

or a relative of any of the above. 11 U.S.C § 101(31)(B) (1988).

⁶⁶ Minkel & Baker, *supra* note 1, at 56. Individuals are appointed to official creditor committees under section 1102 of the Bankruptcy Code. 11 U.S.C. § 1102 (1988).

⁶⁷ See Minkel & Baker, *supra* note 1, at 58-64. See, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939) ("dominant or controlling stockholder" is a fiduciary); *In re Herby's Foods, Inc.*, 2 F.3d 128 (5th Cir. 1993); *In re 604 Columbus Ave. Realty Trust*, 968 F.2d 1332, 1336 (1st Cir. 1992); *In re Marquam Inv. Corp.*, 942 F.2d 1462 (9th Cir. 1991); *In re Fabricators, Inc.*, 926 F.2d 1458, 1465 (5th Cir. 1991) (rigorous scrutiny where bankruptcy trustee seeks to subordinate "a claim arising from the dealings between a debtor and an insider"); *Barlow v. Budge*, 127 F.2d 440 (8th Cir.), *cert. denied*, 317 U.S. 647 (1942); *In re Union Meeting Partners*, 160 B.R. 757 (Bankr. E.D. Pa. 1993); *In re Harborview Dev. 1986 Ltd. Partnership*, 152 B.R. 897 (D.S.C. 1993); *In re Chas. P. Young Co.*, 145 B.R. 131, 136 (Bankr. S.D.N.Y. 1992) (citing *In re Fabricators*); *In re Daugherty Coal Co.*, 144 B.R. 320, 324 (N.D.W.V. 1992); *In re E.F. Hutton Southwest Properties II, Ltd.*, 103 B.R. 808 (Bankr. N.D. Tex. 1989); *In re Inter-Island Vessel Co., Inc.*, 98 B.R. 606 (Bankr. D. Mass. 1988); *In re Sleepy Valley, Inc.*, 93 B.R. 925 (Bankr. W.D. Tex. 1988).

⁶⁸ *In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

⁶⁹ *Id.* at 299.

⁷⁰ *Cf.* 11 U.S.C. § 101(31)(B) (1988).

⁷¹ See *Trading Claims*, *supra* note 1, at 35-36.

⁷² *Id.* The fire wall is recognized by the Securities Exchange Commission

III. REGULATION OF CLAIMS TRADING

A. REGULATION UNDER THE BANKRUPTCY ACT OF 1898 AND THE BANKRUPTCY CODE

Claims trading dates back to the Revolutionary War, when the founding fathers attempted to buy the claims of the insolvent states for \$0.25 on the dollar, while arranging to have the debts assumed by the new federal government and paid in full.⁷³ Regulation of claims trading dates back to the beginning of bankruptcy law in the United States. Chapter X of the Bankruptcy Act of 1898 expressly regulated claims trading.⁷⁴ The Bankruptcy Act of 1978, however, does not include any provisions regulating claims trading.⁷⁵ It is unclear from the legislative history whether this omission was intentional or a result of oversight. Nor did the advisory committee consider the importance of the Chapter X guidelines for claims trading when it drafted the 1983 Rules of Bankruptcy Procedure.⁷⁶

Members of the advisory committee and some commentators assert that, because the Bankruptcy Code does not authorize any regulation of claims trading, the courts have no power to promulgate rules, such as Rule 3001(e), to regulate it.⁷⁷ Supreme Court precedent predating the Bankruptcy Code, however, favors court regulation of claims trading.⁷⁸ According to some

for use in tender offers. *Id.*; 17 C.F.R. § 240.14e-3(b) (1990).

⁷³ CLAUDE G. BOWERS, JEFFERSON AND HAMILTON: THE STRUGGLE FOR DEMOCRACY IN AMERICA 43-48 (1925).

⁷⁴ Bankruptcy Act of 1898, §§ 212, 249 (codified at 11 U.S.C. §§ 612, 649 (1976)) (repealed effective Oct. 1, 1979).

⁷⁵ Chapter X of the Bankruptcy Act of 1898 regulated claims trading in order to protect the securities-trading public. In re Pleasant Hill Partners, 163 B.R. 388, 391 (Bankr. N.D. Ga. 1994). However, other chapters of the 1898 Act did not regulate claims trading "because Congress assumed that trade creditors and bank creditors knew their debtor and needed less protection." *Id.*

⁷⁶ *Trading Claims*, *supra* note 1, at 13.

⁷⁷ Barbara Franklin, *Trading Creditors' Claims: Bar Challenges Bankruptcy Courts' Role in Deals*, N.Y. L.J., Oct. 4, 1990, at 5 ("If there are to be any restrictions on trading of claims or disclosure required, it should be written into the Bankruptcy Code by Congress, said Alan M. Resnick," who served as the reporter for the Advisory Committee on Bankruptcy Rules.); Conti et al., *supra* note 7, at 298.

⁷⁸ In re Pleasant Hill Partners, 163 B.R. 388, 391 (Bankr. N.D. Ga. 1994)

courts, pre-Code precedent still applies because no evidence exists that Congress, in writing the new Code, intended to overturn it.⁷⁹

B. BANKRUPTCY RULE 3001(e)

The 1983 Rules of Bankruptcy Procedure included Rule 3001(e), which governs the transfer of claims in bankruptcy.⁸⁰ Prior to its amendment in 1991, Rule 3001(e) required not only that parties transferring claims inform the court that a transfer of claims was taking place, but also that they disclose the consideration paid for the transferred claims.⁸¹ If, after a

(citing *American United Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138 (1940)). In *Avon Park*, the Supreme Court set aside confirmation of a plan, indicating that the court has control over the whole process of formulation and approval of reorganization plans and that its control included scrutiny of surrounding circumstances. *Avon Park*, 311 U.S. at 145-46.

⁷⁹ *Pleasant Hill*, 163 B.R. at 391 n.3; see *United Sav. Assoc. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988).

⁸⁰ Section 3001(e)(1)-(2), as amended in 1991, provides:

(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 terms 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 with 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 hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the original transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.

11 U.S.C. app. Rule 3001(e)(1)-(2) (Supp. IV 1992). The United States Supreme Court promulgates the Bankruptcy Rules pursuant to its statutory authority under 28 U.S.C. § 2075 (1988).

⁸¹ 11 U.S.C. app. Rule 3001(e)(1)-(2) (1988) (repealed Aug. 1, 1991). Before the 1991 amendments, Rule 3001(e) provided as follows:

(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

hearing, the court determined that the claim was unconditionally transferred, it could substitute the transferee for the transferor in the bankruptcy proceeding.⁸² At the same time, courts could disapprove a transfer in situations where, for example, the amount paid for claims was significantly lower than that provided in the reorganization plan.⁸³ Indeed, the advisory committee notes to the Rule encouraged this court involvement:

[T]he interests of sound administration are served by requiring the post-petition transferee to file with the

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 an order substituting the transferee for the original claimant, otherwise the court shall enter such order as may be appropriate.

Id.

⁸² *Id.*

⁸³ See, e.g., *In re Revere Copper and Brass*, 58 B.R. 1 (Bankr. S.D.N.Y. 1985) (refusing transfer where offer was for 20% of the face value of the claims while the plan proposed 65%); see also *In re Allegheny Int'l Inc.*, 100 B.R. 241 (Bankr. W.D. Pa. 1988) (imposing additional procedures for claims trading in addition to those in Rule 3001(e)); *In re Odd Lot Trading, Inc.*, 115 B.R. 97, 101 (Bankr. N.D. Ohio 1990) (examining the adequacy of claims buyers' 3001(e) disclosure, but concluding that the disclosure, which included buyers' predictions concerning the value of claims under the proposed plan and the remaining obstacles to approval of the plan, was sufficient).

Although the original version of Rule 3001(e)(2) simply required the court to determine whether the transfer had occurred unconditionally, several courts — including *Revere Copper* and *Allegheny* — interpreted the rule to allow them to exceed their ministerial functions and regulate the transfer of claims by requiring a certain level of disclosure. Courts tended to take this activist role when they believed there was bad faith on the part of the claims purchaser, or that informational advantages caused some other inequity.

proof of claim a statement of the transferor acknowledging the transfer and 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 the estate.⁸⁴

By requiring evidence of the consideration paid for the claim,⁸⁵ the old Rule 3001(e) provided some meaningful disclosure for claims trading. However, the resulting court intervention chilled the claims trading market. One commentator described the situation as follows:

The problem with things now . . . is that the amount and type of disclosure ordered varies between judges. The lack of uniformity has created uncertainty, chilling the private market for claims and causing sellers, many of whom are only interested in cashing out as quickly as possible, to take greater losses than they otherwise would.⁸⁶

Rule 3001(e) was amended in 1991 to reduce court oversight of claims trading.⁸⁷ The current rule simply requires the transferee to provide evidence of the transfer to the court.⁸⁸ If the transferor does not object within 20 days of notification by the clerk, the court substitutes the transferee for the transfer-

⁸⁴ 11 U.S.C. app. Rule 3001(e) advisory committee's note (1988). Courts used this advisory committee note as a basis for intervening in the claims trading process. *See, e.g.*, *In re Revere Copper and Brass, Inc.*, 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985).

⁸⁵ The old Rule 3001(e)(1) provided that

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.*

11 U.S.C. app. Rule 3001(e)(1) (1988) (repealed Aug. 1, 1991) (emphasis added).

⁸⁶ Franklin, *supra* note 77.

⁸⁷ 11 U.S.C. app. Rule 3001(e) advisory committee's note (Supp. IV 1992); Conti et al., *supra* note 7, at 298.

⁸⁸ 11 U.S.C. app. Rule 3001(e) (Supp. IV 1992).

or.⁸⁹ The advisory committee notes to the 1991 amendments state that the purpose of the amended Rule is:

[T]o limit the court's role to the adjudication of disputes regarding transfers of claims. If a claim has been transferred prior to the filing of a proof of claim, *there is no need to state the consideration for the transfer or to submit other evidence of the transfer.* . . . This rule is not intended either to encourage or discourage post-petition transfers of claims or to affect remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.⁹⁰

The amended Rule limits court involvement in claims trading to resolving disputes between transferors and transferees.⁹¹ Moreover, the language makes it clear that only the transferor may object to a transfer.⁹² If no objection is timely filed, the court is required to effect the transfer.⁹³

One significant advantage of the amended rule is that it may facilitate claims splitting.⁹⁴ Unlike the current rule, the former Rule 3001(e) required that transfers of claims be unconditional.⁹⁵ The bankruptcy court in *Ionosphere*⁹⁶ decided that splitting a claim violated the old Rule 3001(e) because it placed a condition on the transfer.⁹⁷ The court feared that claims

⁸⁹ *Id.*

⁹⁰ 11 U.S.C. app. Rule 3001(e) advisory committee's note (Supp. IV 1992) (emphasis added). The change in this rule was subject to minimal public debate or comment, with fewer than ten written comments delivered to the committee. See Franklin, *supra* note 77, at 5.

⁹¹ *Id.* The Rule provides that "[i]f a timely objection is filed, the court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law. *Id.*

⁹² *Id.*

⁹³ See *id.* The full text of the rule appears *supra* note 80.

⁹⁴ 1992 *Developments*, *supra* note 8, at 512.

⁹⁵ See 11 U.S.C. app. Rule 3001(e) (1988).

⁹⁶ In re *Ionosphere Clubs, Inc. and Eastern Air Lines, Inc.*, 119 B.R. 440 (Bankr. S.D.N.Y. 1990).

⁹⁷ *Id.* at 443 (stating that the primary objective of the requirement that claims be unconditionally transferred is to enable the court to monitor claims and protect against inequitable conduct).

splitting would have two undesirable ends. First, it would greatly increase the administrative burden on the debtor.⁹⁸ Second, claims splitting would allow a party to circumvent the § 1126(c) confirmation and voting procedures by increasing the total number of creditors in a class.⁹⁹

The *Ionosphere* court's fears were misguided. First, claims based on publicly traded instruments can be split, affecting voting rights under § 1126(c).¹⁰⁰ The court's concern that claims splitting allows circumvention of § 1126(c) is thus less relevant, since such activity takes place anyway. Second, there is no evidence to support the contention that the debtor's burden would be significantly increased.¹⁰¹ Moreover, any added burden would be outweighed by the benefits derived from the resulting increase in activity. A claims purchaser would be more willing to buy a claim if it is able to take only the untested portion of the claim.¹⁰² The seller of the claim would be better off because it could keep the questionable portion of a claim which, due to informational advantages, would be worth more to the seller than any third party would be willing to pay.¹⁰³ The seller can thus sell off that part of the claim that has a reasonable market value while keeping the portion which would be undervalued by the market. In addition, a seller of a large claim may have difficulty finding a single buyer. Thus claims splitting makes large claims more marketable.¹⁰⁴

The effectiveness of the 1991 amendments to Rule 3001(e) is nevertheless limited because the new Rule applies only to certain types of claims. The final sentence of the advisory committee's notes indicates that a distinction will be drawn between claims subject to nonbankruptcy regulation and those that are not: "This rule is not intended . . . to affect remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the

⁹⁸ *Id.* at 444.

⁹⁹ *Id.* Section 1126(c) requires the approval of two-thirds in amount and a majority in number of all claims in order for a plan to be accepted. 11 U.S.C. § 1126(c) (1988).

¹⁰⁰ *1992 Developments, supra* note 8, at 513.

¹⁰¹ *Id.* at 514.

¹⁰² *Id.* at 512.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

transfer of a claim."¹⁰⁵ Thus, the rule preserves rights the transferor or transferee may have under contract or securities laws. The rationale for distinguishing claims based on the applicability of securities laws is far from clear and serves only as an additional source of confusion.¹⁰⁶

C. ALTERNATIVE CODE PROVISIONS

While the new Rule 3001(e) precludes courts from using it as a basis for regulation of claims trading, courts can still use other sections of the Bankruptcy Code to regulate claims trading. These sections include: § 105,¹⁰⁷ concerning general equitable powers; § 1125(b),¹⁰⁸ concerning solicitation of votes; and § 1126(e),¹⁰⁹ concerning good faith requirements.¹¹⁰ Courts may also use pre-Code common law precedent to justify intervention.¹¹¹

Section 105 of the Bankruptcy Code gives the court the general equitable power to issue any order that is necessary or appropriate to administer the Chapter 11 estate.¹¹² The court's potential power under § 105 is very broad:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.¹¹³

¹⁰⁵ 11 U.S.C. app. Rule 3001(e) advisory committee's note (Supp. IV 1992).

¹⁰⁶ As discussed *infra* Part V, the distinction between claims based on securities and those based on trade claims is illogical.

¹⁰⁷ 11 U.S.C. § 105(a) (1988).

¹⁰⁸ *Id.* § 1125(b).

¹⁰⁹ *Id.* § 1126(e).

¹¹⁰ *In re Pleasant Hill Partners*, 163 B.R. 388, 391 (Bankr. N.D. Ga. 1994).

¹¹¹ *Id.*; see *supra* text accompanying notes 78-79.

¹¹² 11 U.S.C. § 105(a) (1988).

¹¹³ *Id.*

Courts have, however, interpreted this provision as applicable only in conjunction with another Code section.¹¹⁴ A court could use this broad equitable power in conjunction with the Code's policy of fairness and equitable distribution among creditors to examine claims trading.¹¹⁵

Some courts have invoked § 1125(b) to regulate claims trading.¹¹⁶ Section 1125(b) creates disclosure requirements for parties who solicit votes for or against a bankruptcy plan.¹¹⁷ Courts have equated claims trading with soliciting votes because the buyer of a claim also buys the votes that it represents.¹¹⁸

A third provision used to seek court intervention is the good faith provision of § 1126(e).¹¹⁹ The 1991 amendments to Rule 3001(e) make use of this provision more difficult because it no longer requires the parties to disclose the terms of the transfer. This lack of information makes monitoring for good faith more difficult.

Another possible road to regulation is through Bankruptcy Rule 2019. Subsection 2019(b)(2) states that the court may "examine . . . any claim or interest acquired by any entity or committee in contemplation or in the course of a case under the Code and grant appropriate relief."¹²⁰ Although this rule mainly applies to fiduciary trading, some contend that it could

¹¹⁴ *Pleasant Hill*, 163 B.R. at 391 n.6 (citing *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988)). In *Norwest*, the Supreme Court stated that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." 485 U.S. at 206.

¹¹⁵ See *Conti*, *supra* note 7, at 309; see also *supra* text accompanying note 12.

¹¹⁶ See *In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

¹¹⁷ 11 U.S.C. § 1125(b) (1988).

¹¹⁸ *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 295 (Bankr. W.D. Pa. 1990); *In re Revere Copper and Brass, Inc.*, 58 B.R. 1, 2-3 (Bankr. S.D.N.Y. 1985). *Contra* *In re Pleasant Hill Partners*, 163 B.R. 388, 391 (Bankr. N.D. Ga. 1994) (refusing to consider the purchase of claims solicitation under § 1125(b)).

¹¹⁹ See 11 U.S.C. § 1126(e) (1988); *Allegheny*, 118 B.R. at 289. For a full discussion, see *infra* text accompanying notes 142-145. Section 1126(e) allows a court, after notice and hearing to "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."

¹²⁰ 11 U.S.C. § 2019(b)(2) (1988).

be construed to allow courts to regulate all claims trading.¹²¹ To date, no court has used this Rule as authority for its action.

D. REGULATION IN THE COURTROOM

Courts have struggled for some time with their role in the regulation of claims trading. Some courts have taken an active role, reading the Bankruptcy Act of 1978 to permit, or even require, their active supervision and regulation of this process.¹²² The central theme in these opinions is the lack of disclosure taking place in the claims trading process and the resulting abuse. This lack of disclosure causes bankruptcy courts to take an active role in three areas: (1) where the claims purchaser looks for control; (2) where the claims seller appears to be unsophisticated and susceptible to abuse; and (3) where there appears to be bad faith on the part of the claims purchaser. One common result of the courts' action in these cases is distress in the legal and investment communities. Concerned parties feel uncertain about how courts will react to claims trading and see no clear guidance on how to plan their activities.

1. *The Unsophisticated Claim Seller: Revere Copper*¹²³

In *Revere Copper*, Phoenix Capital Corporation solicited claims from creditors at twenty percent of their face value from November 5, until December 6, 1984.¹²⁴ On November 30, however, the *Wall Street Journal* reported that under a potential plan proposed by the debtor, claimants would receive sixty-five percent of the face value of their claims.¹²⁵ In accordance with former Rule 3001(e)(2), Phoenix sought court approval of the purchase. The court refused to approve the transfer of claims.¹²⁶

¹²¹ See Lurey & Ryan, *supra* note 8, at 754-55.

¹²² See *Allegheny*, 118 B.R. at 301-03 (the court has "ample power" to formulate appropriate remedies"); In re *Revere Copper and Brass, Inc.*, 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985) (stating that Bankruptcy Rule 3001(e)(2) permits the court to order substitution where appropriate after a hearing).

¹²³ In re *Revere Copper and Brass, Inc.*, 58 B.R. 1 (Bankr. S.D.N.Y. 1985).

¹²⁴ *Id.* at 1-2.

¹²⁵ *Id.* at 2.

¹²⁶ *Id.* at 3. Phoenix was required to get court approval of its claim

The court looked to the advisory committee notes of the former Rule 3001(e) as justification for its action.¹²⁷ It worried that "solicited creditors may be unaware of their rights and options and fall prey to the belief that the bankruptcy inevitably will result in their receiving the proverbial ten cents on the dollar or worse."¹²⁸ It then examined § 1125 of the Bankruptcy Code, which prohibits solicitation of votes in connection with a filed plan unless the solicitation is accompanied or preceded by a disclosure statement.¹²⁹ Since Phoenix did not provide the assignors with sufficient information, the court ordered that none of the assignments be approved until the creditors had been given thirty days to revoke their assignments.¹³⁰ It also ordered Phoenix to provide any future assignors with a disclosure statement.¹³¹

The court was concerned with protecting unsophisticated creditors. It wanted creditors to be "plainly advised of their options."¹³² However noble its concern may be, the court should ensure a level playing field only, not protect parties from their own ignorance. The court could have set a good precedent by barring only the trades that took place before the article disclosed the predicted value of the claims. By placing an affirmative duty on the purchaser to provide information to creditors, even though the information was available to even a minimally concerned creditor, the court lost sight of the rationale for regulating claims.

purchase because it was buying trade claims. If it had bought claims based on a bond or debenture, it could have avoided the application of Rule 3001(e)(2), and the case never would have come before the court. *See supra* text accompanying note 105.

¹²⁷ The court cited the advisory committee note to former Rule 3001(e), which states that requiring disclosure of the consideration "will assist the court in dealing with evils that may arise out of post-bankruptcy traffic in claims against an estate." *Revere Copper*, 58 B.R. at 2 (quoting 11 U.S.C. app. Rule 3001(e) advisory committee's note).

¹²⁸ *Revere Copper*, 58 B.R. at 2.

¹²⁹ *Id.* at 2-3. The court went on to describe the type of disclosure required: "[t]he disclosure statement must contain adequate information which means information of a kind and in sufficient detail to enable a hypothetical reasonable investor typical of holders of claims to make an informed judgment about the plan." *Id.* at 3 (citing 11 U.S.C. § 1125(a)(1)).

¹³⁰ *Id.* at 3.

¹³¹ *Id.*

¹³² *Id.* at 2.

2. *Control and Bad Faith: Allegheny*¹³³

In December of 1989, Allegheny International ("Allegheny") filed its plan for reorganization under Chapter 11 of the Bankruptcy Code.¹³⁴ After the expiration of the period in which the debtor had an exclusive right to file a plan, Japonica Partners ("Japonica"), an investment group seeking control of Allegheny, purchased subordinated debentures of Allegheny with a face value of \$10,000 for \$2,712 in order to qualify as a party in interest and to file a plan of reorganization.¹³⁵ Japonica's plan offered cash equivalents of \$6.42 per share and gave Japonica control of the debtor.¹³⁶ The debtor's plan offered \$7.00 per share of stock.¹³⁷

After the court approved the debtor's disclosure statement, Japonica began acquiring claims held by secured bank lenders. Eventually Japonica obtained enough claims to achieve a blocking position.¹³⁸ This ensured the defeat of the debtor's plan and made confirmation of Japonica's own plan more likely. Japonica bought most of these claims for eighty to eighty-five percent of their face value.¹³⁹ It paid ninety-five percent of the face value for the claim that gave it a blocking position.¹⁴⁰ The debtor moved to have Japonica's votes disqualified as cast in bad faith under § 1126(e) of the Bankruptcy Code.¹⁴¹

¹³³ *In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

¹³⁴ *Id.* at 286.

¹³⁵ *Id.* at 286.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.* at 286-87. A blocking position refers to the amount of claims owned by a single claimant in any one class. Section 1126(c) of the Bankruptcy Code provides that:

(c) A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

11 U.S.C. § 1126(c) (1988).

¹³⁹ *Allegheny*, 118 B.R. at 287.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* (citing § 1126(e) of the Bankruptcy Code, which allows the court to disqualify the ballot of "any entity whose acceptance or rejection . . . was not

The court found that Japonica had violated § 1126(e) of the Bankruptcy Code by acting in bad faith.¹⁴² Because good faith is not defined in the Bankruptcy Code, the court looked to § 203 of the Bankruptcy Act of 1898 and case law interpreting this section.¹⁴³ The finding of bad faith was based on several actions by Japonica. First, the court found that Japonica did not file its plan until the "eleventh hour."¹⁴⁴ Second, Japonica did not purchase significant claims in the debtor until the voting period, at which time Japonica was a proponent of a plan.¹⁴⁵ The court also decided that Japonica's status as a plan proponent made it an insider and therefore subject to fiduciary duties.¹⁴⁶ Japonica had also solicited claims both before and after approval of its disclosure statement.¹⁴⁷

The court found that Japonica's solicitation of claims was equivalent to soliciting votes in favor of its plan.¹⁴⁸ A creditor cannot solicit votes before approval of its disclosure statement.¹⁴⁹ The court was disturbed by the fact that allowing Japonica to solicit claims would basically allow them to buy votes since they would vote the claims purchased in favor of their plan. Debtors, however, are not allowed to solicit votes until a disclosure statement is filed so that claim holders are informed when they vote. Thus, Japonica was doing something the debtor itself was prohibited from doing.

The court then focused on the manner in which Japonica acquired its claims. First, the court noted that the way that Japonica acquired claims was discriminatory because it treated people in the same class differently.¹⁵⁰ Second, the court

in good faith or was not solicited or procured in good faith").

¹⁴² *Id.* at 289.

¹⁴³ *Id.* at 287-89 (citing Bankruptcy Act of 1898, § 203 (repealed effective Oct. 1, 1979)).

¹⁴⁴ *Id.* at 289.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 299.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 295.

¹⁴⁹ 11 U.S.C. § 1125(b) (1988). Section 1125(b) requires that a plan proponent not solicit acceptance until the court approves its disclosure statement. *Id.*

¹⁵⁰ Those that accepted Japonica's offer received immediate cash; those that did not had to wait for the reorganization plan. *Allegheny*, 118 B.R. at 296-97. Section 1123(a)(4) requires that any plan of reorganization treat each claim or

inferred that Japonica acted in bad faith, noting that Japonica acquired a blocking position in the most senior class (making confirmation difficult without its vote). In making this finding, the court asserted that Japonica's purpose in purchasing claims was to assert control over the debtor, rather than to further its interests as a member of a class. By inferring an intent equivalent to bad faith, the court exercised a great deal of discretion. The court disqualified the votes cast by Japonica as cast in bad faith.¹⁵¹

The court's decision in *Allegheny* has been controversial.¹⁵² On one hand, it has caused distress among practitioners about how to trade in bankruptcy claims without running violating the Bankruptcy Code. On the other, it demonstrates how far courts will go to stretch the provisions in the Bankruptcy Code to regulate claims trading. For example, there is no authority in the Code for the court to equate solicitation of claims with solicitation of votes. There is no authority to support the court's finding that Japonica was an insider due to its status as a plan proponent. The court wholly ignored the positive effects of claims trading, focusing instead on the abuses.

interest of a particular class the same. 11 U.S.C. § 1123(a)(4) (1988).

¹⁵¹ *Allegheny*, 118 B.R. at 290. An even harsher result was reached in *In re Chateaugay*, 86 B 11270 slip op. (Bankr. S.D.N.Y. Mar. 11, 1988), cited in Mayerson et al., *supra* note 1, at 641. In that case, Regal formed a shell corporation to acquire unsecured claims against a Chapter 11 debtor. *Id.* Regal intended to acquire control of the debtor and propose a 100% payment plan. *Id.* Although Regal took no action to hide its intentions, it failed to disclose its intentions to the creditors. *Id.* Regal offered 33% of the face value for unsecured claims, and procured claims from over 450 creditors. *Id.* The *Chateaugay* court, following the court in *Revere Copper*, found that the inadequate disclosure invalidated the claims trades. *Id.* Viewing Regal's actions as intentional omissions, the court refused to effect the assignment of claims. *Id.* at 640. Moreover, the court refused to cancel the assignments, leaving Regal to seek refunds from the holders of the unsecured claims. *Id.* at 641.

As in *Revere Copper* and *Allegheny*, the *Chateaugay* court went beyond all authority in the Bankruptcy Code, diminishing the power of the legitimate argument for some regulation of claims trading.

¹⁵² See *Trading Claims*, *supra* note 1; Minkel & Baker, *supra* note 1, at 74-101; Caplan, *supra* note 7, at 1063-65; Charles, *supra* note 8, at 275-77, 303-04; Millstein & Siegel, *supra* note 8, at 404; Neely, *supra* note 8, at 156-60; White, *supra* note 8, at 36-38; Skeel, *supra* note 8, at 513-15; Sabin et al., *supra* note 7; Lurey & Ryan, *supra* note 8, at 768-69; Africk, *supra* note 7, at 1413-16; Mayerson et al., *supra* note 1, at 655-56.

The *Allegheny* court's hostility towards claims trading arises from the lack of disclosure. If Japonica had provided disclosure similar to that required of debtors, the court would have had difficulty finding bad faith. The court was also concerned that creditors who accepted Japonica's offer would be treated differently from those who did not. This difference in treatment will occur in most claims trading situations. Creditors, however, should have the opportunity to choose between selling their claims for less money now or waiting out the bankruptcy proceedings in an attempt to receive more. As long as there is adequate disclosure, no unfairness will result from allowing creditors to choose between these two options.

3. *Litigation Under Amended Rule 3001(e)*

In response to the court's actions in *Revere Copper and Allegheny*, Congress amended Rule 3001(e). As intended, the amendments significantly reduced litigation over claims trading and courts have removed themselves from the claims trading process. As a result there is little case law on the amended rule. Its effects have, however, been documented in some court opinions.

a. *Odd Lot Trading*¹⁵³

Although decided prior to the effective date of the amendment to Rule 3001(e), the court in *Odd Lot Trading* cited the proposed amendments as some evidence of the purpose of the rule. In this case, AMROC Investments, L.P., ("AMROC") solicited claims from Odd Lot claim holders, enclosing three pages from a thirty-two page disclosure statement.¹⁵⁴ The three pages indicated that the proposed plan provided for payment of \$0.80 on the dollar while AMROC was offering \$0.60.¹⁵⁵ The debtor objected to three assignments of claims, and one assignor objected. The debtor asserted that it filed its objections as a fiduciary and that it had a duty to be fair to all constituents.¹⁵⁶ The debtors argued that the purpose of § 1125(b) of the Bankruptcy Code was to provide holders of

¹⁵³ In re *Odd Lot Trading, Inc.*, 115 B.R. 97 (Bankr. N.D. Ohio 1990).

¹⁵⁴ *Id.* at 98.

¹⁵⁵ *Id.* at 99.

¹⁵⁶ *Id.*

claims with sufficient information to enable them to make informed decisions and that these assignments violated the spirit of the law.¹⁵⁷

The court, citing Rule 3001(e), stated that the Bankruptcy Code does not address solicitation of claims.¹⁵⁸ It noted that the proposed amendment to Rule 3001(e) was intended to lessen the court's role in the claims trading process, which was questioned by the judges in *Revere Copper* and *Allegheny*.¹⁵⁹ The court distinguished *Revere Copper* and *Allegheny* by emphasizing that AMROC provided "sufficient information and did not mislead the assignors when soliciting to purchase claims."¹⁶⁰

b. *SPM Manufacturing*¹⁶¹

In the *SPM Manufacturing* bankruptcy, the secured creditor agreed with unsecured creditors to divide any money received among themselves to the exclusion of other priority creditors. This arrangement would have violated the absolute priority rule because some unsecured creditors would receive partial payment while other priority creditors would receive nothing.¹⁶² The First Circuit Court of Appeals held that the bankruptcy court lacked equitable power to compel a secured creditor to pay an unsecured creditor's portion over to the estate for distribution according to priority.¹⁶³ In dicta, the court analogized the agreement at issue in the case to a transfer under amended Rule 3001(e).¹⁶⁴ The court stated that the amendment was intended to restrict the bankruptcy court's power to inspect the terms of the transfer.¹⁶⁵ As a consequence of the amended rule, the court could disapprove a transfer of a claim if the transfer involved a breach of fiduciary duty or fraud, but it

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 100. The Court noted that § 1125(b) of the Bankruptcy Code addresses solicitation of acceptance or rejection of plans of reorganizations, not claims. *Id.*

¹⁵⁹ *Id.* at 101.

¹⁶⁰ *Id.*

¹⁶¹ *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993).

¹⁶² *Id.* at 1315.

¹⁶³ *Id.* at 1318.

¹⁶⁴ *Id.* at 1314-15.

¹⁶⁵ *Id.* at 1314.

could no longer disapprove a transfer based on its terms.¹⁶⁶ If the unsecured creditors had sold their claims to the secured creditor, the result would be the same as in a transfer under Rule 3001(e). The unsecured creditors would receive money, and the priority claimants would not.¹⁶⁷ The court concluded that it could not prohibit an agreement calling for a sharing of claims when the same result could be accomplished by selling the claims as authorized by Rule 3001(e).¹⁶⁸

IV. REGULATION UNDER THE SECURITIES ACTS

Congress passed the Securities Act of 1933¹⁶⁹ and the Securities Exchange Act of 1934¹⁷⁰ in an attempt to regulate the trading of securities in public markets. It sought to ensure that the investing public received accurate information and that rules were in place to protect investors from manipulation or exploitation by those who possess control of or have access to non-public information.¹⁷¹ The Acts accomplish these goals by requiring the filing of disclosures with the Securities and Exchange Commission ("SEC"), the agency charged with implementing and enforcing these Acts.¹⁷² For purposes of claims trading, securities laws are relevant in two respects: (1) certain provisions of the securities laws may apply to claims trading, depending on the type of claim and the court's interpretation of the Securities Acts; and (2) the policies underlying the development of securities laws apply to claims trading.

¹⁶⁶ *Id.* The terms of the transfer would include, for example, inadequate consideration.

¹⁶⁷ *Id.* at 1315.

¹⁶⁸ *Id.*

¹⁶⁹ 15 U.S.C. § 77 (1988).

¹⁷⁰ *Id.* § 78.

¹⁷¹ George J. Stigler, *Public Regulation of the Securities Market*, 37 J. BUS. 117 (1964), reprinted in RICHARD A. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW & SECURITIES REGULATION* 347 (1980) (noting that the purpose of regulation in the securities market is to increase truth in the world, to prevent or punish fraud, and to protect the innocent investor).

¹⁷² See, e.g., 17 C.F.R. §§ 240.13d, 14d, 14e (1993).

A. WHAT IS A SECURITY?

The Securities Act of 1933 and the Securities Exchange Act of 1934 apply to all securities.¹⁷³ If the instrument in question is a security as defined by the Acts, then the Acts will apply whether or not the company associated with the instruments is in bankruptcy.¹⁷⁴ Defining the term security is the threshold concern in determining the applicability of securities laws.

Neither the Securities Act nor the Securities Exchange Act includes a claim arising out of bankruptcy in its definition of a security.¹⁷⁵ Although a claim is not listed in either definition, the definitions are broadly written and have been interpreted broadly by the courts.¹⁷⁶ In fact, the Supreme Court describes the Securities Acts' definitions of securities as "sufficiently broad to encompass virtually any instrument that might be sold as an investment."¹⁷⁷ The broad reading given to these definitions has not been extended to claims in bankruptcy.¹⁷⁸ The

¹⁷³ The term "security" is broadly defined under both the Securities Act of 1933 and the Securities and Exchange Act of 1934. The 1933 Act defines a security as:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1988).

The 1934 Act is similarly broad. See 15 U.S.C. § 78c(a)(10) (1988).

¹⁷⁴ Section 1145 of the Bankruptcy Code exempts the issuance of a debtor's securities from federal and state registration requirements. 11 U.S.C. § 1145 (1988).

¹⁷⁵ See *id.* §§ 77b(1), 78c(a)(10).

¹⁷⁶ *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

¹⁷⁷ *Id.*

¹⁷⁸ In 1990, a spokesman for the SEC said that the SEC was monitoring developments in claims trading. Franklin, *supra* note 77, at 5.

Securities Act of 1933 comes closest by including "evidence of indebtedness" in its definition of a security.¹⁷⁹ No court, however, has held that a Chapter 11 claim qualifies as a security under this definition.¹⁸⁰

Case law also fails to provide any clear definition of security. The most relevant interpretation of the definition of a security was provided by the Supreme Court in *Reves v. Ernst & Young*.¹⁸¹ In *Reves*, the Supreme Court adopted the "family resemblance" test to distinguish between an investment and a commercial note.¹⁸² This test involved four factors: (1) the buyer's and seller's general motivations, (2) the existence of an active market for speculation or investment, (3) the investing public's reasonable expectations, and (4) the presence of some factor which reduces the risk of the instrument enough to make the application of securities laws unnecessary.¹⁸³ Arguably, a claim in bankruptcy satisfies the four factors. The *Reves* test, however, may be limited to its facts. The court in *Reves* distinguished between commercial paper and notes.¹⁸⁴ No court has used the *Reves* test to call a trade claim a security.¹⁸⁵

Some commentators argue that the distinction between securities and trade claims is nonsensical and should be abandoned in favor of uniform regulations.¹⁸⁶ In most Chapter 11 situations a claim is similar to a security (e.g. it represents the right to receive a payment or an equity share in the reorganized entity).¹⁸⁷ Accepting this view, securities laws appear to be an

¹⁷⁹ *Trading Claims*, *supra* note 1, at 48.

¹⁸⁰ *Id.*

¹⁸¹ *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

¹⁸² *Id.* at 63 (citing *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976)).

¹⁸³ *Id.* at 66.

¹⁸⁴ *Id.* at 60-67.

¹⁸⁵ *Trading Claims*, *supra* note 1, at 47.

¹⁸⁶ For a comprehensive discussion of the application of securities laws to bankruptcy claims, see Conti et al., *supra* note 7; James D. Prendergast, *Applying Federal Securities Law to the Trading of Bankruptcy Claims*, 3 FAULKNER & GRAY'S BANKR. L. REV. 9 (1991). See also Anthony M. Sabino, *No Security in Bankruptcy: The Argument Against Applying the Federal Securities Laws to the Trading of Claims in Bankruptcy*, 23 PACIFIC L.J. 109 (1992) (arguing that securities laws should not be applied to bankruptcy claims).

¹⁸⁷ *Trading Claims*, *supra* note 1, at 32.

effective vehicle with which to regulate claims trading as they are well-established, widely known, and would result in more uniformity than would the bankruptcy courts' use of its equitable power under the Bankruptcy Code. Such a proposal would, however, also subject claims trading to all the formal requirements of the securities laws such as disclosure and registration statements.

In a related *Allegheny* case,¹⁸⁸ the bankruptcy court for the Western District of Pennsylvania suggested a way to apply securities regulation to claims trading. In this case, the court likened the Chapter 11 filing to creating a market in nonpublicly traded securities.¹⁸⁹ The court was concerned that in this "market" claimants are not protected by disclosure statements, and the court expressly indicated its desire that Congress step in to regulate the activity.¹⁹⁰

The Bankruptcy Code specifically exempts sales of securities under a reorganization plan from the requirements of the Securities Acts.¹⁹¹ This creates an inference that Congress intended to regulate bankruptcy separately. The policy considerations involved in bankruptcy are special enough that they are addressed by specific provisions in the Code. Claims trading is no different, and thus warrants specific treatment in the Bankruptcy Code. Indeed, application of securities laws to claims in bankruptcy may cause havoc with the orderly administration of bankruptcy proceedings. This Note argues that there are more efficient means of ensuring adequate disclosure; specifically, the Bankruptcy Code itself should regulate claims trading.

B. RELEVANT PROVISIONS OF THE SECURITIES ACTS

Several considerations arise from claims regulated under securities laws. The broadest implications for claims trading arise from the antifraud provisions of § 10(b) of the Securities Act and Rule 10b-5, promulgated under § 10(b).¹⁹² Rule 10b-5 prohibits any untrue statement, omission of any material fact necessary to make a statement not misleading, or any other

¹⁸⁸ *In re Allegheny Int'l, Inc.*, 100 B.R. 241 (Bankr. W.D. Pa. 1988).

¹⁸⁹ *Id.* at 243.

¹⁹⁰ *Id.*

¹⁹¹ 11 U.S.C. § 1145 (1988).

¹⁹² *Trading Claims*, *supra* note 1, at 46-47.

deceptive, fraudulent or misleading practices in connection with the purchase or sale of any security.¹⁹³

One difficulty with the non-applicability of the Securities Acts to claims trading is the increased potential for insider trading and other actions inconsistent with the policies of the Securities Acts. Guarding against insider trading thus becomes the responsibility of the bankruptcy court. Rule 3001(e), however, gives the bankruptcy court little authority and no information with which to prevent such abuses. As Part V of this Note discusses, disclosure is necessary to achieve fairness among all parties involved in a bankruptcy.

In a non-bankruptcy situation, an entity purchasing stock in a corporation to gain control of that corporation must comply with Regulations 14E and 14D of the Securities and Exchange Act of 1934. Regulation 14D requires comprehensive disclosure and filings with the SEC¹⁹⁴ and Regulation 14E governs the making of a tender offer.¹⁹⁵ If the purchaser intends to make a tender offer, Regulation 13D is also applicable. Regulation 13D requires the purchaser to disclose its identity, how much of the corporation it has acquired and for how much money, and its intentions with respect to the corporation.¹⁹⁶

In the bankruptcy context, a party can attempt to gain control of a corporation by purchasing creditors' claims. Assuming that the claims are not based on publicly traded instruments, the claims purchaser avoids the reporting requirements placed on a similarly situated person in a non-bankruptcy context.¹⁹⁷ This contravenes the Securities Acts' policy to protect investors. In the bankruptcy setting, it is the creditors

¹⁹³ 17 C.F.R. § 240.10b-5 (1993).

¹⁹⁴ *Id.* §§ 240.14d-1 to 240.14d-103.

¹⁹⁵ *Id.* §§ 240.14e-1 to 240.14e-6.

¹⁹⁶ *Id.* §§ 240.13d-1 to 240.13d-101.

¹⁹⁷ A current example of this situation is the Federated Department Store purchase of approximately \$480,000,000 worth of claims in the Macy's Chapter 11 bankruptcy. Federated purchased this block of claims in an attempt to force a merger with Macy's, which wishes to remain independent. See Gavin Power, *Rival Buys a Piece of Macy's: Federated Stores Wants to Merge with Retailer*, S.F. CHRON., Jan 3, 1994, at A1 (reporting on Federated's desire to merge with Macy's after purchasing Macy's claims); Patrick M. Reilly & Ellen Shapiro, *Federated Bidding for Macy Through Bankruptcy Court*, WALL ST. J., Jan. 3, 1994, at A3 (same); Stephanie Strom, *Federated Acquires Stake in Macy's in a Bold Move Toward Expansion*, N.Y. TIMES, Jan. 3, 1994, at A1 (same).

who need protection. Without some disclosure requirements, these creditors will be reluctant to trade claims. Since claims trading can be beneficial to all involved, this Note argues that the Bankruptcy Code should encourage claims trading.

V. A PROPOSAL FOR REGULATING CLAIMS TRADING

The lack of guidance under the present Bankruptcy Code has created a great deal of uncertainty in the business community as to when a court will involve itself in claims trading. This uncertainty decreases efficiency by limiting market activity, increasing transaction costs, and placing unsophisticated creditors at risk of being treated unfairly. Mayerson, Sarachek, and Swersky state:

[B]uyers and sellers of claims still operate in an atmosphere of uncertainty and must be prudent. Different courts have taken different approaches to regulating trading claims from benign neglect to activist intervention, perhaps in violation of principles of the Bankruptcy Code. One must, therefore, view the area of selling claims as fraught with risks — both the risks inherent in the nature of claims or the claimant-assignors themselves and the risk of whether a bankruptcy court will validate the sale of the claim. These risks must be taken into consideration in negotiating and pricing a sale of claims.¹⁹⁸

Nevertheless, claims trading has become a billion dollar business.¹⁹⁹ While functioning as an investment for claims purchasers, claims trading enables creditors of Chapter 11 debtors to convert their claims to cash. Clarification of the regulations governing the process will improve both fairness and efficiency.

To promote an active market in claims trading, both bankruptcy courts and creditors must be provided with information. The principles of efficiency and fairness are best served by requiring a threshold disclosure from all claims purchasers. The bankruptcy judge's role should be limited to avoiding arbitrary and inconsistent results. A "safe harbor" should

¹⁹⁸ Mayerson et al., *supra* note 1, at 661.

¹⁹⁹ *See id.*

protect those claims purchasers in compliance with the proposed disclosure requirements.

The idea that claims trading is better left unregulated is misguided. First, claims trading is already regulated in certain circumstances. Rule 3001(e) applies only to claims "other than those based on a publicly traded instrument."²⁰⁰ Thus, if the claim is based on a publicly traded instrument, the purchaser and seller will have to meet the disclosure requirements of all applicable securities laws. Trading in other types of claims is not subject to similar disclosure requirements. No logical rationale exists for this distinction.

Second, the amended Rule 3001(e) will not prevent the courts from becoming involved in the claims trading process.²⁰¹ Even if courts attempt to stay out of the process, interested parties will continue to search the Bankruptcy Code for new ways to initiate court intervention on their behalf. Bankruptcy courts have broad equitable powers under § 105 of the Code,²⁰² and nothing in Rule 3001(e) prevents courts from intervening in claims trading under §§ 1126(e), 1125(b), or Rule 2019(b).²⁰³

The Bankruptcy Code's failure to adequately address claims trading has led bankruptcy courts to regulate in an ad hoc manner, with the tolerance for claims trading dependent upon the jurisdiction and presiding judge.²⁰⁴ The new Rule 3001(e), which lessens the courts' involvement in the claims trading process, exacerbates the problem. While Rule 3001(e) was amended in an attempt to gain greater uniformity across jurisdictions and to facilitate claims trading, it eliminates whatever

²⁰⁰ 11 U.S.C. app. Rule 3001(e)(2) (Supp. IV 1992).

²⁰¹ See *supra* text accompanying notes 56-61.

²⁰² See 11 U.S.C. § 105 (1988).

²⁰³ See discussion *supra* Parts III.B and III.C. Courts can still use these provisions to justify intervention, depending on the ingenuity of counsel. Minkel and Baker note that

The Bankruptcy Code is silent on the question of claims trading. When new issues and problems arise in a bankruptcy case, the first impulse may be to parse through the Bankruptcy Code and Bankruptcy Rules to find a hook on which a bankruptcy court can hang an equitable remedy. In doing so, a number of courts seem to have made a policy decision about the wisdom of claims trading. But policy decisions are for Congress, not the courts, to make.

Minkel & Baker, *supra* note 1, at 101.

²⁰⁴ See discussion *supra* Part III.

protection was previously available, and it is unclear whether the change will actually result in greater uniformity or efficiency.²⁰⁵

A. THE NEED FOR DISCLOSURE

Contrary to its intended effect of increasing the efficiency of the market, the lack of adequate disclosure under the amended Rule 3001(e) impairs the claims market. In order to create an efficient market, disclosure of the terms of claims trades, as well as the true identity and interests of buyers, must be required. Without disclosure of the prices of previous trades, creditors will not have good information regarding the values of their claims and will therefore be reluctant to sell. Without disclosure of the true identity of a claims purchaser (not just the nominal purchaser as is currently required), these purchasers may use fronts and confidentiality agreements to depress prices.²⁰⁶

The present Bankruptcy Code should be amended to provide specific guidelines for claims trading. To allow activity on this scale without providing guidance as to how the activity should take place invites inequity and manipulation. As with securities, the most efficient means of regulating claims trading is by ensuring that there is adequate disclosure. Simple regulations regarding disclosure by parties involved would go a long way towards creating efficient and equitable markets for claims trading.

The benefits of disclosure would outweigh the costs. Requiring disclosure would reduce litigation and lower transaction costs. The costs of providing information and monitoring disclosure would be limited.²⁰⁷ Moreover, a mandatory disclosure

²⁰⁵ Another effect of the amendments to Rule 3001(e) is that vote buying becomes a greater concern. Conti, *supra* note 7, at 309. The pre-1991 version of Rule 3001(e) required not only that the terms of a transfer be disclosed to the court but also that the transfer be unconditional. 11 U.S.C. app. Rule 3001(e) (1988) (repealed effective Aug. 1, 1991). These requirements limited vote buying arrangements in which a claims purchaser bought bankruptcy claims on the condition that the purchaser's reorganization plan was confirmed. Conti, *supra* note 7, at 307. The amended Rule 3001(e), however, neither requires disclosure nor that the transfer be unconditional. See 11 U.S.C. app. Rule 3001(e) (1988 & Supp. IV 1992).

²⁰⁶ Conti, *supra* note 7, at 304-05.

²⁰⁷ The information costs are limited to providing the court with notice of the trade and its terms. Monitoring costs would also be minimal because the safe harbor proposed by this Note provides a self-enforcing mechanism. It is

rule would promote efficiency in the claims trading market. Evidence from trading in bonds, which are subject to the disclosure rules of the Securities Acts, indicates that the market is efficient at pricing these investments during the pendency of a bankruptcy.²⁰⁸ With adequate information, the value of the failed entity is maximized. Creditors wishing to participate in the reorganization to gain control of the debtor or to maximize the value of their investment may do so. Those creditors wishing to receive cash for their claim may do so.

Disclosure regulations should consider the motive of the purchaser.²⁰⁹ The claims purchaser's motives are not always apparent, and its intentions may change over time. These practical problems, however, do not differ in any material respect from those encountered in securities regulation. It may be necessary to require disclosure if a claims purchaser owns more than a certain percentage of the face value of claims owned, similar to the five percent figure used for tender offers under the Securities and Exchange Act.²¹⁰

B. A SAFE HARBOR

Balancing fairness and efficiency in claims trading is difficult. On one hand, claims trading should be encouraged by allowing the market to operate with no interference. On the other, the trading process should be fair to all parties involved. To balance these competing interests, this Note proposes requiring disclosure of the parties in interest and the consideration paid for a claim, while at the same time prohibiting any further court intervention in the claims trading process. Contrary to what some have proposed,²¹¹ the disclosure called for should not be coupled with court intervention in the claims trading process. Rather, a "safe harbor" should be created for the

in the purchaser's interest to provide full and accurate disclosure to obtain the benefits of the safe harbor. See discussion *infra* Part V.B.

²⁰⁸ Allan C. Eberhart & Richard J. Sweeney, *Does the Bond Market Predict Bankruptcy Settlements?*, 47 J. FIN. 943 (1992).

²⁰⁹ For example, a disclosure rule might require a purchaser who has acquired a significant portion of a class of claims to disclose her percent share of the class as well as whether she intends to use her purchases to gain control of the debtor.

²¹⁰ Securities Exchange Act of 1934, § 13(d) (codified at 15 U.S.C. § 78m(d) (1988)).

²¹¹ See Conti et al., *supra* note 7.

claims purchaser. As long as the claims purchaser complies with disclosure requirements, the court would not be allowed to intervene in the transaction.

This proposal would require sending notice to all creditors that a secondary market in claims may be created.²¹² The notice would explain that upon the transfer of any claim, notice must be given to the court disclosing the actual purchaser and seller as well as the consideration given for the claim.²¹³ This information would be available to interested parties and to the public. Creditors could use the information to discover the market price for comparable claims. Trade creditors, who currently cannot reliably determine the value of their claims, could use price information to prevent overreaching by more sophisticated parties. This provision would ensure a level playing field while preventing the court from intervening in an efficient marketplace.

A second aspect of this proposal would require any party that acquires a predetermined level²¹⁴ of the claims of the bankrupt estate in any specific class to file a separate notice identifying itself and declaring its intentions. Such notice would be available to all interested parties. Full disclosure by parties accumulating a position in claims will further aid potential sellers in fairly pricing their claims.²¹⁵

²¹² This notice could simply be added to the notice given when the creditors are initially contacted regarding the filing of the bankruptcy petition.

²¹³ This notice provision would also require insiders to declare their position to the seller.

²¹⁴ This level, perhaps 5%, could be uniform for all bankruptcies or set by the court after classes of claims are created.

²¹⁵ For disclosure purposes, there is no reason to treat a claim based on a security differently from one based on a trade creditor's claim. For many investors, claims, like securities, are just another investment vehicle. The rationale for disclosure under securities laws thus applies to claims trading. The current Bankruptcy Code and the 1991 amendments to Rule 3001(e) do not recognize this reality.

Although the same disclosure policy underlies all claims, this Note argues that the disclosure requirements for claims trading should be part of the rules regulating bankruptcy. It is clear that Congress intended bankruptcy to operate independently of the securities laws. See discussion *supra* text accompanying note 191. Furthermore, it would be unrealistic to assume that securities rules as they stand should apply to claims in bankruptcy. The securities laws were structured to operate in a completely different environment. The rules governing bankruptcy differ dramatically from those that govern a going concern. More important, the SEC lacks the expertise to

Claims trading is a desirable activity, but this proposal acknowledges that, even with disclosure, abuse is possible.²¹⁶ This Note argues that the benefits derived from a free and efficient claims trading market outweigh the small amount of abuse that some parties may attempt. On balance, creditors will benefit from both the active market and the information provided by the disclosure requirement. Therefore, under this proposal, if adequate disclosure is provided, an irrebuttable presumption of validity will attach to the trade. If, however, the parties fail to provide the notice and disclosure required by this proposal, the bankruptcy court would be free to use its general equitable power under § 105 to examine the trade.²¹⁷ The threat of such intervention by courts will serve as a self-enforcing mechanism, encouraging parties to comply to gain the benefit of the safe harbor.

This proposal will give notice to all parties that information regarding the value of claims is available and will allow parties to engage in this activity without the fear of court intervention. Without a safe harbor provision, the validity of a claim transfer would depend on the individual bankruptcy judge's view of what constitutes fairness or overreaching by a party, both subjective determinations, making it impossible for parties to predict the consequences of their activity.

CONCLUSION

Claims trading is big business, and all indications show that it will continue to grow in the future. It serves a useful function in the bankruptcy process, providing a liquid market for claims and, in many cases, speeding up the bankruptcy process. The importance of claims trading makes it imperative that it be regulated under the Bankruptcy Code. Fundamental to such guidance is the need for disclosure to ensure that all parties in the process have access to relevant information. Parties must know the circumstances under which court in-

regulate activities of a firm in bankruptcy.

²¹⁶ See *In re Revere Copper and Brass, Inc.*, 58 B.R. 1 (Bankr. S.D.N.Y. 1985). For discussion of this case, see *supra* text accompanying note 123. The disclosure will be of little help to the first creditor to sell a claim. However, an efficient market would quickly correct for this problem, making disclosure beneficial on the whole.

²¹⁷ 11 U.S.C. § 105 (1988); see *supra* text accompanying notes 112-115.

volvement will occur so that they may predict the outcome of their actions. Unless such regulation is imposed, courts will continue to apply the present Code inconsistently and inequitably. The result of such action can only be an increase in uncertainty in the financial markets and a decrease in claims trading.

Trading claims is a productive activity and should not be subject to fear and risk due to the uncertainty of court intervention. The proposal for disclosure coupled with a safe harbor provision provides parties with the necessary information to engage in claims trading with predictability. Society would be better served by clearly defined rules that lay out disclosure requirements but provide a "safe harbor" free of court intervention for a trade that meets these requirements.

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