ARE BANKRUPTCY CLAIMS SUBJECT TO THE FEDERAL SECURITIES LAWS?

HON. ROBERT D. DRAIN[*] AND ELIZABETH J. SCHWARTZ[**]

INTRODUCTION

Over 11 years have passed since Bankruptcy Rule 3001(e) was amended to streamline the trading of bankruptcy claims and dramatically curtail the bankruptcy courts' role in the claim-trading process. During that period, trading in distressed debt continued to increase, with the formation of numerous distressed debt funds with assets in excess of $1 billion.[1] Many recent high-profile chapter 11 cases – *WorldCom*,[2] *Enron*,[3] G*lobal Crossing*,[4] and *K-Mart*,[5] to name a few – have focused attention on investing in the debt of troubled companies and highlighted the perhaps now dominant role of "vulture" investors in large and medium-sized chapter 11 cases.

This article considers whether the federal securities laws apply or should apply to bankruptcy claims and participations in such claims,[6] or whether, instead, the bankruptcy courts' power under various sections of the Bankruptcy Code and the Bankruptcy Rules suffices to control the abuses targeted by the securities laws. In particular, we examine whether bankruptcy claims qualify as "securities" under the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the

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[*] Robert Drain is a United States Bankruptcy Judge for the Southern District of New York. At the time of his appointment in May 2002, he was a partner in the New York law firm of Paul, Weiss, Rifkind, Wharton & Garrison. Judge Drain received his B.A. degree cum laude from Yale University in 1979 and his J.D. degree in 1984 from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar for three years. Judge Drain is a member of the American Bankruptcy Institute and the Association of the Bar of the City of New York, where he was a past secretary of its Committee on Bankruptcy and Corporate Reorganization.

[**] Paul, Weiss, Rifkind, Wharton & Garrison, New York, New York. The authors gratefully acknowledge the assistance of Simeon Gold (Weil, Gotshal & Manges) for insights into the operation of the securities laws in bankruptcy cases, and Benjamin Finestone (New York University Law School, 2004).

[1] There is no rigorous published data on the size and scope of the market in bankruptcy claims. Commentators offer anecdotal evidence of a market in the billions of dollars. *See* Thomas Donegan, Note, *Covering the "Security Blanket": Regulating Bankruptcy Claims and Claim-Participations Trading under the Federal Securities Laws*, 14 BANKR. DEV. J. 381, 386 (1998) [hereinafter Donegan]; Andrew P. Logan III, Note, *Claims Trading: The Need For Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 495 (Winter 1994) [hereinafter Logan] (referring, based on press accounts or interviews with traders, to a multi-billion dollar industry); Michael H. Whitaker, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure,* 3 CORNELL J.L. & PUB. POL'Y 303, 303, 310 (Spring 1994) [hereinafter Whitaker] (referring to multi-billion dollar industry using press accounts and interviews with traders). Most vulture funds buy large amounts of distressed bonds in addition to bankruptcy claims. However, given the reported size of such funds and the apparent degree of such investors' participation in a large number of bankruptcy cases as holders of bank and trade debt in addition to bonds, multi-billion dollar estimates appear reasonable.

[2] Chapter 11 No. 02-13533 (AJG) (Bankr. S.D.N.Y.).

[3] Chapter 11 No. 01-16034 (AJG) (Bankr. S.D.N.Y.).

[4] Chapter 11 No. 02-40188-reg (REG) (Bankr. S.D.N.Y.).

[5] Chapter 11 No. 02-B-02474 (SPS) (Bankr. N.D. Ill.)

[6] References hereafter to "bankruptcy claims" include participations in such claims. In our experience, there is an active market in participations in bank claims in chapter 11 cases although less so in trade and other claims.

"1934 Act"), including as applicable under the Williams Act,[7] and consider arguments previously made for and against application of the federal securities laws to bankruptcy claims.[8] We do not address state securities laws.

Largely because of the Supreme Court's refusal to adopt a clear definition of "security" for purposes of the securities laws, the issue is complex. At the heart of the issue – and perhaps vindicating the Supreme Court's emphasis on the particular context of an instrument in deciding whether it is a security – is the fact that an obligor's insolvency *transforms*, and triggers a market in, its obligations. Thus, while certain debt instruments, such as public bonds, undoubtedly qualify as securities under the federal securities laws (and have never been covered by Bankruptcy Rule 3001(e)), the Bankruptcy Code requires that publicly traded bonds and bank loans and trade debt, which were not securities before the start of the bankruptcy case, be treated similarly.[9] In other words, they are all transformed into claims that have similar rights in the debtor's estate.

> Any unsecured claim in bankruptcy may trade like a speculative instrument. For example, . . . several brokers were prepared to quote a price for trade claims against Wheeling-Pittsburgh Steel Corporation [during its chapter 11 case]. Because the Bankruptcy Code does not, on the distribution side, ordinarily differentiate between types of claims within a class, one can argue that for the purpose of the 1934 Act's antifraud provisions a trade claim is no different than a publicly traded debenture. The trade claim in bankruptcy would not be the first instrument, which is not a security when issued but is a security when resold. Consider the humble home mortgage. When issued it is clearly not a security. When resold on the secondary mortgage

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[7] The 1933 Act is codified at 15 U.S.C. §§ 77a *et seq.*, the 1934 Act is codified at 15 U.S.C. §§ 78a *et seq.*, and the Williams Act is codified at 15 U.S.C. §§ 78m(d), (e), 78n(d)–(f).

[8] *Compare* James D. Prendergast, *Applying Federal Securities Laws to the Trading of Claims in Bankruptcy*, 3 F & G BANKR. L. REV. 9 (1992) [hereinafter Prendergast] (arguing for treating bankruptcy claims as securities); and Donegan, *supra* note 1, at 396 (arguing for treating bankruptcy claims as securities), *with* Stephen H. Case, *Trading in Claims*, 826 PLI/COMM 75, 95 (2001) (stating it is fairly clear trade claims are not securities); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 8 (1990) [hereinafter Fortgang & Mayer] (presenting arguments for application of securities laws to bankruptcy claims, but concluding that such application is "unclear at best"); Anthony Michael Sabino, *No Security in Bankruptcy: The Argument Against Applying the Federal Securities Laws to the Trading of Claims in Bankruptcy*, 24 PAC. L.J. 109 (1992) [hereinafter Sabino] (arguing against treating bankruptcy claims as securities); Ellen R. Werther, Scott E. Ratner & Robert J. Fraley, *Trading in the Claims of Chapter 11 Debtors*, 683 PLI/COMM 317, 325, 328 (1994) (stating bank debt and trade claims are not securities); Whitaker, *supra* note 1, at 332–33 (1998) (conceding bankruptcy claims resemble securities, but arguing against application of securities laws because of resulting disruption of orderly administration of bankruptcy cases). *See also* Joy Flowers Conti, Raymond Kozlowski, Jr. & Leonard S. Ferleger, *Claims Trafficking in Chapter 11 – Has the Pendulum Swung Too Far?*, 9 BANKR. DEV. J. 281, 347–52 (1992) [hereinafter Conti] (proposing amendments to Bankruptcy Code and Bankruptcy Rules analogous to various provisions of securities laws).

[9] *See* 11 U.S.C. §§ 1122(a), 1123(a)(4).

market, however, it becomes a security.[10]

Complexity arises not just from the fact of this transformation but also because the transformation (and the resulting market) is the largely unintended consequence of a bankruptcy regime premised on sometimes countervailing regulatory and policy concerns than the securities laws. The Supreme Court cases determining whether an instrument is a security have emphasized whether there is an existing regulatory alternative to the securities laws. Thus, it is this *bankruptcy context*, admittedly a difficult concept to capture because it is subject to change, that precludes a snap judgment that actively traded bank and trade claims are subject to the securities laws.

I. SUMMARY

In the few years between the onset of large-scale vulture investing and the amendment of Bankruptcy Rule 3001(e), bankruptcy courts addressed certain claim trading abuses in ways that to some extent mirrored the securities laws. Writing between amended Rule 3001(e)'s proposal and its adoption, Fortgang and Mayer ended their important article *Trading Claims and Taking Control of Corporations in Chapter 11*, with uncharacteristic enthusiasm: "[T]he explosion of claims trading and the increase in contests for control of chapter 11 debtors have set in motion swift new currents in chapter 11 practice, carrying the bankruptcy bench and bar in directions unknown. All that is certain is that the voyage is underway."[11] Interestingly, however, while the culture of chapter 11 may have changed significantly with the influx of profit-motivated investors in distressed debt, the promise of major new developments in the case law has not been fulfilled in the intervening years.

Not only has no court applied the securities laws to fill any vacuum left by the amendment of Rule 3001(e), but also we have been unable to locate a single reported decision in which anyone *argued* that the securities laws should apply to claim trading. Apparently only one decision applies the securities laws to claim trading even by analogy.[12]

Moreover, despite an ever-growing amount of vulture investing, which often occurs with an eye to obtaining a controlling interest in the reorganized debtor's equity securities by means of acquiring bankruptcy claims, we have not seen a related growth in litigation over vote designation under section 1126(e) of the Bankruptcy Code, over other remedies, such as claim subordination, that are available to check the coercive

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[10] Fortgang & Mayer, *supra* note 8, at 52–53; *see also* Donegan, *supra* note 1, at 386 (explaining claim buyers "treat claims like stocks and other high yield investments.").

[11] Fortgang & Mayer, *supra* note 8, at 115; *see also* Richard Lieb, *Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor*, 48 BUS. LAW. 915, 915–19 (1993).

[12] *See In re* Applegate Prop. Ltd., 133 B.R. 827, 830 (Bankr. W.D. Tx. 1991) (discussing insider's undisclosed purchase of claims). *Applegate*'s reference to the securities laws, which was only by analogy, was primarily directed, however, at the adequacy of a proposed disclosure statement under section 1125 of the Bankruptcy Code. It therefore was in line with decisions like *In re* Crowthers McCall Patterns, Inc., 120 B.R. 279, 300 (Bankr. S.D.N.Y. 1990) (stating courts may analogize to reporting requirements of securities laws when considering whether to approve a disclosure statement).

use of acquired claims (whether bank and trade claims *or* public debt), or over alleged fraud or misrepresentation in the claim-acquisition or solicitation process. As Fortgang and Mayer pointed out, such litigation remedies share features with the securities laws and, arguably, were developed in place of applying the securities laws to bankruptcy claim trading.[13]

Indeed, perhaps the most salient point about the securities laws and bankruptcy claim trading, which often is stated with some pride, is that there is an active, functioning, and enormous (in terms of dollar amount) market in distressed claims that is *not actively regulated.*

Parties to bankruptcy cases are not shy to assert their grievances. One may conclude, therefore, that the distressed debt trading market works well and does not need fixing, including by application of the securities laws. It can be argued, further, that courts have sufficiently developed rules governing the designation of votes under section 1126(e), and the subordination of claims that have been acquired or used improperly, for practitioners and vulture investors to self-police.[14] Additionally, most trades in distressed debt today probably are between "accredited investors" under Regulation D[15] or are subject to Rule 144A[16] and, therefore, exempt in most relevant ways from the securities laws in any event. Therefore, there may be few available potential plaintiffs for securities law fraud actions.

On the other hand, the fact that most, *but not all*, claim trading is between large sophisticated entities also highlights some concerns. Compared to other markets, the bankruptcy claim market is inefficient and discontinuous,[17] notwithstanding the presence of well-established brokers of distressed debt and active research departments at several investment banks. Effective entry into the market is difficult and generally limited to sophisticated institutions. Reliable information about debtors and chapter 11 cases is not regularly available and large creditors have frequent opportunities to access inside information.[18] Might the market be improved for all participants by making it more transparent? Moreover, it appears inevitable that market forces will lead to the expansion of the buyer pool to include more small investors eager to reap the returns currently achieved by today's large players. Once doctors and dentists gain access to the market, might the securities laws require such transparency?

Further, there is at least good anecdotal evidence that small unsophisticated sellers – trade creditors sometimes characterized as "involuntary" participants because they

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[13] Fortgang & Mayer, *supra* note 8, at 55–56, 79–85, 103–04.

[14] *See infra* at Section III.A.

[15] 17 C.F.R. §§ 230.501–508.

[16] *Id*. at §§ 230.144A.

[17] *See* John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1219 (1991) (commenting on irregularity of similar market in public bonds); Johnathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1014 (1990) (describing generic inefficiencies in markets); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1686, 1739–40 (1996) [hereinafter Tung] (comparing bankruptcy claim market unfavorably to stock market).

[18] *See* Tung, *supra* note 17, at 1733 (commenting on difficulty of obtaining current information).

did not buy their claims as investments but, rather, were stuck with their obligor's default – already are widely engaged in the distressed debt market and are taken advantage of.[19]

Finally, recent developments in the securities markets have shown that complacency can temporarily mask serious problems.[20] It is at least worth a second look, therefore, whether bankruptcy claim trading is sufficiently regulated.

Upon examination, however, applying the securities laws to bankruptcy claims is problematical. First, although the arguments for defining bankruptcy claims as "securities" do not strain the relevant statutes and can be articulated within the Supreme Court's interpretive framework, such an application would be surprising (breaking new ground), disruptive,[21] and, in large measure, unnecessary.

Bankruptcy has its own disclosure, voting and remedial regime that, although not a perfect overlap with the securities laws, largely negates the need to apply them. Indeed, the application of the securities laws, particularly their registration/disclosure requirements, to claim trading would impinge on the bankruptcy process. This is not just because most people involved in bankruptcy cases are not very well versed in the securities laws.[22] Generally, the key disclosure requirements of the securities laws are ill suited to bankruptcy cases. The debtor, who normally would be responsible for such disclosure, has little incentive to make a market in claims (which it did not treat as securities before bankruptcy), and neither it nor other constituents want to spend time and money on additional levels of public reporting.[23] Moreover, to foster negotiation,

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[19] *See* Robert M. Lawless, *Failure and Forgiveness: Rebalancing the Bankruptcy System*, 15 BANKR. DEV. J. 409, 424 (1999) (reviewing KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997)) ("[C]laims buying puts pressures on small creditors to accept offers and diminishes other creditors' power in the bankruptcy case."); *see also* Donegan, *supra* note 1, at 393 ("[T]he buyer often . . . is more sophisticated than the selling creditor, and . . . by its typically larger size, afforded greater economies of scale in its due diligence investigation of the value of the claim(s).").

[20] *See generally* John Cassidy, *The Greed Cycle*, THE NEW YORKER, Sept. 23, 2002, at 68–69 (describing executives' abuse of stock options absent regulatory and legislative oversight); Mark Gimein, *You Bought, They Sold,* FORTUNE, Sept. 2, 2002, (detailing corporate insiders' enormous profits while stockholders lost 70-90% of their holdings).

[21] *See* Fortgang & Mayer, *supra* note 8, at 48 (stating although bankruptcy claims might arguably fall within 1933 Act's definition as "evidence of indebtedness," no court has found a chapter 11 claim to be security). The absence of a bright line test for a "security" under the securities laws probably would lead to an extended period of uncertainty while lower courts grappled with whether to follow the lead of the first court to designate a bankruptcy claim as a security. *But see* Fortgang & Mayer, *supra* note 8, at 46 ("[T]he time may come when the entire area of bankruptcy jurisprudence melts into the securities laws, which would makes sense."); Whitaker, *supra* note 1, at 333–34 ("[S]ecurities laws appear to be an effective vehicle with which to regulate claims trading as they are well established, widely known, and would result in more uniformity than would the bankruptcy courts' use of its equitable power under the Bankruptcy Code.").

[22] *But see* Richard M. Cieri, David P. Porter, Scott J. Davido & Heather Lennox, *Safe Harbor in Uncharted Waters – Securities Law Exemptions Under § 1125(e) of the Bankruptcy Code*, 51 BUS. LAW. 379, 412–13 (1996) [hereinafter Cieri] (discussing applicability of securities laws in various bankruptcy settings); Fortgang & Mayer, *supra* note 8, at 6, 79–85, 103–04 (discussing cases in which securities laws arguably were relevant to bankruptcy claim trading issues at least by analogy).

[23] Disclosure problems increase if a trustee, who may not have access to accurate information, replaces the debtor. *See* Susan Jensen-Conklin, *Financial Reporting by Chapter 11 Debtors: An Introduction to Statement of Position 90-97*, 66 AM. BANKR. L.J. 1, 2–3 (1992) (noting inadequacy of debtor's books and records often precludes certification of audited financial statements).

the Bankruptcy Code has a flexible, contextual approach to valuation,[24] and public disclosure in accordance with the securities laws would undermine that negotiating model by pinning at least the debtor to a specific valuation. Negotiations also would be hampered by a truly fluid market (who would one negotiate with?)[25] and by the possibility of a new tide of litigation and claims over alleged post-petition violations of the securities laws.[26] For at least some of these reasons, even securities law reporting required outside of bankruptcy is often reduced or eliminated as a practical matter after the start of a bankruptcy case in deference to the debtor's bankruptcy schedules and monthly reporting requirements under the Bankruptcy Rules, not to mention other sections of the Bankruptcy Code that expressly limit the reach of the securities laws or provide a safe harbor.[27]

If one accepts that most of the registration/disclosure requirements of the securities laws unacceptably impose on the bankruptcy process, only the anti-fraud provisions are left for consideration. However, even if one could hypothetically uncouple the securities laws' disclosure requirements from their anti-fraud provisions, given the Supreme Court's limitation of those anti-fraud provisions generally to the knowing use of inside information[28] the Bankruptcy Code remedies discussed below for dealing with "insider" purchasers largely fulfill the same purpose as the securities laws.

Therefore, perhaps with the exception of (a) concerted claim marketing schemes and (b) tender offers (particularly post-confirmation tender offers) for claims to obtain reorganization shares that would qualify for registration upon the debtor's emergence from bankruptcy (where a third party would be providing disclosure, which, therefore, would not unacceptably impinge on the bankruptcy process), the securities laws probably should not apply to bankruptcy claims.[29]

This does not mean, however, that one cannot profit by analogy to well-developed

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[24] Various Bankruptcy Code provisions deal with valuation issues. *See, e.g.*, 11 U.S.C. §§ 506(a), 1129(a)(7), 1129(b)(2); *see also* 11 U.S.C. § 1125(d) (stating "adequate information" for disclosure statement purposes "is not governed by any otherwise applicable non-bankruptcy law, rule, or regulation.").

[25] Even now reorganizations are occasionally frustrated by untimely changes in the key creditors if trading occurs before entry into lockup or "plan support" agreements.

[26] It is not clear whether 11 U.S.C. § 510(b) applies to *post-petition* securities law claims. *See generally* Am. Broad. Sys. v. Nugent (*In re* Betacom of Phoenix, Inc.), 240 F.3d 823, 828–31 (9th Cir. 2001) (discussing historical treatment and interpretation of section 510(b)).

[27] *See* 11 U.S.C. §§ 1125(e), 1145. Section 1125(e) may not provide safe harbor for fraud, however. *See* Jacobson v. AEG Capital Corp., 50 F.3d 1493, 1496 (9th Cir. 1995) (stating "[I]f the securities fraud alleged came from some other source or procedure than disclosure and solicitation, then section 1125(e) would not provide immunity.").

[28] Generally, fraud under the securities laws consists of the misappropriation of confidential information for trading purposes in breach of a duty owed to the source of the information. United States v. O'Hagen, 521 U.S. 642, 652 (1997). *See* SEC v. Zandford, 122 S. Ct. 1899, 1906 (2002) (utilizing misappropriation theory in establishing securities fraud action against broker); Chiarella v. United States, 445 U.S. 222, 228 (1980) (requiring relationship of trust and confidence between shareholders of corporation and those who use confidential information).

[29] One hopes that there is at least enough uncertainty about whether the securities laws apply in these areas (as well as under section 11145(b)(1)(A) of the Bankruptcy Code, which gives underwriter status to entities that purchase claims or interests "with a view to distribution of any security received or to be received in exchange for such claim or interest") to cause potential violators to police themselves.

securities law jurisprudence when responding to certain abuses in bankruptcy cases[30] or that courts and the bar should turn a blind eye to common law fraud or other abuses of unsophisticated sellers. In other words, too much may be read into the amendment of Rule 3001(e). That amendment expressly did not eliminate remedies for such wrongs, and bankruptcy remedies, as discussed below, that share features with the securities laws, although adapted to the bankruptcy context, render the application of the securities laws to bankruptcy claims largely unnecessary. Indeed, the application of the securities laws to bankruptcy claims, which we believe would be unfortunate, would, ironically, most likely occur only if courts abandoned such traditional bankruptcy law remedies by over-emphasizing the change effected by the amendment of Rule 3001(e). In other words, whether bankruptcy claims are securities is a closer question than one might first think, and, consistent with the Supreme Court's contextual analysis, including consideration of alternative regulatory schemes to the securities laws, the existence of alternative bankruptcy remedies probably is the key factor in whether a bankruptcy claim is a security.

II. CLAIM TRADING ISSUES UNDER THE BANKRUPTCY CODE

Financial institutions and other sophisticated investors acquire bankruptcy claims at a discount to make a profit upon resale or the ultimate distribution to creditors under a chapter 11 plan,[31] and/or to gain a controlling stake when their pre-petition debt is exchanged for equity in the reorganized company. Public policy benefits of claim trading include (i) increased market liquidity, (ii) enhancement of sellers' recovery,[32] (iii) certain sellers' tax planning[33] or management of regulatory risks,[34] (iv) trade creditors' normalization of their relationships with the debtor,[35] and (v) consolidation

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[30] *See* Fortgang & Mayer, *supra* note 8, at 46 (analogizing features of bankruptcy remedies to securities laws); Tung, *supra* note 17, at 1749–50 (recommending availability of "trading blackout" injunction after relatively early stages of chapter 11 case, to protect against abuses).

[31] Generally, the purchaser of a bankruptcy claim succeeds to the rights of its seller. Absent special circumstances, discussed below, a discounted purchase price is irrelevant to the ability to enforce the claim in full. *See In re* Executive Office Ctrs., Inc., 96 B.R. 642, 649 (Bankr. W.D. La. 1988) (stating purchaser of bankruptcy claim succeeds to rights of seller regardless of discounted purchase price).

[32] Sellers, even trade creditor sellers, do not necessarily sell too cheaply. They may know enough about the debtor and its business to out-bargain a claim purchaser. Because post-petition interest on unsecured claims is generally disallowed under section 502(b)(2) of the Bankruptcy Code, their decision to start their claim sale proceeds working for them now instead of waiting for a later distribution on the principal portion of their claim, may be prescient. S*ee* Whitaker, *supra* note 1, at 303 (noting creditors with large claims may want to sell part of their claim, as hedge).

[33] A claim sale may establish a tax loss that enables a creditor to time a deduction efficiently. *See* Whitaker, *supra* note 1, at 310.

[34] Banks may want to reduce their bad debt exposure. *See* Donegan, *supra* note 1, at 384–85 (discussing banks' motivation to sell claims may be influenced by increased minimum capital requirements). They also are subject to certain limitations on the period that they can hold stock of the reorganized debtor, which they may receive under a chapter 11 plan if they choose not to sell their claims. 12 C.F.R. § 1.7. Regulators or trustees of insolvent creditors also may feel pressure to sell their claims; for example, the California's Insurance Commissioner caused the sale of Executive Life Insurance's distressed debt portfolio at a significant discount to face value and, ultimately, to recovery value.

[35] Trade creditors may prefer to sell their claim than to be adverse to a debtor with whom they want to

of diverse interests in the hands of a few sophisticated investors, leading to more vigorous negotiations, rapid reorganizations and maximization of value for remaining creditors because the consolidated creditor group has greater strength.

Regardless of its benefits, the multi-billion dollar claim trading market also has raised public policy concerns because it is largely unregulated, at least by the SEC.[36] As Bankruptcy Judge Cosetti stated in *In re Allegheny Intern., Inc.*, "By the filing of a bankruptcy case, a market in nonpublicly traded securities is created. Claimants are not protected by a disclosure statement [until one is filed]. It is an undesirable practice."[37]

In fact, the market in distressed debt, including bank and trade debt in addition to bonds, actually starts not with the filing of the bankruptcy case but when the debtor is perceived to be insolvent, which may occur months before the filing. The debtor's insolvency, with the backdrop of a potential bankruptcy filing, changes the tenor of bank, trade and other non-publicly traded claims into claims on the debtor's equity and into claims that in all likelihood eventually will be treated the same as public debt claims of the same priority in bankruptcy. Insolvency also creates an environment that existing creditors want to exit and hopeful investors want to enter. In our experience, it is at this time that vulture investors start acquiring large amounts of debt at significant discounts. Although this fact illustrates the increasing efficiency of the distressed debt market, it does not necessarily mean, however, that market forces (and market regulation) are ready to override countervailing bankruptcy law principles and procedures. While important and generally beneficial, the claim market has not yet become the paradigm for bankruptcy cases. The question remains, though, how to reconcile important bankruptcy policies and procedures with a sometimes flawed market.

Such flaws undoubtedly exist. Bankruptcy courts and commentators have found the solicitation of unsophisticated creditors by sophisticated buyers with superior information particularly troubling.[38] Anecdotally, including in our own experience, non-institutional creditors or their counsel fairly frequently contact counsel for chapter 11 debtors or creditors committees asking how to respond to offers to purchase their claims. Such inquiries usually confirm that many other creditors appear to have been solicited to sell their claims but have lacked the initiative or know-how to contact professionals for the debtor or the creditors committee. In any event, such professionals usually are reluctant to provide investment advice and are constrained

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maintain a good relationship. *See* Donegan, *supra* note 1, at 382–83; s*ee also In re* Celotex Corp, 224 B.R. 856, 856–57 (Bankr. M.D. Fla. 1998) (noting claim trading may contribute to reorganization process if original creditors have lost faith in debtor).

[36] *See* Daylene Crudo, *Claims Trading: Managing the Confusion*, 9 AM. BANKR. INST. J. 29 (1995); Donegan, *supra* note 1, at 386, 388.

[37] 100 B.R. 241, 243 (Bankr. W.D. Pa. 1988) [hereinafter *Allegheny I*].

[38] *See infra* at Section III.A.; *see also* Prendergast, *supra* note 8, at 10–11. *But see* Herbert P. Minkel, Jr. & Cynthia A. Baker, *Claims and Control in Chapter 11 Cases: A Call for Neutrality*, 13 CARDOZO L. REV. 35, 44 (1991) [hereinafter Minkel] (arguing information regarding financial status of debtors is readily available) (It should be noted that Mr. Minkel was Japonica's counsel in *Allegheny*, discussed below).

from discussing non-public information.[39] Unless a disclosure statement has been filed or, better still, approved, therefore, most creditors have little information to evaluate whether a pennies-on-the-dollar offer is shockingly off the mark, or – more to the point – whether they are being misled. In large chapter 11 cases, moreover, the date for filing the debtor's schedules of assets and liabilities and statement of affairs under Bankruptcy Rule 1007 often is extended, and, when filed, such information and the information in the debtor's monthly operating reports frequently does not help to answer the key questions: the amount and timing of distributions.

Although takeover attempts by means of claim acquisitions are not particularly common in chapter 11 cases, commentators also have been troubled by claim-buyers' ability to gain control of the reorganization equity without being subject to the securities laws designed to regulate bids for control, and bankruptcy courts have imposed certain limits on such purchasers. As discussed below, however, the bankruptcy courts have dealt with each of these issues by applying sections 510(c), 1123(a)(4), 1125(b) and 1126(e) of the Bankruptcy Code rather than looking to the securities laws. With one twenty-year-old exception, the district courts also have not dealt with these issues at all in a securities law context.

Bankruptcy courts addressed such concerns in a few influential decisions when the claim trading market first began to grow in the 1980s, although, as Fortgang and Mayer pointed out, cases decided under the Bankruptcy Act are important precedent.[40] In large measure because of the 1991 amendment of Bankruptcy Rule 3001(e), however, the flow of these decisions has in some respects stopped and in others has considerably slowed. Certain commentators have therefore called for more regulation, including the imposition of the securities laws to fill the alleged vacuum – at least to protect unsophisticated claimants from exploitation.[41] One could argue, of course, to the contrary that the amendment of Rule 3001(e) established a general laissez faire policy toward bankruptcy claim trading and that any attempt to regulate such trading therefore is misguided. As discussed below, however, that debate is largely a red herring; less should be read into the amendment of Rule 3001(e) on both sides. The uneasy relationship between market principles and the securities laws, on the one hand, and traditional bankruptcy law concerns and procedures, on the other, is more complex.

A. Bankruptcy Rule 3001(e) and Other Remedial Sources: Is There a Vacuum?

Although bankruptcy courts have examined claim trading under a variety of

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[39] *See* Carl A. Eklund & Lynn W. Roberts, *Bankruptcy Ethics: Article: The Problem With Creditors' Committees in Chapter 11: How to Manage the Inherent Conflicts Without Loss of Function*, 5 AM. BANKR. INST. L. REV. 129, 146 (1997) (stating committees should keep non-public information in strictest confidence); *see also* Robert A. Benjamin, *Fiduciary Responsibilities of Creditors' Committee Members with Respect to Securities and Commodities Transactions*, 10 AM. BANKR. INST. L. REV. 493, 493 (2002) (noting potential for conflict of interest).

[40] Fortgang & Mayer, *supra* note 8, at 94–97.

[41] *See* Prendergast, *supra* note 8, at 9; Donegan, *supra* note 1, at 381. *But see* Sabino, *supra* note 8, at 109.

Bankruptcy Code provisions, the applicability of the federal securities laws to such trading received more commentator attention after the 1991 amendment of Bankruptcy Rule 3001(e), governing the claim transfer process. This is largely attributable to commentators' belief that the amendment left a remedial gap that only the securities laws could fill.[42]

Before August 1, 1991, Bankruptcy Rule 3001(e)(2) provided that the substitution of the transferee as holder of a claim after the filing of the proof of claim required court approval after notice and a hearing.[43] It was not unusual, therefore, for transferees to serve notice of proposed claim transfers not only on the transferor but also on parties in interest in the bankruptcy case. Third parties then could object to the transfer. The terms of the transfer were disclosed to the court,[44] which was in a position to determine, regardless of any objection to the transfer, whether the seller was sufficiently informed of the value of its claim or, to the contrary, was susceptible to being misled.

In 1991, Rule 3001(e) was amended with the express intention of curtailing judicial oversight of claim trades by limiting the requirement of court approval, reducing the description of the trade to be filed with the court, and eliminating third party involvement.[45] As stated by the Advisory Committee Note to the 1991

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[42] *See* Donegan, *supra* note 1, at 381. Note, however, that Rule 3001(e) never applied to participations, which constitute a major part of the distressed debt market.

[43] The pre-1991 amendment version of Bankruptcy Rule 3001(e) provided, in relevant part:

> Transferred Claim.
>
> (1) Unconditional Transfer Before Proof Filed. If a claim other than one based on a bond or debenture has been unconditionally transferred before a proof of the claim has been filed, the proof of claim may be filed only by the transferee. If the claim has been transferred after the filing of the petition, the proof of claim shall be supported by (A) a statement of the transferor acknowledging the transfer and *stating the consideration for the transfer* and why the transferee is unable to obtain the statement from the transferor.
>
> Unconditional Transfer After Proof Filed. If a claim other than one based on a bond or debenture has been unconditionally transferred after the proof of claim has been filed, evidence of the *terms of the transfer shall be filed by the transferee*, The clerk shall immediately notify the original claimant by mail of the filing of the evidence of transfer and that objections thereto, if any, must be filed with the clerk within 20 days of the mailing of the notice or within any additional time allowed by the court. *If the court finds, after a hearing on notice, that the claim has been unconditionally transferred, it shall enter an order substituting the transferee for the original claimant, otherwise the court shall enter such order as may be appropriate.*

(emphasis added.)

[44] *See* FED. R. BANKR. P. 3001(e)(2) (stating evidence of "terms of transfer shall be filed by the transferee."). Rule 3001(e)(2)'s requirement to disclose the "terms of transfer" for transfers after a proof of claim was filed did not expressly require public disclosure of the sale price, unlike Rule 3001(e)(1), and it was common under former Rule 3001(e)(2) to file a copy of the assignment agreement but to document the price paid for the claim in a separate "pricing letter" that was not filed. *But see* Whitaker, supra note 1, at 303, 317–19 (characterizing prior version of Rule 3001(e) as requiring disclosure of sale *consideration*); Logan, *supra* note 1, at 500 (same).

[45] The current version of Bankruptcy Rule 3001(e) provides in relevant part:

> (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

Amendment:

> 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.

In short, amended Rule 3001(e) dispenses with notice (other than notice to the transferor), and the court should not become involved unless the transferor objects to its own purported trade. Moreover, the parties to the trade are not required by the amended rule to disclose any terms of transfer.[46]

The Advisory Committee Note also underscores the limited issues for determination under Rule 3001(e): "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*" (emphasis added).

Although the amendment may have been prompted by concern that the former Rule inhibited the claim market,[47] the Advisory Committee Note expressly does not bless all claim trading.[48] Perhaps significantly as to whether the securities laws should apply to claim trading, the Advisory Committee made it clear that any remedies available to the *two parties to the transfer*, such as for misrepresentation, are not affected by the Rule. Thus, the drafters arguably suggested that a gap left by the

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> 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 by the transferor.

(emphasis added.)

[46] The Distressed Debt Committee of the not-for-profit Loan Syndication and Trading Assoc., Inc. has developed standardized forms for claim trading, further streamlining the market in bankruptcy claims. The standard form continues the pre-amendment practice of not disclosing the sale price.

[47] *See* Conti, *supra* note 8, at 297–98 (noting courts' refusal to transfer claims under former version of Rule 3001(e) "affected the liquidity of the claims market"); Logan, *supra* note 1, at 500–01 (describing former rules as "frustrating the goal of providing a liquid market"). *See generally* Minkel, *supra* note 38, at 35.

[48] FED R. BANKR. P. 3001(e)(2) Advisory Committee Note.

amendment might be filled by the application of, among other remedies, the securities laws:

> This rule is not intended either to encourage or to discourage post-petition 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.[49]

Before its 1991 amendment, Rule 3001(e)(2) invited fairly open-ended court review of the fairness of a pending trade. Such review in practice focused on the potential for abuse of unsophisticated or ill-informed sellers. In addition, courts dealt with two other areas relating to claim trading – purchases by "insiders" and purchases in connection with a takeover attempt or otherwise to influence a chapter 11 plan – in which they also emphasized the importance of disclosure, as well as the adverse effect on bankruptcy cases of buyers whose interests that did not coincide with the interests of creditors generally. These cases reveal the types of remedies that might properly survive the amendment of Rule 3001(e) and whether Rule 3001(e)'s amendment did, in fact, leave a vacuum to be filled by the securities laws. They also help illustrate the bankruptcy context in which claim trading occurs.

The first group of cases, which involved only disclosure problems, not plan-related issues, has been frequently discussed. The courts in *In re Revere Copper and Brass, Inc.*,[50] and *Alegheny I*,[51] refused to approve claim purchases unless the sellers were adequately informed of the status of the case. In*Revere*, a vulture investor entered into 28 assignments with trade creditors at about the time that *The Wall Street Journal* ran a brief story on the debtor's announcement of a chapter 11 plan that paid creditors significantly more than the proposed claim trade prices.[52] The court gave the sellers 30 days to revoke their assignments.[53] The court also stated that it would not approve assignments in the future

> unless it appears that the claimants have been advised at the time of solicitation and again at the time a check in payment of Phoenix's offer is tendered of the pertinent terms of Revere's announced or any subsequently filed plan and the procedural status of the chapter 11 case and plan . . . .[54]

The court did not mention the securities laws, and the facts are insufficiently developed to determine whether, if the bankruptcy claims were securities, the trades would have been subject to unwinding under the securities laws, although it is possible

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[49] *Id*. (emphasis added).
[50] 58 B.R. 1 (Bankr. S.D.N.Y. 1985).
[51] *In re* Allegheny Intern Inc., 100 B.R. 241 (Bankr. W.D. Pa. 1988) [hereinafter *Allegheny I*].
[52] *In re* Revere, 58 B.R. at 1–3.
[53] *Id*. at 3.
[54] *Id*.

that rescission or injunctive relief would have been available. It is not clear from the facts, for example, whether the purchaser was trading based on material non-pubic information as required by Rule 10b-5. The court placed the disclosure burden on the *transferee*, not the debtor.[55]

A plan was pending in *Allegheny I* that would pay many creditors the full principal amount of their claim, yet claims were being assigned for "extraordinary discounts."[56] The court required the *debtor* to provide disclosure regarding the value of the claim (somewhat analogous to a registered corporation's reporting obligations under the 1933 Act), for which, however, the debtor would be deemed held harmless.[57] Specifically, the court required a potential transferee to notify the debtor of the proposed claim transfer, and, within 15 days after such notice, the debtor had to provide the proposed transferor with its "best estimate of the value" of the claim. Upon the filing of a new disclosure statement, the debtor had to provide prospective transferors with a summary of relevant information culled from it.[58] Only if no objections were filed within the following 20 days would the court approve the assignment.[59] Stating its belief that Congress did not intend to permit "trafficking" in claims before the distribution of an approved disclosure statement, the court compared such trades to contracts of adhesion, in which one party has improper superior knowledge.[60] However, on reconsideration, the court (unlike the court in *Revere*) rescinded its earlier order that had permitted transferors to terminate pending assignments.[61] As in *Revere*, the court did not discuss the securities laws or whether the buyers were trading on material inside information or whether there were other facts that would have given rise to a remedy under the securities laws if the bankruptcy claims had been treated as securities.

In *In re Ionosphere Clubs, Inc.*,[62] the court noted its "informational supplement" to Rule 3001(e)(2), which required the assignee to represent that it "did not solicit the assignor via the use of misinformation," and to file with the court any letter soliciting the claim assignment.[63] In reviewing pending assignments under Rule 3001(e), therefore, the court had created a framework for transferors to preserve a garden-variety misrepresentation claim against their transferee.[64] (Neither transferees nor the debtor were required, though, to provide potential transferors with disclosure about the debtor, the bankruptcy case or the value of the claim.) In *Ionosphere,* however, the court found that both parties to the transfer were sophisticated institutions and did not

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[55] *Id*. at 2.
[56] Allegheny I, 100 B.R. at 243.
[57] *Id*. at 243–44.
[58] *Id*. at 244.
[59] *Id*.
[60] *Id*. at 243.
[61] *Id*. at 242.
[62] 119 B.R. 440 (Bankr. S.D.N.Y. 1990).
[63] *Id*. at 443 n.3 (providing requirement may be met (a) by submitting copy of letter soliciting claim or (b) statement that solicitation not through letter and certification that no misleading communication occurred).
[64] *Id.* at 446 (requiring evidence of terms of transfer to prevent "improper proliferation of claims, wrongdoing and inequitable conduct").

need to be protected from their bargain.[65] Also relevant is *In re Odd Lot Trading, Inc.*,[66] in which the court approved a group of discounted claim purchases over the debtor's objection, noting that the transferee's three-page summary of the disclosure statement "provided sufficient information and did not mislead the assignors when soliciting to purchase claims . . . ." The court also noted, however, that there were no Bankruptcy Code restraints on trading in the debtor's public bonds and stock and questioned, therefore, why claim trading should be constrained (apparently not considering that the securities law restraints on trading in the bonds and stock may not apply to trading in claims).[67] Moreover, the court noted that the imminent amendment of Rule 3001(e) would greatly reduce the court's involvement in claim transfers,[68] thus implying that the court would not necessarily have required any disclosure after adoption of the amended Rule.

Before the amendment of Bankruptcy Rule 3001(e), bankruptcy courts also restricted the ability of insiders to purchase bankruptcy claims and imposed various limits on the use of claims purchased to control the debtor or the plan process. Such cases have antecedents in two Supreme Court decisions from the 1940s that support broad use of the bankruptcy courts' equitable powers to prevent unfairness.[69] These decisions were not based, even by analogy, on the securities laws.

Employing its equitable powers in *American United Mutual Life Ins. Co. v. City of Avon Park*, the Court refused to approve confirmation of a chapter IX composition because a fiduciary had solicited votes without the fiduciary's disclosure of its earlier purchase of bonds.[70] Justice Douglas held that under the circumstances the court must scrutinize the voting:

> Where such investigation discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of the investors against an inside few, or of one class of investors from the encroachments of another, the court has ample power to adjust the remedy to meet the need. The requirement of full, unequivocal disclosure; the limitation of the vote to the amount paid for the securities; the separate classification of claimants; the complete subordination of some

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[65] *Id*.

[66] 115 B.R. 97, 101 (Bankr. N.D. Ohio 1990).

[67] *Id*. at 100.

[68] *Id*. at 100–01.

[69] *See* Young v. Higbee Co., 324 U.S. 204, 209 (1945) ("Equity looks to the substance and not merely to the form.") (citing Sprague v. Ticonic Nat'l Bank, 307 U.S. 161 (1939)); Am.United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 145 (1940) (stating equitable "principles are a part of the control which the court has over the whole process of formulation and approval of plans of composition or reorganization, and the obtaining of assents thereto.").

[70] Avon Park, 311 U.S. at 146–47. It is not clear that the fiduciary was acting on an improper motive or would necessarily profit from its purchases. The Court stated that the claims were purchased "in order to facilitate consummation of a composition by placing them in friendly hands" and that the purchases put the fiduciary in a potential conflict position. *Id*. at 142, 144.

> claims, indicate the range and type of the power which a court of bankruptcy may exercise in these proceedings.[71]

Although certain language in the opinion suggests that the fiduciary's prompt disclosure of its purchases might have solved the problem, *Avon Park* stands for more than merely a disclosure requirement. For example, it holds that the plan's uniform classification and treatment of all bonds, including the bonds purchased by the fiduciary at a discount, was improper and unfair discrimination in favor of the fiduciary.[72]

Young v. Higbee Co,[73] also attacked claim purchases under the rubric of preventing discriminatory treatment. There, two preferred shareholders challenged insiders' discounted debt purchases. Following the logic of *Avon Park*, they contended that the insiders' claims should be limited to the amount of the purchase price.[74] Then, however, the insiders silenced their attackers by buying the two objecting shareholders' stock; they also got the two shareholders to agree to dismiss their appeal of plan confirmation.[75] The Court held, however, that the appeal of confirmation could be preserved by the substitution of other preferred shareholders for the selling shareholders, *and* that the selling shareholders' recovery should be limited to the actual value of their shares:

> [T]he consideration of the sale which Potts and Boag made was not merely their own interest in the bankruptcy estate, but the interest of all the preferred stockholders. The situation which enabled them to traffic in the interests of others was created by a statute passed to protect the interests of all of them . . . . They cannot avail themselves of the statutory privilege of litigating for the interest of a class and then shake off their self-assumed responsibilities to others by a simple announcement that henceforth they will trade in the rights of others for their own aggrandizement.[76]

The Court exercised its equitable power to order an accounting to deprive the selling preferred shareholders of "the money paid in excess of the stock value [that] in equity and good conscience belong[s] to the [other] stockholders."[77]

Bankruptcy courts thereafter continued to use their equitable power to deal with "insider" and other post-petition claim purchasers' encroachment on the rights of other creditors. Sometimes this was done by subordinating the acquired claim, sometimes

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[71] *Id.* at 146 (citing Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); Pepper v. Litton, 308 U.S. 295 (1939); First Nat'l Bank v. Poland Union, 109 F.2d 54, 55 (2d Cir. 1954); McEwen v. Grimes (*In re* McEwen's Laundry, Inc.), 90 F.2d 872 (9th Cir. 1937).

[72] *Id.* at 144, 147–48.

[73] 324 U.S. 204 (1945).

[74] *Id.* at 206 n.2.

[75] *Id.* at 208.

[76] *Id.* at 212–13.

[77] *Id.* at 214.

by designating, or disallowing the vote of the acquirer.[78]

Judge Cosetti's opinion in *Allegheny II*[79] dealt with such issues in the most detail. Although we will not review that much-discussed decision at length, five aspects of *Allegheny II* are notable. First, citing, among other authorities, *Young v. Higbee*, the court designated the votes of a purchaser (Japonica) of bank and bond claims under section 1126(e) of the Bankruptcy Code because the purchaser was a "voluntary claimant," "acting other than as a creditor" (i.e. it was acting only to acquire the debtor for the lowest price) and, therefore, acting with an "ulterior purpose."[80] Second, the votes of banks who entered into an undisclosed agreement to sell their when-issued reorganization stock to an investment bank (DLJ) allied with the debtor's senior management were *not* designated under section 1126(e), because the banks were acting as creditors, would have voted the same way without the agreement, and were not paid a premium.[81] The court nevertheless unwound the foregoing agreement to purchase the banks' when-issued stock, however, because it had been kept secret and might have enabled DLJ and senior management to gain control of the reorganized debtor.[82] Fourth, the court deprived Japonica of the "control profit" that it otherwise would have derived from acquiring claims and bonds when it also was a plan proponent (and before approval of its disclosure statement).[83] In so holding, the court employed its equity powers, citing, among other decisions, *Avon Park*, as well as Bankruptcy Code sections 1123(a)(4) (requiring similar treatment of similarly situated claims), 1125(b) (requiring an approved disclosure statement before solicitation of votes on a plan), and 1129(a)(3) (requiring a plan to be in good faith).[84]

Finally, *Allegheny II* reveals some of the problems in using equitable principles to regulate claim trading. That is, while it was clear that Japonica's conduct was, in some measure, improper, clear guidelines from the decision are not easily found. For example, did the court deprive Japonica of its "control profit" because of Japonica's status as an insider, which the court was at pains to establish based on Japonica's obtaining inside information during due diligence and its generally overbearing conduct,[85] or from the pressures that Japonica's initial acquisition of a blocking

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[78] *See, e.g., In re* Gladstone Glen, 739 F.2d 1233, 1237 (7th Cir. 1984) (holding claim purchased at discount during chapter XI case by insider limited to purchase price, although no wrongdoing shown); *In re* Executive Officer Centers, 96 B.R. at 649–50 (concluding claim purchased at discount by *non*-insider would not be subordinated; claim *would* have been subordinated or reduced to amount of purchase price if assignee had been insider); s*ee also In re* Allegheny Int'l., Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990) [hereinafter *Allegheny II*]; *In re* Ionosphere Clubs, 119 B.R. at 445 (noting in addition to authority under Bankruptcy Rule 3001(e)(2), court has equitable power "to fashion appropriate remedies to protect against threatened harm to, or interference with the sound administration of, the estate," citing, among other decisions, *Avon Park*).

[79] 118 B.R. at 282.

[80] *Id*. at 289–90.

[81] *Id*. at 290–93.

[82] *Id*. at 316, 323.

[83] *Id*. at 304.

[84] *Id*.

[85] *Id.* at 298–99 (holding Japonica received inside information and was an insider); *see* Suniati Yap, *Investing In Chapter 11 Companies: Vultures or White Knights?* 2 SW. J. L. & TRADE AM. 153, 172 (1995) (noting several factors leading to decision).

position[86] placed on prospective sellers to accept Japonica's offer or suffer a lengthy confirmation battle?[87] What was the deciding factor in not designating the votes tied to the DLJ transaction: that the banks were original, "involuntary" creditors, or that they would not unduly profit from the transaction? At what time do claim purchases start to equate to a *sub rosa* chapter 11 plan, requiring the imposition of the Bankruptcy Code's disclosure, classification and equal treatment rules? Lastly, should a potential acquirer by means of claim purchases be given any extra leeway if the debtor, as in *Allegheny II*, wants to maintain control and therefore refuses to consider a potentially beneficial sale under section 363(b) of the Bankruptcy Code? That clearly was not the view of the *Allegheny II* court, although, arguably, creditors' recoveries increased because of Japonica's course of claim purchases. These questions, however, should not necessarily dissuade courts from pursuing such remedies, which could be refined in the normal course of case law development.

Decisions after the amendment of Bankruptcy Rule 3001(e) recognized that a primary pillar for policing claim trading had been eliminated.[88] Moreover, *Northwest Bank Worthington v. Ahlers*,[89] which limited use of section 105 of the Bankruptcy Code to furthering or implementing another specific provision of the Code, in some respects undermined the bankruptcy courts' equitable power to regulate trading. Court-mandated disclosure requirements simply to protect unsophisticated creditors, as in *Revere* or *Allegheny I*, have gone by the boards, the post-amendment decisions endorsing the Advisory Committee Note's hands-off approach to claim assignments themselves, if not always to issues raised by claim trading that arise in the voting or plan confirmation context.[90]

Because the amendment to Bankruptcy Rule 3001(e) was so clearly intended to limit the bankruptcy court's review of the claim trade itself, almost all of the cases that cite amended Rule 3001(e) have arisen in a different context. Generally they have

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[86] *See* 11 U.S.C. § 1126(c). Because at least two-thirds in dollar amount of actually voted claims are required for a class to accept a plan, purchase of one-third in dollar amount of the claims in an impaired class ensures that the plan cannot be confirmed on a consensual basis unless the creditor with the blocking position agrees.

[87] *See* Allegheny II, 118 B.R. at 297 ("The debenture class was forced [by Japonica's blocking position] to face a real dilemma – cash now, but in indefinite amounts, or more delay related to confirmation of the Japonica plan. The debenture holders were coerced into selling their claims. This constitutes bad faith.").

[88] *See, e.g., In re* Pleasant Hill Partners, L.P., 163 B.R. 388, 391 n.5 (Bankr. N.D. Ga. 1994).

[89] 455 U.S. 197, 206–07 (1988).

[90] *See In re* Univ. Towers, Inc., 227 B.R. 727, 729 (Bankr. W.D. Mo. 1998) (granting assignee's motion to strike debtor's "suggestions" in support of transferor's objection to claim assignment, because purpose of Rule 3001(e) is simply to confirm transfer is binding and only transferor has standing to object); Troy Sav. Bank v. Travelers Motor Inn, 215 B.R. 485, 490–91 (N.D.N.Y. 1997) (holding secured creditor was not prejudiced by procedural violation of Rule 3001(e)(2), which might have enabled secured creditor to bid competitively for claims. "The purpose of Rule 3001(e)(2) . . . is not to give unrelated third parties notice of transfer, but to give *transferor* notice of claim by the transferee."); *In re* Crosscreek Apartments, Ltd., 211 B.R. 641, 646 n.7 (Bankr. E.D. Tenn. 1997) (questioning debtor's standing to challenge noncompliance with Rule 3001(e)); *cf. In re* Altman, 265 B.R. 652, 658–59 (Bankr. D. Conn. 2001) (vacating prior order denying debtor standing to object to claim transfer, because of possible collusion between claim purchaser and seller's attorney retained by chapter 11 trustee whose successful appointment was pursued by claim purchaser); *In re* Celotex Corp., 224 B.R. at 856–57 (lengthy dicta on benefits of claim trading and court's limited role under amended Rule 3001(e), before deciding which of two competing assignees actually owns claim).

involved an attempt, usually by a debtor, to designate the vote or subordinate the claim of a claim purchaser who has proposed a competing plan, objected to confirmation of the debtor's plan or otherwise opposed the debtor in possession or trustee. Such courts cite Rule 3001(e) as authority for *not* designating the vote or refusing to impose a remedy on the claim purchaser. No party in interest, as opposed to commentators,[91] appears to care about simply protecting the market in claims or defending against misrepresentation in connection with the claim transfer itself except as a secondary consequence of promoting confirmation of its favored plan. Thus the amendment to Bankruptcy Rule 3001(e) does seem to have left some form of a vacuum, at least in the basic sophisticated buyer/unsophisticated seller fact pattern addressed by *Revere* and *Allegheny I,*[92] and may have induced some courts to exercise more restraint toward insider purchases and the purchase of claims for takeover purposes, as well.

The leading case after the amendment to Rule 3001(e) in this regard is *Viking Associates v. Drewes* (*In re Olson*).[93] In that chapter 7 case, the debtors' children first tried to buy the estate's assets and, when rebuffed by the trustee, instead purchased all of the unsecured claims against the estate at a steep discount and then moved with the debtor to dismiss the case.[94] The bankruptcy court denied the dismissal motion, and the trustee sold the assets to a third party for a significantly higher price than the children had been willing to pay, resulting in proceeds well in excess of the secured debt and potentially a large profit to the children on their claim purchases.[95] The bankruptcy court, however, disallowed the claim transfers to the children above the amount of the discounted prices that they had paid.[96] The Eighth Circuit reversed because the transferors had not objected and, therefore, under amended Rule 3001(e) the court lacked the power to intrude.[97] It did so even though the bankruptcy court had found that the children had special knowledge of the value of the assets and "obtained many of the claims from the creditors by providing them with false, misleading and incomplete information."[98] "The language of the Rule is mandatory and directs the court to substitute the name of the transferee for that of the transferor in the absence of a timely objection from the transferor," held the Eighth Circuit.[99] Responding to the trustee's argument that section 105 permitted the court to limit the claim transfers, the court stated, "These equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules."[100]

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[91] *See* Conti, *supra* note 8 at 281, 300–09 (arguing amended rule conflicts with Bankruptcy Code's underlying disclosure policy); Logan, *supra* note 1, at 495 (recommending further amendment to Rule 3001(e)(2) to require disclosure of sale price and terms).

[92] Except, of course, if the transferor objects to its own purported transfer within the time prescribed by Rule 3001(e).

[93] 120 F.3d 98 (8th Cir. 1997).

[94] *Id*. at 100.

[95] *Id*.

[96] *Id*.

[97] *Id*.

[98] *Id*. at 100–01.

[99] *Id*. at 102.

[100] *Id*. (quoting Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987), *cert denied*, 485 U.S. 962 (1988)).

> [T]he Olson children simply pursued their own economic self-interest. If they made misrepresentations to their assignors, the wronged parties could have objected to the Bankruptcy Court, or could have pursued their remedies under nonbankruptcy law, as by suing to rescind the transfer of the claims in any court – presumably a state court – with jurisdiction. The claims transferors have taken neither of these steps. We think people should be allowed to decide for themselves whether to seek redress for an alleged injury.[101]

Perhaps *Olson* can be explained by on its particular context: rather than rely on section 510(c) of the Bankruptcy Code, for example, the bankruptcy court *sua sponte* used Rule 3001(e) to, in effect, partially disallow or subordinate the Olson childrens' claim.[102] Moreover, as a chapter 7 case, *Olson* did not raise the classification, voting and good faith issues that occur in connection with chapter 11 plans. That being said, the decision also can be read broadly to direct bankruptcy courts to steer clear of policing claim trading, even trading by insiders who fraudulently use non-public information. Rather than recognize a uniform rule to discourage such trading, *Olson* relegates the imposition of any remedy to action by individual transferors who might have been injured.[103] Presumably, the *Olson* court therefore also would have invalidated the supplement to former Rule 3001(e) imposed in *In re Ionosphere Clubs*,[104] in which transferees were required to certify that they had not provided misinformation to their transferors. (Given the customary use of "big boy" acknowledgments[105] in claim-trading documentation, it is not clear whether *Olson's* approach would leave transferors with a viable remedy.) After a somewhat similar discussion of the amendment to Rule 3001(e), the district court in *Troy Savings Bank*,[106] upheld the bankruptcy court's refusal to designate the vote of one of the debtor's friends, who bought claims with the avowed goal of helping the debtor stay in business. The opponent of plan confirmation argued that the purchaser had not complied with Rule 3001(e), but the court held that there was no prejudice; only the transferors were entitled to notice, and the purchaser had bought the claims with "a

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[101] *Id*. at 102 n.4. The transferors had not objected to the sale in either *Revere* or *Allegheny I.*

[102] Section 510(c) apparently would have been inapplicable if the transfer had been permitted, because it appears that the children bought all the unsecured claims: there would have been no claims to which the children's' claims could be subordinated.

[103] *In re* Olson, 120 F.3d 98, 102 n.4 (8th Cir. 1997). *Olson* does not mention *Avon Park* or similar cases.

[104] 119 B.R. at 443 n.3.

[105] These are acknowledgments by each party to the trade that it has relied only on its own investigation in deciding to enter into the transaction, by each party that the other party may have material non-public information, and that each party holds the other party harmless for any failure to disclose such information. The efficacy of a "big boy" letter is illustrated by *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51, 56 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) (holding participations at issue were not securities, and concluding "the waiver provision in the MPA's signed by the loan participants specifically absolved Security Pacific of any responsibility to disclose information relating to Integrated's financial condition.").

[106] Troy Sav. Bank v. Travelers Motor Inn, 215 B.R. at 485.

legitimate business interest."[107]

Official Unsecured Creditors' Committee v. Stern (*In re SPM Mfg. Corp*)[108] is another case after Rule 3001(e)'s amendment that applies a hands-off approach to claim transactions even if they arguably impinge on the Bankruptcy Code's other requirements. In *SPM*, the debtor's unsecured creditors committee agreed with the debtor's senior secured lender to cooperate against the debtor and split their recoveries according to a sharing formula. Thereafter, the court concluded that the debtor could not be reorganized and ordered the sale of its assets.[109] After the committee and the lender started to achieve that result, they got around to disclosing their sharing agreement to the court, which at that time took no action.[110] Once the sale was concluded, the debtor's principals objected to the secured lender's sharing sale proceeds with the unsecured creditors as provided in the agreement. (The principals wanted the money to stay in the estate because they were jointly liable for the debtor's unpaid withholding taxes, which would be paid if the money that the secured lender had agreed to pay to the unsecured creditors was instead paid to the estate, the tax claim having a higher priority that the general unsecured claims.) The bankruptcy court agreed and ordered the committee's "share" distributed to the estate to preserve the Bankruptcy Code's priority distribution scheme.[111] Equating the secured lender/committee agreement to a claim purchase, however, the First Circuit reversed.[112]

Citing the amendment of Rule 3001(e), the First Circuit stated "the circumstances in which claims transfers are expressly said to be invalid are limited,"[113] and those limitations did not pertain here. "The bankruptcy court would have had no authority to prevent the general, unsecured creditors from transferring their claims" to the secured lender for the same amount that they received under the agreement.[114] The court did note that the committee was not a fiduciary for the whole estate, but only for the unsecured creditors (whose interests it well served).[115] Moreover, the agreement did not affect voting on a plan and thus did not implicate section 1126(e), and, in any event "As for future cases, we note that the bankruptcy court always retains the power to monitor and control the tenor of reorganization proceedings" and could in the right circumstances reconstitute a committee under section 1102(a)(2) of the Bankruptcy Code or designate votes under section 1126(e).[116] Nevertheless, given that the committee paid nothing for its "share" except its agreement (which for a time was not disclosed to the court and may never have been disclosed to the unsecured creditor body) to work in concert with the secured lender to subvert the debtor's reorganization efforts, one sees a distinct change from *Young v. Higbee.*

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[107] *Id*. at 490–91.
[108] 984 F.2d 1305 (1st Cir. 1993), *reh'g en banc denied*.
[109] *Id*. at 1308–09.
[110] *Id*.
[111] *Id*. at 1309–10.
[112] *Id*. at 1313–14.
[113] *Id*. at 1314.
[114] *Id*. at 1315.
[115] *Id*. at 1315–16 (holding committee's fiduciary duty runs only to parties or class it represents).
[116] *Id*. at 1317.

Two additional circuit court opinions also bear on whether there is a trend to cut back on the bankruptcy courts' power to police the consequences of claim trading. In *Century Glove, Inc. v. First American Bank of New York*,[117] the Third Circuit interpreted narrowly the requirement of section 1125(b) of the Bankruptcy Code that holders' acceptance or rejection of a plan cannot be solicited before transmittal of a court-approved disclosure statement. Noting "We find no principled, predictable difference between negotiation and solicitation of future acceptances [and] therefore reject any definition of solicitation which might cause creditors to limit their negotiations," the court held that "solicitation" for purposes of section 1125(b) would be limited to the specific request for an official vote.[118] This has become the majority view.[119]

Significantly, *Century Glove* disagreed with the argument that absent an approved disclosure statement creditors were unprotected against material misrepresentations (which *Allegheny II*, for example, had asserted).[120] "The problem with the argument is that it rests on an erroneous interpretation of the law . . . . § 1125(b) does not limit communication between creditors. *It is not an anti-fraud device.*"[121] In emphasizing the importance of negotiation, and, therefore, the need not to impede "free and open" communication among parties to bankruptcy cases, the Third Circuit did not, however, completely ignore the risk of abuse: "[B]ecause they are not 'solicitations,' pre-disclosure communications may still be subject to the stricter limitations of the securities laws. 11 U.S.C. § 1125(e)."[122] The court did not address whether or how the securities laws might apply to all bankruptcy claims; its focus was more on the bankruptcy courts' limited oversight role, or at least limits on the bankruptcy courts' ability to use section 1125(b) of the Bankruptcy Code to police communications and transactions based on the absence of an approved disclosure statement.

However, in *Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*,[123] the Third Circuit endorsed the application of the bankruptcy courts' equitable powers to remedy the effects of an insider's purchase of claims. In so doing, the court did *not* protect specific claim sellers (it protected the market only indirectly by imposing a general approach that would discourage abusive purchases in the future). The court found Citicorp Venture Capital ("CVC") to be an insider because of its 28% ownership of the debtor and its right to nominate a board member.[124] After the debtor filed a plan but before it filed a disclosure statement, CVC

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[117] 860 F.2d 94 (3d Cir. 1988).

[118] *Id*. at 101.

[119] *See In re* Clamp-All Corp., 233 B.R. 198, 205–06 (Bankr. D. Mass. 1999) (listing majority and minority decisions and taking minority position).

[120] *See* Allegheny II, 118 B.R. at 296 (Bankr. W.D. Pa. 1990).

[121] Century Glove, 860 F.2d at 101. (emphasis added.)

[122] *Id*. at 102. *Century Glove* also noted that creditors *would* have the benefit of an approved disclosure statement before they actually voted, "giving the creditor a chance to reconsider its preliminary decision." *Id*. Of course, if a creditor had in the meantime sold its claim or signed a lockup agreement, it would not have the benefit of such second chance.

[123] 160 F.3d 982 (3d Cir. 1998).

[124] *Id*. at 984.

purchased a blocking position of unsecured claims "at a significant discount" but neither "requested [n]or obtained the approval of the board, the Committee, or the court before buying the notes.[125] Nor did CVC disclose to any of the selling creditors its identity as buyer or its fiduciary status."[126] CVC then opposed confirmation of the debtor's plan (which it had supported before it obtained a blocking position) and offered its own plan under which it proposed to acquire the debtor's assets.[127] Seeing the bankruptcy court's adverse reaction to CVC's surreptitious purchases, CVC agreed not to vote its claims.[128] The bankruptcy court was not satisfied, however, and imposed a *per se* rule that CVC's claim would be reduced to the aggregate amount of its claim purchase price. Because of the estate's insolvency, this not only deprived CVC of its profit but also reducing its recovery by an additional several million dollars.[129] The Third Circuit reversed, however, holding that the imposition of a *per se* rule was improper:

> At a minimum, the remedy here should deprive CVC of its profit on the purchase of the notes. That can be accomplished by subordinating CVC's claim under § 510(c) to the extent necessary in order to limit its recovery to the purchase price of the notes. Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.[130]

In so holding, the court noted broad equitable authority under *Pepper v. Litton*[131] simply to disallow a fiduciary's claim without engaging in an equitable subordination analysis, but declined to decide whether section 510(c) of the Bankruptcy Code superseded that power to disallow for improper conduct.[132]

Unlike the courts in *Olson* and *Century Glove*, the court did not focus on the rights of the *transferors* (whom *Olson* and *Century Glove* stated should look to nonbankruptcy remedies for protection). Instead, the *Citicorp Venture* court inquired whether "the *non*-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization."[133] Further, it is not clear whether the court's holding that CVC would, at a minimum, be deprived of its claim trading profit would apply in every case of an insider's trading. Consistent with its directive to apply section 510(c), the court's ruling leaves open the possibility that an insider's claim would not be subordinated at all if the facts showed that the non-selling creditors were not injured.[134]

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[125] *Id*. at 985.
[126] *Id*.
[127] *Id*.
[128] *Id*.
[129] *Id*. at 991.
[130] *Id*.
[131] 308 U.S. 295 (1939).
[132] *See* Citicorp Venture Capital, 160 F.3d at 991.
[133] *Id*. at 992. (emphasis added.)
[134] *See* H.R. 595, 95th Cong. (1977) (stating principles of equitable subordination are left to courts develop based on facts); *see also* Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter*

For example, if CVC's claim purchases led to competition between potential acquirers of the debtor, with a resulting increase in creditor recoveries, should CVC's claims have been subordinated?

Not all courts have been as "hands off" as *Olson* or *SPM*, but there has been no discernable trend to protect, in the bankruptcy court, those who sold their claims at a discount after the amendment to Rule 3001(e).[135] Such protection arises only as an indirect consequence of restrictions somewhat fitfully placed on those who would use their claim purchases improperly in the plan process. For example, in *In re Applegate Property*,[136] the bankruptcy court declined to approve the debtor's disclosure statement because it failed to reveal an insider's purchase of a blocking position,[137] and designated the insider's vote on a competing plan.[138] Perhaps uniquely in the claim trading cases, *Applegate* expressly looked to the securities laws by analogy, but did so only to support its finding that the debtor's disclosure statement was inadequate:

> Certainly a related entity's acquiring a block of stock that could potentially dictate the buyout of a company would often be an appropriate subject for disclosure under the securities laws. The materiality standard adopted by the Supreme Court with respect to proxy solicitations under section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 77k (1975) and Rule 14a-9, 17 C.F.R. § 240.14a-9 (1975), promulgated thereunder, is that 'an omitted fact is material if there is a reasonable likelihood that a reasonable investor would consider it important in deciding how to vote.' In addition, 15 U.S.C. § 78m(d) imposes disclosure requirements when an entity acquires beneficial ownership of 5% or more of certain classes of stock. Beneficial ownership can be viewed in terms of voting power.[139]

A number of cases also have concluded that a claim purchaser's votes should not

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11 of the Bankruptcy Code, 56 AM. BANKR. L.J. 293, 300 (1982) (noting bankruptcy courts' discretion in applying principles of equitable subordination).

[135] *See generally* Conti, *supra* note 8, at 320.

[136] 133 B.R. at 827.

[137] *Id*. at 830–31 (failure to disclose insider's purchase was material omission).

[138] *Id*. at 833 n.4, 835 (The court held "The purchasing of claims by an affiliate or insider of the Debtor for the sole or principle purpose of blocking a [plan] competitor from purchasing such claims is an obstructionist tactic done in contemplation of gaining an unfair advantage over other creditors. Such conduct cannot, as a matter of law, be in good faith" (citing Young v. Higbee, 324 U.S. at 210-11), although it also found that "Bankruptcy Rule 3001(e) was substantially satisfied and does not present any relevant legal issues."). *But see* Park Plaza Assocs. Ltd. P'ship v. Conn. Gen. Life Ins. Co. (*In re* 255 Park Ave. Assocs. Ltd. P'ship), 100 F.3d 1214 (6th Cir. 1996):

> Appellants' first argument, that a plan proponent cannot also purchase claims of creditors, is meritless. Nothing in the Bankruptcy Code or the case law suggests such a rule. While a plan-proponent's purchase of votes may shed light on that proponent's motive, whether bad faith exists can only be decided after an analysis of the facts of each case.

Id. at 1219;Troy Sav. Bank v. Travelers Motor Inn, 215 B.R. at 490–91.

[139] *In re* Applegate Prop., 133 B.R. at 830 (citations omitted).

be designated under section 1126(e) of the Bankruptcy Code only *after* noting, among other things, that the purchaser made the same offer to all creditors (or at least to all non-insider creditors) in the solicited class and was an existing creditor, not a stranger to the case.[140] It is not always clear in these opinions, however, whether the court examined the particular facts and circumstances for abuse of the bankruptcy process or, instead, whether the court applied a hard and fast rule against insider or vulture purchasing[141]

One court in the First Circuit also has interpreted *SPM* narrowly,[142] although it took pains to state that a purchase of claims was not at issue.[143] In *CGE Shattuck*, a secured creditor and plan proponent stated in its disclosure statement that it would pay a subset of the non-insider creditors an amount in excess of their distribution from the estate if its amended plan was confirmed, it received stay relief, or the case was converted by a specified date.[144] Noting that "The closer a proposed transaction gets to the heart of the reorganization process, the greater scrutiny the Court must give to the matter," the court determined that the secured creditor's proposal was an end run around the Bankruptcy Code in violation of sections 1122, 1123(a)(4), and 1126 and declined to approve the disclosure statement or the creditor's undertaking.[145]

B. Commentators' Responses

Commentators have continued to state that a bankruptcy court can, under certain circumstances involving insiders, coercive acquisitions or non-creditor motives, invoke sections 1123(a)(4), 1125(b) and 1126(e) of the Bankruptcy Code and equitable

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[140] *See* Figter Ltd. v. Teachers Ins. & Annuity Ass'n of America (*In re* Figter Ltd.), 118 F.3d 635, 640 (9th Cir. 1997) (holding Class 2 creditor acted with good faith after purchasing twenty-one of thirty-four Class 3 unsecured claims, making debtor's plan unconfirmable, because among other reasons, creditor made offers for all Class 3 unsecured claims and was among existing creditors); *In re* 255 Park Ave. Assocs., 100 F.3d at 1219 (noting current creditor acted in good faith when offering full value for all claims of non-insider unsecured creditors); *In re* Marin Town Center, 142 B.R. 374, 380 (N.D. Cal. 1992) (finding purchase of controlling block of claims by existing creditor not per se improper); *In re* Waterville Valley Town Square Assocs., Ltd., 208 B.R. 90, 95–96 (Bankr. D. N.H. 1997) (finding creditor acted reasonably and with good faith after making offers to all unsecured creditors except those closely related to debtor); *In re* Cross Creek Apartments, 211 B.R. at 644 (noting existing creditor attempted to buy all unsecured claims); *In re* Pleasant Hill Partners, 163 B.R. at 395 (explaining existing creditor sought to purchase all claims for full value). *Pleasant Hill* also expressed some concern that claim trading could potentially lead to abuse of unsophisticated sellers. However, having noted that "The only provision in the Code or the Rules relating to the purchase and sale of claims in bankruptcy cases is Bankruptcy Rule 3001(e), [which], however, is entirely administrative, . . ." the court stated "As a result of having no clear Congressional mandate regarding trading claims, the case law relating to trading claims is far from well-settled," and chose not to follow *Revere* and *Allegheny I. Id.* at 393–92.

[141] *But see In re* 255 Park Ave. Assocs., 100 F.3d at 1219; *In re* Dune Deck Owners Corp., 175 B.R. 839, 845–46 (Bankr. S.D.N.Y. 1995) (holding evidentiary hearing was required to determine whether blocking positions were purchased to further interests as a creditor or to obtain advantages in another capacity contrary to estate's and creditors' interests).

[142] *In re* CGE Shattuck, 254 B.R. 5 (Bankr. D.N.H. 2000).

[143] *Id.* at 11.

[144] *Id.* at 8.

[145] *Id.* at 12–13.

principles to regulate attributes of claims purchased post-petition.[146] In concern for unsophisticated creditors, moreover, some commentators also have recommended that Rule 3001(e) be amended to require that the price and other terms and conditions of the purchase be disclosed promptly, and that insider status be disclosed.[147] (Most claim purchasers today doggedly resist attempts under Bankruptcy Rule 2004 or other discovery devices to obtain such disclosure, on the usually successful basis that it is confidential proprietary information.) Commentators also have suggested additional protections.[148] Finally, others making arguments outlined in Part V below, have recommended that the federal securities laws be applied to regulate claim trades in some or all respects, either by recognizing that bankruptcy claims are "securities" or by means of an amendment to the applicable statutes.

The evolution of the case law on claim trading supports to some extent these authors' position that the Bankruptcy Code does not suffice to protect all of the public policy interests fostered by the securities laws. There also is some truth in Conti, Kozlowski & Ferleger's statement that "[t]head hoc creation of law in this area through court decisions produces great uncertainty which can only chill the market for claims."[149] The Advisory Committee Note to amended Rule 3001(e) and certain decisions discussed above also appear to have opened the way for the potential application of the securities laws to bankruptcy claims by highlighting that the curtailment of the bankruptcy court's involvement in policing claim trading does not leave parties unprotected under non-bankruptcy law. It remains to be seen, however, whether that step can or should be taken in light of differing policies and procedures of the securities laws and the Bankruptcy Code (which the securities laws and the Code at least in part expressly acknowledge), as opposed to the continued development of the bankruptcy jurisprudence.

III. FEDERAL SECURITIES LAWS

The federal securities laws through registration and disclosure requirements, restrictive trading rules and anti-fraud provisions, regulate securities trading. The securities laws are premised upon ensuring that investors receive accurate information and are protected from manipulation by those with control or access to nonpublic

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[146] *See* Conti, *supra* note 8, at 347–48 ("Absent any change in the Bankruptcy Code, bankruptcy courts in the exercise of their equitable power can and will continue to fashion remedies for the trading of claims for profit or control when that trading runs afoul of one or more of the basic tenets of bankruptcy law."); Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1, 33 (1991) ("Purchases by an acquirer in contemplation of or in furtherance of a plan of reorganization should themselves be viewed as part of that plan. Under section 1123(a)(4), the acquirer cannot purchase claims unless its sellers know what they are giving up."); Tung, *supra* note 17, at 1744 (arguing for continuing validity of equitable remedies).

[147] *See* Conti *supra* note 8, at 347; Logan *supra* note 1, at 503–04; Whitaker, *supra* note 1, at 339.

[148] *See* Tung, *supra* note 17, at 1749–50 (arguing for ability to obtain trading injunction once chapter 11 "matures" into plan confirmation process); Whitaker, *supra* note 1, at 339–40 (suggesting "safe harbors" where courts cannot intervene if purchasers follow disclosure requirements).

[149] Conti, *supra* note 8, at 347.

information.[150] The federal securities laws also provide that in certain cases those with supervisory capacity, encompassed by the term "control,"[151] may be held responsible for the acts of persons they supervise. The 1933 and 1934 Acts "were designed to provide investors with material information and to protect the investing public from the sale of worthless securities through misrepresentation. The legislation was intended to encourage honest dealing in securities and thereby bring back public confidence in the investment markets and to eliminated the unethical and unsafe practices of bank and corporate officers."[152]

A. Significant Provisions of the Securities Laws

The following briefly summarizes relevant federal securities law provisions.

1. The 1933 Act

The 1933 Act regulates public offerings of securities, prohibiting, subject to certain exemptions, the sale or trading of securities that are not covered by a proper registration with the SEC, and also prohibits fraudulent or deceptive practices in any offer or sale of securities.[153] The basic purpose of the 1933 Act is to assure the availability of adequate, reliable information about securities offered to the public by requiring such registration. As discussed in more detail below, sections 1125 and 1145 of the Bankruptcy Code in significant measure expressly supersede the 1933 Act's disclosure and registration requirements with respect to securities to be issued under or in connection with a chapter 11 plan, but the Bankruptcy Code does not otherwise expressly supersede such requirements.

- **a. Section 5.** Under section 5 of the 1933 Act, subject to significant exemptions as discussed below, one may not offer or sell securities to the public before filing with the SEC a proper registration statement containing information required under sections 7 and 10 of the 1933 Act and the SEC's rules and forms.[154]
- **b. Section 4(1).** Section 4(1) of the 1933 Act exempts from registration transactions by any person other than an issuer, underwriter or dealer. Together with the exemption found in section 4(3) of the 1933 Act (for certain transactions by dealers), most secondary trades (i.e., trades of securities

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[150] Whitaker, *supra* note 1, at 331 (citing George J. Stigler, *Public Regulation of the Securities Market*, 37 J. BUS. 117 (1964), *reprinted in* RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW & SECURITIES REGULATION 347 (1980)).

[151] *See* 69 AM. JUR. 2D *Securities Regulation – Federal* § 6.

[152] Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 237 (2d Cir. 1985) (quoting legislative history; citations omitted); *see also* Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 580 (10th Cir. 1991) (quoting same passage with approval).

[153] *See* Thomas Lee Hazen, THE LAW OF SECURITIES REGULATION § 1.2[3][A] (4th ed. 2002) [hereinafter Hazen].

[154] 15 U.S.C. § 77e (1994). *See* HAZEN, *supra* note 153, at § 2.2[1].

already outstanding) are, therefore, exempt from further registration.[155] Unless another exemption applies, holders may sell "restricted securities"[156] under section 4(1), however, only if they can prove that they did not take the securities with the intent to distribute them and that they are not participating in a distribution of securities.[157]

c. "Underwriter." Section 2(a)(11) of the 1933 Act defines an "underwriter" (in part) as a person who purchases from an issuer (or anyone who is controlling, or controlled by, or under direct or indirect common control with, an issuer) with a view to, or offers or sells for an issuer in connection with, the distribution of any security.[158] "Distribution," as used in the definition of underwriter, has a meaning similar to that of "public offering."[159]

d. "Control" Person. The section 4(1) exemption was not intended to extend to secondary offerings by a "control person,"[160] because, given the definition of an underwriter, resales by a control person may be deemed sales by an issuer to an underwriter (if the purchaser intends to resell) or sales by an underwriter (who purchased from the issuer with intent to resell). These results can be avoided, and the exemption used, however, by ensuring that the control person does not take securities with a view to reselling them, the sales made by the control person do not constitute a distribution, and the control person takes the same precautions that an issuer must take to prevent a subsequent distribution by the purchaser of the securities.[161]

e. Section 4(2). An important safe harbor for an ordinary corporate issuer wishing to raise money without registration is found in section 4(2) for "transactions by an issuer not involving any public offering."[162] Very large amounts of securities have been sold under this exemption – mostly in private

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[155] *Id*. at § 77d (1994). *See* HAZEN, *supra* note 153*,* at § 4.26.

[156] 17 C.F.R. § 230.144. *See also* Oppenheimer Fund, Inc. v. Sanders, 437 U.S. 340, 343 (1978) (defining "restricted security" as generally referring to security acquired from issuer in nonpublic, unregistered transaction); Hazen, *supra* note 153, at § 4.69 (same).

[157] Schloss v. Danka Bus. Sys. PLC, No. 00-7403, 2000 U.S. App. LEXIS 29317 at *3 n.2 (2d Cir. Nov. 13, 2000); Ackerberg v. Johnson, 892 F.2d 1328, 1335 n.6 (D. Minn. 1989); 69 AM. JUR. 2D *Securities Regulation – Federal* § 192.

[158] 15 U.S.C. § 77b(a)(11).

[159] Ackerberg, 892 F.2d at 1335 n.6; Neuwirth Inv. Fund, Ltd. v. Swanton, 422 F. Supp. 1187, 1194–95 (S.D.N.Y. 1975); 69 AM. JUR. 2D *Securities Regulation – Federal* § 69.

[160] SEC v. Cavanagh, 155 F.3d 129, 134 (2d Cir. 1998); SEC v. Lybrand, 200 F. Supp. 2d 384, 393 (S.D.N.Y. 2002); 69 AM. JUR. 2D *Securities Regulation* – Federal § 193. As defined by the SEC, "control" -- including the terms "controlling," "controlled by," and under "common control with"-- means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract or otherwise. 17 C.F.R. § 240.405. Control of a corporation is usually a question of fact. For example, it is clear that ownership of more than 50% of the voting stock of a corporation enables a shareholder to control the corporation's conduct. The meaning of control, however, is not limited to majority stock ownership but depends upon actual power to direct the corporation. 17 C.F.R. § 240.405; *see* Ruefenacht v. O'Halloran, 737 F.2d 320, 325 (3d Cir. 1984); 69 AM. JUR. 2D *Securities Regulation – Federal* § 7 (explaining Congress' understanding of "control").

[161] Ackerberg, 892 F.2d at 1336; McDaniel v. Compania Minera Mar de Cortes, etc., 528 F. Supp. 152, 161 (D. Ariz. 1981); 69 AM. JUR. 2D *Securities Regulation – Federal* § 193.

[162] Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 899–900 (5th Cir. 1977).

placements of large blocks of securities with institutional investors.[163] The 1933 Act does not define "public offering" but the exemption is intended to permit sales to "accredited investors" (discussed below) who presumably have access to enough information that they do not need the protection of the registration/disclosure requirements of the 1933 Act.[164]

f. Rule 144. Because of uncertainty whether anyone buying from an issuer in a private transaction and wishing to resell might be viewed as an "underwriter," the SEC adopted Rule 144,[165] which applies objective criteria to that and other situations in which underwriter status might be unclear. The Rule permits the public sale in ordinary trading transactions of limited amounts of securities owned by, among others, persons who have acquired restricted securities of the issuer.[166] Rule 144 provides a nonexclusive safe harbor exemption from registration for public resales of unregistered restricted securities for a person's own account or the account of an affiliate of the issuer if all of the Rule 144 requirements are satisfied. (Among other things, Rule 144 includes a one-year holding period before resale of restricted securities is permitted, and volume limits for sales of securities (both restricted and other securities) within any three-month period.)[167] Once Rule 144 is satisfied, the seller will not be deemed an underwriter under section 4(1) of the 1933 Act and will be exempt from the 1933 Act's registration requirements.

g. Regulation D ("accredited investor"). Under Regulation D,[168] offers and sales of securities by an issuer solely to "accredited investors" are considered nonpublic offerings under section 4(2) of the 1933 Act and therefore are exempt from the Act's registration requirements.[169] An "accredited investor" includes various sophisticated persons and entities such as banks, insurance

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[163] 15 U.S.C. § 77d(2) (1994); Hazen, *supra* note 153, at § 4.24[1].

[164] *See* 69 AM. JUR. 2D *Securities Regulation – Federal* § 163; s*ee also* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (describing application of exemption to individuals who have adequate knowledge). S*ee generally* Mark v. FSE Sec. Corp., 870 F.2d 331, 333 (6th Cir. 1989) (defining non-public offering as offering to those who can fend for themselves).

[165] 17 C.F.R. § 230.144.

[166] SEC v. Lybrand, 200 F.Supp. 2d 384, 394-95 (S.D.N.Y. 2002); Netwolves Corp. v. Sullivan, 2001 U.S. Dist. LEXIS 5905 at *32–33 (S.D.N.Y. May 9, 2001); 69 AM. JUR. 2D *Securities Regulation – Federal* § 1962.

[167] Lybrand, 200 F.Supp. 2d at 394–95; *Sullivan*, 2001 U.S. Dist. LEXIS at *32-33; 69 AM. JUR. 2D *Securities Regulation – Federal* § 196. Rule 144 requirements include (i) the public availability of adequate information regarding the securities, (ii) restricted securities must have been held for at least one year before sale, (iii) the amount of securities sold in any three month period may not exceed specified volume limits, (iv) sales must be made in ordinary brokers' transactions or transactions directly with a market maker, and (v) Form 144 must be filed with the SEC and the principal national securities exchange on which such securities are admitted to trading, except for certain small sales. Lybrand, 200 F.Supp. 2d at 394–95; 17 C.F.R. § 233.144; Amy Bowerman Freed, *Securities Law for Nonsecurities Lawyers – Rule 144 Introduction*, SD57 ALI-ABA 183, 185.

[168] 17 C.F.R. § 230.501–508. *See* Hazen, *supra* note 153, § 4.19.

[169] 17 C.F.R. § 230.506. *See* Wright v. Nat'l Warranty Co., 953 F.2d 256, 260 (6th Cir. 1992) (stating if sale is made to accredited investors no registration is required); *see also* AM. JUR. 2D *Securities Regulation – Federal* §§ 147, 171.

companies, investment companies, employee benefit plans, private business development companies, certain business trusts or partnerships, certain trusts managed by a "sophisticated person" and others passing certain financial hurdles.[170]

h. Rule 144A. A question remains whether a person who purchases securities from the issuer in a nonpublic transaction can resell the securities in another private transaction and, if so, what limits apply to such resales. This situation technically is not covered by the exemptions in section 4(1) (sales by non-issuers not involving a public offering) or section 4(2) (sales by issuers not involving a public offering). The SEC therefore adopted Rule 144A, which provides a nonexclusive safe harbor exemption from registration for private resales of restricted securities to "qualified institutional buyers"[171] if certain conditions are met. Rule 144A can be used by any person selling restricted securities other than the issuer of such securities.[172] The exemption is available only for securities of a class that is not traded on any U.S. securities exchange or in the NASDAQ system.[173]

i. Sections 3(a)(9) and 3(a)(10) and Sections 1125(e) and 1145 of the Bankruptcy Code. Unlike the foregoing provisions of the 1933 Act, sections 3(a)(9) and 3(a)(10) expressly do not apply "with respect to a security exchanged in a case under [the Bankruptcy Code]."[174] In a non-bankruptcy exchange, section 3(a)(9) exempts from the 1933 Act's registration requirements "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;" section 3(a)(10) provides an exemption for the offer and sale of securities issued in exchange for claims, or partly in exchange for claims and partly for cash, if the terms and conditions of the issuance are approved by a court or governmental authority authorized to grant such approval.[175]

Sections 3(a)(9) and 3(a)(10) reveal a policy to exempt from registration exchanges or sales embodying non-market transactions in which the issuer is exchanging its own securities, or claims are being exchanged for securities. The same

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[170] *See* 17 C.F.R. § 230.501(a) (stating full definition of "accredited investor"); *see also* Wright, 953 F.2d at 260 (defining accredited investor as per Rule 501(a)). *See generally* Hazen, *supra* note 153, § 4.23[1].

[171] Entities owning and investing in the aggregate at least $100 million in securities of nonaffiliates, including banks, insurance companies, registered investment companies, employee benefit plans, small business investment companies, business development companies and investment advisors.

[172] *See* Buck v. U.S. Digital Communications, Inc., 141 F.3d 710, 712 (7th Cir. 1998) (describing transactions by any person other than issuer are exempt); s*ee also* S.E.C. v. Cavanagh, 155 F.3d 129, 134 (2d Cir. 1998) (discussing exemption for those who are not issuers). *See generally* U.S. v. Lindo, 18 F.3d 353, 358 (6th Cir. 1994) (holding party was issuer and did not qualify for exemption).

[173] *See* 17 C.F.R. § 230.144A; *see also* Hazen, *supra* note 153, § 4.30[4]. *See generally* Goodwin Prop. v. Acadia Group, Inc., No. 01-49-P-C, 2001 U.S. Dist. LEXIS 9975, at *23 (D. ME July 17, 2001).

[174] 15 U.S.C.S. §§ 77c(a)(9) and 77c(a)(10) (respectively).

[175] *Id*.

policy carries over to the Bankruptcy Code (which expressly supersedes sections 3(a)(9) and 3(a)(10)). Thus, with certain exceptions, the Bankruptcy Code exempts the issuance or sale of securities *in connection with a chapter 11 plan* from the securities laws. Section 1125(e) of the Bankruptcy Code provides that

> A person that solicits acceptance or rejection of a plan, in good faith and in compliance with the applicable provisions of this title, or that participates, in good faith and in compliance with the applicable provisions of this title, in the offer, issuance, sale, or purchase of a security, offered or sold under the plan, of the debtor, of an affiliate participating in a joint plan with the debtor, or of a newly organized successor to the debtor under the plan, is not liable, on account of such solicitation or participation, for violation of any applicable law, rule or regulation governing solicitation or acceptance or rejection of a plan or the offer, issuance, sale, or purchase of securities.[176]

Similarly, section 1145(a) of the Bankruptcy Code provides that, except with respect to an entity that is an "underwriter" as defined in section 1145(b),[177] section 5 of the 1933 Act and any state or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security, does not apply to offers or sales of securities of the debtor under a plan, an affiliate participating in a joint plan or of a successor to the debtor under a plan, including through the issuance or exercise of warrants, options, subscription or conversion rights or privileges, in exchange or partial exchange for a claim against or interest in the debtor or such affiliate.[178] Section 1145(b)(1) of the Bankruptcy Code

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[176] *See also* 17 C.F.R. § 240.14a-2(4); AGS Prop., 1991 SEC No-Act LEXIS 1129 at *1–2 (Sept. 30, 1991) (providing no liability will attach for any omission or misstatement in disclosure statement so long as solicitation was made in good faith); American First Corp., 1989 SEC No-Act LEXIS 980 at *3 (Sept. 14, 1989) (stating SEC will not recommend enforcement action if Sec. 14(a) and 14(c) of 1934 Act are not complied with in solicitation of votes on chapter 11 plan based on representation solicitation was made through disclosure statement meeting requirements of section 1125 of Bankruptcy Code and approved by bankruptcy court).

[177] *See* 11 U.S.C. § 1145(b). Under section 1145(b)(1) of the Bankruptcy Code, an "underwriter" is, with limited exceptions set forth in section 1145(b)(2), an entity that:

> (A) purchases a claim against, interest in, or claim for an administrative expense in the case concerning, the debtor, if such purchase is with a view to distribution of any security received or to be received in exchange for such claim or interest;
> (B) offers to sell securities offered or sold under the plan for the holders of such securities;
> (C) offers to buy securities offered or sold under the plan from the holders of such securities, if such offer to buy is –
> (i) with a view to distribution of such securities; and
> (ii) under an agreement made in connection with the plan, with the consummation of the plan, or with the offer or sale of securities under the plan; or
> (D) is an issuer as used in . . . § 2(11) [of the 1933 Act], with respect to such securities.

See In re Stanley Hotel, Inc., 13 B.R. 926, 931–33 (Bankr. Colo. 1981) (discussing requirements of 11 U.S.C. § 1145(b)(1)).

[178] *See* 11 U.S.C. § 364(f) (providing similar exemption for post-petition financing).

also exempts "ordinary trading transactions of an entity that is not an issuer"—even by "underwriters"—from registration. Congress enacted section 1145 because the 1933 Act's definition of underwriter (section 2(a)(11)) includes anyone who "purchases" securities with a view to distribution, thereby potentially precluding creditors from subsequently selling securities received under a plan without filing a registration statement or using another exemption.[179] Thus, under section 1145(b)(3) of the Bankruptcy Code, an entity that is not an underwriter under section 1145(b)(1) also is not an underwriter under section 2(a)(11) of the 1933 Act as to any securities offered or sold to such entity under section 1145(a)(1).

A detailed discussion of sections 1125(e) and 1145 of the Bankruptcy Code is beyond the scope of this article. However, a few points are worth noting in addition to the fact that, at least for *plan* purposes and with the exception of "underwriters," the Bankruptcy Code treats the issuance, sale or exchange even of securities that otherwise would have to be registered as, in effect, a non-market driven, private transaction, not subject to the securities laws. In this model, creditors and interest holders are viewed as having been involuntarily placed in the position of engaging in an exchange, sale or issuance of their reorganization securities, and, therefore, such transaction should not be subject to the securities laws. Of course, the transaction is not thereby left unsupervised: the bankruptcy court must first approve the disclosure statement as containing adequate information, and the solicitation and participation in the issuance or sale of plan securities must be in good faith, for section 1125(e)'s safe harbor to apply.[180] (Further, as noted in *Century Glove*, section 1125(e) does not apply to solicitations and sales conducted apart from an approved disclosure statement.)[181] Similarly, section 1145(a)'s exemption will not apply unless the bankruptcy court has confirmed the chapter 11 plan, finding that the plan and its proponent are in compliance with the applicable provisions of the Bankruptcy Code and that the plan has been proposed in good faith and not by any means forbidden by law.[182] Moreover, section 1145(b)'s definition of "underwriter" provides assurance that parties emerging under the plan with control[183] and those engaging in true market-making activity, or

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[179] *See* S. REP. NO. 95-989, at 131–32 (1978); H.R. REP. NO. 95-595, at 420–21 (1977).

[180] *See* Cieri, *supra* note 22, at 391 (noting at least five potential remedies for failure to meet section 1125(e)'s good faith safe harbor requirement – four are applied by bankruptcy court while other is application of securities laws' anti-fraud provisions to disclosure statement solicitation); *see also In re* Ogden Modulars, Inc., 180 B.R. 544, 547 (Bankr. E.D. Mo. 1995) (holding pursuant to 11 U.S.C. § 1144 court may revoke confirmation if order was procured by fraud); *In re* Michelson, 141 B.R. 715, 730 (Bankr. E.D. Cal. 1992) (finding disclosure used to obtain confirmation of plan of reorganization was fraudulent warranting revocation of confirmation).

[181] Century Glove, 860 F.2d at 102.

[182] *See* 11 U.S.C. § 1129(a)(1)-(3); s*ee also* 11 U.S.C. § 1129(d) (stating plan may not be confirmed if its principal purpose is avoiding application of Sec. 5 of 1933 Act); *In re* Main St. AC, Inc., 234 B.R. 771, 775 (Bankr. N.D. Cal. 1999) (construing and applying section 1129(d)).

[183] Section 1145(b)(1)(D) provides that an "underwriter" includes an issuer under section 2(a)(11) of the 1933 Act. The term "issuer" as used in that section includes any person directly or indirectly controlling the issuer. 15 U.S.C.A. § 77 (b)(11). Notwithstanding the section's plain meaning, courts have construed section 1145(b)(1)(D)'s reference to "issuer" to apply *only* to control persons and not to the debtor itself, because to do otherwise would render the 1145(a) exemption meaningless. *See, e.g., In re* Standard Oil & Exploration, Inc., 136 B.R. 141, 149–50 (Bankr. W.D. Mich. 1992). The legislative history of section 1145 suggests that any creditor receiving at least 10% of the relevant securities will be a controlling person and thus an issuer under

"classic" underwriters, will not be covered by the exemption.[184]

Finally, section 1145(b)(1)(A) excepts from the registration exemption entities that purchase claims or interests "with a view to distribution of any security received or to be received in exchange for such claim or interest." This would appear to remove purchasers of distressed debt, whether or not a security, at discounted prices from the safe harbor of section 1145(a),[185] and may also suggest that Congress recognized that the Bankruptcy Code's well developed regime is nevertheless an incomplete substitute for the securities laws when it comes to claim trading. On the other hand, section 1145(b)(1)(A)'s focus on *post*-reorganization securities may indicate that Congress' only interest in the application of the securities laws to the acquisition of claims in bankruptcy cases was in the limited, post-confirmation context. Moreover, section 1145(b)(1)(A) does not appear ever to have been used against an investor in distressed securities, and the only case to have construed the exception applied it narrowly.[186] Commentators also state that the exception should be read narrowly or that another exemption under section 1145 should apply generally to protect at least most claim purchasers from stepping into the 1933 Act's registration requirement upon plan confirmation.[187] The SEC also has issued no-action letters (a) applying the "ordinary trading transaction" exemption, with certain very limited exceptions, to "accumulators"

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section 1145(b)(1)(D) excepted from the registration exemption. H.R. REP. NO. 95-595, at 237–38 (1977); ALAN N. RESNICK & HENRY J. SOMMER, 8 COLLIER ON BANKRUPTCY ¶ 1145.03[3][d][i] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2001) [hereinafter RESNICK]. Past informal inquiries to the SEC concerning the 10% test, however, indicate that the SEC will look at all facts to determine control and that ownership of in excess of 10% is only one relevant factor.

[184] *See In re* Kenilworth Sys. Corp., 55 B.R. 60, 63 (Bankr. E.D.N.Y. 1985) (stating only real underwriters are subject to registration requirements of Securities Act); *In re Stanley Hotel*, 13 B.R. 926 at 932-33 (stating only securities dealers and participants in classic underwriting are subject to securities requirements of Securities Act under section 1145); RESNICK, *supra* note 183, at ¶ 1145.03 [3][d][i] ("The legislative history of section 1145 is clear that subsection (b) has a limited purpose, namely to define "real underwriters" that participate in "classical underwriting" who should be required to register securities received under a plan prior to reselling such securities in the after market.").

[185] *See* RESNICK, *supra* note 183, at ¶ 1145.03[3][a]:

> A person who purchases claims against the debtor after the filing of the title 11 case at a discount, knowing it will receive an equity interest in the debtor which it anticipates it will sell in the after market, may well have purchased 'the claim' with a view to distribution of the security to be received in exchange for the claim. Consequently, such a person may be designated an underwriter under section 1145(b)(1)(A).

[186] *See In re Kenilworth Sys*., 55 B.R. at 62 (finding debtor improperly refused to distribute shares because a claim purchaser purportedly was not covered by the registration exemption under section 1145(b)(1)(A). The court held, to the contrary, that the purchaser was exempt; section 1145(b)(1)(A) applies to those purchasing with a view to *distributing* reorganization securities, and the purchaser bought with a view only to *redeeming* the securities.)

[187] *See* Fortgang & Mayer, *supra* note 8, at 60–61 (suggesting "ordinary trading transactions" exemption in section 1145(b)(1) should protect non-affiliates (i.e., non-control parties) who sell through brokers' transactions). Fortgang and Mayer also note that the plain meaning of section 1145(b)(1)(A) should protect most claim purchasers because they would not have purchased with clear knowledge that particular securities would be issued on account of the claim, and, being the recipient and not the implementer of a plan distribution, they should not be considered to have purchased with a view to distribution to the general public. *Id*.; *see also* RESNICK, *supra* note 183, ¶ 1145.03[3][a] (stating claims bought at discount far in advance of issuance of plan securities may not have been purchased with view to distribution of such securities; intent of purchaser may need to be examined).

(purchasers of claims before plan confirmation with a view to distribution of plan securities in exchange therefore) and "distributors" (persons who offer to sell on behalf of creditors securities to be received under a plan in exchange for claims) if such accumulator or distributor acts as a broker on an exchange or in the over-the-counter market when the debtor is a reporting company under the 1934 Act,[188] and (b) concurring that persons deemed to be underwriters under section 1145(b)(1)(A) who were not affiliates of the issuer could make unregistered offers and sales of reorganization securities of a debtor that were not subject to the reporting requirements of the 1934 Act in ordinary trading transactions subject to the volume limitations of Rule 144(e)(2) and subject to substantially the same exceptions as set forth in the*UNR* no-action letter.[189]

2. The 1934 Act

The 1934 Act applies to trading in securities after their issuance. To improve the national markets in securities, it was enacted to require reporting available to persons trading in securities, to prohibit deceptive practices in connection with the purchase or sale of securities, including the improper use of non-public information, and to regulate transactions by officers, directors and principal security holders.[190]

a. Section 10(b). Section 10(b) of the 1934 Act provides in relevant part that

> It shall be unlawful for any person, directly or indirectly, by the use

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[188] *See* UNR Indus., Inc. SEC No-Action Letter, 1989 WL 246122 at *8 (July 11, 1989) (ordinary trading exemption to be applied). The exemption would apply provided that none of the following three factors were present:

> (a) concerted action by (i) recipients of securities distributed under a plan of reorganization, in connection with the sale of such securities, or (ii) distributors on behalf of one or more such recipients in connection with such sales, or (iii) both;
> (b) (i) informational documents concerning the offering of the securities prepared or used to assist in the resale of such securities other than the Disclosure Statement and any supplements thereto and (ii) documents filed with the [SEC] by the issuer pursuant to the [1934] Act; or
> (c) special compensation to brokers and dealers in connection with the sale of such securities designed as a special incentive to resell such securities, other than the compensation that would be paid pursuant to arm's-length negotiations between a seller and a broker or dealer, each acting unilaterally, and not greater than the compensation that would be paid for a routine similar-sized sale of a similar issuer.

Id.; *see also In re* Manville Corp., SEC No-Action Letter, 1986 WL 68341 at *3 (August 28, 1986) (discussing no-action letter permitting accumulators of securities to resell securities in ordinary trading transactions under section 1145(b)(1)(A)).

[189] *See* AWS Reorg, Inc., SEC No-Action Letter, 1997 WL 665063 at *3 (October 27, 1997) (noting persons who may be deemed section 1145 underwriters may resell their securities subject to volume limitations set forth in section (e)(2) of Rule 144); I.C.H. Corp., SEC No-Action Letter, 1997 WL 180475 at *15 (April 14, 1997) (stating persons who would otherwise be section 1145 underwriters (other than affiliates of respective issuer) may freely resell their securities pursuant to "ordinary trading transactions" if three factors listed are not present).

[190] *See* 15 U.S.C. § 78(b) (discussing necessity of regulation); 69 AM. JUR. 2D *Securities Regulation – Federal* § 301 (discussing purpose background and scope of 1934 Act); *see also* Hazen, *supra* note 153, § 9.1, at 409–10.

> of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.[191]

Section 10(b) applies whether or not such securities were registered on a national exchange.

b. Rule 10b-5. As promulgated by the SEC under section 10(b) of the 1934 Act, Rule 10b-5 provides that

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[192]

c. Section 12. Section 12 of the 1934 Act requires any issuer with a class of securities traded on a national securities exchange to register with the SEC.[193] "In order for a security to be listed on an exchange, the issuer must register with both the exchange and the SEC, providing information that is substantially the same as that required for initial issues under the 1933 Act."[194]

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[191] 15 U.S.C. § 78(j).

[192] 17 C.F.R. § 240.10b-5.

[193] 15 U.S.C. § 78(l). This registration is not the same as the registration required of an offering of securities under the 1933 Act. The 1933 Act registration covers only the initial distribution of securities and subsequent distributions by underwriters, and does not entitle securities to be traded or listed on an exchange, to be traded in the over-the-counter market or to be resold by the persons who receive the securities in the initial distribution. Generally, the 1934 Act's registration requirement applies to publicly traded securities and requires current information to be made available to the market in which the securities are traded. A company that has registered a class of securities under the 1934 Act will still have to register a particular offering of securities of that class under the 1933 Act if the 1933 Act requires it. *See* Hazen, *supra* note 153, § 9.2[1][A], at 411; 69 AM. JUR. 2D *Securities Regulation – Federal* § 577.

[194] 69 AM. JUR. 2D *Securities Regulation – Federal* § 2. *See* 15 U.S.C. § 78l (b) (listing registration

d. SEC Legal Staff Bulletin No. 2. It is tempting, but probably too broad, to conclude from the foregoing discussion of sections 1125(e) and 1145, above, that all of the securities laws go on vacation after the start of a bankruptcy case.[195] As noted above, however, the Bankruptcy Code exemptions apply only in the context of the chapter 11 disclosure statement and plan consummation (and under section 364(f) in connection with post-petition financing). Debtors that are subject to the reporting requirements of the securities laws otherwise generally must remain subject to those requirements during the bankruptcy case.[196]

The SEC's legal staff has acknowledged a relatively narrow exception to this rule that would permit debtors to file their monthly operating reports under Bankruptcy Rule 2015 in place of their Form 10-K and 10-Q filings.[197] However, "the relief given applies only to filing Forms 10-K and 10-Q. The issuer still must satisfy all other provisions of the [1934] Act, including filing the current reports required by Form 8-K and satisfying the proxy, issuer tender offer and going-private provisions. Issuers reorganizing under the jurisdiction of the Bankruptcy Court must file a Form 8-K to disclose any material events relating to the reorganization."[198] Moreover, the exception will not apply if, among other things, the issuer's 1934 Act reports have not been current for the 12 months preceding its Bankruptcy Code filing or if its securities are traded on a national securities exchange or NASDAQ or the issuer is unable to establish that there is not an active market in its securities.[199]

On the other hand, we understand that, without being able to obtain the express permission of the SEC, debtors' reporting obligations under the securities laws often are, at best, loosely complied with. This mixed message again highlights tensions and limitations in the interplay between the securities laws and the Bankruptcy Code and bankruptcy process. Debtors under the Bankruptcy Code generally are not looking to foster a market in their securities, and often are not unhappy to be de-listed from an exchange; they want to conserve cash and resources and not make valuation disclosures. Moreover, management of many debtors may not have reliable information to disclose; for example, they may have serious problems obtaining audited financials. And, because the bankruptcy process is at the same time fast-moving and full of twists and turns, disclosure may not be meaningful, and even may be misleading, until the case is at the stage of plan confirmation, which is, after all,

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procedures of 1934 Act); 15 U.S.C. § 77(g) (listing registration requirements of securities under 1933 Act).

[195] *See In re* Frontier Airlines, Inc., 93 B.R. 1014, 1021 (Bankr. D. Colo. 1988) ("The [SEC] is the administrative agency charged with the enforcement of the securities laws. It has clearly abdicated its role in the reorganization area in favor of the bankruptcy court and has not only acceded to but has espoused the most liberal interpretation possible of section 1145.").

[196] *See* Securities Exchange Act of 1934, Staff Legal Bulletin No. 2 (CF) (April 16, 1997), 1997 SEC No-Act. LEXIS 538 at *2–3.

[197] *Id*. at *10.

[198] *Id*. at *10–11 (footnotes omitted).

[199] *Id*. at *9. ("General statements in the request that trading has been 'minimal' or 'insignificant' are not sufficient to enable the Division to reach a conclusion on the request.").

usually the primary focus.[200]

B. The Williams Act

The provisions of the 1934 Act dealing with tender offers and the acquisition of control[201] are also known as the Williams Act. The Williams Act is intended to protect public shareholders from secret and coercive tender offers.[202]

> The arguments marshaled by supporters of the legislation related to three main points. First, it was unfair to require public shareholders to make decisions about their investments without a minimum amount of information concerning an acquirer and its plans. Second, the ability of an acquirer to act in secret could impair the functioning of the public securities markets and the public's trust in the fairness of those markets. Third, the lack of disclosure was not appropriate when the federal securities laws were intended to provide a comprehensive scheme of disclosure to the public about investments in securities.[203]

Like section 1123(a)(4) of the Bankruptcy Code, the Williams Act also prevents discrimination among holders subject to a tender offer.[204]

Under section 13(d) of the Williams Act, any person or group that becomes the owner of more than 5% of any class of securities registered under section 12 of the 1934 Act must, within 10 days of such acquisition, file with the issuer and the SEC a statement setting forth (i) the person's background, (ii) the source of funds used for the acquisition, (iii) the purpose of the acquisition, (iv) the number of shares owned and (v) any relevant contracts, arrangements or understandings.[205] Section 14(d) contains a similar requirement for any person or group intending to solicit a tender of more than 5% of a class of securities registered under section 12.[206] Therefore, the purchaser's disclosure supplements the existing disclosure in connection with the registered

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[200] Of course there are exceptions, such as sales of significant assets under section 363(b) of the Bankruptcy Code (11 U.S.C. § 363(b)), decisions to liquidate all or a significant portion of the business, major management changes, and the entry into or termination of material contracts.

[201] §§ 13(d), (e) and 14(d)-(f) (15 U.S.C. §§ 78m(d), (e) (1983), n(d)-(f)).

[202] Before the Williams Act, a tender offer could be pursued without meaningful disclosure, because the purchaser was not an issuer and it did not require the approval of the target's board or shareholders in a vote covered by the proxy rules. Like the vulture investor who acquires claims in order to wrest control of the chapter 11 process from the debtor and obtain control of the reorganized entity, the purchaser in a tender offer sidesteps dealing with the target's board and/or a meaningful shareholder vote. *See* Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 55 (2d Cir. 1985) (noting before Williams Act tender offeror had no obligation to disclose any information to shareholders by using cash tender offer could act in complete secrecy).

[203] Conti, *supra* note 8, at 324 (summarizing legislative history); *see* S. REP. NO. 90-550 at 4 (1967) (stating one purpose of legislation is to correct current gap in Securities Exchange Act of 1934 to provide for full disclosure in connection with cash tender offers); H.R. REP. NO. 90-1711 at 2 (1968) (noting changes to 1934 Act would require disclosure of pertinent information and provide other protections to stockholders).

[204] 15 U.S.C. § 78m(d), (e).

[205] *Id*. at § 78m(d); 17 C.F.R. § 240.13d–1(a); Hazen, *supra* note 153, § 11.2[1] at 483–84.

[206] 17 C.F.R. § 240.14d–2 to d–4, d–6.

securities.

Sections 13(e) and 14(e) make it unlawful for any person to misstate or omit a material fact or engage in any fraudulent, deceptive or manipulative act or practice in connection with an issuer's purchase of more than 5% of equity securities registered under section 12 or a tender offer, respectively.[207] (Note: the tender offer does not have to be in respect of securities registered under section 12.) These sections also give the SEC authority to adopt rules and regulations to prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices, and the SEC has adopted rules prescribing the duration and conduct of a tender offer**.** Section 14(d)(5) gives a depositor the right to withdraw securities deposited during the open period of a tender offer.[208] Section 14(d)(6) requires a pro rata distribution when a larger amount of securities has been deposited pursuant to a tender offer than requested.[209] Section 14(d)(7) provides that if a tender offer is revised before its expiration, the incremental, increased consideration must be offered to all who have securities taken up by the tender offer.[210] Compare *Allegheny II*'s holding that Japonica had not acted in good faith when it purchased bank claims at different prices,[211] and its holding that Japonica's tender to the subordinated bondholders was not in good faith because the tender price differed from the price to the non-tendering bondholders under Japonica's plan.[212]

The SEC also has adopted rules to control abuses with respect to "squeeze out" or "coercive" transactions by issuers covered by section 13(e) as they pertain to public security holders.[213] Thus a privatization transaction will require disclosure of alternative transactions considered, the reasons for the structure and timing of the transaction, the benefits and detriments of the transaction**,** directors who dissented or abstained from voting on the transaction and the reasons therefore, the factors relied on in determining whether the transaction was fair to unaffiliated security holders**,** reports, opinions or appraisals received, whether the transaction required approval by a majority of unaffiliated security holders, and other financial and qualitative analyses of the transaction's fairness.[214]

Neither the Williams Act nor the SEC defines a "tender offer." "The question of just what is encompassed by the term 'tender offer' was intentionally left open in an effort to preserve the flexibility of both the [SEC] and the courts in making

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[207] *Id*. at § 240.13e, 14e.

[208] 15 U.S.C. § 78n(d)(5).

[209] *Id*. at § 78n(d)(6).

[210] *Id*. at § 78n(d)(7); *see* 17 C.F.R. § 240.13e-4 (requiring among other things withdrawal right, proration for oversubscribed bid, and "best price" rule). Also, Rule 10b-13 prohibits bidders from purchasing, directly or indirectly, securities otherwise than pursuant to that bidder's pending tender or exchange offer for such securities. 17 C.F.R. § 240.10b-13.

[211] Allegheny II, 118 B.R. at 297.

[212] *Id*. at 296.

[213] 17 C.F.R. § 240.13e-3; *see* Mark J. Lowenstein, *The SEC and the Future of Corporate Governance*, ALA. L. REV. 783, 804 n. 90 (1994) (discussing corporate abuses § 13e seeks to curb).

[214] 17 C.F.R. § 240.13e–3.

determinations on a case-by-case basis."[215] The legislative history listed the attributes of a tender offer to include a bid, a premium price, tender by those solicited, and the conditional nature of the buyer's obligation.[216] In keeping with its view that the definition should be somewhat flexible, the court in *Wellman* listed seven elements as characteristic of a tender offer: (i) whether there is an active and widespread solicitation of public security holders, (ii) whether the solicitation is made for a substantial percentage of the issuer's stock (although this may be less than 5%), (iii) whether the offer is made at a premium over the prevailing market price, (iv) whether the terms of the offer are firm rather than negotiable, (v) whether the offer is contingent on the tender of a fixed minimum number of shares, and/or a ceiling, (vi) whether the offer is open for a limited time, and (vii) whether the offerees are subject to pressure to sell their stock.[217]

Under this flexible approach, and assuming that bankruptcy claims are securities, attempts by vulture investors to acquire control of a class of claims and thereby control of the debtor's chapter 11 plan might fit within the definition of "tender." Clearly bankruptcy courts considering whether a remedy should lie in connection with a purchaser's acquisition of claims for control purposes could look to the Williams Act and the courts' fairly narrow definition of a tender offer for analogous support. Perhaps because of the foregoing, as well as the special pressures addressed by the Williams Act and a potential supervisory vacuum under bankruptcy law following plan confirmation, the only reported decision that we are aware of that has treated bankruptcy claims as securities, although they would not have been securities pre-bankruptcy, has been under the Williams Act.[218] Discussion of *SEC v. Texas Int'l.* however, is best left to a subsuming topic: the surprisingly unsettled (given the large amount of litigation and precedent generally in connection with the federal securities laws) definition of a "security" for securities law purposes.

IV. DEFINITION OF A "SECURITY"

The federal securities laws will not apply to bankruptcy claims unless such claims are "securities."

One of the best arguments for applying the securities laws to bankruptcy claims is the extensive and well-developed nature of securities law jurisprudence (in addition to the statutes and rules themselves and guidance from the SEC, including in the form of no-action letters), as contrasted with the somewhat slender and haphazard bankruptcy

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[215] Wellman v. Dickinson, 475 F. Supp. 783, 825 (S.D.N.Y. 1979), *aff'd on other grounds*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

[216] S. REP. NO. 90-550, at 2 (1967); H. REP. NO. 90-1711, at 2 (1968); *see also* Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1206 (2d Cir. 1978) (discussing legislative history).

[217] Wellman, 475 F. Supp. at 823–24 (applying seven factors); *see also* Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 56–57 (2d Cir. 1985) (listing *Wellman* factors but stating "elevation of such list to a mandatory 'litmus test' appears both unwise and unnecessary.").

[218] *See* SEC v. Texas Int'l. Co., 498 F. Supp. 1231, 1239–40 (N.D. Ill. 1980) [hereinafter *SEC v. Texas Int'l*]. *But see* Lipper v. Texas Int'l Co., 1979 U.S. Dist. LEXIS 13210, *3–8 (W.D. Okla. April 6, 1979) [hereinafter *Lipper*] (taking contrary position on same facts).

case law dealing with analogous situations under the rubric of subordination, classification, and vote designation and the bankruptcy courts' inherent equitable power.

It is significant, then, that the threshold issue of whether a particular instrument or transaction is a "security" "has created great confusion in the courts,"[219] and that the definition remains amorphous and elusive. Indeed the Supreme Court has acknowledged, "It is fair to say that our cases have not been entirely clear on the proper method and analysis for determining the presence of a 'security.'"[220] More recent case law has not resolved the confusion, because the courts have refused to apply a bright line test. To further the purpose of the securities laws, they have instead recognized that "in interpreting the term 'security,' 'form should be disregarded for substance and the emphasis should be on economic reality'" to address "the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'"[221]

A second reason for uncertainty about the scope of the definition of "security" cuts *against* broad enforcement and, indeed, has been used to limit the definition to less than the plain statutory meaning. This is the Supreme Court's utilization of the so-called "context clause" – that is, the clause introducing the definitional sections of the 1933 and 1934 Acts: "Unless the context otherwise requires . . ."[222] – to support a narrower reading of "security." As stated in *Marine Bank v. Weaver*, "The definition of 'security' in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires."[223] (The Court also has made it clear that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.")[224]

As discussed below, there are good arguments that in light of the bankruptcy *context* all bankruptcy claims should not be treated as securities, and there are also some arguments, particularly given the amendment of Rule 3001(e) and some bankruptcy courts' subsequent "hands off" approach, that the bankruptcy context now supports, although perhaps only in limited circumstances, treating bankruptcy claims as securities. Use of the context clause to support the application of the securities laws would be somewhat unusual, however, because it has generally been used to limit such application. In effect, one would have to argue that while the Bankruptcy Code

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[219] Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 282 (1999) [hereinafter Globerman]; *see also* Steven Amchen, Jessica Cordova, & Paul Cicero, *Securities Fraud*, 39 AM. CRIM. L. REV. 1037, 1060–61 (2002) (discussing various cases attempting to identify what qualifies as security); Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": the "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 490 (1987) (noting "[t]he confusion and uncertainty surrounding the most fundamental question in securities law: the definition of 'security' itself.").

[220] Landreth Timber Co. v. Landreth, 471 U.S. 681, 688 (1985).

[221] Reves v. Ernst & Young, 494 U.S. 56, 60–61 (1990) (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), and SEC v. W.J. Howey, 328 U.S. 293, 299, *reh'g denied*, 329 U.S. 819 (1946)).

[222] 15 U.S.C. § 77b(1)–(15); 15 U.S.C. § 78c(a)(1)–(40).

[223] 455 U.S. 451, 558–59 (1982). *See generally*, Park McGinty, *What is a Security?,* 1993 WIS. L. REV. 1033 (1993) (discussing interpretations of "context clause" in securities litigation).

[224] Weaver, 455 U.S. at 556.

originally usurped the field that would otherwise have been occupied by the securities laws, that context changed with the amendment to Rule 3001(e). Following similar logic, the Second Circuit in *Gary Plastic* cited *Weaver* for the proposition that "Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served and the factual setting as a whole." [225] Thus, although *Weaver*, applying a context clause analysis, held that a certificate of deposit was not a security, application of a context clause analysis led the Second Circuit to find that the particular certificate of deposit at issue in *Gary Plastic* was a security.[226] Among other things, unlike in *Weaver*, federal banking regulation did not protect the holders of the CDs in *Gary Plastic*: "Were we to find the CDs sold through this CD Program not to be covered by the federal securities laws, a gap would exist in the regulatory scheme that would strip the investor of needed federal protection."[227]

More fundamentally, however, reliance on the context clause can lead to ambiguous or conflicting precedent.[228]

The initial disruption of the established bankruptcy process that would result from defining all bankruptcy claims as securities would therefore be compounded by the fact that the answer to the fundamental question of whether bankruptcy claims are securities is not easy and might differ from court to court and even from transaction to transaction. What is the merit to the securities laws' well-developed guidelines if great uncertainty would attend any court's decision to apply those guidelines to bankruptcy claims? This concern will not, however, stop a litigant from raising the issue of the application of the securities laws in a particular circumstance or keep courts from examining the question. Moreover, Congress and the courts' focus on economic reality and flexibility may indeed be justified by the very example of trade and bank debt, whose holders do not need protection under the securities laws when the debt is incurred but may need such protection when their obligor becomes insolvent or seeks bankruptcy relief and trading in such debt becomes active. As noted by the Supreme Court:

An approach founded on economic reality rather than on a set of *per se* rules is subject to the criticism that whether a particular note is a 'security' may not be entirely clear at the time it is issued. Such an approach has the corresponding advantage, though, of permitting the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition. One could question whether, at the expense of the goal of clarity, Congress overvalued the goal of avoiding manipulation by the clever and dishonest. If Congress erred, however, it is for that body, and not this Court, to correct its mistake.[229]

It is ironic, however, that a non-bankruptcy court would in likelihood decide an

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[225] 756 F.2d at 240.
[226] *Id*.
[227] *Id*. at 241–42.
[228] *See* Globerman, *supra* note 219, at 294.
[229] Reves, 494 U.S. at 63 n.2.

issue heavily dependent upon an assessment of the bankruptcy "context."[230]

A. Statutory Language

1. 1933 Act and 1934 Act definitions of "security"

The definitions contained in the 1933 Act and the 1934 Act differ only slightly, although perhaps significantly as they might apply to bankruptcy claims such as trade claims that are not reduced to a note or other instrument. (The 1933 Act definition includes "evidence of indebtedness," which might apply to all bankruptcy claims that are not memorialized in a note or other instrument. The 1934 Act definition does not refer to "evidence of indebtedness.") Courts and commentators frequently state that, notwithstanding such minor differences, the two definitions should be read as virtually the same.[231]

In relevant part the 1933 Act provides,

> The term 'security' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security . . . or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, or warrant or right to subscribe to or purchase, any of the foregoing.[232]

In relevant part the 1934 Act provides,

> The term 'security' means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement . . . any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, . . . or, in general, any instrument commonly known as a 'security;' or any certificate of interest or participation in, temporary or interim

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[230] *See, e.g.*, 15 U.S.C. § 78aa (stating district court has exclusive jurisdiction over violations of 1934 Act, including actions under Rule 10b-5); *see also* 28 U.S.C. § 157(d) (providing for withdrawal of reference to district court if "resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.").

[231] *See, e.g.*, Reves, 494 U.S. at 61 n.1 (affirming proposition in *Forman)*; United Hous. Found. v. Forman, 421 U.S. 837, 847 n.12 (1975) (holding "definition of a security in . . . the 1934 Act is virtually identical to the definition in the [1933 Act] and, for present purposes, the coverage of the two Acts may be considered the same."); Prendergast, *supra* note 8, at 12. *But see* Fortgang & Mayer, *supra* note 8, at 49 (noting Supreme Court's original application of this conclusion, in Tcherepnin v. Knight, 389 U.S. at 342, was dicta).

[232] 15 U.S.C. § 77b(a)(1).

> certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[233]

Both the 1933 Act and the 1934 Act definitions include "any . . . right to . . . purchase" a security. Arguably that would include a bankruptcy claim if it were clear that the bankruptcy claim would be exchanged for a post-reorganization security. However, to our knowledge no court has taken this approach; moreover, it could be argued that the right to "purchase" a security does not cover a bankruptcy claim that will be exchanged for a security.

2. Bankruptcy Code definition of "security"

The Bankruptcy Code itself contains a definition of "security" that includes items specified in the 1933 Act and 1934 Act definitions, such as notes, stock, bonds, debentures and "any claim or interest" commonly known as a "security," but expressly excludes "debt or evidence of indebtedness for goods sold and delivered or services rendered" – thereby implicitly excluding certain bankruptcy claims, such as trade debt, from the definition of "security." [234] However, the Bankruptcy Code definition is not intended to supersede the securities laws' definition generally; its use is limited to the Bankruptcy Code, where it is used sparingly, for example in section 1145 of the Bankruptcy Code with respect to reorganization securities exchanged for claims. At most, the Bankruptcy Code definition highlights that neither the securities laws nor the Bankruptcy Code answer whether the securities laws apply to bankruptcy claims.

B. Supreme Court Tests for "Security"

The Supreme Court has articulated various tests for determining whether an instrument or transaction constitutes a "security" within the meaning of the securities laws, two of which clearly remain current. However, as the Court's decisions make clear, "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."[235] "Even a casual reading of [the definitional section] reveals that Congress did not intend to adopt a narrow or restrictive concept of security in defining that term."[236] Thus the 1933 and 1934 Acts "as remedial legislation should be construed broadly to effectuate [their] purposes,"[237]

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[233] *Id.* at § 78c(a)(10).
[234] 11 U.S.C. § 101(49)(B)(vii).
[235] Howey, 328 U.S. at 301.
[236] Tcherepnin v. Knight, 389 U.S. at 336.
[237] *Id.* at 336; *see* SEC v. Am. Inst. Counselors, 1975 U.S. Dist. Lexis 14586 at *49 (D.C. Dec. 30, 1975) (recognizing well established principle of broad construction of remedial statutes such as Securities Acts); c*f.*

and the courts should not be unduly boxed in by either of the two currently-used tests if another test better articulates the economic reality of a particular instrument or transaction. As stated by the Court in *Reves*, "To hold that a note is not a 'security' unless it meets a test designed for an entirely different variety of instrument 'would make the Acts' enumeration of many types of instruments superfluous,' and would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments."[238]

The Court, though, also has repeatedly stated that "Congress did not, however, 'intend to provide a broad federal remedy for all fraud.'"[239] Rather, with the assistance of the SEC, courts should employ a flexible approach grounded in economic reality to determine whether particular instruments or transactions should be deemed securities in light of "Congress' purpose in enacting the securities laws . . . to regulate *investments*, in whatever form they are made and by whatever name they are called."[240]

1. *Howey* test for "investment contracts"

Under the test set forth by the Supreme Court in *Howey*,[241] an instrument is an "investment contract" included in the Acts' definition of "security" if it is a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[242] In *Howey*, the Court held that the sale of strips of land in a citrus grove development, in conjunction with a service contract under which the seller agreed to cultivate and market the development's crop and remit the net proceeds to the investors, involved a "security" under the 1933 Act.[243]

2. *Reves* test for note ("family resemblance test")

In *Reves*, the Court determined that certain demand notes sold by a farmer's cooperative to members and nonmembers were securities under the 1934 Act.[244] This issue was in doubt notwithstanding that the 1934 Act's definition of "security" includes "notes" with a maturity date of the cooperative's notes, because earlier Supreme Court precedent, consistent with the Court's generally flexible approach, had recognized that a "'note' may now be viewed as a relatively broad term that encompasses instruments

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Phillips v. Kaplus, 764 F.2d 807, 817 (11th Cir. 1985) (applying broad construction of Securities Acts while recognizing limits to construction).

[238]494 U.S. 56, 56 (1990) (quoting Landreth Timber, 471 U.S. 681, 692 (1985)).

[239]*See* Reves, 494 U.S. at 61 (quoting *Weaver*, 455 U.S. at 556).

[240]*Id.* at 61 (emphasis in original).

[241]Howey, 328 U.S. at 293.

[242]*Id.* at 298–99.

[243]*Id.* at 300 ("The investors provide the capital and share in the earnings and profits; the promoters manage, control, and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts regardless of the legal terminology in which such contracts are clothed.").

[244]Reves, 494 U.S. at 67.

with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context."[245] "Thus, the phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."[246]

Given the characteristics of the note at issue, and the 1934 Act's inclusion of "any note" in its definition of "security," *Reves* did not use the *Howey* test. Having been included in the Acts' definition of "security," any note would be presumed to be a security; however, that presumption could be rebutted if the note at issue bore a "family resemblance" to any of the following notes commonly recognized not to be securities: (i) a note delivered in consumer financing, (ii) a note secured by a home mortgage, (iii) a short-term note secured by a lien on a small business or some of its assets, (iv) a note evidencing a "character loan" to a bank customer, (v) a short-term note secured by an assignment of accounts receivable, (vi) a note which simply finalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of customers of a broker, it is collateralized), or (vii) a note evidencing loans by a commercial bank for current operations.[247] (It should be kept in mind, however, that, depending on the context, transactions involving even the foregoing types of notes can also *be* securities: e.g., securitizations of home mortgages or notes secured by accounts receivable. The list "is not graven in stone.")[248]

Recognizing that "some standards must be developed for determining when an item should be added[249] to the [non-securities] list[,]"*Reves* states the following four factors should be examined to determine whether the instrument or transaction bears a "family relation" to the listed exceptions and, therefore, would not be a security despite being a note:

- **parties' motives.** If the instrument was issued to raise money for the general use of the business or to finance a substantial investment and the buyer is interested primarily in the profit that the note is expected to generate, it would likely be a security. If it was issued to facilitate the purchase of a minor asset or a consumer good, to improve cash flow or for another consumer or commercial purpose, the instrument is less likely to be a security;[250]
- **plan of distribution.** If there is common trading of the instrument for speculation or investment, or if it is offered and sold to a broad segment of the public, it is likely to be a security;[251]

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[245] *See* Landreth Timber, 471 U.S. at 694.

[246] Reves, 494 U.S. at 62–63.

[247] *Id*. at 65.

[248] *Id*. at 66 (quoting Chem. Bank v. Arthur Anderson 726 F.2d 930, 939 (2d Cir. (1984)).

[249] Or, presumably, it could be subtracted from the list of non-securities depending on the context of the transaction at issue. *See, e.g.*, Banco Espanol, 973 F.2d at 56 ("We recognize that even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities.").

[250] Reves, 494 U.S. at 66.

[251] *Id*.; *see also* SEC v. C.M. Joiner Leasing Corp. 320 U.S. 344 (1943) (basing "securities test," in part on

- **the investing public's reasonable expectations.** The court will consider an instrument to be a security, even if an economic analysis of a particular transaction might suggest otherwise, if the reasonable public expectation is that it is a security protected by the securities laws; here, apparently, whether the public views the instrument, such as stock, as an *investment* vehicle is key;[252] and
- **existence of another regulatory scheme.** If there is another factor, such as another regulatory scheme, that significantly reduces the "risk" of the instrument that would otherwise be addressed by the securities laws, the instrument will not be treated as a security.[253]

Applying this analysis, *Reves* determined that the notes at issue were securities: the holders expected to earn a profit, or a return on investment; the notes were offered over an extended time to many people[254] and held by many people,[255] although not traded on an exchange; the notes were advertised as an "investment"; and the notes would escape federal regulation entirely if not subject to the securities laws.[256]

Reves derived its last factor (whether there is an alternative regulatory scheme) from *Weaver*[257] and *International Brotherhood of Teamsters v. Daniel*.[258] Unfortunately, it is not clear from the Court's language the type of "risk" (i.e., the risk of nonpayment or the risk of fraud or another harm addressed by an alternative regulatory scheme) that an alternative regulatory scheme is supposed to reduce for the application of the securities laws not to be necessary. *Reves* observed that the notes were uncollateralized and uninsured, as compared to the certificates of deposit in *Weaver*, which were fully insured, thereby suggesting that whether the alternative regulatory scheme reduces the risk of nonpayment is the key inquiry.[259] However, the Court also stressed that the notes were not subject to "substantial regulation" under federal banking laws or ERISA, and would escape federal regulation entirely if the securities laws did not apply, indicating that the mere existence of an alternative regulatory scheme, perhaps providing for a meaningful measure of disclosure, was what the Court had in mind.[260] This is consistent with *Daniel*, the first instance in which the Court relied on the existence of an alternative regulatory scheme – in that case, ERISA – to determine that an instrument or transaction was not a security. In *Daniel* the Court stated, "The existence of this comprehensive legislation governing

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distribution plan).

[252] Reves, 494 U.S. at 67, 68–69; *see* Landreth Timber, 471 U.S. at 697-700 (noting stock is security even if it is stock in closely held corporation because of public perception); Forman, 421 U.S. at 851, 858 (stating right to receive profits from work of others is key to in public perception investment is security).

[253] Reves, 494 U.S. at 67.

[254] *Id*. at 68 (stating notes were marketed to 23,000 co-op members and non-members).

[255] *Id*. ("[M]ore than 1,600 people held the notes when the Co-op filed for bankruptcy.").

[256] *Id*. at 69.

[257] Weaver, 455 U.S. at 551.

[258] 439 U.S. 551 (1979); *see* Reves, 494 U.S. at 67, 69 (citing *Weaver* and *Daniel* for analysis of alternate regulatory schemes).

[259] Reves, 494 U. S. at 69.

[260] *Id*.

the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans.[261] "Since ERISA regulates the substantive terms of pension plans, and also requires certain disclosures, it was unnecessary to subject pension plans to the requirements of the federal securities laws as well."[262]

Weaver complicates the "alternative regulatory scheme" analysis further because it is not clearly reasoned. As in *Daniel*, the Court focused on a comprehensive regulatory scheme with independent reporting and supervision that should reduce the chance of fraud. The instrument at issue in *Weaver,* a certificate of deposit, "was issued by a federally regulated bank which is subject to the comprehensive set of regulations governing the banking industry [including] the reserve, reporting and inspection requirements of the federal banking laws" as well as regulation of advertising relating to the interest paid on deposits.[263] However, the Court then observed that such CDs were insured by the FDIC and thus "virtually guaranteed payment in full."[264] Therefore, "It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates are abundantly protected under the federal banking laws."[265] There were two problems with this analysis. First, the Weavers were suing because they were *not* protected under the banking laws; they were not suing to collect on their CD, which was federally insured, but because the bank that had issued the CD had allegedly defrauded them into *pledging* the CD back to it as part of an investment, which the bank had solicited, in a third party's business that owed money to the bank.[266] Second, the Court made no effort to explain why this gap in the alternative regulatory scheme should not be filled by the securities laws, such as by arguing that to fill the vacuum would disturb other carefully considered features of the banking laws. The Court instead simply stated, without explanation, "We reject respondents' argument that the certificate of deposit was somehow transformed into a security when it was pledged, even though it was not a security when purchased."[267] Unfortunately, *Reves* did not clarify the ambiguities stemming from this analysis.

Weaver and *Reves*' "alternative regulatory scheme" factor is probably best viewed, however, in light of both decisions' emphasis on the need to adopt a flexible, contextual approach to fulfill the purpose of the securities laws. Indeed, notwithstanding *Weaver*'s dicta, in which the Court rejected the possibility that an event could transform a non-security into a security, *Weaver's* underlying context clause analysis especially argues in *favor* of recognizing that particular circumstances, such as the filing of a bankruptcy case or, perhaps, a corporation's insolvency resulting in active trading of claims, could transform into a security an instrument that was not a security when first issued, unless

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[261] Daniel, 439 U.S. at 569–70.
[262] Weaver, 455 U.S. at 558 n.7 (discussing *Daniel)*.
[263] *Id*. at 558.
[264] *Id*.
[265] *Id*. at 559.
[266] *Id*. at 553–55.
[267] *Id*. at 559 n.9.

another regulatory scheme already covers the ground. Applying that approach, and quoting *Weaver,* the Second Circuit in *Gary Plastic*, for example, examined how the particular CD program at issue involved a joint effort between the deposit banks and a brokerage house and, therefore, fell into a gap not fully covered by the banking laws.[268] Similarly, the Second Circuit was careful to limit it's ruling in *Banco Espanol* to the particular loan participations at issue; the manner in which other participations were used, pooled or marketed might lead to a different result.[269] On the other hand, courts have jumped through some peculiar hoops at least partly because of *Weaver.* For example, *Gary Plastic* noted that two of many CDs involved were not entirely insured,[270] and in *Banco Espanol* the Second Circuit held, over a strong dissent, that a loan participation program conducted on Security Pacific's trading floor and touted for its competitive investment value did not involve securities.[271] In applying the *Reves* factors, *Banco Espanol* noted, "the Office of the Comptroller of the Currency has issued specific policy guidelines addressing the sale of loan participations. Thus the fourth factor – the existence of another regulatory scheme – indicated that application of the securities laws was unnecessary."[272] Again, however, the court did not go beyond this flat statement to explore whether that banking regulation left gaps inconsistent with the securities laws or whether those gaps had to be tolerated in light of other critical aspects of the alternative regulatory scheme.

Not surprisingly, given the flexible standard described above, the proper application of both the *Howey* and *Reves* tests has continued to raise issues reflected in a number of fairly recent decisions.[273]

C. Texas International and Lipper

Two district court decisions involving the same facts,*SEC v. Texas Int'l Co.*[274] and *Lipper,*[275] apparently are the only instances in which a court has considered whether

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[268] Gary Plastic, 756 F.2d at 241-42.

[269] Banco Espanol, 973 F.2d at 56 ("We rule only with respect to the loan participations as marketed in this case.").

[270] Gary Plastic, 756 F.2d at 241 n.5.

[271] Banco Espanol, 973 F.2d at 55.

[272] *Id*.

[273] *See, e.g.*, Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808 (2d Cir. 1994) (finding mortgage participations to be securities under *Reves* test; distinguishing *Banco Espanol* on its facts, including sophistication of investors in *Banco Espanol* as compared to broad based participants here, and fact that Investment Advisors Act complements and does not replace the Securities Acts); Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159, 167 (S.D.N.Y. 2001) (holding negotiable CDs satisfied *Howey* test for "investment contract," but foreign exchange transactions and interest rate swaps did not; investors relied on promoter's efforts with regard to CDs but not other instruments and these CDs were not subject to banking regulations); Roer v. Oxbridge Inc., 198 F.Supp. 2d 212, 222 (E.D.N.Y. 2001) (stating short term notes were securities under *Reves,* even with maturity of less than nine months, because offered to broad segment of public (although not traded on exchange) for investment purposes); BRS Assoc., LP v. Dansker, 246 B.R. 755, 760 (S.D.N.Y. 2000) (finding participation of mortgage notes and mortgage receivables were not securities under *Reves*; participations were sold only to limited partners well acquainted with defendant's business).

[274] 498 F. Supp. At 1238.

[275] Lipper, 1979 U.S. Dist LEXIS 13210 at *3.

bankruptcy claims are securities for purposes of the securities laws. They preceded *Weaver* and *Reves* and involve a fairly narrow fact pattern, but nevertheless are relevant and in ways anticipated those cases. Both involved actions under the Williams Act.

During the four-month interval between confirmation of the chapter X plan of King Resources Company ("King") and the issuance of the stock of the reorganized debtor, Phoenix Resources Company ("Phoenix"), the defendant in each decision, Texas International ("TI") made a tender offer to approximately 20,000 creditors to purchase a class of claims against King that would have entitled TI to obtain a controlling interest in Phoenix's stock when issued.[276] Although TI accompanied its tender offer with solicitation materials giving detailed information on its offer, the status of the reorganization and the terms of the plan,[277] in *SEC v. Texas Int'l* the SEC sought injunctive and equitable relief against TI for violation of the Williams Act.[278] In *Lipper*, a member of the class of tendering creditors sought relief under the Williams Act.[279]

In *Lipper* the district court applied the plain meaning of section 14(d) of the Williams Act to dismiss the plaintiff's claim. According to the court, under section 14(d) the registration of the issuer's stock under section 12 is a prerequisite to maintenance of an action, and here the new stock was not yet registered at the time of the tender. Neither the fact that King's old stock, which was cancelled under the plan, had been registered nor the fact that under the plan the tendered claims entitled the claimants to Phoenix's new stock when issued, which the court apparently did not consider to be relevant, changed the analysis.[280]

However, in *SEC v. Texas Int'l* the district court granted the SEC's motion for summary judgment and denied TI's motion to dismiss, which had been based on the same plain meaning argument that TI had made in *Lipper*.[281] (Once it found that the Williams Act could apply to the tender, however, the court found that in all but one instance TI had complied with the Act and, therefore, it denied the SEC's request for injunctive relief and rescission.)[282] Acknowledging that it had to stretch to apply the Williams Act, the court in *SEC v. Texas Int'l.* nevertheless concluded that "to permit the non-registration of the new Phoenix stock [at the time of the tender] to work an escape of the protective provisions of the Williams Act would allow TI to fall into the cracks of the securities laws simply because of the unorthodox nature of the issuance

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[276] SEC v. Tex. Int'l., 498 F. Supp. at 1237–38, 1238 n.1 (stating creditors tendered enough claims for Texas International to be entitled to approximately 44% of Class B stock when issued, and Texas International subsequently advised reorganized debtor that it bought enough other stock to obtain majority control).

[277] *Id*. at 1238, 1246–47. In addition, the creditors had previously voted on the reorganization plan after disclosure, and creditor representatives, although not the individual creditors who received TI's offer, had the benefit of a report to the court by the SEC in fulfillment of its advisory role under chapter X and other disclosure materials. *Id*.

[278] *Id*. at 1238.

[279] Lipper, 1979 U.S. Dist. LEXIS 13210, at *2.

[280] *Id*. at *7–*8.

[281] *See* SEC v. Texas Int'l., 498 F. Supp. at 1239.

[282] *Id*. at 1255.

of securities in reorganization proceedings."[283] Given the imminence of the issuance of the securities and the economic realities of Phoenix's succession to King (whose securities *had* been registered), "a narrow construction of the statute would defeat Congressional objectives in providing full disclosure of corporate acquisitions to public investors."[284]

Notably, as if in anticipation of *Weaver* and *Reves,* the court also recognized that, given the *post*-confirmation timing of the tender, "the alternative protective eye of the reorganization court was designed only to scrutinize the issuance of the new securities, not to examine the adequacy of disclosure in tender offers for those securities. It therefore failed to provide substitute protection for the [solicited] class."[285] In other words, the Bankruptcy Act's equivalent of section 1145 of the Bankruptcy Code was irrelevant to this post-confirmation, pre-effective date tender and left a gap that the Williams Act needed to fill.

V. BANKRUPTCY CLAIMS AS SECURITIES

The application of the foregoing standards to bankruptcy claims requires an appreciation of many diverse factors, including (a) the rights entailed by and nature of a bankruptcy claim, (b) the reasonable expectations of claim holders, (c) the market for such claims, and (d) the bankruptcy law context. Except for the bankruptcy law context, these factors will differ on a case-by-case basis, but one can generalize to a degree.

In some measure, bankruptcy does transform notes, trade debt and other rights, such as tort claims, into rights that have common characteristics with each other and with well-recognized securities such as corporate bonds. That is, a bankruptcy case may be viewed as a new context for instruments and related transactions that would not have been securities pre-bankruptcy. The debtor must schedule all known claims, and, except in no-asset cases, a bar date will be established by which time each claimant who disputes how the debtor has scheduled its claim, or whose claim is scheduled as contingent or unliquidated, may file a proof of claim that is prima facie evidence of the claim.[286] Further, sections 1122 and 1123(a)(4) the Bankruptcy Code require similarly situated claims to be classified and treated similarly, for example, by lumping all unsecured claims together regardless of whether, pre-bankruptcy, they were securities. Finally, all similarly situated claims (whether or not they were securities pre-petition) may ultimately receive distributions in the form of securities.

As noted by one commentator in distinguishing bankruptcy claims from the participations at issue in *Banco Espanol* (where the court found that a participation in a specific loan did not create a new instrument having a separate identity from the underlying, non-security, loan):

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[283] *Id*. at 1243.
[284] *Id*.
[285] *Id*. at 1244.
[286] *See* 11 U.S.C. § 502(a); FED. R. BANKR. P. 1007(b), 3001-3003.

On the filing of a petition in bankruptcy, the holder of an unsecured claim, such as a trade payable, no longer holds a trade payable. Instead he or she holds a claim in the bankruptcy estate for whatever dividend may be provided under the plan of reorganization to creditors of the same class . . . . Referring back to *Banco Espanol*, the post-petition claim does have an identity separate from the pre-petition open book account and is now a participation in the estate, an undivided interest in the class dividend . . . . With the exception of an unimpaired class at the inception of the case,[287] the filing of the petition transforms the non-security trade payable into a claim. As such, that claim has a separate identity, a participation in the estate, which is far different than the commercial transaction underlying the original debt.[288]

From such a viewpoint one can move quickly to describing the creditor's new bundle of rights, embodied in the debtor's schedules or the creditor's proof of claim, as an "evidence of indebtedness"—one of the specific terms listed in the 1933 Act definition of "security" and, as described above, tacitly covered also by the 1934 Act definition.[289] Then one can apply the *Howey* test or the *Reves* test, as described below, to show that this bundle of rights is a security.

One can apply the *Howey* test in favor of treating bankruptcy claims as securities because: (i) the claim purchase involves an investment of money; (ii) the claim is in a common enterprise – the bankruptcy estate; (iii) the purchase and sale is based on the reasonable expectation of profits, not a commercial transaction; and (iv) the profits are expected from the efforts of others – management or a chapter 11 trustee, official and unofficial committees, the bankruptcy court, etc.[290]

It can be argued, to the contrary, that bankruptcy claims are not securities under *Howey* because: (i) at least the initial claim seller's "investment" in the estate is involuntary, based on a commercial transaction upon which the debtor defaulted, and such a seller does not expect profits in the traditional sense; and (ii) most large claim purchasers at some point actively assert their rights in the bankruptcy case, and, therefore, they cannot be said to derive their profits solely from the efforts of a third party or parties such as the debtor's management.[291]

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[287] *See* Prendergast, *supra* note 8, at 12 (explaining in only the very rare instance of a class' designation at the case's inception as unimpaired under section 1124 of the Bankruptcy Code, such as a trade debt class provided with full payment under a prepackaged plan, can it be argued that there has been no transformation of pre-bankruptcy debt into something new. He distinguishes cases in which the ultimately negotiated plan treats class as unimpaired, because uncertainty up to that time has transformed pre-petition debt into something else). *But see* Sabino, *supra* note 8, at 19–22 (treating some claims as securities and other unimpaired claims not as securities would lead to "Orwellian absurdity").

[288] Prendergast, *supra* note 8, at 42; s*ee also* Allegheny I, 100 B.R. at 243 (noting filing of bankruptcy case creates "a market in nonbpublicly traded securities"); Whitaker, *supra* note 1, at 333 (explaining in most chapter 11 cases claims are similar to securities because they represent right to receive payment or equity share in reorganized entity); Donegan, *supra* note 1, at 390 (noting upon commencement of bankruptcy case fixed commercial right to cash payment becomes right to receive undefined consideration at indefinite time on speculative basis).

[289] *But see* Fortgang & Mayer, *supra* note 8, at 42 (questioning whether omission of "evidence of indebtedness" from 1934 Act's definition of security can be so easily ignored as based ultimately on Supreme Court dicta).

[290] *See* Prendergast, *supra* note 8, at 14; Donegan, *supra* note 1, at 401–03.

[291] *See* Sabino, *supra* note 8, at 132–33.

Under *Reves,* bankruptcy claims arguably are securities because: (I) although the pre-bankruptcy right giving rise to the claim may not have been a security, the claim is either an "evidence of indebtedness" and, therefore, entitled to a rebuttable presumption that it is a security and does not bear a family resemblance to well-recognized non-securities; and (II) the claim should not be added to that list of non-securities because: (i) the parties are *motivated* by investment, a hope to profit from the transaction in light of their predictions about the ultimate distribution to creditors; (ii) *distribution/marketing* is not limited, given the established market for bankruptcy claims, which reaches out to creditors who have never before engaged in that market; (iii) the investing *public perceives* bankruptcy claims should be subject to the securities laws, based on, among other things, awareness of the market in distressed claims by a wide array of creditors, conduct of claim trading by well-recognized brokers, investment banks and others involving a wide array of parties, and standardized forms; and (iv) the Bankruptcy Code, particularly since the amendment of Bankruptcy Rule 3001(e) and subsequent trends in the case law, is not an *alternative regulatory scheme* rendering the application of the securities laws unnecessary.[292]

On the other hand, the *Reves* test can be applied against treating bankruptcy claims as securities as follows: (I) a pre-bankruptcy non-security cannot be transformed into a security by the mere fact of the obligor's filing for bankruptcy; (II) in any event, bankruptcy claims bear a family resemblance to well-recognized non-securities because (i) the initial seller, at least, does not have a traditional investment profit *motive*, (ii) *distribution/marketing* is limited in today's market, which is discontinuous and specialized, restricted largely to sophisticated buyers *and* sellers (or unsophisticated sellers who, however, have attorneys who are sophisticated in the bankruptcy process); (iii) the *public perception* is that bankruptcy claims are not securities, based on, among other things, the conduct of most, if not all, parties who engage in claim trades and the fact that no post-Code decision has found such a claim to be a security; and (iv) the Bankruptcy Code is an *alternative regulatory scheme* with, among other things, its own disclosure requirements and well-developed precedents applicable to purchases by insiders and abusive attempts to gain control of the reorganized debtor by purchasing controlling interests in classes of claims.[293]

However, such an approach, on either side of the question, can be too mechanistic, in light of the remedial flexibility in the Acts' definitional scheme and the bankruptcy context. It does not answer the fundamental question whether defining bankruptcy claims as securities would fulfill the purpose of the securities laws and not violate the Bankruptcy Code context, considerations that inform the *Reves* test. Sections 1125(e) and 1145 of the Bankruptcy Code highlight the importance of that question. They essentially treat claimants in bankruptcy – even claimants holding securities – as *involuntary* investors. The policy underlying section 1145 recognizes that, having been stuck with their obligor's bankruptcy, such involuntary "investors" should not be deemed "underwriters" subject to the securities laws, unless, as provided in section

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[292] *See* Prendergast, *supra* note 8, at 12–14; Donegan, *supra* note 1, at 406–13.
[293] *See* Sabino, *supra* note 8, at 124–28.

1145(b), they fit certain narrow exceptions that equate to their being *voluntary* investors. Because most creditors of bankrupt debtors are in that position involuntarily, their reasonable expectations differ from typical investors in securities. Yes, they want to recover as much as possible on their claim, and in this sense they can be said to seek a "profit" from their unhappy starting point on the bankruptcy petition date; however, they have various avenues to achieve that result, only one of which involves selling the claim. (Indeed, Sections 3(a)(9) and 3(a)(10) of the 1933 Act embody much the same exemption policy for non-bankruptcy exchanges by an issuer with existing security holders of one security for another and of securities for claims or partly for claims and partly for cash.) Thus the Bankruptcy Code permits and usually rewards creditors' active participation in the case to maximize their recovery.

On the other hand, there are other creditors of bankrupt debtors (indeed, of non-bankrupt but insolvent debtors) who do not fit the "involuntary" model. They actively seek to become creditors by buying various forms of indebtedness at a discount with the intention of making a classically defined profit, or even to acquire control of the reorganized entity. Over the last fifteen years their influence on the bankruptcy process has grown exponentially. In many large chapter 11 cases, they control most of the claims, and by the use of several well-established brokers, as well as standardized forms, they have developed, if not a formal exchange, at least enough trading activity to create an informal market in distressed claims. Given such large-scale involvement by vulture investors, it also now is fairly common for par claimants, or their lawyers, to know about this market and to consider participating in it. This is particularly apt in large chapter 11 cases, in which the normal creditor finds it difficult to play an effective role in the plan process and, therefore, is tempted to quit the case at an early stage by selling its claim.

In such large chapter 11 cases, the debtor already may be a public reporting company, so that information deemed relevant under the securities laws may be available to claimants even if their particular claims are not securities. However, this is far from always the case, and, of course, if a particular claim is not a security, the holder will not have a remedy under the securities laws even if its obligor is subject to securities law reporting. Further, requiring a vulture investor to register only its post-reorganization securities under section 1145(b) of the Code does not provide much help for the claimants who sold the investor their claims during the chapter 11 case. On top of that concern, whenever a vulture investor seeks to acquire enough claims, *en masse*, to control the reorganized debtor, claimants face the additional pressures and risks addressed by the Williams Act. The policies underlying the securities laws, therefore, would be fulfilled by treating all bankruptcy claims as securities in at least two scenarios: (i) where active trading is taking place, particularly if the purchaser is an insider or has inside information[294] and (ii) where an investor is seeking to acquire

[294] The parties most in need of protection obviously are unsophisticated creditors who receive active marketing by vulture investors. (Often such investors will get wind of a "small claims" class, for example, in which, for administrative convenience, the debtor proposes to make a 100% cash distribution to creditors with claims that are allowed under a dollar threshold amount, such as $1000, but such investors may not advise those that they solicit of this fact). *See* Fortgang & Mayer, *supra* note 8, at 46–47 (suggesting small trade creditors such as

claims or a class of claims to gain control of the reorganized debtor.

This cannot end the inquiry, however, because of the unique context of bankruptcy claim trading and the presence of alternative bankruptcy protections that, in large measure, guard against the same abuses as the securities laws. Particularly in connection with attempts to buy claims to obtain control of the reorganized debtor, the Bankruptcy Code gives bankruptcy courts several remedies, discussed in section III, above, to protect against the risks addressed by the Williams Act. Moreover, without denying the benefits of consistency, these remedies give the bankruptcy courts valuable flexibility in such acquisition scenarios that the securities laws might not provide. For example, a bankruptcy court should be free to consider whether and how a claim acquisition strategy actually injures creditors. As noted in section III.A., above, if the debtor has refused to consider bona fide third party offers, because, for example, management would be displaced, and a claim acquisition strategy actually increases creditors' recoveries, no remedy might be justified. Also, the bankruptcy remedy of equitable subordination would permit reaching back to the pre-petition period when an abusive vulture investor first started buying claims, whereas it is difficult to draw lines as to when a claim is transformed into a security, most commentators assuming that the only applicable line is the petition date although significant vulture buying occurs before then. Relying on Bankruptcy Code remedies instead of the securities laws in such situations admittedly might at times leave *sellers* without redress; however, the threat of subordination, vote designation and related injunctive relief premised on breaches of sections 1123(a)(4) or 1125(b) of the Bankruptcy Code should encourage vultures intent on a takeover strategy to police themselves. (The relative lack of litigation over such issues during the last decade suggests that such self-regulation occurs.)

Moreover, individual sellers still could pursue garden-variety fraud or breach of representation claims.

It could be highly disruptive, moreover, if the bankruptcy court's supervisory function over the plan process were diluted or even supplanted by securities law litigation, for example with motions for an injunction or rescission under the Williams Act occurring in the district court simultaneously with the bankruptcy court's consideration of balloting and plan confirmation.

Similarly, there is well developed, and, in light of *Citicorp Venture*,[295] increasingly sophisticated precedent for dealing with insiders' wrongful purchases of claims under the Bankruptcy Code, particularly given the Code's broad definition of "insider." As with the takeover scenario, such remedies may not provide redress for individual sellers; however, the threat of partial disallowance or subordination of the claims improperly purchased by an insider should discourage such purchases at least as much

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those in *Revere* deserve protections of Rule 10b-5 although difficult to justify under current law); Prendergast, *supra* note 8, at 15 (stating key issue is protecting the unsophisticated seller from the sophisticated buyer); Donegan, *supra* note 1, at 420 (noting focus on protecting the typically unsophisticated seller). Trades among sophisticated parties would be exempt under the 1933 Act if they fit, for example, Regulation D, pertaining to "accredited investors."

[295] 160 F.3d at 982.

as the threat of having to pay damages to one's seller. Particularly given the limitations on causes of action under Rule 10b-5,[296] it is difficult to see a large gap between the Bankruptcy Code remedies and the securities law remedies in the insider-purchaser scenario. As discussed in section III above, the amendment of Bankruptcy Rule 3001(e) should not lead to the creation of such a gap, whether in the takeover-purchaser or the insider-purchaser scenario, despite possibly discernable trends in the reported decisions. Of course, if bankruptcy courts take an increasingly hands-off position with respect to either of the foregoing scenarios, the securities laws may be evoked to fill the void, but that would be unfortunate given the collateral damage to the bankruptcy process.

A larger gap between the securities laws and the Bankruptcy Code does exist, however, with respect to the disclosure function of the securities laws, which is most relevant to the simple unsophisticated seller/sophisticated buyer scenario. That gap is most evident before the approval of a disclosure statement under section 1125 of the Bankruptcy Code. As noted in section V, above, there also is a gap with respect to the limited fact pattern of *SEC v. Texas Int'l.*[297] the *post-confirmation*, *pre-effective date* purchase of claims to obtain control of the reorganized debtor. By that time, the bankruptcy court has little power to fashion a remedy, its supervision of the plan process having been completed.

It is not likely that there will be an opportunity, moreover, to fulfill the anti-fraud goal of the securities laws as long as purchasers from unsophisticated sellers do not try to influence the plan process in a way that another party in interest opposes, because with the amendment to Rule 3001(e) the court probably otherwise may never learn of concerted, manipulative marketing of unsophisticated sellers by sophisticated purchasers with material inside information. If bankruptcy claims were treated as securities, the SEC at least would be able to develop means to track claim trades and discern potential insider trading situations. A court would be on shakier ground, therefore, in declining to deem bankruptcy claims as securities where a seller was injured because of the absence of registration/disclosure or SEC involvement, because the court would not be relying on the fundamental overlap of the Bankruptcy Code with the securities laws to justify such a holding, as with the other scenarios discussed above, but, rather, on the *policy differences* between the Code and the securities laws.[298] The court would have to find that bankruptcy policy outweighed the disclosure

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[296] *See, e.g.*, Chiarella v. U.S., 445 U.S. at 229 (noting purchaser of stock who has no duty to prospective seller because he is neither insider nor fiduciary has been held to have no obligation to reveal material facts); U.S. v. O'Hagen, 521 U.S. at 651 (holding "liability under Rule 10b-5 . . . does not extend beyond conduct encompassed by § 10(b)'s prohibition."); Conti, *supra* note 8, at 320 n.168 (quoting Rule 10b-5, "Unless a person has nonpublic information from the *issuer* of securities or a fiduciary of the issuer, that person can freely buy and sell securities of that issuer. A non-insider has no obligation to disclose to the other party to a transaction what its intentions are concerning an issuer or what value it places on the securities being bought and sold or even what it knows about the issuer.").

[297] SEC v. Tex. Int'l., 498 F. Supp. at1244.

[298] *See* Sally S. Neely, *Investing in Troubled Companies and Trading in Claims and Interests in Chapter 11 Cases – A Brave New World* 109, 203 (ALI-ABA Course of Study in The Fundamentals of Chapter 11 Business Reorganizations C836 1993) (noting federal securities laws were not designed with chapter 11 in mind; thus it

and agency enforcement policies of the securities laws. And, as discussed above, it is not even clear whether the "alternative regulatory scheme" factor and context clause analyses of *Reves*, *Weaver*, and *Daniel* contemplate such a balancing approach.

A key conflict between the securities laws and bankruptcy stems from the imposition of the securities laws' registration and disclosure requirements. Except for a debtor that already is making significant public disclosure under the securities laws because of its public bonds or stock, that conflict could be very significant. As noted above, the chapter 11 debtor – or, worse still, a chapter 11 trustee – often will be ill-equipped to provide new disclosure under the securities laws. Such disclosure is expensive and time consuming, yet does not benefit the debtor, which, after all, is not raising money based on the disclosure, or its estate.[299] Indeed, as discussed in section II above, such public disclosure could well be detrimental to the critical task of negotiating a plan, which requires flexibility. (One also could at least argue, in light of a debtor's various disclosure requirements under the Bankruptcy Rules, that even before approval of a disclosure statement the disclosure policy of the securities laws is partly fulfilled by the filing of the debtor's schedules and monthly operating reports.) It also is not clear whether the automatic subordination of securities law claims under section 510(b) of the Bankruptcy Code applies to claims arising from the *post-petition* purchase or sale of securities. The creation of a potentially large new category of administrative claims against chapter 11 debtors would not bode well for chapter 11 cases.[300] And of course treating all bankruptcy claims as securities might lead to the awkward scenario described above in which a district court might be asked to enjoin transactions in conflict with the bankruptcy court's supervision of the plan confirmation process.

Requiring sellers who are true "involuntary holders" to make disclosure, because their claims have been transformed into securities, also is not desirable because it severely limits their liquidity.[301]

To overcome these obstacles, commentators have suggested that debtors do not need to be treated as "issuers" under the 1933 Act subject to section 5's registration requirement, at least on the petition date. They argue that the involuntary transformation of a trade payable or note into a claim on the petition date is not a "sale"

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would "do more harm than good for courts to attempt to . . . stretch those laws to cover chapter 11 trading."); Whitaker, *supra* note 1, at 432–34 (arguing although bankruptcy claims may resemble securities, securities laws should not be applied because of resulting havoc to orderly administration of bankruptcy cases).

[299] Steven L. Schwarcz, *Rethinking A Corporation's Obligations To Creditors*, 17 CARDOZO L. REV. 647, 681 (1996) (noting cost and time-consuming nature of federal securities law disclosure requirements).

[300] *See* Reading v. Brown, 391 U.S. 471, 486 (1968) (holding post-petition negligence of receiver is entitled to administrative claim); *In re* Charlesbank Laundry, Inc., 755 F.2d 200, 203 (1st Cir. 1985) (holding civil compensatory fine for violation of injunction by corporation engaged in chapter 11 reorganization qualified as administrative expense); *cf. In re* Int'l. Wireless Communications Holdings, Inc., 279 B.R. 463, 470–71 (D. Del. 2002) (holding creditor's claim arose pre-petition as such was subject to subordination under section 510(b)).

[301] *See* Donegan, *supra* note 1, at 416–18 (arguing because transformation of trade payable into claim (and security) is not registered under 1933 Act, it is restricted security and not freely tradable without proper registration statement or applicable exemption).

under the Act, there being no investment decision by the claimant at that time.[302] One also can argue that, as in the decisions that decline to find the debtor to be an "issuer" subject to registration under the plain language of section 1145(b)(1)(D) of the Bankruptcy Code,[303] because that would vitiate the provision's purpose, courts should decline to treat debtors as issuers of claims that are transformed into securities by the bankruptcy filing. Applying similar logic, it has been suggested that unsophisticated sellers can utilize the exemption under section 4(1) of the 1933 Act (because they did not acquire their claims with a view to further distribution) and sophisticated sellers (or sellers with access to inside information) can utilize Rule 144A or could sell in private placements under section 4(2).[304] Then, only those who properly should be bound to provide disclosure would be purchasers who are engaged in actively marketing or investing in the purchase or sale of claims. Nevertheless, it is evident that great uncertainty would surround the debtor's and other parties' disclosure responsibilities if courts began to hold in blanket fashion that claims were transformed into securities upon the commencement of a bankruptcy case. Legislation or rulemaking would be the only sure solution.[305] Given the substantial overlap of the Bankruptcy Code remedies discussed above with the securities laws, as well as the unique policy concerns raised by injecting an increased layer of disclosure and SEC enforcement into the bankruptcy process, such legislation and rulemaking would have to be narrowly focused before it did more good than harm.

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[302] Prendergast, *supra* note 8, at 14–15.

[303] *See, e.g., In re* Standard Oil & Exploration, Inc., 136 B.R at 149-50.

[304] Prendergast, *supra* note 8, at 5–16.

[305] *See, e.g.*, § 3(a)(5) of the 1933 Act, 15 U.S.C. § 77c(a)(5), which, at the request of spokesmen for the United States Building and Loan League who argued that the Act's registration requirements would be prohibitive, exempts "any security issued by a building and loan association, homestead association, savings and loan association, or similar institution" from those requirements (although such securities nevertheless are subject to the Act's anti-fraud provisions). Tcherepnin v. Knight, 389 U.S. at 340-41.