Distressed Debt Investing and the United States Bankruptcy Code

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September 2003

Introduction

There is an active and growing market in distressed debt.[1] The market experienced tremendous growth throughout the 1980's and '90's, and it now has reached a global scale. It has been estimated that last year in the U.S. alone there was approximately US$600 billion of distressed debt in the market.[2] The market's size and past successes have attracted a substantial amount of capital.

Distressed-debt investors ("DDIs"), sometimes referred to as "vultures," have been growing in number and size. It is estimated that, since the year 2000, the amount of capital under management by distressed-debt investors has nearly doubled to approximately US$50 billion.[3] The market's rapid growth (spurred by the lure of profit) has attracted considerable attention. Tales of profiteering and ungentlemanly conduct have led some to wonder if the market is out of control. Although abuses have occurred, it appears the market has effectively policed itself.

The market encompasses debtors in, and out of, court-supervised insolvency proceedings. As the market has grown and deepened, DDIs have evolved. Gone are the days when DDIs largely focused on the debt of bankrupt companies. Today DDIs have evolved into a variety of breeds. Their diversity reflects a variety of strategies used to make money in this fast growing market.

The debt purchased by DDIs may be grouped into four basic categories: (i) publicly traded debt such as registered or Rule 144 A securities (although typically unsecured, these public debt securities are often referred to as "bonds," (ii) bank debt, (iii) privately placed debt securities (usually referred to as "notes," and (iv) trade claims (e.g., debt to suppliers and others in commercial trade). DDIs do not, however, limit themselves only to debt. DDIs actively invest in instruments across the whole of a company's capital structure, from senior secured debt to junior subordinated bonds to common stock.

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[1] *See, e.g.*, Dane Hamilton, *Vultures Raising Billions for Buying Spree*, Reuters, February 22, 2003; Phyllis Berman, *The Life of a Vulture*, Forbes, September 30, 2002 at page 337; Hilary Rosenberg, *The Vulture Investors* (1992).

[2] Nick Evans, *Vultures Fly High as Distress Intensifies*, Euromoney Institutional Investor PLC, May 1, 2002.

[3] *Id.*

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Although public securities laws are applicable to a large segment of the distressed-debt market, a substantial amount of the market is relatively unregulated. This paper does not, in any great detail, examine the application of the public securities laws to the distressed-debt market. Instead this paper focuses on the application of the United States' bankruptcy law (statutes, rules and case law) in this market.

A substantial part of the distressed-debt market remains unregulated for good reason. Courts and lawmakers are appropriately reluctant to over-regulate for fear of chilling a beneficial market.

The market for distressed debt is beneficial for a number of reasons. For example, trading in debt claims provides valuable liquidity. Having the ability to exchange claims for cash rather than enduring what are often prolonged proceedings at the end of which are uncertain distributions is an important benefit. Another benefit is that distressed-debt investors are often a driving force toward a prompt reorganization. Distressed-debt investors tend to carefully study the companies in which they invest. Given distressed-debt traders buy at a discount, they are in a better position to compromise their claims and still make profit.

Nevertheless, the lack of regulation in a substantial part of the market has fueled suspicions that DDIs need their feathers trimmed. An examination of the law and experience in this area suggests, however, that there is little need for additional regulation.

The following sections examine how United States bankruptcy law (in conjunction with the securities law) provides an effective scheme for regulation of the distressed-debt market.

The United States Bankruptcy Code and Rules of Bankruptcy Procedure

United States federal bankruptcy law does little to inhibit trading in debt claims. The Bankruptcy Code (Title 11 of the United States Code) does not contain any specific provisions governing trading in claims. The law promotes a free market in trading.

Trading in claims prior to the commencement of proceedings is virtually unfettered. True, the usefulness of a claim may be impaired once proceedings commence. For example, Bankruptcy Code § 553 governs setoff rights after commencement of proceedings. Section 553 provides that certain claims may not be used for setoff purposes, including claims transferred to a claimholder by an entity other than the debtor within 90 days prior to the commencement of the proceedings. Therefore section 553 dampens, to some extent, the market. In short, the commencement of proceedings may affect the usefulness of a claim, but nothing in the Bankruptcy Code hinders the free exchange of claims pre-petition.

Rule 3001(e)

After the start of proceedings trading in claims is minimally regulated. Rule 3001(e) of the Federal Rules of Bankruptcy Procedure imposes certain procedural requirements to effect transfers of claims after commencement of proceedings. Rule 3001(e) provides, in relevant part, as follows:

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(e) Transferred claim

(1) Transfer of claim other than for security before proof filed

If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.

(2) Transfer of claim other than for security after proof filed

If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed 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, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. 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 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 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 a hearing, the court shall enter such orders respecting these matters 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 alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed 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

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> 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 a hearing, the court shall enter such orders respecting these matters as may be appropriate.
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> (5) Service of objection or motion; notice of hearing
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> A copy of an objection 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.

Note, Rule 3001(e) does not apply to transfers of claims based on publicly traded notes, bonds, or debentures. Such claims are freely traded without the need to notify the court or other parties in interest.

Rule 3001(e) was amended in 1991. The Advisory Committee Note to the 1991 amendment stated:

> 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 transferee is substituted for the transferor in the absence of a timely objection by the alleged transferor. In that event, the clerk should note the transfer without the need for court approval. If a timely objection is 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. . . ."

Consequently, Rule 3001(e) provides for the intervention of the bankruptcy court only in those instances where a timely objection to the claim transfer has been filed.

Some courts have strictly applied Rule 3001(e). For example, the 8th Circuit Court of Appeals, in the case of Viking Associates, L.L.C. v. Drewes, reversed the lower court and wrote:

> 'Prior to 1991, some courts interpreted [Bankruptcy] Rule 3001 as authorization for courts 'to monitor the manner in which claims are transferred or assigned and thereby prevent, inter alia, the improper proliferation of claims, wrongdoing and inequitable conduct.' . . . The prior rule required transferees to file evidence of the

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> terms of the claims transfer with the court. Any objections to the transfer had to be filed within 20 days of the notice of the transfer or 'within any additional time allowed by the court.' Moreover, under the old rule, '[i]f the court finds, after a hearing on notice, that the claim has been unconditionally transferred, it shall enter an order substituting the transferee for the original claimant, [sic] otherwise the court shall enter such order as may be appropriate.' The prior rule thus envisioned that the Bankruptcy Court had a role to play in every claims transfer. Under the new rule, however, this is no longer the case.
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> Since no unsecured creditor objected to the transfers in this case, the Bankruptcy Court had no authority to disallow the transfers.[4] (citations omitted)

Although a strict interpretation of the rule suggests courts should not intervene in the claims transfer process absent a dispute among the parties, courts are not left without the power to remedy abuses. In fact, as noted above, the Advisory Committee Note to the 1991 amendments to the Rule stated: "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." When abuses occur, or harm to the debtor is threatened, courts are empowered to take appropriate action.

Restricting the Trading of Claims To Protect the Debtor's Estate

Direct restrictions on claims trading in U.S. bankruptcy proceedings have been imposed to protect a debtor's right to control the property within the debtor's bankruptcy estate. Bankruptcy Code section 362(a)(3) provides, in relevant part, as follows:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, . . . operates as a stay, applicable to all entities, of—
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> . . .
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> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate; . . .

A number of courts have restricted trading in debt claims (and in the trading of equity shares) where such trading has threatened the loss of certain valuable tax attributes; specifically, net operating losses ("NOLs").[5] Faced with the threat of a potential loss of the debtor's valuable NOLs (tax attributes which courts have recognized as property of the bankruptcy estate), bankruptcy courts have exercised their equitable powers to give effect to Bankruptcy Code §

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[4] Viking Associates, L.L.C. v. Drewes (In re Olson), 120 F.3d 98, 101 (8th Cir. 1997).

[5] For a discussion of this subject, *see* John J. Rapisardi, *Thou Shalt Not Trade: Restrictions on Trading in Bankruptcy*, New York Law Journal, Volume 229 (2003).

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362(a)(3). Those courts have done so to protect the debtor's interest in its NOLs. Nevertheless, those courts also have been careful to balance the debtor's needs against the need to minimize the chilling effects on market. Consequently, courts have avoided wholesale restrictions on debt trading in favor of tailored measures designed to protect the debtor's property without unduly inhibiting free trade.

Bankruptcy Code §§ 1126(e) and 510(c)

Bankruptcy Code §§ 1126(e) and 510(c) have been used to redress certain trading abuses.

Section 1126(e)

Bankruptcy Code Section 1126 provides a general rule that the holder of an allowed claim or interest in a chapter 11 case may accept or reject a plan. Section 1126(e) authorizes a court to "designate" any entity whose acceptance or rejection of a plan was not in good faith. An entity "designated" pursuant to § 1126(e) will have its acceptance or rejection of a plan disregarded in the plan approval process. Consequently, § 1126(e) is a powerful tool that a court can use to disenfranchise a claimholder who has acted in less than good faith.

Without providing an exhaustive review of the case law defining what justifies a finding of an absence of "good faith", we note there are a few key cases which illustrate the pitfalls which await an unscrupulous (or merely careless) DDI.

In re Allegheny International

For example, the chapter 11 case of Allegheny International, Inc., et al. before the United States Bankruptcy Court for the Western District of Pennsylvania in 1990[6/] is a veritable roadmap of pitfalls to avoid.

In Allegheny a distressed-debt investor, Japonica Partners, L.P., suffered a stinging defeat in the chapter 11 proceedings of Allegheny International and its 14 subsidiaries. Japonica, over a period of time, acquired a variety of claims with the aim of ultimately gaining control of the debtor companies. To effect its strategy Japonica proposed a plan of reorganization to compete against the plan proposed by the debtor entities. Instead of success Japonica's plans were frustrated when the bankruptcy court "designated" Japonica and confirmed (approved) the debtors' plan of reorganization. Had Japonica not been disenfranchised, it would have had the votes to defeat the debtors' plan of reorganization.

What are the lessons to be learned from Japonica's mistakes?

First, DDIs should take note that if they intend to become a plan proponent, their conduct will be subject to great scrutiny. The Court concluded that as a plan proponent Japonica had

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[6/] In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa 1990).

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impermissibly chosen an "end run" around the bankruptcy process by purchasing, through a public tender process, approximately 62% of the claims in a particularly significant class of debt. Japonica launched its tender offer prior to the Court's approval of the disclosure statement that accompanied Japonica's plan. Japonica also was purchasing claims at a time when creditors were voting on the debtors' plan. The Court concluded that Japonica acted in bad faith by offering to purchase claims (something the Court characterized as offering to a provide settlement to a class of claimholders) in the absence of a confirmed (approved) plan. The Court noted,

> [I]t is beyond dispute that a debtor may not pay creditors outside of a plan of reorganization. Other courts have held that such attempts were an impermissible circumvention of the Bankruptcy Code. . . . Japonica's strategic purchases of claims in strategic classes to advance the position of the proponent is not acceptable and constitutes at least bad faith, if not an unlawful act, in the pursuit of confirmation of its plan."[7] (citations omitted)

Second, DDIs cannot place themselves in positions in which they receive information not generally available to other parties in interest and the general public, and then use that information to strategically buy claims and exert undue influence on the debtor.

Japonica obtained a Court order permitting Japonica, as a plan proponent, to perform certain "due diligence" on the debtors. As Japonica obtained information and purchased more claims, Japonica grew more and more confident its strategy to gain control of the debtors would succeed. Japonica used the due diligence process and its growing power in ways the Court viewed as attempts to control the bankruptcy process for the benefit of Japonica's expected future administration of the debtors. The court concluded, "[t]he court finds that Japonica has engaged in a pervasive pattern of bad faith designed to control the debtor and manipulate the bankruptcy process."[8]

Note that DDIs have been criticized for acquiring claims, taking positions on creditors' committees and using that information to unfairly trade claims.[9] It is true that if the subject debt claims are not public securities there is little that can be done to punish traders who trade on inside information, especially if such traders never plan to vote on a plan of reorganization. However, the holder of a claim acquired with the aid of inside information who plans to participate in the plan approval process may find itself "designated" by the court pursuant to Bankruptcy Code § 1126(e).

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[7] *Id.* at 296.

[8] *Id.* at 299.

[9] *See, e.g.*, BCD News and Comment, *Chapter 22: Are vulture investors to blame?*, August 22, 2001.

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Third: DDIs would do well to avoid purchasing claims within the same class at various times and at various prices in an attempt to execute a grand "control" strategy. Citing an earlier 2nd Circuit Court of Appeals case, the Court in Allegheny wrote:

> [T]he purchase of claims for the purpose of securing approval or rejection of a plan of reorganization is not per se bad faith: 'The mere fact that a purchase of creditors' interests is for ... securing the approval or rejection of a plan does not of itself amount to 'bad faith.' When that purchase is in aid of an interest other than an interest as a creditor, such purchases may amount to 'bad faith' . . . .'[10] (citations omitted).

The Court in Allegheny concluded that Japonica acted "in aid of an interest other than an interest as a creditor." The Court concluded that Japonica's purchases of claims to acquire a blocking position in certain critical classes of claims, and Japonica's "eleventh hour" filing of a competing plan of reorganization evidenced an intent to gain control of the debtors through bad faith manipulation of the bankruptcy process.

This is not to say that DDIs cannot, in good faith, acquire debt claims with the express intention of seeing those debt claims converted to equity interests. Obviously there is a fine line separating acceptable conduct and bad faith.

In re Dune Deck Owners Corp.

The chapter 11 case of Dune Deck Owners Corp. is another case illustrating what constitutes objectionable conduct. That case was decided by the United States Bankruptcy Court for the Southern District of New York in 1995.[11] Although the Court postponed judgment on the debtor's motion to have a certain claimholder "designated" pursuant to § 1126(e), the Court extensively commented on the nature of bad faith in the plan confirmation process. After noting that § 1126(e) was derived from § 203 of the repealed Bankruptcy Act of 1898, the Court noted that the case law under the old Act "recognizes two types of bad faith: (1) the claim holder attempts to extract or extort a personal advantage not available to other creditors in its class, and (2) the creditor has an 'ulterior motive', such as to procure some collateral or competitive advantage that does not relate to its claim."[12] (citations omitted).

Quoting an earlier case entitled In re Pine Hills Collieries Co., the Court in Dune Deck observed:

> [T]he test is plainly to be sought in the motives of the holder of the claims.... If a selfish motive were sufficient to condemn reorganization policies of interested

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[10] In re Allegheny, 118 B.R. at 289, quoting In re P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945).

[11] In re Dune Deck Owners Corp., 175 B.R. 839 (Bankr. SDNY 1995).

[12] *Id.* at 844.

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> parties, very few, if any, would pass muster. On the other hand, pure malice, "strikes" and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior. [13] (citations omitted).

The Court went on to list a number of badges of bad faith, including (1) attempts to assume control of the debtor, (2) efforts to put the debtor out of business or otherwise gain competitive advantage over the debtor, (3) efforts to destroy the debtor out of pure malice, and (4) efforts to "obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize."[14]

These cases provide useful illustrations of the type of conduct which may lead to the "designation" of an entity pursuant to Bankruptcy Code § 1126(e). Where a distress-debt investment strategy depends on the investor's ability to vote on a particular plan of reorganization, that investor is well advised to avoid the pitfalls identified in these cases.

Section 510(c)

Section 510(c) of the Bankruptcy Code codifies a well developed doctrine of United States bankruptcy law: the doctrine of equitable subordination.
Section 510(c) provides, in relevant part, as follows:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may--
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> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
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> (2) order that any lien securing such a subordinated claim be transferred to the estate.

Courts have employed the doctrine of equitable subordination to subordinate claims for cause. Where a creditor is found to have acted in bad faith, a bankruptcy court may exercise its equitable powers to subordinate such creditor's claims. Equitable subordination is a tool bankruptcy courts may use to balance the interests of creditors.

A good example of the type of conduct that can result in the equitable subordination of claims may be found in the chapter 11 case of Papercraft Corporation. Papercraft filed its voluntary petition under chapter 11 in March 1991. Papercraft commenced its chapter 11 case after several months of negotiations with creditors during which an agreement was reached on a restructuring

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[13] *Id.* at 844 *quoting* In re Pine Hills Collieries Co., 46 F. Supp. 669 (E.D. Pa. 1942).

[14] In re Dune Deck Owners Corp., 175 B.R. at 844-45.

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plan. Papercraft filed for bankruptcy to give effect to that pre-negotiated plan. Following commencement of the case in March 1991 a substantial delay occurred before the disclosure statement was filed in October 1991. During that period of delay one of the shareholders, Citicorp Venture Capital, Ltd. ("CVC"), anonymously purchased approximately 40% of certain First and Second Priority Notes (the "Notes") issued by Papercraft. CVC had not owned any of the Notes prior to the start of the proceedings. After acquiring the Notes, CVC objected to the confirmation of Papercraft's plan of reorganization (the pre-negotiated plan) and offered its own competing plan. At the time CVC was purchasing claims, it also was obtaining confidential information about Papercraft's financial condition and prospects. Using that confidential information CVC designed its competing plan to favor its interests. Needless to say, CVC bought itself a great deal of trouble. In October 1995 the Bankruptcy Court issued a decision and order in which it found that CVC's conduct constituted a breach of CVC's fiduciary duty to Papercraft and its creditors, and ordered CVC's claims limited to the amount CVC paid for those claims.[15/] Developments only worsened for CVC thereafter. Various appeals led to the equitable subordination of CVC's reduced claim amounts to claims for certain administrative costs and professional fees, claims for harms caused by delays in the plan process, and claims for lost interest income. CVC's position as a shareholder and plan proponent, and its use of confidential information to favor its interests, seriously offended the courts and other creditors.

Particularly noteworthy are the comments written by the Third Circuit Court of Appeals in its review of the equitable subordination of claims. In its recent decision filed on March 19, 2003, that Court wrote:

> In the exercise of its powers as a court of equity, the bankruptcy court may subordinate claims for cause, applying traditional principles of equitable subordination. . . . Although § 510(c) codifies the doctrine of equitable subordination, it does not detail the requirements of such subordination. Instead, it merely states that the doctrine is to be applied 'under the principles of equitable subordination,' and the legislative history states that Congress intended that the courts develop these principles.
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> The doctrine of equitable subordination is remedial, and the goal 'is to undo or to offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.' '[T]he bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate.' . . . The inequitable conduct may arise out of any unfair act by the creditor as long as the conduct affects the bankruptcy results of the other creditors. Because equitable subordination is remedial rather than penal, a claim should be equitably subordinated only to the extent necessary to offset the harm suffered by

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[15/] In re Papercraft Corp., 187 B.R. 486 (Bankr. W.D. Pa. 1995).

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> the debtor and its creditors as a result of the inequitable conduct."[16] (citations omitted).

Clearly, equitable subordination is available to redress the harms occasioned by creditors who enter the bankruptcy process through the purchase of claims and/or securities at a discount and in search of profit. Where such creditors use their claims as elements in a strategy to achieve a grander goal (e.g., control of the debtor and a handsome profit on the debt claims purchased) such investors run the risk that their conduct may be viewed as acting in bad faith.

Conclusion

The distressed-debt market has flourished in the past two decades. It is now on a global scale. The early successes of the pioneer DDIs attracted more players and more capital. DDIs have increased in number, many carving out niches in the market. The evolution of the market reflects the evolution of the DDIs.

Although substantial parts of the market remain almost unregulated, matters appear to be under control. The market has done a good job of policing itself. In addition, it appears that the securities law and the bankruptcy law (statutes, rules and case law) provide sufficient safeguards. There are few reported cases in which distressed-debt investors have been found to have in a manner contrary to law.

The few instances in which courts have been forced to intervene have provided useful insights into the types of practices DDIs should avoid. As a consequence, the careful, professional DDIs continue to enjoy successes by employing an increasing variety of acceptable strategies and tactics. In short, we have an active and beneficial distressed debt market without an unacceptable level of abuses.

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[16] Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims (In re Papercraft), 323 F.3d 228, 233-34 (3d Cir. 2003).

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