Buyer Beware: The Pitfalls of Insider Claims Trading in Bankruptcy.
By Eric J. Monzo

Claims trading, the buying and selling of claims of a bankrupt company, has grown greatly in recent years and has become commonplace in large chapter 11 cases. In 2012, for example, even during a slowdown in large chapter 11 filings, distressed investors bought and sold more than $41 billion in bankruptcy claims. *The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2012-2014)*, p. 240, citing Dow Jones Daily Bankr. Rev., Jan. 28, 2013. Claims may be purchased for a variety of reasons. Historically, investors who purchased bankruptcy claims often hope to profit in one of three ways: (1) selling their claims within a short period of time for a profit; (2) exchanging claims for debtors' more valuable assets; or (3) effectuating a reorganization plan in which debt is traded for equity in the company. *See* Andrew Africk, "Trading Claims in Chapter 11: How Much Influence can be Purchased in Good Faith under Section 1126?," 139 U. Pa. L. Rev. 1393, 1394 (1990).

The "loan to own" strategy employed by a corporate insider claims purchaser may unwittingly subject the investor to additional risk. Critics contend that such maneuvering may deny the debtor, to the detriment of its creditors, the opportunity to reorganize by favoring a sale of the company and liquidation because the motivation of the investor differs from that of original creditor. *See* Kenneth A. Rosen, Claims Trading Warps the Bankruptcy System, The Wall Street Journal, Jan. 14, 2016 http://blogs.wsj.com/bankruptcy/2016/01/14/claims-trading-warps-the-bankruptcy-system/ ("Claims trading and the allowance of claims at their face value when claims were acquired at a fraction of face value distorts the bankruptcy process."). Insider investors, may see an opportunity to purchase claims to reduce the claims pool in order to maximize their pecuniary gain and increase control in the company and the chapter 11 process. However, such investors should be cautioned that purchasing claims may increase their risk of

having the acquired claims equitably subordinated, reduced or reclassified, or in certain cases, result in serious allegations of illegal insider trading. Generally, corporate insiders are require to either abstain from trading securities or disclose any material nonpublic information in their possession prior to trading. *See e.g, Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. Docket 907, 1961 WL 60638 at * 3 (Nov. 8, 1961) ("We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment…If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.").Courts may reduce the claims with respect to insiders or others fiduciaries. *See e.g., In re MC2 Capital Partners, LLC*, 2013 WL 772959 at *2 (Feb. 27, 2013), ("the exception to the general rule that transfers are to be taken at face value applies when the transferee has fiduciary duties to the debtor or the transfer is an attempt to circumvent the consequences of those duties."); *In re Papercraft Corp.*, 211 B.R. 813, 815 (W.D. Pa. 1997), aff'd, 160 F.3d 982 (3d Cir. 1998). A bankruptcy court may also, in its equitable discretion disallow, claims "so that any distributions to which they would be entitled [would be] redistributed to the other creditors and ultimately to the shareholders." *In re Washington Mut., Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011), vacated in part, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

In *Washington Mutual*, Judge Mary Walrath, while denying plan confirmation, discussed allegations of "insider trading" by certain claims purchasers. *See In re Washington Mut. Inc.*, 461 B.R. at 255. Judge Walrath's analysis was tailored to whether the allegations gave rise to a "colorable" claim sufficient to confer standing, in this case, the Equity Committee, to pursue

claims for equitable disallowance. *Id.* The Court, however, did discuss the relevant of trading activity in determining whether it was done based on material nonpublic information. *Id.* at 259. It is important to note that the Court did not reach a final judgment on the merits of the insider trading allegations and was subsequently vacated in part. The decision is relevant should there be a "buying spree" in claims, which may be based on information not readily publically avaiable.

With the potential pitfalls associated with an insider purchasing bankruptcy claims, should practitioners worry more about it occurring in the context of chapter 11? In 2011, Bankruptcy Rule 2019 was amended to increase disclosures by investors that are members of *ad hoc* committees, groups, or investors otherwise acting collectively in the bankruptcy case, so that these investors are required, in these circumstances to disclose, among other things, their names, addresses, and nature and amount of each "disclosable economic interest" they hold against debtors. Further, Bankruptcy Rule 3001(e) governs the mechanics of filing and preserving transferred claims. Despite the increased disclosures and focus on the claim transfer process under the Bankruptcy Code, case law, such as *Washington Mutual*, will continue to dictate the practice of claims trading by insiders.