Buying claims against a Chapter 11 debtor

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Of all the changes to the Chapter 11 process since the advent of the Bankruptcy Code in 1978, few have had a more far-reaching effect than the exponential growth of the claims trading market. Today, although the bank that served as agent under a secured loan facility will usually remain in that capacity during the borrower's bankruptcy case, the secured claims themselves are likely to be dispersed among investment firms that specialise in buying distressed debt. The same is true for unsecured claims: once a company files for bankruptcy protection, its bonds, unsecured notes and trade debt are likely to be concentrated in the hands of 'repeat players' with an appetite for risk and, in some cases, a deep understanding of the bankruptcy process.

The burgeoning market in secured and unsecured claims is a product of the opportunities presented by a bankruptcy filing. For passive investors, a Chapter 11 case often presents the opportunity to purchase claims at a significant discount. The company's trade creditors are usually eager to cut their losses and to avoid the delay in payment associated with bankruptcy. Many financial creditors are likewise unwilling to bear the risks associated with a Chapter 11 case and would prefer to deploy their capital elsewhere. In all major claims categories, therefore, the uncertainties inherent in the Chapter 11 process create the possibility for a high return on investment.

For strategic investors, including would-be majority owners of a reorganised debtor, investing in a Chapter 11 debtor offers additional advantages. First, strategic buyers of claims can often accumulate a large position without publicly disclosing their purchases. In some circumstances, investors can also benefit from the lack of clarity regarding the debtor's prospects to obtain a controlling stake in the debtor at a favourable valuation.

Despite its potential advantages, buying claims against Chapter 11 debtors involves an array of legal risks. The judicial process mandated by the Bankruptcy Code can have a meaningful effect on the value of claims that is independent from economic fundamentals. All investors, therefore, must approach a Chapter 11 case with an appreciation not only of the high costs associated with bankruptcy, but also of the ways in which bankruptcy can interfere with contractual expectations. Strategic investors, moreover, face multiple obstacles both to the accumulation of large claim positions and to the use of such positions to influence the Chapter 11 process.

This chapter presents an overview of some of the principal risks and issues confronting post-petition investors, with an emphasis on recent legal developments. The first section focuses on two challenges faced by investors in Chapter 11 debtors:

- assessing the effect of a bankruptcy filing on the value of claims; and
- complying with the disclosure rules governing claims trading.

The second section focuses on two challenges faced specifically by strategic investors:

- accumulating a large enough stake in a debtor to influence the Chapter 11 process; and

- navigating the Bankruptcy Code's voting rules.

The second section also explains that purchasing claims can be a useful tool for parties that wish to purchase assets from a debtor.

Buying claims as a passive investment

Valuing a claim

The post-petition investor seeks to buy claims at a favourable price relative to their future value. It is therefore critical to such an investor that the price paid for claims reflects all the legal risks associated with their ownership. In many cases, the factors that can depress the value of a claim in bankruptcy are no different from the business and market factors that affect trading prices outside of bankruptcy. Yet the bankruptcy process can itself impact the value of claims, both through rules that affect entire classes of claims and rules that endanger the value of particular claims. This section focuses on several ways in which the bankruptcy process can affect the value of secured and unsecured claims.

Post-petition interest

Section 502(b)(2) of the Bankruptcy Code provides for the disallowance of claims for "unmatured interest". The effect of that provision, at least in the case of an insolvent debtor, is to prevent unsecured or undersecured creditors from collecting interest on their claims, including default and compound interest, that would otherwise accrue after a bankruptcy filing.

Oversecured creditors – that is, those with security interests in collateral with a higher value than the amount of their claims – are not similarly disadvantaged. Under Section 506(b) of the Bankruptcy Code, oversecured creditors are entitled not only to post-petition interest, but also to any reasonable fee, cost or charge (including attorneys' fees) provided for in a loan agreement.

Despite their entitlement to post-petition interest and fees, secured creditors of a Chapter 11 debtor still face major risks to their yield. Two recent cases, *Calpine* and *Northwest Airlines*, highlight one of those risks: that Chapter 11 debtors will seek to take advantage of favourable borrowing conditions to repay debt that is either non-callable (ie, not subject to pre-payment) or callable only with a pre-payment fee. Courts have consistently held that non-callable debt may be pre-paid in bankruptcy. Many courts, moreover, have permitted pre-payment of secured debt either without awarding any contract damages to lenders or by awarding such damages only on an unsecured basis. Lenders that negotiate pre-payment fees are somewhat better off: while courts scrutinise the reasonableness of such fees, they will generally enforce fees that do not exceed the actual damages resulting from pre-payment.

The plan process presents an additional risk to secured creditors: that the debtor will reinstate their loans at a lower interest rate under a cramdown plan. Even when a class of creditors votes against a Chapter 11 plan, the plan can be confirmed if it is deemed fair and equitable. Where a plan provides that secured creditors will retain their liens and receive deferred payments equal to the present value of their claims, the 'fair and equitable' test is generally satisfied and the discount rate that reflects 'present value' is determined by the court. Although many courts have used the contract interest rate as a reference, other courts have determined the proper rate based on a so-called 'formula approach', under which the court adjusts the national prime rate to account for the risks associated with the loan as of confirmation.

Equitable subordination

Section 510(c) of the Bankruptcy Code permits a bankruptcy court to "equitably subordinate" all or part of a particular creditor's allowed claim to the claims of other creditors. Equitable subordination is available when a creditor has engaged in inequitable conduct – such as fraud – that injured other creditors.

A significant open question in the law of claims trading is whether a claim that would be equitably subordinated in the hands of one party is still subordinated in the hands of a party that buys that claim. The traditional understanding among practitioners had been that the buyer of claims essentially steps into the seller's shoes, so that any defence against the claims travels with them. The bankruptcy court in the *Enron Case* recently concurred in that view: it held that, where the seller of claims under a credit agreement engaged in inequitable behaviour prior to the sale, the claims of the buyer would be equitably subordinated. On appeal, however, the District Court for the Southern District of New York ruled that equitable subordination is "personal" and does not travel with a claim, provided that the transferee acquires the claim in good faith pursuant to a sale. In doing

so, the court drew a distinction between an 'assignment' and a 'sale' of a claim. With respect to assignments, the district court agreed with the bankruptcy court that an "assignee stands in the shoes of the assignor and subject to all equities against the assignor". In contrast, the court found that, where a sale is effected, the "purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances" (*In re Enron Corp*, 06 Civ 7828, – BR –, 2007 WL 2446498, at *5 (SDNY Aug 27 2007)).

The distinction between sales and assignments is difficult to apply in practice. For example, many contracts are styled as 'sale and assignment' agreements, rendering any distinction between the two terms meaningless. In addition, customary provisions in credit agreements describe the transfer of loan interests as 'assignments', even though the buyers of such interests likely consider themselves no different from other claims purchasers. Given the uncertainty that currently prevails on the issue, buyers would be well advised to insist upon indemnities from their sellers that would require the sellers to cover any losses and expenses resulting from an equitable subordination action.

Substantive consolidation

Along with equitable subordination, substantive consolidation is a creature of bankruptcy that can significantly change the value of a claim. The substantive consolidation of two or more affiliated debtors – so that their assets and liabilities are pooled for the purpose of distribution – is a tool that may be used when the financial affairs of separate debtors are hopelessly entangled. A proponent of substantive consolidation generally must show either that:

- pre-petition, the entities for which substantive consolidation is sought "disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity"; or
- "postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors" (*In re Owens Corning*, 419 F 3d 195, 211 (3d Cir 2005)).

Notwithstanding the high legal barriers to substantive consolidation, debtors often propose plans of reorganisation that effectively consolidate members of their corporate family. Buyers of trade claims are in some cases particularly at risk from substantive consolidation: to the extent that the trade claims are held against an operating subsidiary, the effect of consolidation is to make claims against the corporate parent rank *pari passu* with that trade debt. However, where operating subsidiaries have guaranteed the parent company's financial debt, the incentives of trade creditors change: in that circumstance, substantive consolidation may benefit trade creditors by allowing them to share in the parent company's assets and the assets of other subsidiaries. Guarantees aside, trade and other creditors of a domestic operating subsidiary may also favour substantive consolidation when the debtor has solvent overseas subsidiaries.

Contractual subordination

In determining priority among creditors of the same class, the provisions of the Bankruptcy Code are often less important than the agreements among creditors themselves. Section 510(a) of the Bankruptcy Code confirms that subordination agreements among creditors are fully enforceable in bankruptcy. In the context of unsecured debt, such agreements generally impose some form of payment subordination: payments to junior debtholders must be turned over until the senior debtholders are repaid in full. Most agreements, however, also contain a provision known as an 'X' clause, under which subordinated debtholders may receive and retain securities in the reorganised debtor as long as they are subordinate to the securities received by senior debtholders. In addition, although subordination agreements are generally enforced in bankruptcy according to their terms, some courts have suggested that they do not extend to post-petition interest unless the agreement at issue explicitly says so.

The surge in leveraged acquisitions over the last few years has led to tremendous growth in the market for 'second-lien' loans. Unlike subordinated unsecured notes, second-lien loans are typically subject to lien subordination rather than payment subordination. The effect of lien subordination is to require junior creditors to turn over the proceeds of shared collateral to senior creditors until the senior creditors are paid in full. However, to the extent that the debtor has unencumbered assets, the senior lenders have no priority in payment from those assets.

Some agreements among secured lenders go beyond lien subordination. For example, some agreements provide that, in the event that senior lenders fail to perfect their liens or such liens are

avoided, the junior lenders are still required to turn over the proceeds of shared collateral until the senior lenders are paid in full. Inter-creditor agreements can also severely limit the junior lenders' flexibility in bankruptcy. Many agreements:

- deprive second-lien lenders of the right to object to debtor-in-possession financings arranged by the first-lien lenders;
- waive the second-lien lenders' right to seek adequate protection; and
- even waive the second-lien lenders' right to vote their claims.

Although the enforceability of voting restrictions has been questioned, buyers of second-lien debt should take care to evaluate the extent to which their rights under the Bankruptcy Code, including voting rights, have potentially been relinquished by contract.

Disclosure obligations

Aside from properly valuing claims, an additional concern for investors is complying with the mechanical and disclosure requirements that are unique to bankruptcy. As an initial matter, a buyer of a claim after the 'bar date' for filing a proof of claim should confirm that the seller filed a proper claim before that date, or at least that the claim has been listed and not disputed by the debtor in its schedule of liabilities.

Federal Bankruptcy Rule 3001(e) governs the transfer of claims. When a claim that has already been filed is transferred, the transferee must file a notice of the transfer with the court. That requirement, however, expressly does not apply to claims based on publicly traded notes, bonds or debentures. As a practical matter, Rule 3001(e) also does not govern when the legal title to a claim is separated from the economic interest in the claim. For example, in certain secured loan structures, the agent bank retains the legal title to the entire loan and files a claim for the full amount thereof, even though economic interests in the loan are distributed among multiple parties. Likewise, both public and non-public debt can be purchased through broker intermediaries, which hold the debt in a 'street name' even though their customers bear the economic risk. When the legal and economic interests in a claim are so separated, purchasers of the economic interest in the claim generally do not file a notice of transfer.

A separate bankruptcy rule, Bankruptcy Rule 2019, requires any 'entity' or 'committee' representing multiple creditors or equityholders to file a statement setting forth, among other things:

- the names of the investors represented by the entity or committee;
- their holdings;
- the times the holdings were acquired; and
- at least in the case of a committee, the amount its members paid for their holdings.

In a recent decision arising out of the *Northwest Airlines Case*, the bankruptcy court in New York strictly applied Rule 2019 to require members of an *ad hoc* (ie, unofficial) committee of shareholders to disclose their holdings, the timing of their purchases and their purchase prices.

The ruling in *Northwest* may lead investors to shy away from forming *ad hoc* committees, despite their advantages. Unlike official committees, *ad hoc* committees have no fiduciary duties to anyone other than their members. Rather, their membership is composed of investors that wish to pursue a common interest, such as maximising the value of particular claims. To the extent that Rule 2019 is strictly enforced, however, investors with common interests may choose to act alone rather than taking the risk that their investment strategies will be exposed.

Buying claims as a strategic investment

Many investors acquire claims against a Chapter 11 debtor solely to obtain a favourable return on investment. Other investors, which we call 'strategic investors', also wish to own a large equity stake in the reorganised debtor, to buy assets from the debtor or to influence the Chapter 11 process by building a blocking or controlling position in one or more classes of claims. In the context of a Chapter 11 case, a blocking position in a class of claims is one that is sufficient to ensure that the class votes against a plan. A controlling position is sufficient to ensure that the class votes in favour of a plan.

To the extent that strategic investors wish to own a large stake in the debtor after confirmation, they typically seek to acquire the so-called 'fulcrum security' – the claims or interests that will make them the residual owners of the reorganised company. When a debtor has adequate collateral to refinance or reinstate all of its secured debt, the fulcrum security is likely to be the debtor's unsecured debt. In contrast, when the debtor can reinstate or repay its first-lien lenders but not lenders with junior liens, the company's second or even third-lien debt will be the fulcrum security. And in cases where the debtor is solvent, pre-

petition equity interests are the fulcrum security. Regardless of which security is ultimately at the fulcrum, its holders are in a position to control the debtor if that security is converted to new equity.

Claim accumulation

The threshold concern for a strategic investor is accumulating a large enough stake in the debtor to accomplish its objectives. There are various obstacles to buying large claim positions. Here, we focus on two of them: fiduciary constraints and tax-related constraints.

Fiduciary constraints

Fiduciary duties and informational disparities among creditors can stand in the way of active claims purchasing. For example, the Bankruptcy Code requires that, in every Chapter 11 case, an official committee of unsecured creditors be appointed. Members of an official committee – which are usually those with the largest positions – generally have the greatest access to information about the debtor and owe fiduciary duties to the constituency whose interests are represented by their committee (usually unsecured creditors). As a result of their receipt of non-public information and their fiduciary duties, committee members must be careful if they are considering any further trading in claims. To the extent that the claims at issue are securities – a category that includes publicly traded bonds and notes – federal securities laws will likely govern. If the claims are not securities, buyers or sellers with non-public information will at least be subject to fraud and other common law claims. In many cases, the US trustee, a government official appointed in each judicial district as an overseer of the bankruptcy process, will insist that committee members refrain entirely from trading.

Given such restrictions, it will often be desirable for strategic investors either to accumulate claims before agreeing to serve on a committee or – if they intend to continue trading claims – to forgo service on a committee, even though such service provides enhanced access to information and the ability to influence the course of a case. Alternatively, committee members that want to trade can ask the court to approve an 'information wall' to regulate communication between individuals engaged in committee work and other individuals from the same institution, such as those at a trading desk.

Parties with informational advantages, whether on a committee or not, can also seek to protect themselves from liability by contract. One such contract is the so-called 'big boy' letter, in which each party agrees that its counterparty may have non-public information but will nonetheless hold the counterparty harmless for failure to disclose such information. Although the efficacy of 'big boy' letters is hardly free from doubt, such letters might provide protection in private litigation between the parties to the letter. They are less likely to be effectual in government enforcement actions, especially where such actions are based on a theory that the party with non-public information violated a duty to someone other than its counterparty.

Tax constraints

The claims market in large Chapter 11 cases is often heavily regulated by court orders that seek to protect the debtor's net operating losses. Net operating losses are an excess of tax deductions over income in a particular year and are valuable because they can be applied against taxable income in other years.

Section 382 of the Internal Revenue Code limits a corporation's ability to use net operating losses after an ownership change by limiting the corporation's ability to offset taxable income against pre-change losses. An ownership change occurs under Section 382 if the ownership of stock in a corporation changes such that, after the change, the percentage of stock owned by one or more five per cent shareholders has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders during a testing period (usually three years). As a general matter, in determining whether an ownership change has taken place, all shareholders that own less than five per cent of the stock in a corporation are treated as a single shareholder.

Because overleveraged debtors often emerge from bankruptcy by distributing a controlling equity interest to their creditors, Section 382's general change of ownership rule could have a drastic effect on many Chapter 11 debtors. However, Section 382 has a bankruptcy exception, under which the annual limitation on net operating losses usage will not apply if:

- the corporation is under the jurisdiction of the bankruptcy court; and
- the shareholders and qualified creditors of the debtor own, as a result of having been shareholders and creditors, at least 50 per cent of the stock in the reorganised debtor.

A 'qualified creditor' is a creditor that receives stock in the reorganised debtor in satisfaction of debt either:

- held at least 18 months prior to the commencement of the bankruptcy case; or
- that arose in the ordinary course of the debtor's business and that has been held by the creditor at all times.

A creditor is also deemed to be a qualified creditor if, as a result of a change of ownership under a Chapter 11 plan, it does not become a five per cent shareholder in the debtor.

It has become the norm for Chapter 11 debtors that wish to exploit the bankruptcy exception to Section 382 to seek (and obtain) orders that permit the debtor to require creditors to sell down claims acquired after entry of a net operating losses protection order to the extent such claims endanger the debtor's net operating losses. Thus, if two creditors each purchase 30 per cent of the debtor's fulcrum security after entry of a net operating losses protection order, they may be required to sell down those positions or, if they fail to do so, forfeit part of their equity stake in the reorganised debtor.

The legality of net operating losses protection orders is largely untested. In one noteworthy opinion arising out of the *United Airlines Case*, an influential appellate court suggested that the only arguable basis for such orders – namely, the Bankruptcy Code's prohibition on acts "to exercise control over property of the estate" – is not legally sufficient, because the mere purchase of claims against a debtor is not an act to "control" estate property" (*In re UAL Corp*, 412 F 3d 775, 778-79 (7th Cir 2005)). Nonetheless, as long as courts in major jurisdictions continue to enter net operating losses protection orders, strategic investors will be subject to the risk of pressured sales.

The plan process

Once a strategic investor accumulates a large stake in a Chapter 11 debtor, it may seek to propose a plan of reorganisation or, more likely, to work cooperatively with the debtor on a plan – to be proposed by the debtor – under which the investor will obtain a large stake in the reorganised company. Even with the debtor's cooperation, the strategic investor's influence over the Chapter 11 process will depend on the plan it favours either being approved by all voting classes or, alternatively, 'crammed down' over the objections of the dissenting classes. In theory, a strategic investor can exert substantial control over the voting process by buying blocking (or larger) positions across various classes. That approach, however, can be complicated by various factors, including the voting rules used in Chapter 11 and the Bankruptcy Code's requirement that votes be cast in good faith.

Voting rules

Section 1126(c) of the Bankruptcy Code sets forth the requirements for creditor approval of a Chapter 11 plan. A class of claims is deemed to accept a plan if the plan is accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the total allowed claims held by the class. If any class votes against a plan, the plan will not be confirmed in the absence of a cram-down.

Claim purchasers should be aware that the majority in number – or 'numerosity' – prong of Section 1126(c) can be tricky to apply. In the case of trade claims, it is likely that each claim purchased from a separate trade creditor will count as a separate claim for voting purposes, because each claim results from a separate transaction with the debtor. In contrast, claims based on notes or bonds from the same issue may not be counted separately once they are concentrated in the hands of one creditor: unlike trade claims, such claims do not arise out of separate transactions. Because votes on Chapter 11 plans are rarely close or contested, such voting-related issues have not come up in many cases; but they are bound to arise more frequently as a result of the rapid expansion of the claims trading market.

Vote designation

The strategic investor, especially one with which the debtor is not working cooperatively, must also be wary of Section 1126(e) of the Bankruptcy Code. That provision allows the court to 'designate' – that is, not count – votes that are not cast in good faith. Although usually applied only in extreme cases, such as those in which a competitor buys claims against a debtor for the purpose of injuring it, Section 1126(e) has the potential to deprive the strategic investor of any influence over the Chapter 11 process.

The most noteworthy (or notorious) decision under Section 1126(e) is *In re Allegheny Int'l*, Inc, 118 BR 282 (Bankr WD Pa 1990). In *Allegheny* Japonica Partners, an investor, bought certain subordinated notes issued by the debtor after the debtor had

proposed a plan of reorganisation. After proposing its own plan, Japonica proceeded to purchase a blocking position in a class of unsecured claims, as well as a class of secured bank debt, in some instances at highly inflated prices. In reaching the conclusion that Japonica had accumulated its claims in bad faith, the bankruptcy court noted various facts:

- Japonica's stated purpose was to take control of the debtor;
- Japonica amassed its position only after it had proposed a Chapter 11 plan to compete with that of the debtor;
- Japonica purchased claims at highly inflated values solely to acquire a blocking position in certain classes;
- In its capacity as a plan proponent, Japonica was a fiduciary of the debtor and had received non-public information; and
- Japonica acquired large positions in classes that had directly conflicting interests in pending litigation.

It is relatively clear that the court considered Japonica a 'bad actor' that had exploited its position as a fiduciary. It is less clear, however, whether the court considered Japonica's purchase of claims for the sole purpose of taking control of the debtor as a sufficient basis for designating Japonica's votes.

Allegheny notwithstanding, numerous cases confirm that an investor's pursuit of its self-interest as a creditor through the purchase of additional claims does not constitute bad faith. Thus, buying a blocking position in a class, even when it is aimed at protecting a creditor's holdings in another class, probably will not be treated as a basis for designation. Courts have also rejected the notion that claims purchased by a plan proponent are necessarily purchased in bad faith. Nonetheless, for the foreseeable future, Section 1126(e) is bound to remain a cause of concern for strategic investors because of its indeterminate language ("good faith") and the case law suggesting that the desire to control the debtor may be an "ulterior motive" (*Allegheny*).

Using secured claims in asset sales

Some investors buy claims to facilitate a purchase of assets from the debtor. Section 363 of the Bankruptcy Code permits a debtor, with court approval, to sell assets outside the ordinary course of business free and clear of liens. Pursuant to Section 363, debtors frequently auction off assets to streamline their business and maximise creditor recoveries.

Section 363(k) of the Bankruptcy Code permits a secured lender to 'credit bid' for property on which it has a lien. Thus, if a secured lender has a $1 million claim against the debtor and an auction of its collateral does not attract bids above that level, the lender is entitled to purchase the collateral by extinguishing its $1 million claim.

Buying secured claims in contemplation of an asset sale can be a beneficial strategy. First, by holding secured claims, a creditor often receives access to information about its collateral that may be more difficult to obtain as an outside bidder. Second, because Section 363(k) permits a creditor to bid in the face value of its claim, the holder of an undersecured position effectively has a right of first refusal with respect to its collateral: if the creditor believes that its collateral is being sold at a discount, the creditor can bid in its debt. If, on the other hand, the creditor believes the collateral is being sold at a fair value, it can maintain its lien on the proceeds of the sale. And in the unusual situation in which credit bidding is not permitted, the creditor can take some comfort that the court-supervised process will yield a reasonable price for the debtor's assets.

Finally, even if no asset sale is proposed, holding secured debt puts a lender in a strong position to sponsor debtor-in-possession financing. In that capacity, the lender can receive a favourable yield and, in some circumstances, dictate the conditions under which a future sale of collateral will take place. Strategic investors, therefore, have numerous reasons to buy claims against the debtor, even if they do not plan to own a stake in the company over the long term.