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COMMENTS ON THE ARTICLES OF PROFESSORS BAIRD AND JANGER

BROOKLYN SYMPOSIUM ON BANKRUPTCY CLAIMS TRADING AND SECURITIES REGULATION

Allan L. Gropper[*]

Professors Douglas G. Baird and Edward J. Janger have clearly and concisely spelled out why we need regulation of what Professor Baird calls "The Bankruptcy Exchange."[1] However, that is not necessarily to agree with Professor Baird's contention that the bankruptcy judge has "established" the exchange in the same fashion that a medieval prince would organize a trade fair or that a group of merchants formed the Chicago Board of Trade.[2] Nevertheless, today's bankruptcy judge functions in an arena where claims trade constantly.

As Professor Baird demonstrates, not only do the bankruptcy judge's decisions affect the trades, but the trades can affect the judge's decisions as well.[3] The concept that a judge's decision in a case may affect the value of a claim is obvious. Although not as obvious, it is also true that trades may affect a judge's decision. For example, in a recent case involving the valuation of a debtor for fraudulent conveyance purposes, the Third Circuit held that the value of a company's stock in a market free of manipulation is virtually conclusive as to the solvency or insolvency of the enterprise.[4] Many other cases, including two of my own, have found that the value placed on an enterprise by a potential acquirer is highly probative when

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1. Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. & FIN. L. 23 (2009). (according to Baird, the Bankruptcy Exchange is the trading of claims against a debtor in bankruptcy proceedings); *see also* Edward J. Janger, *The Costs of Liquidity Enhancement: Transparency Costs, Risk Alteration and Coordination Problems*, 4 BROOK. J. CORP. & FIN. L. 39 (2009).

2. Baird*, supra* note 1, at 24.

3. *Id.*

4. VFB L.L.C. v. Campbell Soup Co., 482 F.3d 624, 632–33 (3d Cir. 2007) (also called the "Vlasic Pickle case" as it involved the spinoff of that business). There, the court held that "[a]bsent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'" *Id*. at 633 (quoting *In re* Prince, 85 F.3d 314, 320 (7th Cir. 1996)); *see also* Statutory Comm. v. Motorola, Inc. (*In re* Iridium Operating L.L.C.), 373 B.R. 283, 293 (Bankr. S.D.N.Y. 2007) (the court stated that the public trading market "remains the best and most unbiased measure of fair market value and, when available to the Court, is the preferred standard of valuation").

judging the opinions of competing expert witnesses.[5] Professor Baird sums up the dangers of relying solely on trades in valuation disputes with the quip: "If the judge follows the market price at the same time those who trade in the market are following the judge, they will simply be chasing each other's tails."[6] This is a good point to recall in the difficult area of valuation.

In any event, both Professors Baird and Janger convincingly demonstrate the importance of subjecting claims trading to some form of regulation. In particular, Professor Janger shows that liquidity enhancement has been overvalued in the bankruptcy context.[7] Both professors correctly emphasize the importance and centrality of disclosure in any regulatory scheme. The bankruptcy judge is frequently asked to make decisions based on the views of the parties before him. Thus, when deciding whether to approve a compromise, the judge is directed to consider, among other things, "the paramount interest of the creditors and a proper deference to their reasonable views in the premises."[8] This is not to argue that we should simply accept the hue and cry of the majority, but as Professor Baird contends, we need to know who the creditors are.[9] Trading in claims and fragmentation of interests make it particularly hard to determine who owns what and whose position should be accorded weight.

If we accept the need for regulation of this large and active market, two pressing questions present themselves: what type of a regulatory structure is required and what is its scope? Unfortunately, neither professor has answered that question; nor did any of the other participants in the Symposium. In light of the present administration's determination to regulate so-called "exotic securities," the need for an answer has become even more compelling in the months since the Symposium took place.[10]

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5. *See In re* Granite Broad. Corp, 369 B.R. 120, 140–41 (Bankr. S.D.N.Y. 2007); *In re* Oneida, Ltd., 351 B.R. 79, 93 (Bankr. S.D.N.Y. 2006).

6. Baird, *supra* note 1, at 27.

7. For example, he cogently examines the decision of the District Court in the *Enron* case holding that in the name of liquidity enhancement, equitable subordination defenses do not run with the claim where the claim is "assigned." *See* Janger, *supra* note 1, at 55–56 (discussing Enron Corp. v. Springfield Assoc. (*In re* Enron Corp.), 379 B.R. 425 (S.D.N.Y. 2007), *vacating*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006)). In order to extend the principle of liquidity enhancement, the court's decision in *Enron* created a distinction between a sale and an assignment that has no basis in any law, including the Uniform Commercial Code, which does not distinguish between a sale and an assignment. *See*, *e.g.*, N.Y. U.C.C. LAW §§ 1-201(32), 9-408 (McKinney 2001); *see also* N.Y. U.C.C. LAW § 9-404(a) (McKinney 2001); N.Y. GEN. OBLIG. LAW § 13-105 (McKinney 1963).

8. *See*, *e.g.*, Wallis v. Justice Oaks II Ltd. (*In re* Justice Oaks II, Ltd.), 898 F.2d 1544, 1549 (11th Cir. 1990) (quoting Martin v. Kane (*In re* A & C Properties), 784 F.2d 1377, 1381 (9th Cir. 1986), *cert. denied*, 479 U.S. 854 (1986) (quoting *In re* Flight Transp. Corp. Sec. Litig., 730 F.2d 1128, 1135 (8th Cir. 1984), *cert. denied*, 469 U.S. 1207 (1985)).

9. Baird, *supra* note 1.

10. *See*, *e.g.*, David Cho & Zachary A. Goldfarb, *U.S. Pushes Ahead With Derivatives Regulation; First in Broad Overhaul: Rules on 'Dark Markets' That Fueled Meltdown*, WASH. POST, May 14, 2009, at A1 ("The Obama Administration yesterday unveiled a plan to regulate a

Derivatives and credit default swaps are usually included in the list of securities or instruments to be regulated, but there is no evidence to date that bankruptcy claims are on the agenda of the putative regulators.

In considering the kind of regulation and disclosure needed to make the bankruptcy process work properly, we must take account of the fact that we are writing on a fundamentally blank slate. There is virtually no regulation of the market for trading in bankruptcy claims at present, except for a few disclosure obligations discussed below. However, it is important to recognize that we have reached this point not because of a conscious decision to leave the market unregulated, but due to the absence of any decision.

There are many reasons why bankruptcy claims trading remains largely unregulated. While claims trading is as old as our nation,[11] the explosion of claims trading that has taken place in recent years is unprecedented. Professor Baird suggests that the current market is in "the hundreds of billions of dollars."[12]

There is also very little regulation in this area because the Bankruptcy Reform Act of 1978,[13] for unknown reasons, omitted the provisions of §§ 212[14] and 249[15] of the former Bankruptcy Act of 1898,[16] as well as former Bankruptcy Rules 10-211[17] and 10-215(c)(4),[18] which modified and supplemented them.[19] Thereafter, the only rule that survived under the Bankruptcy Code, and that was construed as a substantive regulation of claims trading, was Bankruptcy Rule 3001(e).[20] As adopted in 1983, Bankruptcy Rule 3001(e) left some room for the bankruptcy court to review

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vast market of exotic financial instruments known as derivatives, which fueled the global economic crisis and wounded some of the biggest names on Wall Street."); *see also* Edmund L. Andrews & Louise Story, *U.S. to Detail Plan to Rein in Finance World*, N.Y. TIMES, Mar. 26, 2009, at A1; Zachary A. Goldfarb, *Geithner Pushes Derivatives Plan; But He Warns Europe May Not Follow*, WASH. POST, July 11, 2009 at A10.

11. *See* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 25–26 (1990) (describing the trading of debt instruments issued by the states during and after the American Revolution).

12. Baird, *supra* note 1, at 23 n.1 (quoting Adam J. Levitin, Jr., *Finding* Nemo: *Rediscovering the Virtues of Negotiability in the Wake of* Enron, 2007 COLUM. BUS. L. REV. 83, 86 (2007).

13. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in scattered sections of 11 U.S.C.).

14. Bankruptcy Act of 1898, § 212, 30 Stat. 544 (codified at 11 U.S.C. § 612 (1976)) (repealed 1978).

15. Bankruptcy Act of 1898, § 249, 30 Stat. 544 (codified at 11 U.S.C § 649. (1976)) (repealed 1978).

16. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978).

17. FED. R. BANKR. P. 10-211 (1973) (repealed 1978).

18. FED. R. BANKR. P. Bank R. 10-215(c)(4) (repealed 1983).

19. Fortgang & Mayer, *supra* note 11, at 27–28. These provisions dealt principally with trading in claims by fiduciaries. *Id.*

20. *See* FED. R. BANKR. P. 3001(e) (1991).

the circumstances of the transfer of a claim.[21] Originally, Bankruptcy Rule 3001(e) required that evidence of a claim transfer, together with evidence of the terms of the transfer, had to be filed with the bankruptcy court.[22] The Rule also stated that "[i]f 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."[23]

This Rule was largely ministerial. The filing of the required information with respect to the transfer disclosed the identity of the holder of the claim and the consideration paid. It also made clear the identity of the creditor for the purposes of voting and distribution.[24] However, the Advisory Committee Note to the Rule indicated that some degree of court oversight was intended, when it stated:

> The interests of sound administration are served by requiring the post-petition transferee to file with the proof of claim a statement of the transferor acknowledging the transfer and the consideration for the transfer. Such a disclosure will assist the court in dealing with the evils that may arise out of post-bankruptcy traffic in claims against an estate.[25]

After the adoption of the amended Rule in 1983, decisions began to deal with the perceived "evils" of this "traffic"[26] by entities that were not insiders or fiduciaries. One of the first cases was *In re Revere Copper and Brass, Inc.*, where a trader had purchased claims at 20 cents on the dollar near the time the debtor publicly announced its intention to propose a plan that would pay 65 cents in cash.[27] Although there were no objections to the notices of claims' transfer under former Bankruptcy Rule 3001(e)(2), the court refused to grant routine approval to the transfers and required that the creditors be given more information and the right to rescind their sales.[28]

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21. *See* FED. R. BANKR. P. 3001(e) (1983) (amended 1991) (the 1983 version of the Rule was adapted from Bankruptcy Rules 301 and 302 of the Bankruptcy Act of 1898).

22. *Id.* The Rule excepted claims "based on a publicly traded note, bond or debenture" and thus preserved the unimpeded transferability of these securities. *Id.* The Rule also set out different procedures for the transfer of claims for security and the transfer of claims before and after a proof of claim had been filed in court. *See id.*

23. *Id.*

24. *See id.*

25. *Id.* advisory committee's note. The Advisory Committee Note cited several cases that illustrated such "evils," all of which involved a breach of fiduciary duty by insiders or fiduciaries, including: *In re* Phila. & W. Ry. Co., 64 F. Supp. 738 (E.D. Pa. 1946); Monroe v. Scofield (*In re* Gallic-Vulcan Mining Corp.), 135 F.2d 725 (10th Cir. 1943); *cf. In re* Latham Lithographic Corp., 107 F.2d 749 (2d Cir. 1939).

26. FED. R. BANKR. P. 3001(e) advisory committee's note (1983) (amended 1991).

27. *In re* Revere Copper & Brass, Inc., 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985).

28. *Id.*

Echoing the Advisory Committee Note to Bankruptcy Rule 3001(e)(2), the court wrote:

> One of the evils attendant upon a solicitation of assignment of claims for a cash payment such as is being made by [the assignee] is that solicited creditors may be unaware of their rights and options and fall prey to the belief that bankruptcy inevitably will result in their receiving the proverbial 10 cents on the dollar or worse.[29]

Another case that illustrated the developing law was *In re Allegheny International, Inc.*,[30] where the court, faced with an active trading market and incomplete public information on the status of the case,[31] "echo[ed] the concerns expressed in *In re Revere Copper and Brass, Inc.*" by imposing on the debtor "the duty of advising the potential assignor of the debtor's estimate of the value of the claim. . . . until such time as a new plan of reorganization and disclosure statement are filed."[32] The court expressed its concerns stating:

> We do not believe that Congress intended the trafficking in claims such as has occurred in this case and others. Such concerns are evident from the 1983 Advisory Committee Note, although we recognize that the cases cited therein involved breaches of fiduciary duty . . . . Although this case does not involve inside knowledge, it is colored with superior knowledge, and thus the assignments are similar to contracts of adhesion. We hope that Congress will address these concerns in the future.[33]

Congress did not act to address these concerns positively. Rather, it responded to the *Revere* and *Allegheny* courts' apparent concerns regarding the application of Bankruptcy Rule 3001(e) by amending it to remove any disclosure requirement pertaining to the price at which a transfer was made and expressly "limit the court's role to the adjudication of disputes regarding transfers of claims."[34] The language in the prior Advisory Committee note relating to the "evils that may arise out of post-bankruptcy

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29. *Id.* at 2.

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

31. *Id.*

32. *Id.* at 242–44. See also the court's later decision in *In re Allegheny Int'l*, *Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

33. *In re Allegheny Int'l Inc.*, 100 B.R. at 243. In *In re Ionosphere Clubs, Inc.*, involving the bankruptcy of Eastern Air Lines, the court found the *Revere* and *Allegheny* decisions inapposite, because the transferor and transferee were both sophisticated institutions with adequate information. *In re* Ionosphere Clubs, Inc., 119 B.R. 440, 446 (Bankr. S.D.N.Y. 1990). The court canvassed the "evils" spawned by claims trading in large cases and expressed concern that the action of the parties there, in partially assigning claims, imposed on the debtors "the substantially increased burden associated with monitoring, administering and objecting to claims which have been filed against the estate." *Id.* at 444.

34. FED. R. BANKR. P. 3001(e) advisory committee's note (1991) (amending FED. R. BANKR. P. 3001(e) (1983)); *see also* Fortgang & Mayer, *supra* note 11, at 41–43.

traffic in claims"[35] was deleted and effectively overridden by the new Advisory Committee Note which stated that amended Bankruptcy Rule 3001(e) "is not intended either to encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under *nonbankruptcy* law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim."[36] In other words, the bankruptcy courts were told to keep out of the claims trading arena. Except in the few areas discussed below, and despite the enormous increase in bankruptcy claims trading since 1991, there have been no new decisions on the order of *Revere* or *Allegheny*.

Although there is no official report of the deliberations of the Rules Committee that recommended the amendments to Bankruptcy Rule 3001(e),[37] it was suggested at the Symposium that the Committee may have viewed a ministerial rule like 3001(e) as being unable to deal with difficult and controversial policy issues, such as what a judge's role should be in connection with the transfer of claims and what should be disclosed.[38] The Rules Committee may have viewed the issues as appropriate for consideration by Congress, or perhaps the Securities Exchange Commission (SEC). Such a view is consistent with the express hope of the *Allegheny* court that Congress would deal with the issue.[39] Nevertheless, after 1991, neither Congress, the SEC, nor any other group took up the task of addressing the issues of the judge's role and the scope of appropriate disclosure concerning claims trading. The period from 1991 until 2008 was not conducive to the promotion of regulation in any sphere. As a result, there is virtually no regulation governing the market for bankruptcy claims.

This is not to say that there is no involvement at all by the bankruptcy courts that bears on some of the claims trading issues raised by Professors Baird and Janger. However, with the exception indicated below, most of the courts' involvement has dealt with the effects of claims trading.[40] The questions presented in such a situation often turn on whether a creditor has economic interests that are adverse to the class in which it votes.[41]

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35. FED. R. BANKR. P. 3001(e) advisory committee's note (1983) (amended 1991).

36. FED. R. BANKR. P. 3001(e) advisory committee's note (1991) (amending FED. R. BANKR. P. 3001(e) (1983)) (emphasis added).

37. The amendments became effective in 1991.

38. Remarks at the Brooklyn Journal of Corporate, Financial & Commercial Law & the Dennis J. Block Center for the Study of International Business Law Symposium: Bankruptcy Claims Trading and Securities Regulation (Feb. 27, 2009).

39. *See In re* Allegheny Int'l Inc, 100 B.R. 241, 243 (Bankr. W.D. Pa. 1988).

40. For example, the Bankruptcy Code provides that the court may, after notice and a hearing, invalidate the vote of "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" the Bankruptcy Code. *See* 11 U.S.C. §1126(e) (2006).

41. Some of the issues arising out of extensive trading in distressed debt are discussed in *In re Adelphia Commc'n Corp.*, 359 B.R. 54 (Bankr. S.D.N.Y. 2006).

The sole exception to the absence of any regulation or rule-making is Bankruptcy Rule 2019.[42] The rule originated in the 1930's and in its current form requires the disclosure of certain information from informal or ad hoc committees of creditors.[43] Until the decisions in the *Northwest Airlines* case in 2007, Rule 2019 was rarely enforced.[44] The claims trading community responded negatively to the *Northwest* decisions, and it urged the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States to eliminate the Rule altogether.[45] However, in July 2009, the Committee instead recommended the adoption of a revised Rule 2019 that preserves the principle of disclosure while meeting some of the traders' principal concerns.[46] While the current proposed revision deletes some of the required disclosures, it also strengthens the Rule by making it applicable to both official and unofficial creditor committees.[47] As of August 2009, the revised rule has been published for public comment.[48] The proposed amendments to Rule 2019 are a useful reference point as we approach the issue of regulation.

There was never a conscious decision that the enormous market in bankruptcy claims should not be regulated. In my opinion, it should be. Along with Professors Baird and Janger, the other participants in the Symposium have ably started the dialogue on this important issue. It is time that Congress turned its attention to it in a comprehensive fashion.

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42. FED. R. BANKR. P. 2019.

43. *See id.*

44. *See In re* Northwest Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *see also In re* Northwest Airlines Corp., 363 B.R. 704 (Bankr. S.D.N.Y. 2007). The decisions applied the disclosure requirements to an informal committee of security holders and refused to provide for the disclosure to be made under seal. *In re Northwest Airlines*, 363 B.R. 701; *In re Northwest Airlines*, 363 B.R. 704. (For full disclosure, these decisions were written by the author of this Comment).

45. *See* Letter from Ira Hammerman, Senior Managing Dir. & Gen. Counsel, Sec. Indus. & Fin. Markets Ass'n, to Peter G. McCabe, Comm. of Rule of Practice & Procedure of the Judicial Conference of the U.S. (Nov. 30, 2007), *available at* http://www.uscourts.gov/rules/BKSuggestions2007/07-BK-G-.pdf.

46. *See* FED. R. BANKR. P. 2019 (Proposed Amendments 2009), *available at* http://www.uscourts.gov/rules/proposed0809/BK_Rules_Forms_Amendments.pdf.

47. *Id.*

48. U.S. Courts, *Rules Published for Comment*, http://www.uscourts.gov/rules/newrules1.htm (comments are due by Feb. 16, 2010).