CLAIMS AND CONTROL IN CHAPTER 11 CASES: A CALL FOR NEUTRALITY*

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Trading in claims in chapter 11 cases has become *cause célèbre* within the bankruptcy bar in recent years. Claims trading has been a topic at the New York University Workshop on Bankruptcy and Business Reorganization for the last two years, and has been the focus of numerous seminars and law review articles.[1] The debate over the merits and demerits of trading in claims has been fueled by the growing market for debt securities of troubled companies, the market for trade claims against debtors, and, in part, by Japonica Partners' successful attempt to obtain control of Allegheny International, Inc. through the acquisition of claims against that debtor.

The existence of a market for claims, whether debt securities or trade claims, can provide substantial benefits to creditors, and to a debtor. The benefits for creditors are obvious. The automatic stay prevents creditors from pursuing payment remedies against the debtor with respect to their prepetition claims.[2] Creditors, particularly unsecured creditors who generally have no right to obtain relief from the automatic stay, may be forced to wait years for payment from the debtor's estate under a plan of reorganization. Access to a market for claims provides creditors with an opportunity to convert their claims into cash which may be needed to pay expenses. A claims market also

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 Fried, Frank, Harris, Shriver & Jacobson acted as bankruptcy counsel to Japonica Partners. The views set forth herein are the authors' and the authors do not purport to express the views of the Advisory Committee on Bankruptcy Rules, Japonica Partners or Sunbeam-Oster Company, Inc., successor to the debtor Allegheny International, Inc.

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1 *See, e.g.*, TRADING IN CLAIMS AGAINST CHAPTER 11 DEBTORS: INVESTMENT & CONTROL ISSUES (P.L.I. 1991) (Com. L. & Prac. Course Handbook, Series No. 569); Mayerson & Sarachek, *Trading Claims: The New Bankruptcy Game, Any Number Can Play*, in BANKRUPTCY DEVELOPMENTS FOR WORKOUT OFFICERS AND LENDERS COUNSEL 1990 (P.L.I. 1990) (Com. L. & Prac. Course Handbook, Series No. 547); 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).

2 11 U.S.C. § 362(a) (1988).

permits a creditor to shift the risks inherent in chapter 11 cases—risks that the debtor's business (and recoveries in the chapter 11 case) will continue to decline or that distributions will be delayed substantially—to a party more willing to accept that risk.

The debtor may benefit as well. To the extent that key suppliers can mitigate the adverse effect of a customer's bankruptcy filing, the supplier may be more willing to extend credit postpetition.[3] As noted by Messrs. Fortgang and Mayer,[4] postpetition investors who pay cash for claims and accept securities or equity under a plan perform a capital-raising function. The investor's willingness to take debt securities or equity in lieu of a cash distribution reduces the pressure on a debtor to sell assets in a chapter 11 case. Further, the reorganization process may be improved by the entry of "new money" creditors who, having invested significant sums postpetition, are generally more willing to commit the time and expense involved in taking an active role in a chapter 11 case.

Notwithstanding the benefits provided by markets for claims, the debate over trading in claims has included calls for regulation, restriction, limitation, or prohibition of trading in claims in chapter 11 cases. Messrs. Fortgang and Mayer have written at length on the subject,[5] and urge that the Bankruptcy Code and/or Rules be amended to restrict or regulate claims trading. In support of this position they suggest that "unwitting" claims sellers should be protected from the "solicitation" of claims by purchasers[6] who do not provide the type of information required in section 1125 of the Bankruptcy Code (the "Code"). Further, they contend that the purchase of claims by an entity that intends to file, or has filed, a plan of reorganization is, in effect, a plan of reorganization.[7] Although there is case law which would support the position taken by Messrs. Fortgang and Mayer, an examination of the courts' reasoning in those cases, the history of claims trading under the Bankruptcy Act, and the economic realities underlying the transactions indicates that the Bankruptcy Code and

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3 Where the debtor's business is operated, 11 U.S.C. § 364(a) authorizes the debtor in possession or trustee to obtain unsecured credit in the ordinary course of business. Trade debt incurred in the ordinary course of business is entitled to priority as an administrative expense under 11 U.S.C. § 507(a).

4 Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 8 (1990) [hereinafter Fortgang & Mayer, *Trading Claims*].

5 *See* Fortgang & Mayer, *Trading Claims*, *id.*; Fortgang & Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991) [hereinafter Fortgang & Mayer, *Developments*].

6 Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 56.

7 *Id.* at 77-86; Fortgang & Mayer, *Developments*, *supra* note 5, at Epilogue.

Bankruptcy Rules are properly neutral on the question of trading in claims.

I. REGULATION OF TRADING UNDER BANKRUPTCY RULE 3001(e)

Congress has not acted to regulate the trading of claims, except to the extent that the purchase and sale of debt securities may be regulated by federal securities laws.[8] Nothing in the Bankruptcy Code specifically addresses the trading or transfer of claims. Bankruptcy Rule 3001(e) sets forth the procedure required for transfers of claims other than claims based on bonds or debentures. However, neither this rule, nor any of the Bankruptcy Rules can abridge, enlarge, or modify any substantive right.[9]

The current form of Bankruptcy Rule 3001(e),[10] effective as of

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8 Explanation of the regulation of trading in debt securities by the federal securities laws is beyond the scope of this article. The potential for conflict between the regulation of claims trading under the securities laws and regulation of claims trading, if any, under the Bankruptcy Code, however, may raise interesting questions. Further, to the extent that resolution of any such conflict or question requires consideration of both the Bankruptcy Code and the federal securities laws, the matter must be heard by the district court, not the bankruptcy court. *See* 28 U.S.C. § 157(d) (1988).

9 28 U.S.C. § 2075 (1988).

10 The revised version of Rule 3001(e) (with deletions from the prior version bracketed and new language italicized) reads as follows:

(e) TRANSFERRED CLAIM.

(1) [Unconditional] *Transfer of Claim Other than for Security Before Proof Filed.* If a claim [other than one based on a bond or debenture] has been [unconditionally] 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.* [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 therefor 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 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 [unconditionally] 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 [original claimant] *alleged transferor* by mail of the filing of the evidence of 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 *alleged transferor files a timely objection and the* court finds, after *notice and* a hearing [on notice], that the claim has been [unconditionally] transferred *other than for security,* it shall enter an order substituting the transferee for the *transferor* [original claimant, otherwise the court shall enter such order as may be appropriate]. *If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.*

(3) *Transfer of Claim for Security Before Proof Filed.* If a claim other than

August 1, 1991,[11] streamlines the transfer process and emphasizes that the Rule is procedural only.[12] No order is required for transfer unless the alleged transferor objects. In the context of transfer of claims, the issue is limited to whether there has been a transfer of a claim from the alleged assignor to the assignee. Accordingly, the

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one based on a *publicly traded note*, bond, or debenture has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer. [If the claim was transferred after the filing of the petition, the proof shall also be supported by (A) a statement of the transferor acknowledging the transfer and stating the consideration therefor, 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.] If either the transferor or the transferee files a proof of claim, the clerk shall immediately notify the other by mail of the right to join in the filed claim. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. *If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate on motion by a party in interest and after notice and* [After] a hearing [on notice], the court shall enter such orders respecting *these matters* [allowance and voting of the claim, payment of dividends thereon, and participation in the administration of the estate] as may be appropriate.

(4) *Transfer of Claim for Security After Proof Filed.* If a claim other than one based on a *publicly traded note*, bond, or debenture has been transferred 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 [original claimant] *alleged transferor* by mail of the filing of the evidence of 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 a timely objection is filed by the alleged transferor, the court, after notice and a hearing, shall determine whether the claim has been transferred for security. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and* [After] a hearing [on notice], the court shall enter such orders respecting *these matters* [allowance and voting of the claim, payment of dividends thereon, and participation in the administration of the estate] as may be appropriate.

(5) *Service of Objection or Motion; Notice of Hearing.* A copy of an objection [to the evidence of transfer] filed pursuant to paragraph (2) or (4) *or a motion filed pursuant to paragraph (3) or (4)* of this subdivision together with a notice of a hearing shall be mailed or otherwise delivered to the *transferor or* transferee, *whichever is appropriate*, at least 30 days prior to the hearing.

H.R. Doc. No. 102-80, 102d Cong., 1st Sess. 306-10 (1991) (as amended August 1, 1991).

[11] Pursuant to 28 U.S.C. § 2075 (1988), the Bankruptcy Rules prescribed by the Supreme Court cannot take effect until ninety days after they have been reported to Congress by the Chief Justice. A vote of both the Senate and the House of Representatives is required to block the effectiveness of the Bankruptcy Rules so reported.

[12] Nothing in the revised version, or even in the prior version, of Bankruptcy Rule 3001(e) requires or required that the procedure be followed to have a legally effective transfer of the claim. Nor would anything in the Code or Rules prohibit the assignor and assignee from agreeing that the assignor will act as the agent of the assignee for purposes of voting and collecting distributions. Indeed, it is similar to a bank selling a participation in a loan.

amended Rule makes clear that the alleged transferor is the only party with standing to challenge whether the transfer has been made. Further, the terms of the transfer need not be filed. Where supplementary information relating to the transfer is relevant to an issue before the court, that information can be obtained through standard discovery procedures. Under the Bankruptcy Code, the bankruptcy court is intended to be an impartial arbiter of disputes, removed from the day-to-day details of administering the case. Amended Bankruptcy Rule 3001(e) is consistent with the Code's policy requiring involvement by the court only where a dispute exists.[13]

The need for change in Bankruptcy Rule 3001(e) arose in several contexts. First, a number of courts had used the prior formulation of Rule 3001(e)—where evidence of the terms of the transfer and court approval of the transfer were required—as a springboard for creating case-specific conditions precedent to court approval of the assignment of claims. Courts cited the literal language of the prior rule requiring court approval of certain transfers as a source for authority to regulate claims trading, notwithstanding Congress's admonition that the power to prescribe rules of bankruptcy procedure was not to abridge, enlarge, or modify any substantive right. Second, revised Bankruptcy Rule 3001(e) specifies when compliance with its procedures is not required: if the "claim" in question is evidenced by a publicly traded bond or debenture.

A. *Historical Development of Rule 3001(e)*

Bankruptcy Rule 3001(e) derives from General Order XXI(3) "which specified the procedure . . . until the adoption of the Bankruptcy Rules by the Supreme Court in 1975."[14] Pursuant to General

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[13] The Advisory Committee Note to amended Rule 3001 explains:

> *Subdivision (e)* is amended to limit the court's role to the adjudication of disputes regarding transfers of claims. If a claim has been transferred 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. If a claim has been transferred other than for security after a proof of claim has been filed, . . . the court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law. This rule is not intended either to encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.

H.R. Doc. No. 102-80, 102d Cong., 1st Sess. 311 (1991).

[14] General Order XXI(3) provided:

> Claims which have been assigned before proof shall be supported by a deposition of the owner at the time of the commencement of proceedings, setting forth the true consideration of the debt and that it is entirely unsecured, or if secured, the security, as is required in proving secured claims. Upon the filing of satisfactory

Order XXI(3) only proof of assignment, and not "evidence of the terms of the transfer," was to be filed. The reference to a deposition "setting forth the true consideration of the debt" in the first sentence of General Order XXI(3) relates to the underlying claim, not to the transfer itself.[15] The Rules of Bankruptcy Procedure, adopted in 1975, elaborated on the General Order to distinguish between unconditional transfers and transfers for security.[16]

Following the effective date of the Bankruptcy Reform Act of

> proof of the assignment of a claim proved and entered on the referee's docket, the referee shall immediately give notice by mail to the original claimant of the filing of such proof of assignment; and, if no objection be entered within ten days, or within further time allowed by the referee, he shall make an order subrogating the assignee to the original claimant. If objection be made, he shall proceed to hear and determine the matter.

General Order XXI(3), 89 F. (iii), (ix)-(x) (1898).

15 The Advisory Committee Note to Bankruptcy Rule 302(d), which replaced General Order XXI(3), stated:

> When a claim is assigned after bankruptcy but before a proof of the claim is filed, General Order 21(3) has required the proof to be accompanied by an affidavit of the assignor who held the claim at the date of bankruptcy. The affidavit duplicates in considerable part the information required to be included in the proof of claim.

BANKR. R. 302(d) advisory committee note, 11 U.S.C. app. at 470 (Supp. V 1975).

16 Rules 302(d) and 10-401(c) of the Rules of Bankruptcy Procedure provided:

> 302(d) TRANSFERRED CLAIM.
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> (1) *Unconditional Transfer Before Proof Filed.* If a claim has been unconditionally transferred before proof of the claim has been filed, the proof of such claim may be filed only by the transferee. If such claim has been transferred after the filing of the petition, it shall be supported by (A) a statement of the transferor acknowledging the transfer and stating the consideration therefor or (B) a statement of the transferee why it is impossible to obtain such a statement from the transferor.
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> (2) *Unconditional Transfer After Proof Filed.* If a claim has been unconditionally transferred after proof thereof has been filed, proof of the terms of the transfer shall be filed, and the court shall immediately notify the original claimant by mail of the filing of such proof of transfer and that objection thereto, if any, must be made within 10 days of the mailing of the notice or within such further time as the court may allow. If the court finds, after hearing if necessary, that the claim has been unconditionally transferred, it shall make an order substituting the transferee for the original claimant. If it does not so find, the court shall make such order as may be appropriate.
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> (3) *Transfer of Claim for Security Before Proof Filed.* If a claim has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer and, if the claim was transferred after the filing of the petition, by (A) a statement of the transferor acknowledging the transfer and stating the consideration therefor, or (B) a statement of the transferee why it is impossible to obtain such a statement from the transferor. If either the transferor or the transferee files a proof of claim, the court shall immediately notify the other by mail that he may join in the claim so filed. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. After hearing if necessary, the court shall make such orders respect-

1978,[17] the Rules of Bankruptcy Procedure were modified, and Rule 3001(e) was adopted. If the language included in the prior version of Bankruptcy Rule 3001(e) provided courts with a springboard for regulating claims trading, the leaping off point was the Advisory Committee Note to that Rule. The Note provided:

> *Subdivision (e).* The rule recognizes the differences between an unconditional transfer of a claim and a transfer for the purpose of security and prescribes a procedure for dealing with the rights of the transferor and transferee when the transfer is for security. The rule clarifies the procedure to be followed when a transfer precedes or follows the filing of the petition. The interests of sound administration are served by requiring the post-petition transferee to file with the proof of claim a statement of the transferor acknowledging the transfer and the consideration for the transfer. Such a disclosure will assist the court in dealing with evils that may arise out of post-bankruptcy traffic in claims against an estate. *Monroe v. Scofield*, 135 F.2d 725 (10th Cir. 1943); *In re Philadelphia & Western Ry.*, 64 F. Supp. 738 (E.D. Pa. 1946); *cf. In re Latham Lithographic Corp.*, 107 F.2d 749 (2d Cir. 1939).[18]

The cases cited by the Advisory Committee do not suggest that claims trading is inherently "evil." Instead, the cases address issues properly considered by a bankruptcy court: the allowance of claims purchased by fiduciaries during the pendency of the bankruptcy case and the voting of claims where only part of the claim is sold. This is in contrast to the "evils" addressed by bankruptcy courts under Bankruptcy Rule 3001(e).

> ing allowance and voting of the claim, payment of dividends thereon, and participation in the administration of the estate as may be appropriate.
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> (4) *Transfer of Claim for Security After Proof Filed.* If a claim has been transferred for security after proof thereof has been filed, proof of the terms of the transfer shall be filed, and the court shall immediately notify the original claimant by mail of the filing of such proof of transfer and that objection thereto, if any, must be made within 10 days of the mailing of the notice or within such further time as the court may allow. After hearing if necessary, the court shall make such orders respecting allowance and voting of the claim, payment of dividends thereon, and participation in the administration of the estate as may be appropriate.

BANKR. R. 302(d), 11 U.S.C. app. at 469-70 (Supp. V 1975) (repealed 1983).

10-401(c). TRANSFER OF CLAIM.

> If a claim other than one founded on a bond or debenture has been assigned, a statement setting forth the terms of the assignment shall be filed with the court and a copy thereof delivered to the trustee or the debtor in possession.

BANKR. R. 10-401(c), 11 U.S.C. app. at 563 (Supp. V 1975) (repealed 1983).

17 Pub. L. No. 95-598, 92 Stat. 2549 (1978).

18 BANKR. R. 3001 advisory committee note, 11 U.S.C. app. at 247 (1988). A virtually identical statement was made in the Advisory Committee Note to Rule 302(d) of the Rules of Bankruptcy Procedure. *See* 11 U.S.C. app. at 470 (Supp. V 1975).

B. *Judicial Regulation of the Evils of Trafficking in Claims*

Courts, citing their authority under the prior version of Bankruptcy Rule 3001(e), have identified a number of "evils" associated with claims trading. An examination of these purported "evils," however, suggests that court-developed restrictions reflect either a paternalistic attitude towards claimants in bankruptcy cases, or an overall dislike for claims transfers in general, rather than a desire to protect against a true disruption of chapter 11 process. The difficulties identified by the bankruptcy courts bear little resemblance to those identified in the cases cited by the Advisory Committee in 1975 and 1983, or in the extensive case law developed under the Bankruptcy Act.[19] Further, judicially fashioned remedies unnecessarily create further uncertainty. In instances where claims transfers may confuse the process of voting on a plan, Rule 3001(e) itself suggests the remedy.

1. *Protection of the Unwitting Seller*

Judge Abram in *In re Revere Copper and Brass, Inc.*[20] and Judge Cosetti in *In re Allegheny International, Inc.*[21] expressed concern that creditors were solicited to sell their claims without receiving sufficient information to make an informed judgment about the offer. They therefore found authority under Bankruptcy Rule 3001(e) to require that information regarding the current status of the chapter 11 case be provided to claimants. Each of the courts also gave transferring claimants an opportunity to rescind the claim transfers.

Judge Abram in *Revere* expressed concern that solicited creditors may be unaware of their rights and options, or of the differences between chapter 7 and chapter 11 cases, and could "fall prey to the belief that bankruptcy inevitably will result in their receiving the proverbial 10 cents on the dollar or worse."[22] The court went on to note that solicitation of acceptances and rejections of a plan is prohibited unless accompanied by a disclosure statement containing sufficient information to enable a hypothetical reasonable investor to make an informed judgment about the plan. Although the court declined to hold that a disclosure statement as contemplated by Bankruptcy Code section 1125[23] is required before an entity may purchase claims, Judge

19 *See infra* Part II(B)-(C).

20 58 Bankr. 1 (Bankr. S.D.N.Y. 1985).

21 100 Bankr. 241 (Bankr. W.D. Pa. 1988).

22 *In re Revere*, 58 Bankr. at 2.

23 11 U.S.C. § 1125(b) provides that an acceptance or rejection of a plan may not be solicited after commencement of a chapter 11 case unless at the time of, or prior to such solicitation, there is transmitted to the holder of a claim or interest a disclosure statement approved by the bankruptcy court as containing "adequate information." "Adequate information" is

Abram did hold that the purchaser was required to provide claimants with sufficient information to enable the claimant to make an informed judgment about the offer.[24]

In *Allegheny*, Judge Cosetti echoed the concerns voiced by Judge Abram, but went further in his condemnation of claims trading. The court expressed the view that the process by which claims are solicited constitutes solicitation under section 1125(b) of the Bankruptcy Code, but provides no information. The process, therefore, unfairly permits a third party to do something which the debtor cannot: pay cash to prepetition suppliers outside the constraints of a confirmed plan.[25] Further, Judge Cosetti found that although the claims purchases did not involve a breach of fiduciary duty or the use of inside information, they were "colored with superior knowledge, and thus the assignments [were] similar to contracts of adhesion."[26] He then proceeded to adopt a procedure which required the debtor to provide the potential assignor with the debtor's best estimate of the value of the assignor's claim.[27]

Fortgang and Mayer cite the *Revere* and *Allegheny* decisions with approval, and urge courts to "preserve the integrity of the bankruptcy process through the zealous protection of those who need it without chilling the markets for chapter 11 claims by judicially freezing transactions between responsible parties who can take care of themselves."[28] However, the underpinnings of the decisions in *Revere* and *Allegheny* are open to serious question.

Purchase and sale of claims, so long as the purchaser is not the debtor, an affiliate of the debtor, or an insider,[29] simply substitutes one creditor for another. The selling creditor is not being asked to waive its rights in favor of junior classes or to accept the risks and/or benefits pursuant to a plan which permanently alters the rights of creditors. Instead, the right to make those decisions and the risks inherent in bankruptcy proceedings are merely shifted to another who

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defined in 11 U.S.C. § 1125(a)(1) as information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would permit a hypothetical reasonable investor to make an informed judgment about the plan. That section also states that adequate information need not include information about any other possible or proposed plan. 11 U.S.C. § 1125 (1988).

24 *In re Revere*, 58 Bankr. at 3.

25 *In re Allegheny*, 100 Bankr. at 243.

26 *Id.*

27 *Id.* at 244. The court went on to grant the debtor permission to provide such information, and further stated that the debtor would be held harmless from claims arising from such disclosure.

28 Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 56.

29 *See discussion infra* Part II(B).

stands in the shoes of the original claimant.[30] The solicitation to sell is not a specific request for acceptance or rejection of a plan which is barred by section 1125(b) of the Code.[31]

Further, the perceived lack of information upon which sellers could otherwise make an informed judgment, and the unfairness of the purchasers' "superior knowledge" may be more apparent than real. Prior to bankruptcy, trade creditors must decide whether to extend credit to their customers based on information available through Dun and Bradstreet and similar services, public filings with the SEC for those companies subject to the reporting requirements of the Securities Exchange Act of 1934, and any other information they are able to obtain regarding their customers. These sources of information continue to be available after the filing of a chapter 11 case.[32] In addition, monthly reports and copies of any pleadings filed are a matter of public record. Creditors frequently contact the debtor or representatives of official committees appointed pursuant to section 1103 of the Code[33] to inquire into the status of the case. Creditors who care to expend the time and effort can inform themselves as to the status of the case and the treatment of their claim under any plan then proposed.

The fact that selling creditors may choose not to avail themselves of information does not make claims purchasers' "superior knowledge" inherently unfair.[34] A free market economy frequently rewards those who through their own diligence obtain "superior knowledge." Further, the sometimes unpredictable risks in chapter 11 cases may raise doubts as to whether claims purchasers' knowledge is truly superior. Claims purchasers are often the losers in the transactions. The evaluation of whether sale of a claim makes sense is in large part a matter of the claimant's circumstances. Selling creditors may have informed themselves about the benefits and risks of the chapter 11 case and decided to sell on that basis, or may have decided that the cost of making that investigation was not warranted in light of the price offered for the claim. There is no statutory authority for a bank-

30 *See discussion infra* Part II(B)(1)-(2).

31 *See* Century Glove, Inc. v. First Am. Bank of N.Y., 860 F.2d 94, 101 (3d Cir. 1988); *see also infra* Part III(B)(3).

32 Claims trading is virtually unheard of in chapter 7, 12, or 13 cases, and relatively rare in cases where the debtor is not subject to the reporting requirements of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78*ll* (1988), where the universe of potential purchasers has difficulty in obtaining current financial information during the bankruptcy case.

33 11 U.S.C. § 1103 (1988).

34 A different rule may apply where the purchaser is an officer, director or insider of the debtor, or is a fiduciary to creditors by reason of serving on an official committee. *See discussion infra* Part II(B)-(C).

ruptcy court to interpose itself in a private transaction, where neither of the affected parties questions the validity of the assignment.

Finally, the bankruptcy court's jurisdiction or authority to adjudicate the "fairness" of the transaction either sua sponte or on the motion of the debtor, or even a trustee, is doubtful at best. As originally introduced in Congress, H.R. 8200 would have given the trustee the power to bring actions on behalf of creditors of the estate against third parties.[35] That provision, however, was deleted in the final version passed by Congress.[36] When the court entertains objections to the transfer from the debtor based on "fairness" or lack of "adequate information" without any objection from the transferor, it is in effect permitting the debtor, exercising the power of the trustee,[37] to bring an action on behalf of a creditor against a third party—in circumstances where the creditor has not requested it! Congress considered whether a trustee or debtor should have the authority to bring that type of action, and whether the bankruptcy courts should entertain such actions, and determined that the jurisdiction of the bankruptcy court should not be expanded to permit adjudication of causes of action between non-debtor parties.[38] Clearly, Congress did not intend that bankruptcy courts use the Bankruptcy Rules, which are intended to address matters of procedure only, to circumvent a policy decision by Congress and controlling Supreme Court precedent on this issue.[39]

2. *Protection of the Bankruptcy Process*

Section 1126(a)[40] of the Code, and Bankruptcy Rule 3018(a)[41] permit holders of claims allowed under section 502[42] of the Code to accept or reject a plan. Bankruptcy Rule 3021 similarly provides for distribution to creditors whose claims have been allowed.[43] Bankruptcy Rule 3001(e) sets up a mechanism for tracking claims where an individual proof of claim must be filed. Viewed as a whole, Rule

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35 Section 544(c) of H.R. 8200 provided for this power. *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 370-71 (1977), *reprinted in* 1978 U.S. CODE CONG & ADMIN. NEWS 5963, 6326. The Bankruptcy Reform Act of 1978 is a revised version of H.R. 8200.

36 124 CONG. REC. S17413 (daily ed. October 6, 1978).

37 11 U.S.C. § 1107 (1988).

38 *Cf.* 11 U.S.C. § 510(c) (1988) (permiting the court to order a claim subordinated for purposes of distribution).

39 Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972) (chapter X trustee precluded from enforcing a claim against an indenture trustee for misconduct on behalf of indenture holders).

40 11 U.S.C. § 1126(a) (1988).

41 BANKR. R. 3018(a), H.R. DOC. NO. 102-80, 102d Cong., 1st Sess. 87 (as amended August 1, 1991).

42 11 U.S.C. § 502 (1988).

43 BANKR. R. 3021, 11 U.S.C. app. at 256 (1988).

3001(e) is designed to facilitate determining which creditors are entitled to either vote on a plan, or to receive distributions under it. Accordingly, where claims transfers would interfere with this purpose, or might destroy the value of assets of the estate, courts may act to protect against material erosion of the value of the debtor's estate, subject to the usual burden of proof and evidentiary requirements inherent in judicial action. Again, however, where Congress has chosen not to regulate the trading of claims, courts should not attempt to do so under the guise of a procedural rule.

a. *Protection of Tax Attributes or Estate Assets*

Tax attributes in the form of net operating loss and certain credit carryforwards (all referred to herein as "NOLs") frequently constitute a significant asset in the debtor's estate. Under the federal tax laws, losses from prior years may be used by a corporation to offset income earned in later years, thereby reducing the corporation's federal tax liability. In certain circumstances, claims trading may limit or impair the value of the debtor's NOLs and, concomitantly, the debtor's estate. Messrs. Fortgang and Mayer suggest that in circumstances where a debtor's NOLs may be impaired as a result of transfers of claims or stock, the corporation may attempt to restrict trading in its claims and/or stock during the bankruptcy case.[44] However, they fail to point to any statute or common law right which would be violated by the trading of claims. The authority of the bankruptcy court to enjoin trading is therefore unclear.

As noted above, nothing in the Bankruptcy Code specifically prohibits or regulates the transfer of claims. Even where such transfer may affect the value of the debtor's NOLs, the transfer would not fall within the express prohibitions of the automatic stay.[45] One possible basis for enjoining claims trading is section 105(a) of the Bankruptcy Code which provides that the bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[46] The statutory language suggests that exercise of the court's power under section 105(a) must be tied to another Code section. Courts have sometimes construed the section more broadly to permit an injunction to issue without violation of a statute; for example, courts have enjoined suits against non-debtor third par-

[44] Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 111-13.
[45] *See* 11 U.S.C. § 362(b) (1988).
[46] 11 U.S.C. § 105(a) (1988).

ties on the basis that such suits adversely affected the estate.[47] Generally, to obtain an injunction in such circumstances, there must be a danger of imminent, irreparable harm to the estate or the debtor's ability to reorganize; there must be a reasonable likelihood of a successful reorganization; the court must balance the relative harm as between the debtor and the creditor who would be restrained; and the court must balance the public interest in successful bankruptcy reorganizations against other competing societal interests.[48]

The bankruptcy court's authority under section 105, however, is not limitless.[49] The fact that claims trading may be involved does not excuse compliance from the legal requisites for an injunction. Even where authority does exist to enjoin claims trading to protect the debtor's NOLs, the bankruptcy court must ascertain that a valuable NOL[50] exists, and that the debtor's ability to use the NOL (and consequently the value of the NOL) will be impaired by further claims transfers. An analysis of the relevant portions of the Internal Revenue Code[51] suggests that the preceding circumstances may be relatively rare, particularly where the debt to be converted into equity includes publicly traded debt securities.

The federal tax laws limit the use of NOLs and certain other losses where there has been an "ownership change." Under section 382 of the Internal Revenue Code of 1986,[52] if an "ownership change" occurs, the corporation's NOL cannot be used to offset future income from operations, provided the new corporation does not continue at least one historic business or use a significant portion of its historic business assets in a business at all times during the two-year period following the ownership change.[53] If the business continuity requirement is satisfied, the aggregate amount of the NOL is not affected. However, the amount of the taxable income in any one year that can

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47 *See, e.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986).

48 *See* 2 COLLIER ON BANKRUPTCY ¶ 105.02[1] (L. King 15th ed. 1991).

49 Section 105(a) does not allow the court to override explicit mandates of other sections of the Bankruptcy Code, or other state or federal statutes; does not allow the bankruptcy court to extend contractual agreements which have expired of their own terms; and should not be employed as a panacea for all ills confronted in the bankruptcy case. *Id.* at ¶ 105.01[3].

50 The value of a debtor's NOLs will depend on if and when the debtor projects it will have taxable income subject to setoff against the NOLs, and how likely it is that the NOLs would be sustained on audit by the Internal Revenue Service.

51 *See* I.R.C. § 382(*l*)(5)-(6) (1988).

52 Enacted in its current form by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

53 *See* P. Asofsky, The Application of Section 382 to Title 11 and Insolvent Debtors, Tax Forum No. 449 at 3 n.9 (February 6, 1989), *citing* I.R.C. § 382(c)(1); H.R. REP. No. 841, 99th Cong., 2d Sess. 189 (1986); Treas. Reg. § 1.368-1(d).

be offset by any pre-change NOLs is limited to the amount of the "section 382 limitation"; specifically, the value of the stock of such corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate set by the Internal Revenue Service.[54] For insolvent corporations or for those where the value of the stock or the corporation is very low prior to the ownership change, the application of section 382 may substantially limit or eliminate the use of NOLs. This harsh treatment of loss corporations following an ownership change is softened to some extent by two special rules that apply to corporations that undergo ownership changes in or through title 11 bankruptcy proceedings.

The first special bankruptcy exception, contained in I.R.C. § 382(*l*)(5), provides that the section 382 limitation will not apply to an ownership change if:

> (i) the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case, and
> (ii) the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders or creditors immediately before such change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) [possessing at least fifty percent of the voting power and representing at least fifty percent of the total value of all of the stock of the new loss corporation].[55]

Section 382(*l*)(5)(E) provides that stock transferred to a creditor in satisfaction of indebtedness is taken into account for purposes of determining whether the fifty percent requirement has been met, only if the indebtedness (i) was held by the creditor at least eighteen months before the date of the filing of the title 11 case, or (ii) arose in the ordinary course of the trade or business of the old loss corporation and is held by the person who at all times held the beneficial interest in such indebtedness.[56]

If a debtor corporation qualifies under section 382(*l*)(5)'s special bankruptcy exception, use of NOLs is not limited by the section 382 limitation. However, the aggregate amount of the NOLs must be reduced by the amount of interest paid or accrued on debt converted into stock during any taxable year ending in the three-year period prior to the ownership change and in the portion of the year prior to

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[54] *See* I.R.C. § 382(a)-(b), (e) (1988).

[55] I.R.C. § 382(*l*)(5)(A) (1988).

[56] I.R.C. § 382(*l*)(5)(E) (1988).

the change.[57] In addition, certain tax attributes including the NOLs must be reduced by fifty percent of the amount of debt forgiven as a result of conversion of the debt into stock. Furthermore, if a second ownership change occurs within two years after the first ownership change, then the section 382 limitation for years following the second ownership change will be zero; that is, NOLs cannot generally be used at all. The ability to use the section 382(*l*)(5) exception may be a tremendous benefit. At the same time, a debtor who has publicly traded securities (particularly securities that may be held in street name), may have very limited ability to substantiate to the court and/ or to the Internal Revenue Service that it has sufficient long-term debt holders to qualify. Further, the amount of interest paid or debt forgiven may affect the usefulness of the NOLs.

Assume, for example, that the debtor corporation has $100 million of subordinated debt plus various trade and senior secured creditors, with NOLs of $75 million in the aggregate. In the two years prior to filing under chapter 11, the corporation paid a total of $30 million in interest on the subdebt. One year after commencement of the chapter 11 case, a plan is confirmed and consummated; it provides for the subdebt holders to receive all the stock of the corporation, valued at $30 million in full satisfaction of their claims. So long as fifty percent of the subdebt holders held their debentures continuously for at least eighteen months prior to the chapter 11 filing, the debtor would emerge from bankruptcy with no limitation on the use of its NOLs, although the NOLs would have to be reduced by the $30 million of interest paid, leaving a balance of $45 million. A total of $70 million (the total subdebt outstanding, less the fair value of the stock issued) was forgiven as a result of the issuance of the stock in exchange for the subdebt under the plan. The NOLs (or other tax attributes) will generally be further reduced by fifty percent of that amount, or $35 million, leaving NOLs of $10 million.

Under the second special bankruptcy rule, if a debtor corporation is not eligible for the I.R.C. § 382(*l*)(5) exception, or if an eligible corporation elects not to have that section apply, then it will be subject to the section 382 limitation, as calculated pursuant to I.R.C. § 382(*l*)(6). Under that section, the value of the old loss corporation shall reflect the increase in value resulting from any surrender or cancellation of creditors' claims in the transaction.

Applying I.R.C. § 382(*l*)(6) to the example given above, the debtor's total NOL of $75 million would not change. Assuming other

57 I.R.C. § 382(*l*)(5)(B) (1988).

claims were fully satisfied and that the long-term tax-exempt rate is eight percent, the reorganized debtor's use of the NOL would be limited to $5.6 million per year (the value of the old loss corporation ($0) plus the cancellation of $70 million in indebtedness multiplied by a long-term tax-exempt rate assumed to be eight percent). Trading of claims during the chapter 11 case, or even prior to the case, does not affect the availability of section 382(*l*)(6) treatment. Although a further ownership change would appear to require recalculation of the section 382 limitation, nothing suggests that a second change would eliminate the use of NOLs completely.

As the examples above demonstrate, where a debtor has NOLs which are a valuable asset of the estate, determining whether treatment of those NOLs will be more advantageous under I.R.C. § 382(*l*)(5) or under § 382(*l*)(6) depends on the debtor's unique circumstances. Because the amount of the NOLs must be reduced under section 382(*l*)(5), it is by no means certain that emerging from bankruptcy with no limit on the NOLs pursuant to subsection (*l*)(5) will be more advantageous than living with the section 382 limitation and no reduction of the NOLs pursuant to section 382(*l*)(6). Unless treatment under section 382(*l*)(5) is determined to be significantly more advantageous, no injunction against claims trading need be issued. Indeed, no injunction under section 105 of the Bankruptcy Code can issue without such a showing.

In *In re TGX Corporation*, the debtor sought to enjoin claims purchases by Steinhardt Partners on the grounds that members of the official committee who had resigned from that committee and sold their claims to Steinhardt had breached a fiduciary duty, and further, on the grounds that claims trading might "jeopardize the debtor's valuable tax attributes."[58] A temporary restraining order was issued by the bankruptcy court. Whatever a court's jurisdiction under section 105(a), the pleadings filed by TGX are more notable for what they do not say than for what they do say.[59] TGX's motion for a temporary restraining order was not supported by affidavits, nor did it allege or assert that TGX would otherwise qualify under I.R.C. § 382(*l*)(5). No mention is made of the treatment of NOLs under I.R.C.

[58] Brief in Support of TGX Corporation's and Official Equity Security Interest Holders Committee's Motion for Issuance of Temporary Restraining Order Under Complaint Requesting Preliminary Injunction, at Part III, TGX Corp. v. Steinhardt Partners (*In re* TGX Corp.), Ch. 11 Case No. 90BK-10499, Adv. Proceeding No. 91 Ap-1016 (Bankr. W.D. La. February 13, 1991).

[59] The TGX brief in support of the motion for a temporary restraining order, *id.*, reads virtually verbatim, from the discussion of tax attributes from Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 111-13.

§ 382(*l*)(6). The parties in *TGX* agreed to a settlement which limited the amount of debt securities Steinhardt Partners could acquire.[60] Notwithstanding the settlement, the bankruptcy court's entry of a temporary restraining order does not appear to have proper evidentiary support.

As noted above, the movant must show there is danger of imminent, irreparable harm to the estate in order to obtain an injunction. In the context of I.R.C. § 382(*l*)(5), this would require a showing both that the debtor has valuable NOLs and that the claim transfer limits contained in I.R.C. § 382(*l*)(5)(E) have not already been exceeded. For the NOLs to maintain their value, any plan proposed must not only provide that fifty percent of the stock of the reorganized debtor be issued to old shareholders or creditors who held their claims for at least eighteen months prior to the chapter 11 filing, but must also prevent an ownership change from occurring in the two years following consummation of the plan. Creditors may be unwilling to accept a stock plan where the stock in the reorganized company can be sold only on a restricted basis. Consequently, the movant may have difficulty showing that a plan of reorganization preserving the full value of the NOLs could be confirmed. Where the value of the NOLs under I.R.C. § 382(*l*)(5) is not substantially higher than when subject to the limitation under I.R.C. § 382(*l*)(6), the harm to creditors restrained from converting their claims into cash may outweigh any "harm" to the value of the debtor's NOLs. The issuance of an injunction is an extraordinary remedy. Particularly where an express statutory proscription is not being enforced, the court should be sure that the requisites for injunctive relief have been satisfied.

b. *Protection of the Voting/Distribution Process*

Concerns such as claims splitting, vote buying,[61] and other matters affecting the mechanics of voting or distribution under a plan may also be properly the subject of judicial action. Judge Lifland in *In re Ionosphere Clubs, Inc.* (*Eastern Air Lines, Inc.*) invoked former Bankruptcy Rule 3001(e)(2) to address a claims transfer that, in his view, constituted improper claims splitting.[62] Although former Bankruptcy Rule 3001(e) could appropriately be used for this purpose, the remedy fashioned by Judge Lifland went beyond that expressly contemplated by the Rule, and even beyond what was necessary to pro-

60 Transcript of Hearing, TGX Corp. v. Steinhardt Partners (*In re* TGX Corp.), Ch. 11 Case No. 90BK-10499, Adv. Proceeding No. 91 Ap-1016 (Bankr. W.D. La. March 8, 1991).

61 See, however, the discussion on voting of purchased claims, *infra* Part III(C).

62 119 Bankr. 440 (Bankr. S.D.N.Y. 1990).

tect against claims proliferation. The court effectively caused or required a change in the economic terms of the agreement reached between two financially sophisticated parties, and the remedy can be viewed as a punitive measure against the claims purchaser.

In *Ionosphere Clubs*, Marriott Corporation filed proofs of claim for amounts in excess of the amounts listed on the debtor's schedules. Amroc Investments L.P. contracted to purchase the claims of Marriott, but only to the extent the claims were listed as undisputed, liquidated, and non-contingent on the debtor's schedules. Under the terms of the assignment agreement, if the transfer was not approved by the bankruptcy court within 180 days after the filing of a motion for entry of an order approving the assignment, Amroc had the right to rescind the purchase agreement.[63] Shortly after a motion was filed, the court "informed"[64] the parties that it would not approve the transfer because of the split nature of the assignment; that is, the scheduled claims were transferred to Amroc, and Marriott retained the portions of the claims in excess of the amounts scheduled. After the expectations of a 100% recovery in the case had diminished substantially, Marriott sought to permanently withdraw the claims it had retained, thereby permitting entry of an order approving assignment prior to 180 days after the filing of the motion for transfer. The court, over Amroc's objection, permitted the amendment of the claims and issued an order approving assignment of the claims on the 180th day after the filing of the motion for transfer.[65] If, however, the court had only been concerned with vote splitting, it could simply have entered an order limiting Marriott's or Amroc's right to vote the claims or participate in the case administration, as expressly contemplated by former Bankruptcy Rule 3001(e)(3) or (4).

The recent changes in Bankruptcy Rule 3001(e) eliminate the justification relied on by several courts to regulate the "fairness" of claims trading. As noted above, courts appear to have regulated trading based upon personal views of the merits or demerits of trading, without careful consideration of the permissible scope of judicial authority under titles 11 and 28 of the United States Code and under the Bankruptcy Rules.

Fashioning judicial "remedies" to deal with the perceived inequities of claims trading chills the market for claims. The cost of complying with the courts' regulation of claims trading must be borne by

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63 *Id.* at 442.

64 *Id.* It appears from the opinion that Judge Lifland did not enter an order denying the transfer at that time, but instead effectively left the parties in limbo.

65 *Id.* at 447.

someone. A purchaser, to protect itself, must determine whether a particular judge has devised his or her own rules or procedures for approving transfers, and, if so, make sure that its papers comply with those "rules." All this costs money, whether in time and effort, or in legal fees. If selling creditors have a unilateral right to rescind assignments up until the time of court approval of such assignment, as the courts in *Revere*[66] and *Allegheny*[67] effectively required, the economic risk of delay and/or rescission suffered by the buyer will affect the prices offered to the seller. From the date of purchase to the date of court approval, a claims purchaser effectively is required to bear the risk of loss. However, at the option of the seller, the claims purchaser can be deprived of the benefits of an increase in the value of the claim. Refusal or failure to enter an order either approving or denying assignment, as was done by Judge Lifland in *Ionosphere Clubs*,[68] unfairly leaves the claims purchaser in limbo without serving any bankruptcy purpose. In an efficient market, the transaction costs and economic risk imposed on claims purchasers will be shifted to claims sellers through lower prices for claims.

As noted above, the existence of a market for claims provides substantial benefits to creditors who may themselves be facing financial difficulty and in desperate need of cash. The imposition of ad hoc rules on claims trading to "protect" selling creditors effectively taxes those creditors who would like to convert their claims into ready cash. Absent a complaint of fraud, misrepresentation, or other cognizable wrong from a party with standing, or a clear congressional mandate, courts should not deprive creditors of the advantages of claims trading based on judges' personal views of its merits or demerits. Regulation of the marketplace is within the sound discretion of Congress and not an appropriate subject for judicial "legislation." Further, the "zealous protection of those who need it" urged upon bankruptcy courts by Fortgang and Mayer[69] and the creation of "remedies" by the court without request from parties to the assignment, immerses the bankruptcy court in administration of the bankruptcy case. This immersion is inconsistent with Congress's clear intent to redefine the role of the bankruptcy court in title 11 cases as

66 *In re* Revere Copper & Brass, Inc., 58 Bankr. 1, 3 (Bankr. S.D.N.Y. 1985); *see supra* notes 22-24 and accompanying text.

67 *In re* Allegheny Int'l, Inc., 100 Bankr. 241 (Bankr. W.D. Pa. 1988); *see supra* notes 25-27 and accompanying text.

68 119 Bankr. at 442.

69 Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 56.

that of an impartial arbiter of disputes.[70]

The revision of Bankruptcy Rule 3001(e) streamlines the transfer process, and should limit court involvement to situations where a true dispute exists between the alleged assignor and assignee of a claim. Creditors in need of cash and entities willing to purchase claims should be free to pursue their economic self-interest without interference from suddenly beneficent debtors whose management may prefer a passive creditor polity over "new equity" not of their choosing.

C. *Exclusion for Claims Based on Publicly Traded Bonds and Debentures*

Under the prior version of Bankruptcy Rule 3001(e), the transfer procedures did not apply to claims "based on a bond or debenture."[71] Because neither the Bankruptcy Code nor Bankruptcy Rules define the terms "bond" or "debenture," the question of what type of debt instruments were exempt from the Rule's requirements was open to debate. The revised version of Bankruptcy Rule 3001(e) makes clear that only publicly traded bonds or debentures are excluded from its transfer procedures.[72]

Messrs. Fortgang and Mayer suggest that the exclusion of bonds and debentures from Bankruptcy Rule 3001(e) was intended to permit public markets in debt securities to function during a bankruptcy case without interference by the bankruptcy court.[73] They further contend that the revised rule is unnecessarily restrictive in that it regulates institutional trading in nonpublicly traded debt securities where Rule 14A issued by the Securities and Exchange Commission permits such trading.[74] As 28 U.S.C. § 2075 makes clear, however, the Bankruptcy Rules are not intended to abridge substantive legal rights.[75] Messrs. Fortgang and Mayer misperceive the purpose of Bankruptcy Rule 3001(e). Rule 3001(e) does not impose substantive regulations on the trading of claims, whether institutional trading or otherwise.

Bankruptcy Rule 3001(e), in conjunction with other rules, is only intended to facilitate recordkeeping and to insure an appropriate "record" from which a court can determine which creditors are entitled to vote on, or receive distributions under, a plan of reorganization. To be treated as a creditor for purposes of voting and distribution, any

70 *See* H.R. REP. NO. 595, 95th Cong., 2d Sess. 4, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 5965-66; 1 COLLIER ON BANKRUPTCY ¶ 1.03[1] (L. King 15th ed. 1991).

71 BANKR. R. 3001(e), 11 U.S.C. app. at 246 (1988) (amended August 1, 1991).

72 *See supra* note 10.

73 Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 21.

74 Fortgang & Mayer, *Developments*, *supra* note 5, at notes 28-30 and accompanying text.

75 *See supra* note 9 and accompanying text.

creditor whose claim is not included on the debtor's schedules of assets and liabilities, or whose claim is scheduled as disputed, contingent, or unliquidated, must file a proof of claim with the court within the deadline fixed by the bankruptcy court.[76] A proof of claim may be filed by a creditor or by an indenture trustee.[77]

Publicly traded bonds and debentures are subject to the Trust Indenture Act of 1939 which, inter alia, requires the appointment of an indenture trustee.[78] The Bankruptcy Code authorizes an indenture trustee to file a proof of claim in respect of the indebtedness issued pursuant to the indenture.[79] Invariably the indenture trustee will file such a claim. Individual bondholders are not required to file proofs of claim, and claims filed will be disallowed as duplicates of the claim filed by the indenture trustee. The transfer agent for the bonds provides the debtor or the court with the list of bond or debenture holders entitled either to vote on any plan of reorganization or to receive distributions under any confirmed plan. The costs of complying with the transfer requirements of Bankruptcy Rule 3001(e), if applied to publicly traded bonds or debentures, would effectively impose a tax or cost on the purchase and sale of those securities without enhancing or improving the record-keeping function of Bankruptcy Rule 3001(e).

Debt securities not within the purview of the Trust Indenture Act of 1939, whether publicly or privately traded, may not have an indenture trustee. Although ownership of those securities may be recorded by a transfer agent, transfer agents are not authorized to file proofs of claim, so that each claimant must file an individual claim. Once a claim has been filed, the entity filing the claim is treated as the owner for purposes of voting and distribution unless a transferee has complied with the transfer procedures of Bankruptcy Rule 3001(e). Although the beneficial interest in the claims may be legally transferred without compliance with Bankruptcy Rule 3001(e), the purchaser or transferee may be dependent upon the record holders' good faith in voting and transmitting any distributions received.

II. Trading By Fiduciaries

When "fiduciaries" in a chapter 11 case act in their own interest, as distinguished from the interest of the estate and its creditors as a whole, concerns arise that the "fiduciary" has somehow breached its

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76 Bankr. R. 3003(c)(2), H.R. Doc. No. 102-80, 102d Cong., 1st Sess. 75 (as amended August 1, 1991).

77 11 U.S.C. § 501(a) (1988); Bankr. R. 3003(c)(1), H.R. Doc. No. 102-80, *id.*

78 Pub. L. No. 76-253, 53 Stat. 1149, 15 U.S.C. §§ 77aaa-77bbbb (1988).

79 11 U.S.C. § 501 (1988).

fiduciary duties, or otherwise acted improperly. Selling claims, buying claims, or both buying and selling claims are instances of a party acting in its own interest. Any of these activities may, in certain circumstances, constitute a breach of a fiduciary duty. However, before rushing to condemn claims trading on that basis, it is appropriate to note the admonition of Justice Frankfurter in *SEC v. Chenery Corp.*:

> But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[80]

There are two categories[81] of participants in chapter 11 cases who are widely viewed as "fiduciaries" or at least as having fiduciary duties. The first category consists of officers, directors and persons in control of the debtor (i.e., statutory insiders);[82] the second consists of members of official committees appointed under section 1102 of the Bankruptcy Code.[83] Historically, regulation of claims trading focused on these parties. Virtually all of the case law on claims trading prior to adoption of the Bankruptcy Code arose in the context of trading by an officer, director, or shareholder of the debtor, or trading by a committee member or a committee's professionals.

A. *Regulation Under Prior Law*

Prior to the adoption of the Chandler Act in 1938,[84] courts sometimes limited claims to the purchase price paid or denied compensation where officers and directors of the debtor or committee members purchased claims during the pendency of a bankruptcy case.[85] With

80 318 U.S. 80, 85-86 (1943).

81 A trustee appointed pursuant to 11 U.S.C. § 1104 (1988) would clearly qualify as a fiduciary. However, because a trustee has no interest in the case apart from management of the estate's assets, trustees will not be discussed.

82 *See* 11 U.S.C. § 101(30) (1988).

83 11 U.S.C. § 1102 (1988).

84 Chandler Act, ch. 575, 52 Stat. 840, 868-69 (1938) (repealed 1979).

85 *See, e.g., In re* Philadelphia & W. R.R., 64 F. Supp. 738 (E.D. Pa. 1946) (claims purchased by directors during bankruptcy limited to price paid); *In re* Los Angeles Lumber Products Co., 46 F. Supp. 77 (S.D. Cal. 1941) (claims purchased by officer, director, and chief counsel to debtor during pendency of case through a corporation formed for that purpose without disclosure that purchases made on officer's behalf); *In re* Republic Gas Corp., 35 F. Supp. 300 (S.D.N.Y. 1936) (compensation denied to members of bondholder protective committee who bought or bought and sold bonds during pendency of bankruptcy case); *In re* McCrory Stores Corp., 12 F. Supp. 267 (S.D.N.Y. 1935) (claims purchased by entity who retained counsel to purchase claims, had counsel appointed to board, who then resigned from the board after receiving information on claims settlements, and thereafter purchased those claims, were limited to price paid).

the adoption of the Chandler Act, Congress expressly authorized bankruptcy judges to limit claims purchased by agents, attorneys, indenture trustees, or committees, to the purchase price paid.[86] Section 212 of the Bankruptcy Act provided:

> The judge may examine and disregard any provision of a deposit agreement, proxy, power or warrant of attorney, trust mortgage, trust indenture, or deed of trust, or committee or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder, may restrain the exercise of any power which he finds to be unfair or not consistent with public policy and may limit any claim or stock acquired by such person or committee in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor.[87]

Section 212 did not absolutely prohibit trading by an agent, attorney, indenture trustee, or a committee, nor did it require that claims be limited to the amount of the purchase price. Instead, its language was permissive: a bankruptcy judge "may limit claims or stock acquired" to the actual consideration paid. This is in contrast to the language of section 249 of the Bankruptcy Act with respect to compensation from the debtor's estate. Section 249 required that such persons be denied compensation, if they purchased or sold claims or stock, or if claims or stock were otherwise acquired or transferred without approval of the bankruptcy judge:

> Any persons seeking compensation for services rendered or reimbursement for costs and expenses incurred in a proceeding under this chapter shall file with the court a statement under oath showing the claims against, or stock of, the debtor, if any, in which a beneficial interest, direct or indirect, has been acquired or transferred by him or for his account, after the commencement of such proceeding. No compensation or reimbursement shall be allowed to any committee or attorney, or other person acting in the proceedings in a representative or fiduciary capacity who at any time after assuming to act in such capacity has purchased or sold such claims or stock, or by whom or for whose account such claims or stock have, without the prior consent or subsequent approval of the judge, been otherwise acquired or transferred.[88]

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86 The Chandler Act did not address trading by officers, directors or other "insiders." The sections quoted below allowed the imposition of sanctions against agents, attorneys, indenture trustees or committees purporting to represent any creditors or shareholders, or a committee, attorney or other person acting in the proceedings in a representative or fiduciary capacity. Insiders would not clearly fall within those categories.

87 Bankruptcy Act of 1898, § 212, 11 U.S.C. § 612 (1976) (repealed 1979).

88 Bankruptcy Act of 1898, § 249, 11 U.S.C. § 649 (1976) (repealed 1979).

The procedural aspects of these sections were supplemented by Bankruptcy Rules 10-211 and 10-215(c)(4).[89] The Rules did not and could not, however, affect the Bankruptcy Act's substantive regulations.[90]

The Bankruptcy Reform Act of 1978[91] did not incorporate the provisions of sections 212 and 249 of the Bankruptcy Act, nor indeed any provision specifically regulating the purchase or sale of claims against a debtor. Messrs. Fortgang and Mayer found the regulation of fiduciary trading under the Bankruptcy Act to be "somewhat illogical" in that the sanctions against trading fiduciaries were remedies of the estate and not the damaged claims seller,[92] and further because the sections did not explicitly sanction a fiduciary who profited by purchasing claims and selling them to a third party.[93] Nevertheless, they suggest that by not including any specific sanctions for trading in the Bankruptcy Code, Congress has failed to adequately regulate fiduciary trading.[94]

In considering whether regulation of fiduciary trading is adequate, it is perhaps appropriate to return to the questions raised by Justice Frankfurter in *SEC v. Chenery.*[95] What parties in a chapter 11 case are fiduciaries? To whom are they fiduciaries? What duties are owed? How does the sale, purchase, or purchase and sale of claims breach those obligations? Careful consideration of these questions leads to the conclusion that, although the Bankruptcy Code is silent on the question of fiduciary trading, other well-established common law doctrines adequately protect against abuse.

B. *Officers, Directors, and Controlling Shareholders*

Officers, directors, and majority shareholders owe fiduciary duties to the corporation in which they serve or have control—both in and out of bankruptcy.[96] This relationship has been variously de-

89 BANKR. R. 10-211, 11 U.S.C. app. at 552-53 (Supp. V 1975) (repealed 1983); BANKR. R. 10-215(c)(4), 11 U.S.C. app. at 554-55 (Supp. V 1975) (repealed 1983).

90 Messrs. Fortgang and Mayer seem to suggest that the Bankruptcy Rules could override substantive regulations contained in the Bankruptcy Act. *See* Fortgang & Mayer, *Trading Claims, supra* note 4, at notes 154-57 and accompanying text. Prior to the enactment of the Bankruptcy Reform Act of 1978, 28 U.S.C. § 2075 did provide that "[a]ll laws in conflict with such rules shall be of no further force or effect after such rules have taken effect." However, in establishing the Supreme Court's power to prescribe the "practice and procedure" under the Bankruptcy Act, Congress specifically stated "[s]uch rules shall not abridge, enlarge, or modify any substantive right."

91 Pub. L. No. 95-598, 92 Stat. 2549 (1978).

92 *See* Fortgang & Mayer, *Trading Claims, supra* note 4, at 31-35.

93 *Id.* at 31-32.

94 *Id.* at 28.

95 *See* text accompanying note 80.

96 *See* W. KNEPPER & D. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS

scribed as imposing "a high fiduciary duty of honesty and fair dealing," a "strict fiduciary duty," "very strict fiduciary responsibilities," or as a "fiduciary relationship."[97] A claim for breach of an officer's or director's fiduciary duties belongs to the corporation. Any such action brought by shareholders must generally be pursued on a derivative basis.[98] The fiduciary relation of officers and directors is with shareholders collectively, not individually, except in special circumstances. Breach of the fiduciary duty to an individual might be found where an insider takes advantage of inside information to deliberately mislead an ignorant shareholder, or where some individual right is impaired by improper acts of an officer or director.[99] The shareholder may only maintain a direct action where there is a special injury to the shareholder independent of the duties owed to the corporation.[100] Thus, it appears that many of the fiduciary duties purportedly owed to shareholders are in fact duties owed to the corporation, although the shareholders may have a right to enforce these duties on behalf of the corporation.

Many complicated issues are raised by questioning whether officers, directors and/or majority shareholders owe a fiduciary duty to creditors. Outside of bankruptcy, or absent special circumstances such as fraud, insolvency, or violation of a statute, officers and directors do not generally owe any "fiduciary" duty to creditors of the corporation.[101] Indeed it appears anomalous to suggest that a "fiduciary relationship," which connotes a relationship based on trust, special confidence, and fairness,[102] can arise where each party is presumed to be acting exclusively in its own interest. Certainly, where the contract between a corporation and its creditor has been

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§§ 1.06-1.08 (4th ed. 1988); 18B AM. JUR. 2d *Corporations* § 1684 (1985) [hereinafter *Corporations*].

97 W. KNEPPER, *supra* note 96, at § 1.06.

98 *See id.* at § 1.07.

99 *Corporations*, *supra* note 96, at § 1692.

100 W. KNEPPER, *supra* note 96, at § 1.07.

101 *See, e.g.*, Broad v. Rockwell Int'l Corp., 614 F.2d 418 (5th Cir. 1980); Simons v. Cogan, 549 A.2d 300 (Del. 1988); McGivern v. Amasa Lumber Co., 77 Wis. 2d 241, 252 N.W.2d 371 (1977).

102 *Cf.* BLACK'S LAW DICTIONARY 564 (5th ed. 1979), which defines a "fiduciary" or "confidential relation" to be:

> . . . A relation subsisting between two persons in regard to a business, contract, or piece of property, or in regard to the general business or estate of one of them, of such a character that each must repose trust and confidence in the other and must exercise a corresponding degree of fairness and good faith. . . . [B]usiness shrewdness, hard bargaining, and astuteness to take advantage of the forgetfulness or negligence of another [are] totally prohibited as between persons standing in such a relation to each other.

fulfilled, no further duty is owed.[103]

In bankruptcy, officers and directors are sometimes described as owing a duty to creditors. It is perhaps more accurate to say that officers and directors owe a continued duty to the *corporation* which may be enforced in a bankruptcy case by or for the benefit of creditors. As the Supreme Court explained in *Pepper v. Litton*:[104]

> A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. . . . While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.[105]

Following similar reasoning, courts have held that in bankruptcy, any right of action against officers or directors for breach of their fiduciary duties is an asset of the estate and enforceable only by the trustee, or a creditors' committee acting on the debtor's behalf.[106] Only where a creditor sustains an identifiable loss peculiar to itself by reason of fraud or negligent mismanagement by officers or directors, can a creditor bring a direct action against such officers or directors.[107] As with shareholders, it appears that the "fiduciary" duties of officers, directors, and majority shareholders are in truth duties owed to the corporation in the first instance.

The obligations or duties owed to a corporation by its officers, directors, or majority shareholders are well established. Such persons owe a duty of obedience; that is, a duty to see that the corporation acts within its corporate powers and obeys the law.[108] They also owe a duty of care. They must be diligent in respect of the management

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103 *See* Broad v. Rockwell Int'l Corp., 614 F.2d 418 (5th Cir. 1980).

104 308 U.S. 295 (1939).

105 *Id.* at 306-07 (citations omitted).

106 Louisiana World Exposition v. Fed. Ins. Co., 858 F.2d 233 (5th Cir. 1988) (creditor may not bring direct action against directors of an insolvent corporation based on mismanagement or breach of fiduciary duty, but corporation does have a cause of action which may be enforced by creditors' committee on debtor's behalf); Koch Ref. v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339 (7th Cir. 1987) (individual creditors lacked standing to bring action to pierce corporate veil; trustee in bankruptcy was proper party to bring alter ego action against debtor's shareholders); Brown v. Presbyterian Ministers Fund, 484 F.2d 998 (3d Cir. 1973) (fiduciary obligation of director normally enforceable by corporation may be enforced by trustee in bankruptcy); Bayliss v. Rood (*In re* W. Va. Indus. Dev. Corp.), 424 F.2d 142 (4th Cir. 1970) (action based on breach of director's duty to corporation may be brought by trustee on behalf of entire community of interests in corporation—creditors as well as shareholders).

107 Ford Motor Credit Co. v. Minges, 473 F.2d 918 (4th Cir. 1973).

108 *Corporations*, *supra* note 96, at § 1684; W. KNEPPER, *supra* note 96, at § 1.05.

and administration of the affairs of the corporation; act in good faith, with such care as an ordinarily prudent person in a like position would use in similar circumstances; and act in a manner that the officer or director reasonably believes is in the best interest of the corporation.[109] Finally, officers and directors owe a duty of loyalty to the corporation they serve, which requires that a director or officer act at all times in the best interest of the corporation, unhampered by personal pecuniary gain.[110]

The troublesome issue with respect to officers and directors who purchase claims during a bankruptcy case is how claims trading breaches or interferes with an officer's or director's duty to a debtor corporation. Although case law under the Bankruptcy Act provides a uniform rule as to the remedy to be granted,[111] the analysis of the breach of duty giving rise to a remedy is less certain.

A few of the cases under the Bankruptcy Act involve clear abuse of a director's position. For example, in *In re McCrory Stores Corp.*,[112] a creditor and shareholder arranged for its attorney to be appointed to the debtor's board of directors. During the attorney's one-month tenure as a director, he obtained information on the debtor's efforts to settle the claims of the landlords. The court found that, prior to his appointment as director, the attorney had been retained to acquire landlords' claims, and that immediately upon resigning as a director, the attorney resumed work and purchased the landlords' claims for cash. Under those circumstances, the court held that the director/creditor's claims would be limited to the purchase price paid. Moreover, the court found that a director who uses confidential information received as a director to compete with the corporation's efforts to settle claims patently violates his duty to the corporation.[113]

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109 *Corporations*, *supra* note 96, at § 1698; W. KNEPPER, *supra* note 96, at § 1.05. *But cf. Corporations* at § 1696 (directors not judged by same strict standard as agent or trustee in charge of private estate).

110 *Corporations*, *supra* note 96, at § 1711.

111 Case law makes clear that as a consequence of an officer or director purchasing claims during the course of a bankruptcy case, the allowance of those claims will be limited to the purchase price paid. *See, e.g.*, Sampsell v. Bridgford (*In re* Bridgford Co.), 237 F.2d 182 (9th Cir. 1956); Monroe v. Scofield (*In re* Gallic-Vulcan Mining Corp.), 135 F.2d 725 (10th Cir. 1943); Terminal & Shaker Heights Realty Co. v. Van Sweringen Co. (*In re* Van Sweringen Co.), 119 F.2d 231 (6th Cir. 1941); Schmitt v. Norcor Co. (*In re* Norcor Mfg. Co.), 109 F.2d 407 (7th Cir. 1940); *In re* Philadelphia & W. Ry. Co., 64 F. Supp. 738 (E.D. Pa. 1946); *In re* Jersey Materials Co., 50 F. Supp. 428 (D.N.J. 1943); *In re* Los Angeles Lumber Prods. Co., Ltd., 46 F. Supp. 77 (S.D. Cal. 1941); *In re* McCrory Stores Corp., 12 F. Supp. 267 (S.D.N.Y. 1935).

112 12 F. Supp. 267 (S.D.N.Y. 1935).

113 *Id.* at 269.

By the same token, a director who learns that a mortgage note against the corporation's real property is available at a sharp discount and finances a friend's purchase of the note, violates his duty to the corporation if he fails to disclose the opportunity to his co-director and shareholder.[114] The duty of loyalty precludes an officer or director from retaining a secret or private profit arising out of his official position; he must account to the corporation for such a profit.[115] Limiting the allowed amount of a claim to the purchase price paid increases the recovery to other claimants against the estate and is comparable to accounting to the corporation for any profit.[116]

Certain courts, however, limited the allowed amount of claims purchased by officers or directors to the purchase price paid, without any discussion of wrongdoing on the part of the insider, or how the purchase breaches any fiduciary duty.[117] These same courts also recognized that where the corporation is solvent, or a going concern, a director may purchase a claim against the corporation at a discount and enforce it for the full amount, absent a present duty to act for the corporation, or overreaching or injury to the corporation. The rationale for the limitation when the corporation is insolvent is unclear at best. In *SEC v. Chenery Corp.* the Supreme Court held that equitable principles do not impose upon officers and directors of a corporation any fiduciary duty to stockholders which precludes the officers or directors from buying and selling stock with full disclosure and at the market price, simply because they are officers and directors.[118] Why a

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[114] *See In re* Jersey Materials Co., 50 F. Supp. 428 (D.N.J. 1943); *see also* Terminal & Shaker Heights Realty Co. v. Van Sweringen Co. (*In re* Van Sweringen Co.), 119 F.2d 231 (6th Cir. 1941) (pledged debentures of debtor, sold at foreclosure sale to corporation formed by debtor's directors without notice to debtor, would be allowed only in amount paid for such debentures).

[115] *Corporations, supra* note 96, at § 1717.

[116] Messrs. Fortgang and Mayer question why, in cases under the Bankruptcy Act, remedies against fiduciaries who traded claims were remedies of the estate and not the damaged claims seller. Fortgang & Mayer, *Trading Claims, supra* note 4, at 28. Where the duty breached is a duty owed to the corporation as opposed to any individual creditor or shareholder, accounting to the corporation for the profit makes inherent sense.

[117] *See* Monroe v. Scofield (*In re* Gallic-Vulcan Mining Corp.), 135 F.2d 725 (10th Cir. 1943); *In re* Philadelphia & W. Ry. Co., 64 F. Supp. 738 (E.D. Pa. 1946); *but cf.* Schmitt v. Norcor Co. (*In re* Norcor Mfg. Co.), 109 F.2d 407 (7th Cir. 1940) (claims purchased through corporate entity without disclosure that purchase was on behalf of corporate officer); *In re* Los Angeles Lumber Prods. Co., Ltd., 46 F. Supp. 77 (S.D. Cal. 1941) (claims purchased through corporate entity without disclosure that purchase was on behalf of corporate officer).

[118] 318 U.S. 80 (1943). On a second appeal after remand to the SEC, the Supreme Court held that the SEC could properly interpret the Public Utility Holding Company Act of 1935 to require that stock purchased by officers and directors during the period of reorganization be limited to the purchase price paid, even where such a finding could not be sustained based on judicially established principles of equity. *See* SEC v. Chenery Corp., 332 U.S. 194 (1947).

higher "fiduciary" standard should be called for in dealings with creditors is questionable.

Although not suggested in the case law under the Bankruptcy Act, established corporate law doctrines would provide a basis for limiting claims purchased by officers and directors to the purchase price paid, at least where the debtor is a going concern. A corporate officer or director is under a fiduciary obligation not to divert a corporate business opportunity for personal gain.[119] Under the corporate opportunity doctrine, a corporate officer or director may not seize for himself a business opportunity which (i) the corporation is financially able to undertake; (ii) is in the corporation's line of business and of practical advantage to the corporation; and (iii) is one in which the corporation has an interest or reasonable expectancy. If such an opportunity is diverted, the corporation may claim the benefit of the transaction.[120]

The purchase of claims against a debtor corporation, in and of itself, would not appear to fall within this rule. A chapter 11 debtor is generally precluded from making payments in respect of prepetition claims except through a plan of reorganization, and in many circumstances will not have the financial wherewithal to purchase claims. However, the ability to purchase claims implies the means to develop financing sources to pay for those claims. Those financing sources are themselves a corporate opportunity which may have substantial practical advantages for the corporation. The debtor corporation certainly has an interest or expectancy in financing sources. Indeed, the debtor's officers may have been selected and hired based on their ability to develop financing for the corporation. Where an officer or director of a debtor corporation diverts such a corporate opportunity, the corporation can properly claim the benefits by limiting the allowed portion of the claims purchased with that financing to the price paid.

Congress has not chosen to regulate the purchase and sale of claims by officers, directors, or other insiders under the Bankruptcy Code.[121] At the same time, nothing in the Bankruptcy Code overrides or replaces the state law duties owed by officers and directors to the corporation. Nor is there any provision preventing individual creditors or shareholders from bringing an action against a corporate officer or director whose trading in claims results in a legally cognizable

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119 *Corporations, supra* note 96, at § 1770.

120 *Id.*

121 Nor was trading in claims by officers and directors regulated under the Bankruptcy Act. *See supra* Part II(A).

wrong to such creditor or shareholder. Bankruptcy courts should tread lightly—if at all—when inventing new duties for directors where Congress has not acted and where existing state law doctrines are so well established.

C. *Official Committees and Committee Members*

Consideration of claims trading by members of official committees against the framework of Justice Frankfurter's analysis[122] requires travel through murkier waters. The extent and scope of the "fiduciary" duties of committee members, and the consequences of breaching those duties, are less well established.

Section 1102 of the Bankruptcy Code[123] provides for the appointment of a committee of unsecured creditors. That committee will ordinarily consist of persons[124] who are willing to serve and who hold the seven largest claims of the kinds represented on the committee.[125] The court may order appointment of additional committees if "necessary to assure adequate representation of creditors or of equity security holders."[126] An official committee appointed under section 1102 may:

> (1) consult with the trustee or debtor in possession concerning the administration of the case;
>
> (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
>
> (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
>
> (4) request the appointment of a trustee or examiner under section 1104 of this title; and
>
> (5) perform such other services as are in the interest of those represented.[127]

The role of a committee or a committee member in a chapter 11 case is distinct from the role played by a debtor's management, officers, and directors. A debtor in possession retains and manages the pool of assets to which all creditors and equity security holders must

122 *See supra* text accompanying note 80.
123 11 U.S.C. § 1102 (1988).
124 "Persons" does not include governmental units. *See* 11 U.S.C. § 101(35) (1988).
125 11 U.S.C. § 1102(b)(1) (1988).
126 11 U.S.C. § 1102(a)(2) (1988).
127 11 U.S.C. § 1103(c) (1988).

look for their recovery. As discussed in the previous section, well-established duties go along with that control. In contrast, under state law creditors ordinarily do not owe any special duty to one another or to the debtor corporation. Each is presumed to act in its own best interest. Absent fraud or tortious conduct, nothing requires or compels a creditor to make a business opportunity available to its debtor, to disclose its expected profits from a transaction, or to account for those profits to a debtor or other creditors.

It follows that in chapter 11, "a creditors' committee and its members owe no duty to the debtor or to the estate. A committee and the holders of claims who serve on it only have a fiduciary duty to the parties or class represented."[128] At the same time, it would seem that committee members must act as fiduciaries to the interests of the class as a whole, and not to the interests of individual class members.[129] The bankruptcy court in *In re Johns-Manville Corp.*[130] summarized the law as to the fiduciary obligations of committee members as follows:

> [T]he individuals constituting a committee should be honest, loyal, trustworthy and without conflicting interests, and with undivided loyalty and allegiance to their constituents. Conflicts of interest on the part of representative persons or committees are thus not be [sic] tolerated. Thus, where a committee representative or agent seeks to represent or advance the interest of an individual member of a competing class of creditors or various interests or groups whose purposes and desires are dissimilar, this fiduciary is in breach of his duty of loyal and disinterested service.[131]

Many of the cases cited for the proposition that committee members act as "fiduciaries" for creditors in fact stand for nothing more than the proposition that committee members, attorneys, and agents for a committee cannot act in a representative capacity or be compensated for acting in such a capacity, where they hold or represent interests adverse to those represented. For example, in *Woods v. City National Bank*[132] the Supreme Court upheld a district court's denial of compensation to members of a bondholders' protective committee

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128 *In re* Microboard Processing, Inc., 95 Bankr. 283, 285 (Bankr. D. Conn. 1989); *cf. In re* Standard Comm'l Tobacco Co., 34 F. Supp. 304 (S.D.N.Y. 1940).

129 For example, an official committee is a party in interest and may object to claims asserted in the case under 11 U.S.C. § 502 (1988). Such an objection would be contrary to the interests of the affected creditor, but would benefit the class represented as a whole. *Cf. In re* Nat'l Equip. & Mold Corp., 33 Bankr. 574 (Bankr. N.D. Ohio 1983) (committee member cannot act through committee in a manner which promotes only that creditor's interest).

130 26 Bankr. 919 (Bankr. S.D.N.Y. 1983).

131 *Id.* at 925 (citations omitted).

132 312 U.S. 262 (1941).

(who were also officers and employees of the underwriter); to the indenture trustee;[133] and to counsel for the committee (who also represented the indenture trustee and underwriter for the bonds). The Court also noted that the underwriter was heavily invested in the debtor's equity and that the underwriter's prospectus for the bonds was under attack in the chapter X case.[134] Similarly, in *In re Realty Associates Securities Corp.*[135] a district court disqualified a committee from acting on behalf of bondholders where members of the committee also served as the bondholders' representatives on the debtor's board of directors. And the bankruptcy court in *In re Johns-Manville Corp.*,[136] imposed sanctions against an attorney/committee member for filing a motion in a state court action on behalf of a private litigant in violation of the automatic stay, after noting that such an action violated the committee member's fiduciary duties.[137]

Although conflicting interests may prevent a person from serving on a committee, once that hurdle is overcome the "fiduciary" duties of committee members should not preclude members from acting in their own interest. All claimants have conflicting interests in one sense, because disallowance of any claim means fewer participants will share in the estate. Even within a committee conflicts may exist which require the members to negotiate against one another; for example, where an unsecured creditors' committee includes senior debt, subordinated debt, and trade debt. Bondholders sitting on a committee may have purchased their bonds at different prices, so that a plan proposed may represent a profit to one holder but a loss to another. Yet nothing requires committee members to disclose the purchase price paid. These differing interests do not prevent entities from serving on a committee. Indeed, members are appointed *because* they have claims against the debtor. At the same time, the committee members share a common interest and duty to attempt to obtain the

133 Under chapter X of the Bankruptcy Act, committees were not appointed to represent the interests of a class of creditors generally, as under section 1102 of the Bankruptcy Code. Instead, they represented the bondholders or shareholders who deposited their securities or gave powers of attorney to the committee. An indenture trustee must act in the interest of all the bondholders under the indenture. The Court thus perceived a conflict in the indenture trustees sitting on the committee. *Id.* at 266-69.

134 312 U.S. at 267; *cf.* Shaw & Levine v. Gulf & W. Indus., Inc. (*In re* Bohack Corp.), 607 F.2d 258 (2d Cir. 1979) (law firm whose senior partner had close business and personal relationship with chairman of debtor's board was disqualified from acting as special counsel to debtor in action based on allegations that debtor's board improperly manipulated).

135 56 F. Supp. 1008 (E.D.N.Y. 1944); *see also In re* International Ry., 86 F. Supp. 546 (W.D.N.Y. 1949) (committee formed primarily to represent interest of bondholder, who was also a significant shareholder, could not act for bondholders in reorganization proceeding).

136 26 Bankr. 919 (Bankr. S.D.N.Y. 1983).

137 *Id.* at 924-25.

best recovery practicable, given the circumstances. Committee membership does not, however, place creditors in the position of true trustees, where they might be expected or required to carry out their responsibilities without regard to their own self-interest.

The parameters of a committee member's "fiduciary" duties are fuzzy at best. That makes the determination of whether the sale, purchase, or purchase and sale of claims violates those duties doubly difficult. Prior to the Chandler Act,[138] courts used their power to control compensation paid from the estate to deny compensation to committee members who purchased securities during the course of the proceeding, on the grounds that such purchases constituted a breach of the committee member's duties to bondholders.[139] This equitable rule was codified in section 249 of the Bankruptcy Act.[140] Before rushing to condemn all claims trading on the basis of this prior law, it is important to note the context in which the rule arose.

Under the Bankruptcy Act, committees obtained their authorization to act on behalf of bondholders by soliciting bondholders to deposit their securities with the committee or to grant powers of attorney. The agreements under which securities were deposited gave the committees comprehensive powers. One court, describing a deposit agreement for a stockholders' committee, noted:

> [S]tockholders gave the committee power to take any and all actions which the committee deemed expedient in connection with the shares of stock of the stockholders in the reorganization proceeding; specifically, to represent the stockholders by intervention or appearance or otherwise in the proceeding; to attend hearings before the court; to vote and act for or against any proposal, resolution or other matter that might be submitted in reference to the estate of the corporation; to prepare, approve, accept or oppose plans of reorganization; and to oppose and contest or assent to any court orders or decrees relating to or affecting all or any part of the property of the corporation; and to act for them with respect to any court orders or decrees relating to or affecting any such property.[141]

Against the backdrop of this type of agreement, statements that "[m]embers of the committees . . . were trustees for the depositing

[138] *Supra* notes 84-86 and accompanying text.

[139] *See In re* Mountain States Power Co., 118 F.2d 405 (3d Cir. 1941); *In re* Republic Gas Corp., 35 F. Supp. 300 (S.D.N.Y. 1936); *In re* Paramount-Publix Corp., 12 F. Supp. 823 (S.D.N.Y. 1935).

[140] *See supra* note 88.

[141] *In re* Standard Comm'l Tobacco Co., 34 F. Supp. 304, 308-09 (S.D.N.Y. 1940) (citations omitted); *cf. In re* Republic Gas Corp., 35 F. Supp. 300 (S.D.N.Y. 1936).

bondholders"[142] or that "it is a fraud in law for a trustee to purchase property which is the subject matter of his trust and the making of such a purchase is misconduct"[143] have a different meaning than if made in the context of committees under chapter 11 of the Bankruptcy Code. Bondholders whose securities were deposited with a committee under the Bankruptcy Act, or who had given power of attorney to a committee, were precluded or impeded from selling their securities or acting on their own behalf in the bankruptcy case.

The potential for abuse by committees under these agreements gave rise to section 212 of the Bankruptcy Act.[144] This section authorized a bankruptcy judge to examine and disregard any provision of a deposit agreement or other authorization by which a committee purported to represent a creditor or stockholder. Section 212 also stated that the bankruptcy judge "*may* limit any claim or stock acquired by such person or committee in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor."[145] Despite this express statutory authorization, there appears to be only one reported case in which claims purchased by a committee member during the course of the bankruptcy proceedings were limited to the purchase price paid.[146] At least under the Bankruptcy Act, the most frequent consequence of a committee member's deviation from his "fiduciary" duties was the denial of the right to act in a representative capacity, or a denial of compensation from the estate.

The role and function of committees under the Bankruptcy Code is very different from practice under the Bankruptcy Act. Although a committee acts as a representative or watchdog over the debtor's activities on behalf of its constituency, the Code makes clear that any creditor or equity security holder is a party in interest who may be heard on any issue in the case.[147] Nothing about a committee's operations prevents a creditor from selling its claim, or purchasing the claims of others. Committees and committee members are not "trustees" and do not hold in trust the property of the constituencies they purport to represent.

In analyzing whether trading in claims by committee members nevertheless violates their fiduciary duties, it is important to consider separately the activities which may constitute "trading." It is not ap-

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[142] *In re Republic Gas*, 35 F. Supp. at 303.
[143] *Id.*
[144] *See supra* note 87.
[145] *Id.*
[146] *In re* Franklin Bldg. Co., 178 F.2d 805 (7th Cir. 1949).
[147] *See* 11 U.S.C. § 1109 (1988).

parent why a committee member who, because of a change in financial circumstances, is no longer willing or able to devote the time necessary for participation on a committee, should be restricted from resigning from the committee, selling its claims, and exiting from the case.[148] A sale of claims simply replaces one creditor with another. It does not result in a disposition of the debtor's assets,[149] or in a transfer of the position on the committee to the purchaser of the claims. Such a transaction is not prohibited simply because there might be some incidental impact on the constituency represented.

The purchase of claims or the purchase and sale of claims perhaps raises more questions. At the same time, however, it is not clear how the purchase of claims, if made with full disclosure of the committee members' status and without fraud, breaches any duty owed to the constituency represented. Outside of bankruptcy, the federal securities laws do not impose an absolute prohibition on the purchase of securities by corporate insiders. No such absolute prohibition on purchases by corporate insiders exists in bankruptcy. It is not clear why a stricter standard should apply to committee members.

Certainly the purchase of claims does not prevent the member from investigating the acts, conduct, assets, or financial condition of the debtor, or other matters relevant to formulation of a plan; nor does it prevent the committee member from carrying out any other statutory duties of the committee. If, during the case, a committee member acquires claims or interests adverse to those represented, the remedy is simple. If the "disability" is temporary, the member can recuse himself from the committee's discussions and/or votes on the subject. If the conflict is substantial, the committee member can resign or the court can order that individual removed from the committee. To the extent that claims purchases increase a member's financial risk, they may provide added incentive for that creditor to carry out the committee's duties with care.

Perhaps the real concern over trading by committee members is that they will use "inside" information obtained through participation in the committee for their individual benefit.[150] However, creditors

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148 None of the cases under the Bankruptcy Act addressed the issue of whether the sale of claims alone would violate a committee member's duties.

149 This assumes that the claim is not purchased by a corporate insider who has a duty to make financing opportunities available to the debtor. *See discussion supra* text accompanying notes 114-16.

150 *See In re* Allegheny Int'l, Inc., 100 Bankr. 241 (Bankr. W.D. Pa. 1988). Judge Cosetti commented in establishing procedures for the transfer of claims:

> 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 Advi-

making rational economic decisions should be reluctant to invest the significant time and energy required, without obtaining some individual benefit from service on a committee. It would be naive to suggest that major suppliers who sit on a committee do not use or consider information gathered by the committee in making credit decisions. So long as the use of that information does not result in abandonment or a conflict with the member's responsibilities as a representative, it is not apparent that any duty arising from committee membership is breached.

Further, although a discussion of the antifraud rules of the federal securities law is beyond the scope of this article, it is important to note that mere possession of internal corporate information[151] will not prevent a person, even a corporate insider, from purchasing or selling securities of that corporation. Corporate employees, officers, and directors can and do purchase securities in the market. As noted by the Supreme Court in *SEC v. Chenery Corp.*,[152] established equitable principles do not preclude officers and directors of a corporation from buying and selling stock, when done in good faith with full disclosure. There is no justification for applying a different rule to committee members. This is not to say that where a committee member's conduct amounts to fraud[153] or violates some other applicable statute or regulation[154] that a court of competent jurisdiction[155] cannot act. At the same time, before condemning trading as a violation of "fiduciary" duties, care should be taken to ascertain whether there is, in fact, a duty impacted by that trading.

> sory Committee Note, although we recognize that the cases cited therein involved breaches of fiduciary duty. A breach of fiduciary duty *implies inside knowledge.*

Id. at 243 (emphasis added). Compare revised Bankruptcy Rule 3001(e) and the accompanying Advisory Committee Note, *supra* notes 10, 13, which depart philosophically from Judge Cosetti's rationale in *Allegheny.*

151 If the simple possession of internal corporate information were enough to prohibit an entity from trading, all corporate insiders would be prohibited from purchasing or selling corporate securities. The federal securities laws do not contain any such blanket prohibition, although section 16 of the Securities Exchange Act of 1934 requires that insiders disgorge short-swing profits resulting from the purchase and sale or sale and purchase of any equity security within a six-month period. The possession of internal information should be distinguished from the possession of "material nonpublic information" standard applied under Rule 10b-5. For a discussion of "material nonpublic information," see L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 718-22 (2d ed. 1988).

152 318 U.S. 80 (1943).

153 The insider trading doctrines under Rule 10b-5 are grounded in the common law tort action of deceit. L. LOSS, *supra* note 151, at 712.

154 For example, a committee member who is in possession of material nonpublic information and uses that information to trade may thereby violate Rule 10b-5, or other regulations of the SEC.

155 *See supra* notes 35-39 and accompanying text.

D. *Plan Proponents as Fiduciaries*

Judge Cosetti's decision in *In re Allegheny International, Inc.*,[156] which discussed the purchase of claims and control by Japonica Partners, is reviewed at length below.[157] One aspect of that opinion, however, warrants mention here. Judge Cosetti apparently takes the view that possession of inside information makes an entity an insider and fiduciary in a chapter 11 case.[158] The term "insider" is defined in section 101(30) of the Bankruptcy Code.[159] Although Judge Cosetti agreed that Japonica Partners was not an officer, director, general partner, or affiliate of any of the debtors, and did not have actual control or legal decision making power, his opinion states: "Japonica sought and received inside information as a proponent of a plan. This court finds as a matter of fact that Japonica is an insider and a fiduciary for purpose [sic] of this reorganization."[160] Such a notion is inconsistent with basic legal concepts.

Black's Law Dictionary defines a "fiduciary" as:

> [A] person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence

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156 118 Bankr. 282 (Bankr. W.D. Pa. 1990).

157 *See infra* Part III.

158 *See In re Allegheny*, 118 Bankr. at 299.

159 That section states in relevant part:

> "insider" includes—
>
> (A) if the debtor is an individual—
>
> (i) relative of the debtor or of a general partner of the debtor;
>
> (ii) partnership in which the debtor is a general partner;
>
> (iii) general partner of the debtor; or
>
> (iv) corporation of which the debtor is a director, officer, or person in control;
>
> (B) if the debtor is a corporation—
>
> (i) director of the debtor;
>
> (ii) officer of the debtor;
>
> (iii) person in control of the debtor;
>
> (iv) partnership in which the debtor is a general partner;
>
> (v) general partner of the debtor; or
>
> (vi) relative of a general partner, director, officer, or person in control of the debtor;
>
> (C) if the debtor is a partnership—
>
> (i) general partner of the debtor;
>
> (ii) relative of a general partner in, general partner of, or person in control of the debtor;
>
> (iii) partnership in which the debtor is a general partner;
>
> (iv) general partner of the debtor; or
>
> (v) person in control of the debtor;
>
> . . .
>
> (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
>
> (F) managing agent of the debtor.

11 U.S.C. § 101(30) (1988).

160 *In re Allegheny*, 118 Bankr. at 299.

involved in it and the scrupulous good faith and candor which it requires. *A person having duty*, created by his undertaking, *to act primarily for another's benefit* in matters connected with such undertaking.[161]

Corporate officers and directors manage the assets and affairs of a corporation for the benefit of the corporation's shareholders, or perhaps, in bankruptcy, for its creditors. The "fiduciary" relation arises not from the possession of confidential information,[162] but from the conduct of the business for the benefit of others. Nothing inherent in the chapter 11 process or the process of proposing a plan of reorganzation would impose upon a creditor or plan proponent a duty to act primarily for another's benefit. Indeed, the opposite can be assumed. A proponent attempting to purchase the debtor's assets naturally wants to pay the lowest price possible, while creditors want to receive the highest price. A creditors' plan may attempt to eliminate equity interests, while a shareholders' plan limits the recovery of creditors. Nothing in that process gives rise to a fiduciary obligation, where one does not already exist. An obligation to act in good faith may be assumed or imposed,[163] but that is not the same as a duty to act primarily for another's benefit.

Messrs. Fortgang and Mayer suggest that Judge Cosetti's finding that Japonica Partners was an insider can be justified, although not for the reasons given by the judge.[164] They note that the definition of "insider" includes "affiliates"[165] (i.e., any entity which holds twenty percent of the voting stock of the debtor), and that Japonica Partners

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161 BLACK'S LAW DICTIONARY 563 (5th ed. 1979) (emphasis added).

162 For example, knowledge that a hostile offer for a corporation is about to occur is perhaps the most market-sensitive information. Yet the entity with that knowledge, the potential acquiror, has no duty to disclose that information until 5% of the stock is acquired. Even at that point, the Williams Act, 15 U.S.C. §§ 78m-78n, does not prohibit further acquisitions of stock, but merely requires disclosure of the purchaser's intentions.

163 See, for example, section 1-203 of the Uniform Commercial Code, which provides: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203 (1989).

164 Fortgang & Mayer, *Developments*, *supra* note 5, at notes 126-31 and accompanying text.

165 "Affiliate" is defined as:

> (A) entity that directly or indirectly owns, controls or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
>
> (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
>
> (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
>
> (B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote,

had purchased claims entitling it to receive more than twenty percent of the stock to be issued under the plan of reorganization.[166] The "entitlement" to receive stock under a plan not yet confirmed or consummated, combined with "attempts to control" the debtors,[167] according to Fortgang and Mayer, supports a finding that Japonica Partners was an insider and that its votes against Allegheny's plan should be disqualified.[168] This reasoning would permit a debtor to confirm a plan of reorganization providing stock to creditors, over the objection of any creditor large enough to receive at least twenty percent of the stock, and who may have demanded that the debtor's management be removed. Surely they cannot be serious!

Whatever one's views on the occasional "unfairness" of the marketplace and those who wield sigificant economic power within it, courts should be cautious about inventing new categories of "fiduciaries" particularly in relationships where neither law, nor equity, nor actual practice contemplates that a relation of trust or confidence might exist. Similarly, courts should not rush to develop equitable remedies for breaches of "duties" that are ill-defined at best. Remedies for fraud, self-dealing by true fiduciaries, conversion, and other cognizable wrongdoing are well established under non-bankruptcy law. Where such conduct occurs, the bankruptcy court or another court of competent jurisdiction can act to remedy the situation. Whether, as a policy matter, further regulation makes good sense is a question for Congress, not the courts, to decide.

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20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or

(D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.

11 U.S.C. § 101(2) (1988).

166 Fortgang & Mayer, *Developments*, *supra* note 5, at notes 126-31 and accompanying text.

167 Judge Cosetti found that Japonica Partners became "deeply involved" in the debtor's insurance coverage and the disposal of certain assets, and demanded that a principal of Japonica Partners be named to the debtors' board of directors, and that the chief executive officer of Sunbeam Corporation (a subisidiary of Allegheny) be replaced with Japonica Partners' designee. *In re* Allegheny Int'l, Inc., 118 Bankr. 282, 298 (Bankr. W.D. Pa. 1990). Japonica's alleged demands were not satisfied by the debtors.

168 Fortgang & Mayer, *Developments*, *supra* note 5, at notes 126-33 and accompanying text.

III. BUYING CONTROL BY BUYING CLAIMS

The most interesting issues surrounding claims trading are those raised by the purchase of claims for the purpose of taking control of or acquiring the reorganized company or its assets. Both Judge Abram in *In re Revere Copper and Brass Inc.* [169] and Judge Cosetti in *In re Allegheny International, Inc.* [170] have expressed concern that "solicitation" of claims is equivalent to the "solicitation" of acceptances or rejections of a plan, but is unaccompanied by the protections of section 1125(b) of the Bankruptcy Code.[171] Judge Cosetti has further suggested that the purchase of claims by a plan proponent constitutes an "end run" around the chapter 11 process.[172] Messrs. Fortgang and Mayer contend that the purchase of claims by a party who intends to file or has filed a plan of reorganization is itself a plan of reorganization, and therefore must comply with the disclosure and equal treatment requirements for a plan of reorganization.[173] Questions also arise in connection with voting on a plan of reorganization: Who is entitled to vote on a plan? When should an acceptance or rejection be designated under section 1126(e) of the Bankruptcy Code[174] as having been made "not in good faith"? And how should the votes of insiders or plan proponents be treated?

Many, if not most, of these issues arose in the chapter 11 cases of Allegheny International and its subsidiaries. As is explained in more detail below, Japonica Partners acquired control of Allegheny and its subsidiaries through the purchase of claims, including purchases made through a tender offer for certain publicly traded debentures during the course of the chapter 11 cases. In July 1990, Judge Cosetti issued a forty-six page memorandum opinion and order designating and disallowing Japonica Partners' rejections of the debtors' plan and imposing certain equitable remedies.[175] Many of the issues discussed in or raised by the *Allegheny* opinion and Japonica Partners' activities were settled by an agreement which led to a modification of the debtors' plan, through which Japonica Partners acquired 99.6% of the equity of the reorganized Allegheny. Although Judge Cosetti's opin-

[169] 58 Bankr. 1 (Bankr. S.D.N.Y. 1985); *see also supra* notes 22-24 and accompanying text.

[170] 100 Bankr. 241 (Bankr. W.D. Pa. 1988); *see also supra* notes 25-27 and accompanying text.

[171] 11 U.S.C. § 1125(b) (1988).

[172] *In re* Allegheny Int'l, Inc., 118 Bankr. 282, 295 (Bankr. W.D. Pa. 1990).

[173] Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 77-86; Fortgang & Mayer, *Developments*, *supra* note 5, at Epilogue. By suggesting that the purchase of claims must meet the requirements of a plan of reorganization, Messrs. Fortgang and Mayer in essence contend that claims cannot be purchased by a plan proponent.

[174] 11 U.S.C. § 1126(e) (1988).

[175] *See In re Allegheny*, 118 Bankr. at 282.

ion and the proceedings in the Allegheny chapter 11 cases are not the exclusive focus of the following discussion, since it is the first-reported decision in a case under the Bankruptcy Code addressing these issues, both the opinion and the circumstances that led to its issuance certainly warrant consideration.

A. *Allegheny International and Japonica Partners*

Allegheny International and some of its subsidiaries filed for relief under chapter 11 of the Bankruptcy Code in February 1988. Certain additional subsidiaries filed in May 1988. The chapter 11 cases were tumultuous from the beginning.[176] Numerous lawsuits were filed, including an action against the senior secured bank lenders (the "Bank Group") by unsecured creditors and equity holders seeking subordination of the Bank Group's claims.[177] For over a year, the debtors proceeded with a merger and acquisition process in which management attempted to market the companies. This process included two unsuccessful bids by the investment banking firm of Donaldson, Lufkin & Jenrette ("DLJ"), the second of which fell through in the spring of 1989. As part of the DLJ bid, Mr. James D. Milligan would have been brought in to run the reorganized companies.[178] Finally after eight failed plans of reorganization, the debtors' exclusive right to file a plan was terminated in June 1989.[179] At approximately the same time, Mr. Milligan was retained as a consultant to the debtors. He was later named chief executive officer of Allegheny's Sunbeam Corporation subsidiary.[180]

The debtors continued their efforts to reorganize through the fall of 1989, and filed two more plans of reorganization, both of which failed. In December 1989, the debtors proposed a plan which provided for the distribution of cash to creditors of certain solvent subsidiaries, and the distribution of stock to all creditors of Allegheny, including the Bank Group. According to the debtors' disclosure

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176 *See* Ansberry, *Takeover Mayhem: When Will Somebody—Anybody—Rescue Battered Allegheny?*, Wall St. J., April 19, 1990, at A1, col. 6.

177 Debtors' Disclosure Statement and Joint Stock Plan of Reorganization, at V-18, *In re* Allegheny Int'l, Inc., Ch. 11 Case No. 88-448 (Bankr. W.D. Pa. February 5, 1990) [hereinafter Debtors' Disclosure Statement].

178 *Id.* at VI-5 to VI-7.

179 Pursuant to 11 U.S.C. § 1121 (1988), the debtor has the exclusive right to file a plan of reorganization for 120 days after the petition is filed, which time may be extended "for cause." Numerous extensions were granted in the *Allegheny* case. Although the debtors went through a "merger and acquisition process" it is important to note that because only the debtors had a right to file a plan during that process, management was protected from offers to acquire the company that management may have viewed as "hostile."

180 Debtors' Disclosure Statement, *supra* note 177, at VI-7 to VI-8.

statement, the stock to be issued under the plan would have an "implied value"[181] of $6.23 to $7.00 per share, subject to further dilution for shares issued with respect to disputed claims, and for shares to be reserved for or issued to management.[182] The debtors' disclosure statement further advised that the reorganized companies intended to adopt a compensation package for Mr. Milligan and senior executives which would result in such management receiving approximately ten percent of the stock of the reorganized Allegheny over a three-year period.[183]

The proposed articles of incorporation for the reorganized companies were attached as an exhibit to the debtors' stock plan. The articles provided that, in the event of a "control transaction," all shareholders would have the right to "put" their shares to the "controlling person" for the highest price per share paid by such person for stock held at the time of the control transaction. Persons receiving stock under the plan of reorganization were excluded from the definition of "control persons" unless they acquired additional shares of common stock "for the actual purpose of exercising control over the Corporation" or if "such person acquires beneficial ownership in excess of 45% of the Common Stock of the Corporation."[184] Because of the concentration of senior debt, up to 63% of the common stock to be issued under the plan would be held by less than twenty-five creditors.

In July 1989, following the termination of exclusivity, Japonica Partners, a New York investment and advisory firm, began to investigate the possibility of acquiring Allegheny and its subsidiaries. In November 1989, Japonica Partners with the backing of Steinhardt Partners, an investment firm managing approximately $1.5 billion in equity assets, offered $683.8 million in cash and securities to purchase Allegheny.[185] That offer was rejected by the debtors' board, which suggested that Japonica Partners file its own plan of reorganization. Following rejection of its bid, Japonica Partners began to inquire whether members of the Bank Group would be interested in selling their claims. These negotiations were suspended when Japonica Part-

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181 The Debtors' Disclosure Statement stated that the "implied value" was arrived at by taking the assumed enterprise value of the corporation, less the amount of debt expected at consummation, and dividing that amount by the number of shares to be issued. It further warns that the implied value of the shares might differ from the actual trading price of the securities. *Id.* at IX-6.

182 *Id.*

183 *Id.* at VII-2 to VII-3.

184 Debtors' Disclosure Statement, *supra* note 177, Exhibit A, Certificate of Incorporation of Sunbeam/Oster Cos., at 3.

185 Wall St. J., Nov. 10, 1989, at B5, col. 3.

ners determined it would file its own plan of reorganization. Japonica Partners acquired one subordinated debenture—in the face amount of $10,000—for $2,400, so that it would have standing to file a plan.[186] Then, on January 24, 1990, one day prior to the close of the hearing on the debtors' disclosure statement,[187] Japonica Partners filed its cash plan. That plan provided for the purchase of the debtors' assets, with the cash proceeds to be distributed to holders of allowed claims and interests, subject to certain holdbacks for claims that were not yet allowed.[188] The debtors' disclosure statement was approved by the court on February 5, 1990, and the court set March 30, 1990 as the last date for submitting acceptances or rejections of that plan.

After filing its plan, Japonica Partners resumed negotiations for the purchase of bank claims. Late in February 1990, Japonica Partners purchased approximately 17.3% of the Bank Group claims for 80% of the face amount of the claims.[189] On March 13, 1990 Japonica Partners purchased another bank claim for 80% of the face amount, so that it then owned approximately 21.8% of the claims in the Bank Group.

In late February or early March, the agent bank for the Bank Group contacted the debtors about its desire to sell the stock that would be distributed to the Banks under the debtors' plan.[190] Mr. Milligan (then CEO of the debtor Sunbeam Corporation, who was to receive along with other senior management approximately 10% of the stock of the reorganized company over three years) had discussions with a number of investors familiar to him who had "a desire to own equity in whatever company [he] ran."[191] Officers of the debtor met and toured various facilities with investors, and with DLJ, who was to represent the investors.[192] Certain officers and employees of the debtors advised members of the Bank Group that they had identi-

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186 11 U.S.C. § 1121(c) permits any "party in interest" to file a plan. "Party in interest" is defined in 11 U.S.C. § 1109 to include "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee."

187 The version of Bankruptcy Rule 3016(a) then in effect provided that a party in interest, other than the debtor, who is authorized to file a plan pursuant to 11 U.S.C. § 1121(c) could file a plan at any time before the conclusion of the hearing on the disclosure statement. BANKR. R. 3016(a), 11 U.S.C. app. at 253 (1988) (amended August 1, 1991).

188 Japonica Partners L.P. Fourth Amended Disclosure Statement and Joint Plan of Reorganization, at I-1 to I-6, *In re* Allegheny Int'l, Inc., Ch. 11 Case No. 88-448 (Bankr. W.D. Pa. May 3, 1990) [hereinafter Japonica's Disclosure Statement].

189 *Id.* at VII-1.

190 *In re* Allegheny Int'l, Inc., 118 Bankr. 282, 291 (Bankr. W.D. Pa. 1990).

191 *Id.* (quoting deposition transcript of James D. Milligan).

192 *Id.* at 292.

fied a potential buyer for the stock on a "when-issued" basis.[193]

On March 16, 1990, DLJ contacted all members of the Bank Group who had not sold their claims to Japonica Partners and advised them that a group of investors had proposed buying stock from the Bank Group on a when-issued basis, at a price of $6.25 per share. When combined with other cash to be received by members of the Bank Group class under the debtors' plan, this offer amounted to a 101% recovery on the principal amount of their claims. Thirteen of the sixteen remaining banks in the Bank Group entered into such contracts.[194] Although the stock purchase agreements did not require the banks to vote in favor of the debtors' plan, they did require the banks to use their "best efforts" to effectuate the agreements.[195] As a condition to closing, the contracts specified that no plan other than the debtors' plan "shall have been approved by the requisite acceptances of the claims of creditors so as to be confirmable under Section 1129 of the Code."[196] The contracts also contained a confidentiality clause which provided:

> Except to the extent required by law, the terms and conditions and other provisions of this Agreement, including, without limitation, the purchase price hereunder and the nature of any transactions contemplated hereby shall be strictly and absolutely confidential and shall be disclosed by neither party hereto to any third person (other than their respective officers, directors, counsel, auditors or financial advisors to the extent such persons need to be apprised thereof) without the express written consent of the other party hereto.[197]

Prior to the close of balloting on the debtors' plan, holders of approximately 36.4% of claims in the Bank Group, who in the aggregate were eligible to receive approximately 17.24% of the stock of the reorganized debtors, entered into contracts to sell their when-issued shares.

During this same period, Japonica Partners continued its efforts to purchase claims. On March 23, it purchased a claim for 85% of

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193 *Id.*

194 Under the terms of the debtors' plan, the Bank Group was entitled to nominate two directors to the board of the reorganized company. One of the nominees of the Bank Group participated in the arrangements for purchase of when-issued shares. *See id.*

195 *Id.*

196 Agreements to Purchase When-issued Shares, at § 4.6 (May 20, 1990) (on file with Cardozo Law Review office). Note that this condition apparently gave DLJ an "out" if creditors voted to accept another plan, even if the debtors' plan was the plan ultimately confirmed. Combined with the "best efforts" clause, this arguably required contracting banks to vote against Japonica Partners' cash plan.

197 *Id.* at § 5.2.

the face amount, and on March 26, it acquired a claim for 95% of the face amount of the claim. After the purchase of the March 26 claim, Japonica owned 33.9%, or more than one-third of the claims in the Bank Group class.[198] Also in March 1990, the debtors scheduled a meeting in Switzerland with holders of claims evidenced by Swiss franc notes issued by a dissolved subsidiary of Allegheny. DLJ attended this meeting as representative of the purchasers of when-issued shares.[199] The indenture trustee for the Swiss noteholders met separately with Japonica Partners. Japonica Partners subsequently tendered for the notes and acquired approximately 94.5% of such notes for 66% of the face amount of the claims. The Swiss franc notes were classified as senior unsecured claims under the debtors' plan. With that purchase, Japonica Partners held 30.45% of the allowed claims in the senior unsecured class, and caused those claims to be voted to reject the debtors' plan.[200]

The debtors failed to obtain the necessary acceptances from three classes of claims or equity interests under the plan: the Bank Group class, the senior unsecured class, and one of two classes of preferred stock. Allegheny sought to designate and disqualify rejections submitted for the claims owned by Japonica Partners, and moved to obtain confirmation of the plan, notwithstanding the failure of the preferred stock class to accept the plan.[201] Japonica Partners and the Equity Security Holders' Committee objected to confirmation and sought to designate the votes of the Bank Group and the entire vote on the plan. The basis for the objection was that the solicitation of contracts for the purchase of when-issued shares with the participation of debtors' management constituted an improper solicitation of acceptances of the debtors' plan in violation of the Bankruptcy Code and federal securities laws. In addition, they contended that the contracts for when-issued shares, combined with the lack of disclosure of

198 "Acceptance" of a plan by a class of claims requires that of the claims submitting acceptances or rejections, at least one-half in number and two-thirds in amount accept the plan. 11 U.S.C. § 1126(c) (1988). A creditor who holds over one-third of the claims in a class can block acceptance by that class. Unless the rejection by that creditor is designated pursuant to 11 U.S.C. § 1126(e), the plan cannot be confirmed unless the cramdown standards of 11 U.S.C. § 1129(b) (1988) are met.

199 *In re Allegheny*, 118 Bankr. at 293.

200 Authors' calculations based on the record.

201 Under the absolute priority rule of 11 U.S.C. § 1129(b)(2)(C), this meant that no class of equity interests junior to the preferred stock class could receive any distribution under the plan. Debtors' management nevertheless moved to "cramdown" the proposed plan and thereby wipe out the debtors' existing shareholders, under circumstances where management would wind up with 10% of the equity of the reorganized company. This came at a time when there was another plan—Japonica Partners' plan—on the table that would provide a cash distribution to equity security holders.

the arrangement, would leave the remaining creditors and interest holders as unwilling shareholders in a management-entrenched company under a plan never disclosed to such creditors and interest holders. Confirmation of the debtors' plan was bitterly contested.[202]

As balloting on the debtors' plan proceeded, Japonica Partners continued its efforts to have its disclosure statement approved and the cash plan submitted to creditors for acceptance or rejection. On April 14, 1990, Japonica Partners announced a tender offer for all three issues of subordinated debentures and for debentures issued by Chemetron Corporation, a subsidiary of Allegheny.[203] The tender offer documents explained that the amount offered pursuant to the tender offer might be less than that offered under either plan of reorganization; that the amounts offered under the plans might increase; and that Japonica Partners had received non-public operational and financial information concerning the debtors.[204] A complete description of the tender offer, along with information on where parties could obtain copies of the tender offer documents, was included in the disclosure statement for Japonica Partners' cash plan. On May 3, 1990, the court entered an order approving Japonica Partners' disclosure statement (including the description of the tender offer) as containing "adequate information"; it also established deadlines for the delivery of the plan and disclosure statement to holders of claims and equity interests, and for the submission of acceptances or rejections of the plan. The tender offer closed on May 15, 1990 and Japonica Partners purchased all securities validly tendered. This left Japonica Partners

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202 *See* Ansberry, *supra* note 176.

203 Japonica's Disclosure Statement, *supra* note 188, at VII-1 to VII-2.

204 The tender offer documents stated:

> *Certain Significant Considerations.* Amendment of the Purchaser's Cash Plan or the Debtors' Stock Plan. As discussed below . . . holders of Securities who tender their Securities pursuant to the Offers will receive cash which may be less than the value of the consideration that would be received under either the Debtors' Stock Plan or the Purchaser's Cash Plan. Moreover, there can be no assurance that either or both of such Plans will not be amended to increase or decrease the amount of cash and/or the value of the securities to be distributed in respect of Securities.
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> . . .
>
> The Purchaser has entered into confidentiality agreements relating to the Debtors pursuant to which the Purchaser is required to maintain the confidentiality of non-public information relating to the Debtors. As a consequence of such agreement, the Purchaser has received non-public operational and financial information concerning the Debtors.

Offers by Japonica Partners to Purchase 9% Subordinated Sinking Fund Debentures due 1989 and 10 3/4% Subordinated Sinking Fund Debentures due 1999 and 10.4% Subordinated Sinking Fund Debentures due 2002 of Allegheny International, Inc. and 9% Sinking Fund Debentures due 1994 of Chemetron Corporation at 6, 17 (April 14, 1990).

with approximately 15.3% of the claims in the Chemetron general unsecured class, and 61.9% of the claims in the Allegheny subordinated debenture class.[205]

The last day for submitting acceptances or rejections of the cash plan was June 8, 1990. In advance of the close of balloting, the Bank Group and certain insurance companies holding senior unsecured claims with a sufficient percentage to "block" acceptance of Japonica Partners' plan, announced that they had submitted rejections of that plan. Thereafter, Japonica Partners purchased the insurance companies' claims for an amount equivalent to $7 per share under the debtors' plan—higher than the amount then offered to the class of senior unsecured claims under the cash plan. At the same time, Japonica Partners moved to modify[206] the cash plan to increase the purchase price for the debtors' assets and the distribution to certain classes under the plan.[207] The insurance companies filed a motion seeking to have the rejections previously submitted withdrawn or changed.[208] The balloting period closed without a decision on the insurance companies' motion, so that Japonica Partners' plan was not accepted by two classes of claims.[209]

After purchasing the insurance company claims, Japonica Partners issued a press release announcing the purchase and stating that under the debtors' stock plan, it would own over fifty percent of the stock of the reorganized company if the debtors' plan were confirmed. Almost immediately thereafter, the Bank Group filed an adversary proceeding in the bankruptcy court seeking equitable relief. The Bank Group alleged that Japonica had attempted to control the debtor, and that the control provision in the proposed articles of in-

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205 Authors' calculations based on the record and on *In re* Allegheny Int'l, Inc., 118 Bankr. 282, 294 (W.D. Pa. 1990).

206 11 U.S.C. § 1127(a) provides:

> The proponent of a plan may modify such plan at any time before confirmation, but may not modify such plan so that such plan as modified fails to meet the requirements of sections 1122 and 1123 of this title. After the proponent of a plan files a modification of such plan with the court, the plan as modified becomes the plan.

11 U.S.C. § 1127(a) (1988).

207 The modifications to Japonica Partners' plan increased the purchase price for the debtors' assets and increased the distribution to the senior unsecured class and to one other class. The increased distribution under the modified plan was higher than that paid to the insurance companies for their claims.

208 The version of Bankruptcy Rule 3018(a) in effect at that time provided that "[f]or cause shown and within the time fixed for acceptance or rejection of a plan" the court may permit a creditor or equity security holder to change or withdraw its acceptance or rejection. BANKR. R. 3018(a), 11 U.S.C app. at 254 (1988) (amended August 1, 1991).

209 *In re Allegheny*, 118 Bankr. at 295. The class of common stock also rejected the cash plan.

corporation for the reorganized company had been triggered,[210] so that other creditors should have the opportunity to "put" their shares to Japonica Partners for the same price per share paid to the insurance companies—$7 per share. A trial was held on an emergency basis.

On July 12, 1990, the court issued a memorandum opinion and order confirming the debtors' plan. In general, the court found Japonica Partners' rejection of the debtors' plan to have been made in bad faith, and therefore designated and disallowed its votes against the debtors' plan.[211] The court declined to disallow the votes of the banks who entered into contracts with DLJ, or the entire vote on the debtors' plan. Although the court found the arrangements with DLJ "inept and ill-timed and lacking disclosure,"[212] it stated that only the votes of creditors or interest holders who were engaged in wrongdoing could be designated under section 1126(e) of the Bankruptcy Code.[213] At the same time, however, the court noted that the transactions with DLJ might have permitted DLJ or others to take control of the debtor. The court therefore voided the contracts for the purchase of when-issued shares.[214] In respect to the adversary proceeding brought by the Bank Group, the court found that Japonica Partners' purchase of claims while a plan proponent was in bad faith.[215] The court further held that Japonica Partners' purchase of the insurance company claims triggered the control transaction provision in the proposed articles of incorporation for the reorganized companies. As a sanction against Japonica Partners' "inequitable and bad faith behavior,"[216] the court ordered that shares to be distributed to Japonica or its affiliates be held in trust by the debtors for a period of three

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210 The articles of incorporation in question were proposed articles for a Delaware shell corporation with which Allegheny International would have merged, when and if its plan were confirmed and consummated. The actual articles on file with the State of Delaware did not include such a provision. In response to the adversary proceeding brought by the Bank Group, Japonica Partners took the position that the appropriate court to interpret the articles of incorporation would be a Delaware court. Further, Japonica Partners contended that because the articles of the shell corporation did not yet include the control provision, and that such a provision would only take effect when and if the debtors' plan was confirmed and consummated, that the Bank Group was improperly requesting that the bankruptcy court issue an advisory opinion on Delaware law that the court did not have subject matter jurisdiction to give.

211 *In re Allegheny*, 118 Bankr. at 289-90.

212 *Id.* at 294.

213 11 U.S.C. § 1126(e) (1988).

214 *In re Allegheny*, 118 Bankr. at 316.

215 *Id.* at 297. The court made no attempt to reconcile its approval of the Japonica Partners' disclosure statement and the implicit authorization to solicit consents to the Japonica Partners' plan with this finding.

216 *Id.* at 301.

years.[217] The shares were not to be entitled to vote on any matter while in trust or while owned by Japonica Partners, although other benefits of ownership would be retained. Japonica Partners could avoid the sanction by establishing its ability and agreement to accept other creditors' and equity security holders' rights to "put" their securities to Japonica Partners within forty-five days from the date of the confirmation order.[218]

Perhaps the best thing about Judge Cosetti's decision is that all the parties were so unhappy with the result that they agreed to settle. Pursuant to the settlement entered into by the parties, Japonica Partners agreed to provide financing for the debtors' plan. The settlement also gave certain classes of claims and equity interests the opportunity to elect to receive their distributions in securities provided for under the plan, or cash approximately equal to $7 per share or $1.53 per warrant, with distributions in accordance with the election to occur approximately seventy-five days after consummation of the modified debtors' plan. Japonica Partners posted funds to assure payment of the "cash election." The Bank Group received cash payments on the effective date of the plan equal to approximately 105% of the principal amounts of their claims. Japonica Partners obtained control and creditors received the cash recovery they had been looking for, at the highest price per share estimated by the debtors.

B. *Purchase of Claims as a Plan*

Messrs. Fortgang and Mayer contend that claims purchases made by a party who has filed, or intends to file, a plan of reorganization should be viewed as part of a plan and must be measured against the Bankruptcy Code standards applicable to plans of reorganization.[219] Judge Cosetti apparently takes a similar position. In *Allegheny*, Judge Cosetti condemned Japonica Partners' claims purchases as an "end run" around the bankruptcy process.[220] In essence, Messrs. Fortgang and Mayer and Judge Cosetti suggest that the purchase of claims amounts to a de facto or sub rosa plan of reorganization. From the perspective of claims sellers, an offer to purchase claims may not differ substantially from a plan of reorganization.

217 *Id.* at 303.

218 *Id.* at 301.

219 Fortgang & Mayer, *Developments*, *supra* note 5, at note 141 and accompanying text.

220 *In re Allegheny*, 118 Bankr. at 295. It is interesting to note that in this regard the court discusses only Japonica's tender offer for the publicly traded debentures and its purchase of the insurance company claims, and not its earlier purchases of the bank claims and Swiss franc notes. Virtually all of the claims held by Japonica Partners were purchased while it was a plan proponent.

However, when considered from the perspective of the estate and its creditors as a whole, the transactions are legally and economically distinct.

In *Allegheny* the court found that Japonica Partners' purchases of claims to advance its position as a plan proponent constituted "bad faith" in the pursuit of confirmation of its plan.[221] Although Judge Cosetti has made clear his distaste for claims trading generally,[222] the July 1990 opinion identifies three areas of concern that prompted the court to conclude that the purchases were in bad faith. First, the court found that Japonica Partners had solicited claims through the tender offer outside its plan both before and after approval of its disclosure statement.[223] The court equated the purchase of claims with the solicitation of acceptances of a plan, and noted that Japonica Partners could not have solicited acceptances of its plan under section 1125(b) of the Bankruptcy Code until after a disclosure statement had been approved by the court.[224] Second, the court found that the purchases and offers to purchase resulted in discriminatory treatment—both within the class of claims to whom offers were made, and between junior and senior classes. Within the class to whom offers were made, creditors who accepted Japonica Partners' offer received immediate cash. In contrast, non-accepting creditors would receive their distribution at some undetermined future date when the "official" plan might be confirmed and consummated.[225] The court further indicated that payment of junior classes prior to the senior classes would defeat application of the absolute priority rule[226] in the event that a more senior class of creditors rejected the plan.[227] Finally, the court reiterated its concern that the purchase of claims allows a plan proponent to do something the debtor could not: pay

221 *Id.* at 296.

222 The 1988 opinion on claims transfers stated, "We do not believe that Congress intended the trafficking in claims such as has occurred in this case and others." *In re* Allegheny Int'l, Inc., 100 Bankr. 241, 243 (Bankr. W.D. Pa. 1988).

223 *In re Allegheny*, 118 Bankr. at 294.

224 *Id.* at 295.

225 *Id.* at 296.

226 If a plan is to be confirmed notwithstanding the failure of a class of unsecured claims to accept that plan, then 11 U.S.C. § 1129(b)(2)(C) requires either that the creditors in the non-accepting class receive property with a value equal to the allowed amount of their claims, or that holders in junior classes receive nothing.

227 *In re Allegheny*, 118 Bankr. at 296. Judge Cosetti also suggests that a plan provision providing for a tender offer would not meet the "best interests of creditors test" of 11 U.S.C. § 1129(a)(7)(A). The best interest test requires that each creditor receive at least as much under the plan as would be received in a chapter 7 liquidation, or have accepted the plan. Assuming that the purchase of claims would constitute a plan of reorganization, it is not clear how the purchase of claims would result in a failure to meet that standard.

creditors outside a plan of reorganization.[228]

Messrs. Fortgang and Mayer voice similar concerns. They state:

> From the perspective of the debtor or other creditors, the purchase of claims can at least be a solicitation of support for a plan or a solicitation of a rejection of a plan already filed. The more widespread the offer to purchase claims, the more it resembles and has the effect of a plan. If the debtor were to offer a group of creditors a cash recovery prior to a plan, it would have to comply with section 1125, so that claims sellers would need a disclosure statement so they could judge whether or not to accept the cash offer. Why should a nondebtor claims purchaser not have to comply with these provisions?[229]

Messrs. Fortgang and Mayer ask the right question: Why should a third party be permitted to provide cash to creditors who want to liquidate their claims against the debtor and exit the case, when the debtor cannot? They overlook the simple answer: Third parties are not using assets of the estate to pay creditors.[230] The transfer of claims against the estate from the original claim holder to a claims purchaser does not dissipate or diminish the assets in the estate available to satisfy the claims and interests of creditors and equity security holders as a whole.

Bankruptcy is a collective proceeding; it requires creditors to proceed as a group through the bankruptcy court to collect on the debts owed them. Once a debtor files a petition for relief, the automatic stay[231] restrains creditors from attempting to collect their prepetition claims outside of the bankruptcy process. Without the automatic stay, creditors could pursue their own remedies against the debtor's property. Those acting first, and able to seize or attach the debtor's property, would receive payment in preference to and to the detriment of other creditors.[232] A business's assets may have substantially more value when operated or sold as a going concern, than if sold through piecemeal liquidation.

The purpose of a title 11 reorganization is to give the debtor and its creditors an opportunity to preserve that value, and to provide an opportunity for the debtor and its creditors, with its shareholders, to analyze the debtor's financial problems and negotiate a restructur-

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228 *In re Allegheny*, 118 Bankr. at 296.

229 Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 44-45.

230 A different analysis would apply if the third party were an affiliate or insider of the debtor. *See supra* Part II(B).

231 11 U.S.C. § 362(a) (1988).

232 H.R. REP. NO. 595, 95th Cong. 2d Sess. 340, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6297.

ing.[233] The plan of reorganization determines how much and in what form creditors will be paid, whether stockholders will continue to retain any interests, and in what form the business will continue. Requiring acceptance of the plan by a certain percentage of creditors and interest holders necessitates negotiation among the affected parties.[234] Permitting the debtor to pay certain, presumably complaining, creditors outside of a plan upsets this process. Such a payment prefers those creditors over others, and correspondingly decreases the amount of assets available to satisfy the other claims against the estate. The remaining creditors, however, are still restrained from pursuing collection activity against the debtor and its assets; further, they have lost their right to negotiate with the exiting creditors for a compromise in the restructuring process.

1. *Effect on Estate Assets*

The key focus in determining whether a transaction constitutes a de facto plan, and therefore an end run around the protections granted creditors in chapter 11 cases,[235] is whether the transaction allocates assets or value among classes of claims or interests, specifies the terms of a reorganization plan to be adopted, or restructures the rights and priorities of creditors.[236] For example, in *In re Braniff* the debtor sought approval of a transfer of its cash, airplanes, and equipment, and terminal leases and landing slots, in exchange for travel scrip, unsecured notes, and a profit participation in the transferee's proposed operation.[237] The agreement, however, provided that the scrip could be issued only to the debtor's former employees and shareholders, or in a limited amount, to unsecured creditors. Noting that any reorganization plan would have to allocate the scrip according to the terms of the sale agreement or forfeit a valuable asset, the Fifth

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233 *Id.* at 220, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6179.

234 *Id.* at 221, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6180.

235 Specifically, those protections consist of the right to receive a disclosure statement, 11 U.S.C. § 1125; the power of creditors holding claims in an impaired class to vote, 11 U.S.C. § 1126; the entitlement of dissenting creditors and equity interest holders to a return equal to or greater than would be received in a chapter 7 liquidation; the requirement that a dissenting class of unsecured creditors be paid in full prior to a junior class receiving or retaining any interest or property, 11 U.S.C. § 1129(b)(2)(B); and the ability of all parties in interest to be heard as to other matters affecting confirmation. *See, e.g., In re* Crowthers McCall Pattern, Inc., 114 Bankr. 877, 881 (Bankr. S.D.N.Y. 1990).

236 *See, e.g.*, Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (*In re* Continental Air Lines, Inc.), 780 F.2d 1223, 1226-27 (5th Cir. 1986); Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983); *In re* Naron & Wagner Chartered, 88 Bankr. 85, 88 (Bankr. D. Md. 1988).

237 Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff), 700 F.2d 935 (5th Cir. 1983).

Circuit reversed the bankruptcy court, finding the transaction to be a sub rosa plan.[238]

The purchase of a claim simply substitutes the purchaser for the original holder. Transfer of a claim from one holder to another does not result in assets being taken from the estate,[239] and does not change or alter the allocation of the debtor's assets among claims against the estate.[240] The new holder of the claim takes over the right to seek recovery from the estate on that claim, and also inherits the risks that the debtor's business will decline, that reorganization will be delayed, or that recoveries from the estate will otherwise be adversely affected. There is no change in the amount or type of assets in the debtor's estate that would or could result in a de facto plan.

2. *Impact on Priorities*

Considered in this light, the concern that the claims purchases by a plan proponent constitute an end run around the plan approval process may be ameliorated. The court in *Allegheny* found that Japonica Partners' purchase of claims outside its plan "caused discriminatory treatment among members of the same class in violation of 11 U.S.C. § 1123(a)(4)" because creditors who accepted the offer received immediate cash, and those who did not accept were left to receive their distribution at some undetermined date.[241] Messrs. Fortgang and Mayer adopt a, similar view, but with a twist. They suggest that a claims purchaser who later proposes a plan (or increases distributions under a plan) paying more to claims in that class, violates section 1123(a)(4) of the Bankruptcy Code because some creditors (those who did not sell) received better treatment than others (those who did

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238 *Id.* at 939-40.

239 Judge Cosetti, in *Allegheny*, suggested that a plan proponent purchasing claims is somehow using assets of the estate rather than the proponent's own resources. The opinion states:

> In a prior opinion in this case, this court declared that the assignment of claims "allows a third party to do something which the debtor cannot" before confirmation of a plan because of the constraints of sections 1125 and 1129. Although the court was critical of the process, the court allowed the trading in claims because the purchasers of claims there were speculators who were using their own resources. Under the special facts of this case, the court cannot apply the same distinction to Japonica. The earlier purchasers of claims were not proponents of a plan—Japonica is!

118 Bankr. 282, 296 (Bankr. W.D. Pa. 1990), *quoting In re* Allegheny Int'l Inc., 100 Bankr. 241, 243 (Bankr. W.D. Pa. 1988). The basis for this statement is unclear. Nothing in the record in that case indicated that claims were paid for with any funds other than those provided by Japonica Partners or its investors.

240 A different rule might apply if the purchaser of the claim were a corporate insider. *See discussion supra* Part II(B).

241 *In re Allegheny*, 118 Bankr. at 295-96.

sell).[242] It follows, they assert, that a plan proponent who purchases claims cannot later amend its plan to provide more favorable treatment to non-sellers, unless all prior sellers are given a chance to share in the higher premium. Early sellers must be afforded the right to share in the later increase, they contend, because at the time the early sellers were "solicited" they did not have adequate information so as to choose less favorable treatment than is offered under the plan.[243]

A transfer of a claim from one holder to another, even where the transferee is a plan proponent, does not result in a violation of section 1123(a)(4) of the Bankruptcy Code. That section requires that a plan "provide the same treatment for each *claim* or interest of a particular class, unless the holder of a particular *claim* or interest agrees to a less favorable treatment of such particular *claim* or interest."[244] The confusion on this point arises from the failure to distinguish between "creditors" and "claims." A "claim" is defined in the Bankruptcy Code as a "right to payment" or a "right to an equitable remedy for breach of performance."[245] A "creditor" is defined in turn as an entity that has a "claim."[246] Section 1123(a)(4) does not require that *creditors* receive the same treatment; it does require that *claims* within a class receive the same treatment. The fact that creditors who sell their claims receive cash from the purchaser does not affect or dictate the ultimate treatment of the transferred claim under a plan. That claim may be satisfied by cash, securities, stock, or other property under a plan, so long as all claims within the class receive the same treatment, or the holders elect less favorable treatment.

For the same reasons, the purchase of claims by a non-debtor plan proponent does not defeat application of the absolute priority rule of section 1129(b)(2)(B).[247] If a plan of reorganization is to be confirmed notwithstanding the failure of an unsecured class of claims to accept the plan, the absolute priority rule requires that either (i) each holder of a claim within the class must receive or retain property of a value equal to the allowed amount of such claim or (ii) holders of claims or interests junior to the non-accepting class will not receive or

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242 Fortgang & Mayer, *Trading Claims*, *supra* note 4, at 49.

243 Fortgang & Mayer, *Developments*, *supra* note 5, at notes 141-42 and accompanying text. Messrs. Fortgang and Mayer appear to be concerned here about the lack of disclosure to the selling claimants. Japonica Partners, however, included a clause in the tender offer documents and in its assignment agreements that indicated the distributions offered under its plan might be increased. *See supra* note 204. It is not clear whether Messrs. Fortgang and Mayer would view such a disclosure as removing any problem under 11 U.S.C. § 1123(a)(4).

244 11 U.S.C. § 1123(a)(4) (1988) (emphasis added).

245 11 U.S.C. § 101(4) (1988).

246 11 U.S.C. § 101(9) (1988).

247 11 U.S.C. § 1129(b)(2)(B) (1988).

retain any property under the plan on account of the junior claim or interest. After a claim purchase, a plan could still be crammed down pursuant to section 1129(b) of the Bankruptcy Code notwithstanding the failure of a senior class of claims to accept. The claims purchaser, however, as the new holder of the purchased claims, would not receive any distribution on account of those junior claims unless the non-accepting senior class is paid in full.

As noted above, transfer of a claim results in a substitution of holders and nothing more. Holders of other claims and equity interests merely have a new face with which to negotiate. They may find the new face more aggressive or less pleasant, but beauty is in the eye of the beholder. The underlying rights and priorities of the parties have not changed.

3. *Purchase of Claims as "Solicitation"*

Judge Cosetti, in his July 1990 decision, found that Japonica Partners' tender offer for publicly traded debentures prior to the time it had an approved disclosure statement was a violation of section 1125(b).[248] Messrs. Fortgang and Mayer apparently share the view that the purchase of claims alongside a plan of reorganization and prior to approval of a disclosure statement constitutes improper solicitation.[249] The views of Judge Cosetti and of Messrs. Fortgang and Mayer are perhaps tied to the view that the widespread purchase of claims constitutes a plan of reorganization. The language of section 1125(b) and the case law on the topic, however, suggests that "solicitation" for the purpose of purchasing claims is not proscribed by section 1125(b).[250]

The statute does not restrict "solicitation" generally; but it does limit solicitation of "an acceptance or rejection of a plan" from a "holder of a claim or interest with respect to such claim or inter-

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248 *In re* Allegheny Int'l, Inc., 118 Bankr. 282, 295-97 (Bankr. W.D. Pa. 1990). The court made no attempt to reconcile its approval of the Japonica Partners' disclosure statement and the implicit authorization to solicit consents to the Japonica Partners' plan with this finding.

249 *See*, Fortgang & Mayer, *Trading Claims, supra* note 4, at 44-45; Fortgang & Mayer, *Developments, supra* note 5, at 29.

250 Section 1125(b) of the Bankruptcy Code provides in relevant part:

> An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information.

11 U.S.C. § 1125(b) (1988).

est."[251] An entity purchasing claims is not seeking the acceptance or rejection, or even any decision regarding the merits or demerits of a plan of reorganization "with respect to such claim."[252] Indeed one can assume the purchaser is reserving the right to make that decision itself. Upon transfer, the purchaser itself becomes the holder of the claim entitled to vote.

The Third Circuit, in *Century Glove, Inc. v. First American Bank of New York*, indicated that "solicitation" within the meaning of section 1125 is to be construed narrowly, so as not to preclude negotiation and discussion among creditors.[253] The purchase of claims by a plan proponent does not necessarily determine how those claims will be voted. While it can be expected that a proponent will vote any claims it owns in favor of its own plan, it could also vote the claims in favor of any competing plan.[254] Further, if a disclosure statement for any plan is later approved, the holder of the claim at that time—the claim purchaser—may reconsider any decision on how to vote those claims.[255]

C. *Buying Claims or Buying Votes?*

For an entity seeking to buy control of a debtor corporation through buying claims, the ability to vote those claims either for or against a plan of reorganization is key. A purchaser who invests substantial sums of money in the purchase of claims will want to have some say about the debtor's future operations, and the structure of any plan. If debtor's management is hostile,[256] then the claims pur-

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[251] *Id.*

[252] *Id.*

[253] 860 F.2d 94, 101-02 (3d Cir. 1988).

[254] 11 U.S.C. § 1129(c) (1988) expressly contemplates that holders of claims and equity interests may vote to accept more than one plan of reorganization. Pursuant to that section, the court may only confirm one plan, and is to consider the preferences of creditors and equity security holders in determining which plan to confirm.

[255] *Cf. Century Glove*, where the court stated:

> A narrow definition [of acceptance] might allow a debtor to send materials seeking to prepare support for the plan, "for the consideration of creditors," without adequate information approved by the court. Though such preparatory materials may undermine the purpose of adequate disclosure, the potential harm is limited in several ways. First, a creditor still must receive adequate information before casting a final vote, *giving the creditor a chance to reconsider its preliminary decision.*

860 F.2d at 102 (emphasis added).

[256] Because of the risks involved, a potential suitor might not want to attempt to acquire a debtor through the purchase of claims unless its other efforts have been completely rebuffed. There may, however, be advantages to acquiring control through the purchase of claims. For example, where the equity value of the debtor is low and the debtor has valuable NOLs, the acquisition of claims which are later converted into stock may preserve the use of the debtor's NOLs despite a change in control. *See supra* Part I(B)(2)(a).

chaser's acceptance or rejection of the plan may be the only say it has in the process.

1. *Acceptance Requirements*

Section 1129 of the Bankruptcy Code, which sets the standards for confirmation of a plan, requires inter alia that each class of claims or equity interests have either accepted the plan, or not be impaired under the plan.[257] A class of claims has accepted a plan if creditors holding at least two-thirds in amount and more than one-half in number have accepted.[258] A class of equity interests has accepted a plan if holders of at least two-thirds in amount of the allowed interests in that class have accepted the plan.[259] In determining whether these thresholds have been met, only those creditors or equity security holders who submit acceptances or rejections are counted.[260] Acceptances or rejections designated under section 1126(e) are further excluded in making this determination.

A plan may be confirmed notwithstanding the failure of a class of claims or equity interests to accept if the treatment of the non-accepting class meets the standards set forth in section 1129(b) of the Bankruptcy Code, including the requirement that the plan be "fair and equitable" to the non-accepting class.[261] As applied to a class of unsecured claims or of equity interests, the fair and equitable standard is often referred to as the absolute priority rule, and requires that a dissenting impaired class receive full compensation for its allowed claims or for its equity interests before a junior class receives anything.[262] Failure to obtain acceptance from all classes of claims or interests does not prevent confirmation of a plan, but it carries a price tag: strict compliance with the chapter 7 priority rules for the non-accepting class.

2. *Purpose of Voting*

Before considering when acceptances or rejections may be designated and disallowed under section 1126(e), it is perhaps relevant to

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257 11 U.S.C. § 1129(a)(8) (1988). A class of claims is "impaired" under 11 U.S.C. § 1124 unless the plan leaves unaltered the legal, equitable and contractual rights to which the claim entitles the holder, cures any defaults, and reinstates all other legal and equitable rights to which the claim entitles the holder; or provides for 100% payment in cash on the effective date.

258 11 U.S.C. § 1126(c) (1988).

259 11 U.S.C. § 1126(d) (1988).

260 *See* 11 U.S.C. § 1126(c)-(d) (1988).

261 11 U.S.C. § 1129(b) (1988).

262 11 U.S.C. § 1129(b)(2)(B)-(C) (1988).

consider why creditors and equity security holders have a right to submit acceptances or rejections of a plan at all. The House Report accompanying the bill including the Bankruptcy Code explains the philosophy behind chapter 11:

> . . . The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer. . . . [N]egotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. The bill only sets the outer limits on the outcome: it must be somewhere between the going-concern value and the liquidation value.
>
> Only when the parties are unable to agree on a proper distribution of the value of the company does the bill establish a financial standard. If the debtor is unable to obtain the consents of all classes of creditors and stockholders, then the court may confirm the plan anyway on request of the plan's proponent, if the plan treats the nonconsenting classes fairly. The bill defines "fairly" in terms of the relative rights among the classes. Simply put, the bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all. The rule is a partial application of the absolute priority rule now applied under chapter X and requires a full valuation of the debtor as the absolute priority rule does under current law. The important difference is that the bill permits senior classes to take less than full payment, in order to expedite or insure the success of the reorganization.[263]

The right of creditors to accept or reject a plan or to propose a plan of reorganization reflects "the legitimate interests of creditors, whose money is in the enterprise as much the debtor's, to have a say in the future of the company."[264] Each holder of a claim or interest must (i) be left unimpaired, (ii) accept the plan, or (iii) receive at least as much as the holder would receive in a chapter 7 liquidation.[265] Beyond that, allocation of value is a matter for negotiation among the parties, provided the requisite majority in each class accepts. The requirement that each class of impaired claims or interests accept the plan, combined with the alternative treatment under section 1129(b), establishes a mechanism through which a minority in a class can refuse to "give up" value to junior classes unless the minority's class is paid in full.

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263 H.R. REP. NO. 595, 95th Cong., 2d Sess. 224, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6183-84.

264 *Id.* at 231-32, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6191.

265 11 U.S.C. § 1129(a)(7) (1988).

3. *Designation and Disallowance of Acceptances or Rejections Pursuant to Section 1126(e)*

The policies underlying chapter 11 link a claimant's or shareholder's economic interest in the estate with the right to vote to accept or reject a plan of reorganization. This right may be withheld in certain circumstances pursuant to section 1126(e) of the Bankruptcy Code, which provides:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.[266]

Nothing in the Bankruptcy Code defines "not in good faith," or even "good faith." In general, "good faith" is an intangible and abstract quality with no technical meaning.[267] This creates difficulty in determining precisely when a claim holder's acceptance or rejection should be designated and disallowed. General wisdom has it that section 1126(e) incorporates pre-Code case law with respect to the disqualification of claims.[268] Virtually all of the cases interpreting the language of section 1126(e) look to case law developed under chapter X of the Bankruptcy Act.[269]

Despite the prevailing view, nothing in the legislative history to section 1126(e) suggests that Congress intended pre-Code case law to govern what circumstances will result in an acceptance or rejection's being "not in good faith."[270] In light of the imprecise nature of a

266 11 U.S.C. § 1126(e) (1988).

267 BLACK'S LAW DICTIONARY 623 (5th ed. 1979).

268 *See, e.g.*, 5 COLLIER ON BANKRUPTCY ¶ 1126.05[2] (L. King 15th ed. 1991).

269 *See, e.g.*, *In re* Gilbert, 104 Bankr. 206 (Bankr. W.D. Mo. 1989); *In re* A.D.W. Inc., 90 Bankr. 645 (Bankr. D.N.J. 1988); Insinger Machine Co. v. Federal Support Co. (*In re* Federal Support Co.), 859 F.2d 17 (4th Cir. 1988); *In re* MacLeod Co., Inc., 63 Bankr. 654 (Bankr. S.D. Ohio 1986); *In re* Featherworks, Corp., 36 Bankr. 460 (E.D.N.Y. 1984); *In re* Landau Boat Co., 8 Bankr. 432 (Bankr. W.D. Mo. 1981).

270 S. REP. No. 95-989, 95th Cong., 2d Sess. 123, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5909, states: "Subsection (f) excludes from all these calculations claims not voted in good faith . . . or not in accordance with the provisions of this title." The House Report states: "Subsection (f) permits the court to designate any person whose acceptance or rejection of the plan was not in good faith or in accordance with the provisions of the bankruptcy code." H.R. REP. 595, 95th Cong., 2d Sess. 411, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS. 5963, 6367. The House Report also contained an explanation of a separate subsection that would have permitted designation based on conflicts of interest:

> Subsection (e) permits the court to designate for any class of claims or interests any person that has, with respect to that class, a conflict of interest that is of such nature as would justify exclusion of that person's claim or interest from the amounts and number specified in subsection (c) or (d). A person might have such a conflict, for example, where he held a claim or interest in more than one class.

"good faith" standard, it is not at all clear that Congress intended to import the standard used under the Bankruptcy Act. Further, a consideration of the differences between chapter 11 under the Bankruptcy Code and chapter X under the Bankruptcy Act suggests that a wholesale adoption of the standard used under prior law may not be appropriate.

a. *Chapter X as a Model*

Chapter X contemplated a rigid and formalized procedure, including the mandatory appointment of a trustee, and the imposition of strict financial rules governing a plan or reorganization.[271] Application of the absolute priority rule was a requirement of chapter X.[272] An approval hearing was required, at which the valuation of the business (and therefore compliance with the absolute priority rule), and other requirements for confirmation had to be established. After the approval hearing, the plan was sent to the SEC for development of an advisory report on the content of the approved plan.[273] The plan could only be submitted to creditors and shareholders for acceptance once all these steps had been completed.[274] Acceptance by two-thirds in amount of the allowed claims of a class was required.[275]

Claim holders voting on a plan in a chapter X proceeding had already received the protections of the absolute priority rule. A valuation of the debtor's business had been made and a court had established that either the dissenting class was receiving payment in full, or

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> Exclusion from one class for voting purposes would not require his exclusion from the other class as well. The result is to overrule cases such as *Aladdin Hotel Corp. v. Bloom*, 200 F.2d 627 (8th Cir. 1953), which, though not in the bankruptcy context, would appear to count votes for a reorganization plan motivated by an attempt to squeeze out a minority of a class. In that case, the conflict of interest of those voting for the plan was clear, but the court permitted the votes.

Id. Subsection (e) of section 1126 in the original H.R. 8200 was deleted on the basis that section 105 constitutes sufficient power to designate exclusion of a creditor's claim based on conflict of interest. 124 CONG. REC. S17420 (daily ed. October 6, 1978).

[271] H.R. REP. NO. 595, 95th Cong., 2d Sess. 221, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6181.

[272] Bankruptcy Act § 221, 11 U.S.C. § 621 (repealed 1979).

[273] Bankruptcy Act § 172, 11 U.S.C. § 572 (repealed 1979).

[274] Bankruptcy Act § 174, 11 U.S.C. § 574 (repealed 1979).

[275] Bankruptcy Act § 179, 11 U.S.C. § 579 (repealed 1979). Section 203 of the Bankruptcy Act provided:

> If the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, in light of or irrespective of the time of acquisition thereof, the judge may, after hearing upon notice, direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance of a plan.

11 U.S.C. § 603 (repealed 1979).

that no class junior to the dissenting class would receive any distribution under the plan. In contrast, in a chapter 11 case under the Bankruptcy Code, the designation of an acceptance or rejection of a plan deprives the dissenters of their right to insist on application of the absolute priority rule.[276] Given these differences, the key focus under the "not in good faith" standard of section 1126(e) should be whether the entity whose vote is being designated has used its acceptance or rejection in such a way that it should be deprived of the right to insist on the absolute priority rule. In that light, instances of designation should be relatively rare.

b. *"Ulterior Motives" and Bad Faith*

Holders of claims against, and interests in, the debtor's estate have a right to vote on a plan of reorganization because their recoveries are dependent on the outcome and form of that plan. The basic rule for deciding whether an acceptance or rejection will be deemed to have been made "not in good faith" in cases under the Bankruptcy Act, as followed in cases under the Code, is easy to explain in theory, but difficult to apply to specific instances.

In general, good faith in accepting or rejecting a plan does not require selfless disinterest; each creditor is expected to cast his vote in accordance with his perception of his own interest.[277] The test seems to be whether the party whose acceptance or rejection is to be disallowed had some improper ulterior reason for their action.[278] The "unfair advantage" or "ulterior motive" may arise from "pure malice, strikes and blackmail" or with a purpose to destroy an enterprise in order to advance the interests of a competing business.[279] The Supreme Court in *Young v. Higbee*, discussing the history of section 203 of the Bankruptcy Act, stated: "The history of this provision makes clear that it was intended to apply to those stockholders whose selfish purpose was to obstruct a fair and feasible reorganization *in the hope that someone would pay them more than the ratable equivalent of their proportionate part of the bankrupt assets*."[280]

As noted above, the examination of "ulterior" motives in chapter X cases arose in the context in which the naysayers had already re-

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276 Presumably, 11 U.S.C. § 1126(e) would only be used against dissenters where they have a sufficient amount of claims to block acceptance in a class.

277 *See, e.g.*, Insinger Machine Co. v. Federal Support Co. (*In re* Federal Support Co.), 859 F.2d 17, 19 (4th Cir. 1988); *In re* MacLeod Co., 63 Bankr 654 (Bankr. S.D. Ohio 1986); *In re* Landau Boat Co., 8 Bankr. 432 (Bankr. W.D. Mo. 1981).

278 *In re MacLeod*, 63 Bankr. at 655-56; *In re Landau Boat*, 8 Bankr. at 434.

279 *In re Federal Support*, 859 F.2d at 19 (citations omitted).

280 Young v. Higbee Co., 324 U.S. 204, 211 (1945) (emphasis added).

ceived the protection of the absolute priority rule. In that situation, the holder of a claim or equity interest might jeopardize the entire reorganization by refusing to consent, without obtaining any substantial economic benefit for its class.[281] In that context, it may have been appropriate for courts to take a closer look at whether the naysayers were acting in respect of an interest other than their interests as creditors of the estate.

A different circumstance presents itself in chapter 11 cases. Failure to obtain the necessary consents does not prevent confirmation of a plan; it merely requires that the plan or the plan proponent satisfy the section 1129(b) standards for "cramdown." A dissenting creditor in this context is not seeking more than its ratable share of the assets; rather, it is insisting on receiving full payment, or if not entitled to full payment, assurance that no distributions are made to junior classes. Why should a creditor or equity interest holder, even one with another interest that would be served if the plan were defeated, not be entitled to insist on the application of the absolute priority rule? All claims in the rejecting class would share equally in the benefit; specifically, either in payment in full or in reallocation of the value that otherwise would be distributed to junior claims or interests.

Nothing in the Bankruptcy Code requires a senior class of claims or equity interests to give up value to junior claims or interests—or as in *Allegheny*, to the debtor's management—without the consent of the requisite majority of the claims and interests in each impaired class. Although there may be circumstances where an "ulterior" motive or secondary interest may truly jeopardize a reorganization, a reorganization is not jeopardized because senior classes decline to give up value. Bankruptcy courts should proceed cautiously when permitting a debtor or junior creditor to use designation and disallowance of claims pursuant to section 1126(e) to circumvent the application of the absolute priority rule.

c. *Purchase of Claims as Bad Faith*

A majority of the cases considering the question have indicated that the purchase of claims by itself does not amount to bad faith, even if the purchase was for the purpose of obtaining approval or rejection of a plan.[282] The *Allegheny* decision,[283] however, stands for

281 To satisfy the absolute priority rule, all of the debtor's value must have been distributed to classes senior or equal to the dissenting class. 11 U.S.C. 1129(b)(2) (1988).

282 *In re Federal Support*, 859 F.2d at 20 (purchaser of claims from holders who had previously voted for plan, did not act in bad faith in casting deciding votes against plan); *In re* Gilbert, 104 Bankr. 206, 216-17 (Bankr. W.D. Mo. 1989) (as long as creditor acts to preserve what he perceives as his fair share of the debtor's estate, bad faith will not be attributed to

the proposition that the purchase of claims by a plan proponent per se constitutes bad faith. This conclusion is not supported by prior case law.

In *Allegheny* the court concluded that by acquiring a blocking position in a senior class, Japonica Partners "defeated the debtor's plan and can defeat any other plan and thereby obstruct a 'fair and feasible reorganization.' "[284] The court went on to note that Japonica Partners was a "voluntary claimant" and had the option of not becoming a creditor if it was unsatisfied by the proposed distribution.[285] Finally, Judge Cosetti expressed concern that if an outsider can purchase a blocking position, the votes of other creditors and interest holders are rendered meaningless.[286]

Judge Cosetti's opinion in this regard fails to consider the legal effect of the claims transfers, and the economic realities that would prevent a significant creditor from acting willy-nilly to drive down claim prices or recoveries. The purchaser of a claim becomes the holder of the claim and is entitled to all the protections and rights in respect of that claim. The purchaser also accedes to the economic benefits and risks associated with the claim. A party who buys claims which are the subject of a proposed plan has the legal right to insist on more favorable treatment for the class or classes in which its claims are included under the proposed plan.

Holders of claims against, and interests in, the debtor's estate are entitled to vote to accept or reject a plan of reorganization because it is their economic interests that are adjusted or restructured through that plan. An entity that holds over one-third in amount of the claims in a class has a significant economic interest in the treatment of claims in that class. In setting the thresholds for acceptances pursuant to section 1126(c) and (d), Congress determined that holders of over one-third in amount of the claims in a class should have "veto power" to insist on application of the absolute priority rule. At the same

purchase of claims to control a class vote); *In re* Frank Fehr Brewing Co., 268 F.2d 170, 180 (6th Cir. 1959) (purchase of claims for purpose of securing approval of a plan which purchaser believes to be in his best interest does not itself amount to bad faith); *In re* Pine Hill Collieries Co., 46 F. Supp. 669, 671 (E.D. Pa. 1942) (to find bad faith there must be more evidence of ulterior purpose than mere fact controlling votes acquired during progress of proceedings, without regard to their intrinsic value and for purpose of defeating plan); *but cf. In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945) (mere fact purchase is for purpose of securing approval or rejection of plan does not amount to bad faith, but purchase of claims which results in more favorable treatment to sellers is in bad faith).

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

284 *Id.* at 289.

285 *Id.*

286 *Id.* at 290.

time, because of the concentration of claims, those entities bear a significant economic risk if the debtor's business or the values in the estate deteriorate. Remaining claim holders can use this economic pressure, along with their own veto, to protect their interests.

d. *Buying Votes as Bad Faith*

A different problem exists where a person who accepts or rejects a plan, does not share the economic risk that delay in confirming a plan may impose on the debtor's estate. This separation of the economic risk from the voting power might occur where the claims purchaser had a right to rescind claim purchases if its plan of reorganization was not ultimately successful, or where an entity obtains an option, rather than the claim itself. In either of those circumstances, the party with the option or right to rescind can take a "full speed ahead—damn the torpedoes" approach to its preferred plan of reorganization, because it is insulated from the damage that may be caused to the estate. It can shift any losses caused by such an approach, either by exercising its right to rescind or declining to exercise its option.

The contracts for when-issued shares in *Allegheny* are an example of this type of arrangement. The contracts were to become effective only if the debtors' plan were confirmed and consummated, and required that the contracting banks use their "best efforts" to effectuate the contracts. Further, it was a condition to the contracts' effectiveness that no other plan be accepted by the requisite classes of creditors so as to be capable of confirmation. Combined with the "best efforts" clause, this pre-condition arguably required the banks to vote against Japonica Partners' plan. The banks had to vote against Japonica Partners' plan, or run the risk that DLJ would find that the conditions for effectiveness of the contract had not been met. At the same time, DLJ had no obligation to pay under the contract unless the debtors' plan was confirmed and consummated, and James Milligan was CEO of the reorganized companies—and was not at risk if neither the debtors' plan nor the Japonica Partners' plan was confirmed. This type of "no risk" option would constitute an impermissible "ulterior purpose" and should cause designation and disallowance of any acceptance or rejection of a plan submitted as a result of such a device.

e. *Voting Claims to Obtain Control*

In *Allegheny*, Judge Cosetti designated and disallowed Japonica Partners' rejections of the debtors' plan, pursuant to section 1126(e) of the Bankruptcy Code. The court held that votes must be designated under that section when the "creditor has cast his vote with an 'ulterior purpose' aimed at gaining some other advantage to which he would not otherwise be entitled in his position."[287] Japonica Partners, the court found, obtained a blocking position in two senior classes under the debtors' plan, and voted against the plan to "obstruct a fair and feasible reorganization" so that it could obtain control of the debtors. According to the court, in seeking to acquire control, Japonica Partners acted in aid of an interest other than its interest as a creditor so that its rejection of the debtors' plan was not in good faith.[288]

The thrust of the opinion on the issue of good faith seems to be that control of the debtor is an "advantage to which [Japonica Partners] would not otherwise be entitled in [its] position."[289] That notion does not find support in the Bankruptcy Code. Section 1121 provides that if a trustee has been appointed, or after expiration of the period in which the debtor has the exclusive right to file a plan, "any party in interest, including . . . a creditor[], . . . may file a plan."[290] The legislative history indicates Congress understood that the right of non-debtors to file a plan could take control away from the debtor—a feature that was even viewed as a desirable feature of the Bankruptcy Code.[291] Further, nothing in the Bankruptcy Code requires a creditor's plan to take any particular form; nor does the Code require that any control premium be shared among all creditors.

Judge Cosetti correctly noted that bankruptcy is a collective and compulsory process. However, the court criticized Japonica Partners for seeking a control profit for itself rather than sharing such a profit with all creditors and all interest holders under a plan of reorganization.[292] Nothing in the Bankruptcy Code or inherent in the bankruptcy process requires any creditor to act principally for another's benefit or to cease looking out for his own private interests. While the collective nature of the process may impose limits on individual creditors' actions, it does not require a creditor to affirmatively act for another.

The demands of creditors and equity security holders under a

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[287] *Id.* at 290 (citing *In re* Gilbert, 104 Bankr. 204, 216 (Bankr. W.D. Mo. 1989) and *In re* Federal Support Co., 859 F.2d 17 (4th Cir. 1988)).

[288] *Id.* at 289.

[289] *Id.* at 290 (citations omitted).

[290] 11 U.S.C. § 1121 (1988).

[291] H.R. REP. NO. 595, 95th Cong., 2d Sess. 231-32, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6191.

[292] *In re Allegheny*, 118 Bankr. at 299.

plan may take many forms: they can demand cash, they can demand debt securities, or they can demand a controlling interest in the stock. Nothing suggests that such demands would not be in furtherance of their right to seek recovery from the assets of the estate. The court did not, and could not, find that Japonica Partners voted against the debtors' plan in order to force the creditors to accept less favorable treatment under the Japonica Partners' cash plan. Cash recoveries under Japonica Partners' plan were within the range of predicted trading values for the stock to be issued under the debtors' plan. Japonica Partners did not have the power to impose its plan without the consent of creditors, since it did not hold two-thirds in amount and more than one-half in number of the claims in each impaired class. As the largest single creditor of Allegheny, Japonica Partners had an interest in avoiding stalemate, and not in creating it.

Judge Cosetti appears to have been disturbed that by voting to reject the debtors' plan, Japonica Partners could be attempting to increase pressure on claimants to sell their claims. He suggests that the strategic purchase of claims is a "manipulation of the reorganization process" and does not maximize the result for all creditors.[293] Perhaps, however, the pressure on claimants to sell their claims came from the two years, and eight failed plans of reorganization, that had passed before Japonica Partners purchased a single claim. Entrance on the scene of a competitor to the debtors' management—one which was not asking creditors to give up ten percent of the equity value of the company for the right to manage the company,[294] but instead was willing to pay, and pay handsomely for that right—did maximize the result for all holders of claims and equity interests. At a minimum, its participation in the process was not prejudicial to equity security holders who were assured of cash distributions under Japonica Partners' plan and would have been wiped out under the debtors' plan.

Outside of bankruptcy, a competitive bid for control of a company can substantially benefit the stakeholders in that company as the competitors increase the offered prices to achieve their end. Judge Cosetti recognized that in filing its plan, Japonica Partners was in competition with the debtor for control.[295] In filing for protection under chapter 11, the board of directors of a debtor corporation puts the company "in play." Once exclusivity is terminated, non-debtors may file a plan that takes control away from the debtor's management, and gives it to another. For creditors looking for cash and not

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293 *Id.* at 299-300.

294 *See supra* Part III(A).

295 *In re Allegheny*, 118 Bankr. at 290.

equity, a contest for control may be a most advantageous turn of events and the prospect of such a battle may encourage creditors to seek termination of the debtor's exclusive right to file a plan of reorganization in order to encourage third parties to make a market for claims and develop alternatives to a debtor-controlled plan. This development in the marketplace may be inimical to the interest of entrenched management, but not necessarily to the interest of creditors and equity security holders.

To the extent that Judge Cosetti's opinion stands for the proposition that a creditor cannot vote against a debtor's plan if it is the proponent of a plan that would take control of the corporation away from the existing debtor, it is unsupported in either case law or statute. To the extent that Judge Cosetti's decision attempts to discriminate between "old" and "new" creditors who purchase their claims in the post-filing market, the court is making a distinction which has absolutely no juridical support. Unless and until Congress limits the rights of creditors to sell their claims to whom and for such consideration as the sellers deem appropriate, the "new" creditors are entitled to the same rights in chapter 11 cases as the "old" creditors including the right to vote against a plan which the "new" creditors deem to be inferior.

IV. Conclusion

Trading in claims raises many interesting and complex issues. When do claims sellers need to be protected from the claims traffickers? How much disclosure is required? Should "fiduciaries" be permitted to sell, or buy and sell, claims? Is the purchase of claims a plan of reorganization? How does the purchase of claims fit within the requirements of a plan of reorganization? The list is inexhaustible.

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.