CONTEMPLATING CLAIMS TRADINGS AT THE MARGINS

ABSTRACT

The buying and selling of claims has become a ubiquitous component of many large chapter 11 bankruptcy cases. At its worst, such “claims trading” inhibits the debtor’s ability to achieve a “fresh start” and the creditors’ ability to obtain a fair distribution of bankruptcy assets, as envisioned by the Bankruptcy Code. At its best, the practice relieves tension and stimulates the bankruptcy process by affording hostile creditors the opportunity to exit early from the bankruptcy case with the transfer of their claims to other, more eager participants.

The current scholarship on claims trading ordinarily limits its focus to the period after the debtor’s filing of a petition for relief but before plan confirmation, which is when the greatest frequency of trading occurs. Alas, other activities that are essential to the resolution of the bankruptcy case also take place during this period. The overlap has consequently prompted most scholars to denounce claims trading as a disruptor in the bankruptcy process.

What the research above fails to recognize is that confining the analysis on claims trading to the single greatest-frequency period leads to incomplete theories. In reality, claims trading takes place outside of this period as well; it is not so temporally bounded, as suggested.

When reexamined outside of the mainstream’s contexts (i.e., prior to the petition date or after plan confirmation), claims trading can offer significant benefits. Trading at these periods fosters healthier bargaining between the debtor and its creditors, and enhances the likelihood of a swift procedure. Thus, bankruptcy constituents should contemplate and, moreover, endorse claims trading at either the pre-petition or post-plan confirmation phases so as to ease concerns about a trade’s disruptive capacity inside a bankruptcy case.

INTRODUCTION

Claims trading, the buying and selling of a claim (i.e., a right to payment), is often associated with a bankruptcy proceeding. Such buying and selling of claims is not a novel phenomenon, but rather an ancient custom “as old as the
Over the years, this custom has ballooned into a multibillion-dollar industry, hinting at claims trading’s importance in the bankruptcy context.3

The claims trading “industry,” however, is not without its faults. In bankruptcy, “[c]laims trading has the tendency to destroy the traditional ‘community’ that a [c]hapter 11 filing is meant to facilitate.”4 Bankruptcy participants have thus come to expect a certain degree of disruption whenever a claims trade occurs.5 Many courts have attempted to institute mechanisms to limit the degree of disruption, but such tactics often further exacerbate and delay the bankruptcy process. This Comment presents an alternate pathway to resolve the issue, one that focuses on how the timing of a trade can both emphasize the benefits of a claims trade and minimize its disruptive costs.

A. The Bankruptcy Process, Generally

To understand how claims trading causes disruptive interference, one must first understand the bankruptcy process, generally. In an attempt to discharge its debts, a distressed corporation may file for bankruptcy under chapter 11 of the Bankruptcy Code (the Code).6 When a debtor corporation files for chapter 11 relief, the debtor’s creditors in turn often file a proof of claim against the corporation’s estate for any outstanding debts owed to them.7 A claim is “a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or [a] right to an equitable remedy.”8 This claim is what entitles a debtor’s creditors to participate in the various stages of the chapter 11 bankruptcy process.9

A critical phase of the chapter 11 bankruptcy process is the plan approval.10 To effectively discharge its debts, the debtor corporation must first set forth a

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3 See id.
5 See id.
7 See id. § 501(a).
8 Id. § 101(5).
9 See id. § 101(10)(A).
10 See id. § 1126.
plan that addresses all allowed claims of its creditors. The Code dictates that creditors are to be segregated into distinct classes based on the type of claim—most commonly into “substantially similar” classes of claims or into an “administrative convenience” class. Each class of creditors then votes to either accept or reject the debtor’s plan, with acceptance of the plan requiring both a super majority (in the amount) as well as a simple majority (in the number) of accepting claims.

Widespread acceptance largely revolves around whether the debtor satisfactorily performs certain obligations or agrees to repay a suitable sum of money as part of the plan. Even when a class of creditors does not agree with the proposed plan, the debtor may attempt to “cramdown” against that class. To cramdown against a class of creditors, the plan cannot “discriminate unfairly, and [must be] fair and equitable[] with respect to each class of claims . . . that is impaired under, and has not accepted, the plan.”

Assuming the plan meets all requisite conditions and all classes of creditors consensually accept the plan or the debtor cramms down against them, the bankruptcy court will confirm the plan. “The provisions of a confirmed plan bind the debtor,” meaning the debtor must meet all performance obligations and complete all planned repayments under the chapter 11 plan. Importantly, though, “the confirmation of a plan discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified.”

The Federal Rules of Bankruptcy Procedure (FRBP) authorize the transfer of a claim at any point throughout the processes mentioned above. The transfer of a claim entails the buying and selling of a creditor’s claims against a debtor corporation in bankruptcy. The majority of these trades occur after the petition

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11 See id. §§ 1126, 1129.
12 Id. § 1122(a)-(b).
13 Id. § 1126(c).
14 See id. § 1129.
15 See id. § 1129(b)(1).
16 Id.
17 See id. § 1129(a).
18 See id. § 1129(b)(1).
19 Id. § 1141(a).
20 Id. § 1141(d)(1)(A) (emphasis added).
date for bankruptcy relief but before plan confirmation. Rather than waiting out the results of the bankruptcy process and bearing the associated risk, a creditor with an allowed claim may opt to sell that claim, usually to a distressed debt investor. The distressed debt investor typically purchases the claim at a discount on the assumption that the claim will later yield a higher rate of return.

B. Question Presented

The associated costs and benefits of claims trading are hotly debated. Supporters argue that distressed debt investors “provide a service to the creditors, often vendors and suppliers, by giving them a quick and certain payout in an inherently uncertain situation.” Conversely, cynics contend that the lack of transparency and oversight in this secondary trading market leads to problems for all parties involved (e.g., litigation that “both delays the resolution and increases the cost of the case.”). Regardless of this disagreement between the costs and benefits associated with claims trading, proponents of both viewpoints

23 See Aaron L. Hammer & Michael A. Brandess, Claims Trading: The Wild West of Chapter 11s, 29 AM. BANKR. INST. J. 1 (July/August 2010) (“Instead of waiting for confirmation of the reorganization plan to determine the value of the claim and authorize its payment . . . the creditor may choose to sell its claim to a third party.”); see also Seth Brumby & Nicoletta Kotsianas, Lehman Brothers Special Financing’s Derivative Claims Secondary Market Grows After Proof-of-Claims Revision, SECONDMARKET (July 8, 2009), https://www.secondmarket.com/education/news/press/lehman-brothers-special-financing%E2%80%99s-derivative-claims-secondary-market-grows-after-proof-of-claims-revision (discussing that as the bar date on the filing on a proof-of-claim approaches, claim trading volume should pick up); AMR Update: Claims Trading Opportunities, SIDLEY AUSTIN, LLP (Aug. 8, 2012), http://www.sidley.com/amr-update-claims-trading-opportunities-08-08-2012 (“Typically, bankruptcy claims trading increases as the proceedings get closer to a plan of reorganization.”).

24 See Hammer, supra note 23.


note that the practice conclusively disrupts the bankruptcy process. So the question remains: does “claims trading help or hinder?”

C. Brief Response

Because most claims trading occurs after the petition for relief but before plan confirmation, the predominant trend has been to focus on the impact of claims trading as between the post-petition and pre-plan confirmation phases of bankruptcy (hereinafter referred to as “T1”). Accordingly, while some literature discusses how claims trading encourages flexibility and liquidity to an otherwise inflexible and illiquid circumstance, most literature stresses how claims trading during T1 precipitates informational asymmetry, which, in turn, allows a select few creditors to gain an excessive degree of influence over the bankruptcy case. Remarkably, though, “no one seems to have called for an outright ban on claims trading.”

This Comment cogitates on the fact that claims trading may also occur at the pre-petition phase (hereinafter referred to as “T0”) or the post-plan confirmation phase (hereinafter referred to as “T2”) of a chapter 11 case.

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29 Compare American Bankruptcy Institute Law Review, Introduction, 23 AM. BANKR. INST. L. REV. 4, 12 (Winter 2015) (“[C]laims trading and derivative products have changed the composition of creditor classes. Although these developments are not unwelcome or unhealthy, the Bankruptcy Code was not originally designed to rehabilitate companies efficaciously in this complex environment.”), with Frederick Tung, Confirmation and Claims Trading, 90 NW. U.L. REV. 1684, 1686 (1996) (“Unfortunately, claims trading has the potential to impede reorganization, imposing costs on the debtor company and its creditors. Because of [c]hapter 11’s collective nature and the significant role of creditors in the process, instability in the creditor constituency may be disruptive.”).

30 The Role of Claims Trading, supra note 27.

31 See Hammer, supra note 23; see also Brumby, supra note 23 (discussing that as the bar date on the filing on a proof-of-claim approaches, claim trading volume should pick up); AMR Update, supra note 23 (“Typically, bankruptcy claims trading increases as the proceedings get closer to a plan of reorganization.”).


 Simply put, claims trading’s reach begins before bankruptcy and extends beyond it. Thus, bankruptcy participants (i.e., courts, creditors, and debtors) ought to contemplate and likewise endorse claims trading toward the margins of the bankruptcy spectrum at T0 and T2. Doing so can minimize the degree of disruption that claims trading sometimes produces in chapter 11 bankruptcy, which in turn may help bankruptcy courts satisfy the Code’s objectives of: (1) offering the debtor a “fresh start” for the future; and (2) distributing the debtor’s assets and income for the benefit of all similarly situated creditors.35

D. Structure

Part I provides for a background on claims trading, with a discussion of the history, market, and potential benefits and drawbacks associated with the buying and selling of claims. Part II posits the possibility for claims trading to occur at the margins. Associated with this section is an in-depth analysis of the benefits related to restricting the practice to the T0 and T2 timeframe. Part III gestures toward how the law might reach the above-mentioned desirable ends. The few

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35 Williams v. United States Fid. & Guar. Co., 236 U.S. 549, 554–55 (1915) (“It is the purpose of the Bankrupt Act to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.”).
suggestions discussed within this portion are meant to be tentative and illustrative rather than fully investigated. Part IV concludes by reinforcing the purpose of this Comment, which in its simplest form is to showcase how limiting claims trading during T1 while promoting its use at the margins reinforces a balanced and fair bankruptcy outcome.

I. BACKGROUND

A. A Brief History of Claims Trading

As previously mentioned, claims trading is not a new phenomenon but rather an old habit that dates back to the late 1700s. Congress first attempted to regulate claims trading with the Bankruptcy Act of 1898 (the Act). In effect, the Act “codified a court’s equitable right to ‘limit any claim or stock acquired by such person or committee in contemplation or in the course of the proceeding under this chapter.’” Other regulatory bodies buttressed this regulation on claims trading with the issuance of similar guidelines on securities trading. Combined, these systems sought to protect the trading public by restricting a trade’s occurrence to only those situations that incorporated appropriate amounts of governmental supervision.

In 1978, however, disagreements between the House and the Senate on how to treat claims trading caused Congress to enact the modern Bankruptcy Code without a single instruction on claims trading. In effect, this decision deregulated the market by rendering pertinent claims trading restrictions found in chapter X of the Bankruptcy Act of 1898 obsolete. Although Congress

36 See Hammer, supra note 23 (“At that time, the original 13 colonies were insolvent, yet owed tremendous debts to soldiers, farmers and merchants for their respective roles in the Revolutionary War. Early American investors purchased these debts for approximately one quarter of their par value, hoping that the new American government would assume full liability.”); see also In re Pleasant Hill Partners, L.P., 163 B.R. 388, 390–91 (Bankr. N.D. Ga. 1994) (discussing how many of the issues surrounding claims trading predate the modern Code).

37 Hammer, supra note 23.

38 Id. (internal citations omitted).


40 Id.; see Fortgang, supra note 1, at 10–11 (“[Chapter X explicitly punished trading by fiduciaries (such as members of protective committees) and explicitly regulated the voting of claims and interests that had been acquired during the case.”); see also The Bankruptcy Act of 1898, §§ 212, 249.

41 See Hammer, supra note 23, at 2 (“In the years leading up to the creation of the modern Bankruptcy Code in 1978, the decision regarding how to reflect the substance of §§ 212 and 249 was considered by both Congress and the National Conference of Bankruptcy Judges. However, when Congress later ‘reconciled the House and Senate bill into the final bill which became the Bankruptcy Code, Congress dropped’ the sections pertaining to the regulation of claims trading.”).

42 Id.
intended for the Code to operate this way, the newly deregulated market for claims trading caused widespread concern.\textsuperscript{43} Congress addressed this concern in 1983 with the enactment of the Federal Rules of Bankruptcy Procedure (FRBP).\textsuperscript{44} Under it, Rule 3001(c) required that parties transferring claims must “inform the court . . . [and] disclose the consideration paid for the transferred claims.”\textsuperscript{45} This procedure allowed courts to challenge trades based on whether sellers had access to adequate information that would “enable them to make an informed decision on the sale of their claim[s].”\textsuperscript{46}

Over the years, this judicial oversight brought about a chill in the markets, “as [it] was perceived to impair the liquidity of claims.”\textsuperscript{47} Congress responded by amending the FRBP in 1991 to greatly limit the degree of judicial involvement with regard to claims trading.\textsuperscript{48} Now under amended Rule 3001(e), courts can still intervene, but only if the transferor or the transferee objects to the trade.\textsuperscript{49} Without any objection, the courts must enter the order recognizing the transfer of the claim.\textsuperscript{50} In short, current rules and regulations broaden the right to trade on a claim.

B. The Current Market

According to economist Henry Dunning MacLeod, “[i]f we were asked—[w]ho made the discovery which has most deeply affected the fortunes of the human race? We think, after full consideration, we might safely answer—The man who first discovered that a [d]ebt is a [s]aleable [c]ommodity.”\textsuperscript{51} As of 2012, the market for claims trading had reached an extraordinary $41 billion.\textsuperscript{52} The volume of claims bought and sold in the bankruptcy markets continues to climb to unprecedented heights, making claims trading a common occurrence in nearly all chapter 11 bankruptcies.\textsuperscript{53}

\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} Id.
\textsuperscript{46} Id.
\textsuperscript{48} Id.
\textsuperscript{49} FED. R. BANKR. P. 3001(e).
\textsuperscript{50} Id.
\textsuperscript{52} COMM’N TO STUDY THE REFORM OF CHAPTER 11, \textit{supra} note 2.
\textsuperscript{53} Maxwell, \textit{supra} note 51.
C. The Impact of Claims Trading on the Bankruptcy Case

Any action that influences the “collective and consensual nature of the chapter 11 process” has the power to sway the outcome of the bankruptcy case.\textsuperscript{54} Since “[c]laims trading has the tendency to destroy the traditional ‘community’ that a chapter 11 filing is meant to facilitate,” bankruptcy participants can expect disruption—both positive and negative—to occur at some point over the course of any chapter 11 petition.\textsuperscript{55}

1. The Positives

Claims trading confers many benefits for both the debtor corporation and its creditors. Importantly, claims trading “provides liquidity to an otherwise illiquid market.”\textsuperscript{56} Without claims trading, creditors must await plan confirmation before (possible) repayment on their claims.\textsuperscript{57} Because stereotypical creditors, such as vendors or customary lenders (i.e., banks), extend credit to a company on the assumption that the credit will be paid back with interest, they never anticipate having to build “their business model . . . around tying up capital in bankruptcy proceedings.”\textsuperscript{58} Accordingly, when a debtor corporation files for bankruptcy, most creditors are unprepared or unwilling to handle the bankruptcy process.\textsuperscript{59}

Fortunately—yet somewhat controversially—there are willing investors looking to enter the bankruptcy market at the exact moment in time when creditors are seeking an early exit.\textsuperscript{60} A distressed-debt investor may relieve a creditor of its stake in the bankruptcy proceeding by purchasing an original creditor’s claim.\textsuperscript{61}

As a result, the notion of “the prototypical general creditor has changed. It is no longer a small player holding a claim much like everyone else’s.”\textsuperscript{62} Instead, it is a large broker-dealer, private equity firm, or hedge fund.\textsuperscript{63} These institutions find the bankruptcy market alluring because it provides “opportunities that the

\textsuperscript{54} Tung, supra note 29, at 1715.
\textsuperscript{55} Goldschmid, supra note 4.
\textsuperscript{56} Ghodasara, supra note 32.
\textsuperscript{57} Baird, supra note 47, at 660.
\textsuperscript{58} Id.
\textsuperscript{59} Id. (“holders of some claims . . . never expected to be long-term investors . . . [and] are not set up to participate in the Chapter 11 proceeding.”).
\textsuperscript{60} Id.
\textsuperscript{61} Id.
\textsuperscript{62} Id. at 653.
\textsuperscript{63} Id. at 652.
highly regulated [public] market . . . d[oes] not." In return for their investment, most investors seek either to gain a profit or acquire strategic control over the entire business post-bankruptcy.65

Regardless of these investors’ motivations, their arrival often adds value and much-needed optimism to the bankruptcy case.66 For instance, in filing a bankruptcy petition the debtor often strains its rapport with its prior partners (and now presumed creditors).67 A distressed-debt investor can relieve mounting tension and thereby free the debtor from an irate creditor.68 Moreover, these investors may stand as the only source of rescue financing available to the debtor in the face of grave odds of survival.69 They likely “have a good sense of the entire value of the enterprise [as compared to] a trade creditor or small bondholder . . . [and thus] may be able to find overlooked value.”70 In fact, such was the case in both Lehman Brothers’ bankruptcy and Kmart’s restructuring during the economic crisis of 2008, when distressed-debt investors swooped in to interject in the bankruptcy process.71

Investors further provide institutional know-how that others in the bankruptcy proceeding may desperately need in navigating repayment protocols and restructuring processes.72 Accordingly, many scholars describe distressed-debt investing “as a phoenix. Rising from the ashes of bankruptcy are revitalized firms, thanks to the determination of investors who immolate short-run destructive behaviors in favor of long-run value maximization.”73

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64 Id. at 659.
65 Id. at 661.
66 Id. (“Claims trading flourishes because it is attractive to buyers as well as sellers.”).
68 Id.
70 Baird, supra note 47, at 661.
72 Baird, supra note 47, at 660.
73 Goldschmid, supra note 4, at 274.
2. The Negatives

Claims trading likewise causes many problems—tantamount among them being a lack of transparency.\textsuperscript{74} According to Arthur Levitt, prior Chairman of the Securities and Exchange Commission (SEC), “transparency promotes the fairness and efficiency of the U.S. capital markets . . . . This is as true for debt markets as for equity markets.”\textsuperscript{75} In bankruptcy, transparency stems from disclosure. In fact, “[i]t has been said that the ‘three most important words in bankruptcy are: disclose, disclose, disclose.’”\textsuperscript{76} The SEC and other agencies, however, afford some claims traders (e.g., hedge funds) significant regulatory leeway to keep information secret that may be otherwise useful to third parties.\textsuperscript{77} Secrecy remains the central focus for these traders; they “do not want the public knowing ‘who their investors are, what they invest in, what they pay for their investments, or, more importantly, what their return is on their investments.’”\textsuperscript{78} Naturally, then, claims trading brings disruption to the bankruptcy process by inhibiting transparency.\textsuperscript{79}

Courts tolerate secrecy out of fear that forced disclosure may negatively impact liquidity within the bankruptcy framework.\textsuperscript{80} Because hedge funds desire to conceal their proprietary investing knowledge, requiring disclosure may cause them to pull away from the claims trading market.\textsuperscript{81} Yet, “[t]ransparency is the very essence of bankruptcy proceedings, and by not holding hedge funds to this standard, the scales are tipped in their favor.”\textsuperscript{82} So whereas a debtor in


\textsuperscript{76} Alexander, supra note 74, at 1416.

\textsuperscript{77} Cf. id. at 1416–17 (indicating that traditional creditors must file a verified statement “containing the following information: (1) the name and address of each creditor . . . ; (2) the nature and amount of the claim . . . and the time of acquisition if it was acquired within a year of the filing of the petition; (3) the facts and circumstances in connection with the employment of the representative filing the statement, and, for committees, the names of the entities who employed or organized the committees; and (4) the amounts of claims . . . , the times they were acquired, the prices paid, and any subsequent sales of the claims or interests.”).

\textsuperscript{78} See id. at 1414.

\textsuperscript{79} Id. at 1435–54.

\textsuperscript{80} See id. at 1438 (“Disclosure . . . threatens this liquidity because the majority of distressed investors are hedge funds that rely on secrecy for their success.”).

\textsuperscript{81} Id.

\textsuperscript{82} Id. at 1440.
bankruptcy has significant disclosure requirements, a distressed debt investor does not.

Outside of bankruptcy, the Securities Act of 1933 and Exchange Act of 1934 bar such secrecy by demanding "continuous disclosure." Under this regulatory regime, a reporting company must deliver to the public “an extensive description of the company’s business, audited financial statements for the fiscal year, and management’s discussion and analysis of the position and performance of the company.” Inside of bankruptcy, no such rules demand an equivalent degree of transparency on the trading of claims. This void provides distressed-debt investors a strategic advantage over other participants, wherein these investors accumulate large amounts of a debtor’s debt through claims trading and in turn then heavily influence the terms of the debtor’s subsequent sale or restructuring. However, “[t]he company or other stakeholders could make different or more timely, proactive decisions regarding a financial restructuring if afforded more complete information.” The informational asymmetry clouds other bankruptcy participants' judgments, spawning uncertainty, added expense, and even conflict in the bankruptcy case.

Besides the issue of disclosure, claims trading also upsets the central framework of the Code, which works to balance a “fresh start” for the debtor with fair distribution of assets to similarly situated creditors. Distressed-debt investors, by definition, are meant to invest and then extract value—either monetary or organizational—from the debtor. While some hedge funds pursue

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84 Harner, supra note 33, at 201–02; see Alexander, supra note 74, at 1420 (discussing how hedge funds, as the predominant trafficker of claims, routinely form “ad hoc” or unofficial committees that evade disclosure requirements.); see also Fed. R. Bank. P. 2019(c) advisory committee’s notes to 2011 amendment (noting that a recent 2011 amendment caused for a discontinuation of the disclosure requirement on the amount paid for the claim and any subsequent sales of that claims.).
85 Cox, Hillman, Langevoort, Securities Regulation Cases and Materials 9–10 (7th ed. 2013). The Securities Act has a goal of protecting investors in primary distributions of securities, while the Exchange Act focuses on the secondary trading markets and its participants. The three types of companies required to register are companies that: (1) have securities listed on a national exchange; (2) have $10 million or more in assets and have securities held by at least 2,000 investors; or (3) have filed a registration statement.
86 Id. at 10.
87 Harner, supra note 33, at 195.
88 Id.
89 Id. at 195–96.
90 Id. at 196.
91 United States Fid. & Guar. Co., 236 U.S. at 554–55 (“It is the purpose of the Bankrupt Act to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.”).
92 Harner, supra note 69, at 107.
long-term investment strategies, “[t]oday’s private investors . . . feel far greater pressure to cash out sooner, even if this destroys long-term value. To that end, they may acquire control (through claims trading) . . . and use that control to strip—and then flip—assets, rendering an otherwise viable firm incapable of reorganizing.”93 Alternatively, a distressed-debt investor may seek not mere profits but control over the entire debtor corporation. Such investors are commonly termed corporate raiders or vulture investors; they “target undervalued, cash-flush or mismanaged companies” and pursue a loan-to-own strategy, whereby the creditor purchases a large debt and subsequently converts the debt into an equity stake in the distressed company.94 With an equity stake comes ownership, whereby the investor gains the right to control the company’s actions both post-plan confirmation and later upon discharge of all debts.95 In these two aforementioned ways, the distressed-debt investor limits the debtor company’s prospects for a “fresh start.”

The complex strategies often employed by distressed-debt investors in claims trading may likewise destroy value for other creditors.96 For instance, hedge funds have been known to literally hedge risk by acquiring various types of interests or debts in the same company.97 In bankruptcy, these varied tranches of debt or equity ownership afford the distressed-debt investor the opportunity to “block an out-of-court restructuring . . . [or] reorganization plan, neither of which can occur without the support of a certain number and amount of claims and interests. This leverage might, in turn, enable the investor to extract rents from other[s] . . . committed to supporting the plan.”98 A distressed-debt investor might also resell its recently-acquired claim and thus force the remaining creditors to re-analyze a proposed chapter 11 plan or re-visit voting preferences in the confirmation of that plan.99 The distressed-debt investor thereby inhibits the repayment or restructuring process in the bankruptcy case.

Claims trading therefore not only “significantly increases existing information asymmetry in restructuring negotiations[,]” but also diminishes the likelihood of a successful “fresh start” for the debtor and a fair distribution of assets to creditors.100 Thus, the claims trading process, especially when enacted

94 Harner, supra note 33, at 158, 165.
95 Id.
96 Lipson, supra note 93, at 1616.
97 Id. at 1616–17.
98 Id. at 1617.
99 See Donegan, supra note 67.
100 Harner, supra note 33, at 195.
during the T1 phase, tends to disrupt the overall flow of the chapter 11 proceeding from start-to-finish.

D. The Struggle to End the Disruption

Amidst the disruption are the courts, “struggling to bring the law and markets in sync.”101 Because the Code and FRBP do not heavily regulate the transfer of a claim, and neither Congress nor the Supreme Court have offered effective guidance on this challenging issue, lower bankruptcy courts are forced to resolve instances of claims trading in a disjointed fashion:102 “Bankruptcy courts presiding over cases in which claims were traded have confronted a host of issues including: imposing disclosure obligations; preventing conflicts of interest on creditors’ committees and bad faith voting on reorganization plans; and preserving the beneficial tax consequences of net operating losses.”103 To bring the law and markets back in alignment, bankruptcy courts (and other bankruptcy participants) must advocate for a system that limits the degree of disruption associated with claims trading while allowing for its merits to shine.

II. ANALYSIS

A. The Possibility of Claims Trading at the Margins

Exactly when claims trading occurs oftentimes defines the degree of disruption felt by the courts and other bankruptcy participants. Most trades occur after the filing of a petition for bankruptcy relief under chapter 11 but before the confirmation of the reorganization or repayment plan (previously referred to as “T1”).104 Trading at this point in time has historically proven to be highly disruptive. Yet claims trading can (and does) likewise occur at points earlier and later along the bankruptcy spectrum, with the outer margins being: (1) before

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101 Levitin, supra note 26 (emphasis added).
103 Id.
104 Hammer, supra note 23 (“Instead of waiting for confirmation of the reorganization plan to determine the value of the claim and authorize its payment . . . the creditor may choose to sell its claim to a third party.”); see also Brumby, supra note 23 (discussing that as the bar date on the filing on a proof-of-claim approaches, claim trading volume should pick up); 4MR Update, supra note 23 (“Typically, bankruptcy claims trading increases as the proceedings get closer to a plan of reorganization.”).
the filing of the petition (previously referred to as “T0”); and (2) after confirmation of the reorganization plan (previously referred to as “T2”).

![Bankruptcy Timeline]

**Figure 2: Bankruptcy Timeline**

Besides providing an “easy exit from a reorganization proceeding for those who are ill equipped to navigate it,” trading at these extremes fosters a more collaborative environment for bankruptcy participants to fashion a suitable outcome.105

In review, acknowledging that claims trading can occur at T0 and T2 is a critical first step to comprehending its benefits.

The Code and FRBP not only guide parties’ actions in a bankruptcy proceeding, but further contemplate when such actions are to occur.106 Put differently, the Code and FRBP know how to account for the timing of an action in bankruptcy. For instance, § 1125 of the Code indicates that a debtor corporation cannot solicit plan acceptance or rejection until after it discloses adequate information and transmits its plan for reorganization to the holder of a claim.107 Similarly, § 1129 of the Code requires, among other things, that confirmation of a plan is to take place only if the plan first complies with applicable provisions of the title, and each class of similarly situated claims holders has voted and by majority vote accepted the plan.108 To trade on a claim, though, § 501 of the Code and Rule 3001 (when read together) only demand that a creditor timely file a proof of claim by written statement.109 Neither regulation expressly limits when the transfer of a claim can occur even though it is discussed generally.110

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106 See *e.g.*, 11 U.S.C. §§ 501(b)–(c), 1125, 1129 (2012); FED. R. BANK. P. 3001(a), (e).
108 See *id.* § 1129 (discussing confirmation of a plan).
109 See *id.* §§ 501(b), (c); FED. R. BANK. P. 3001(a), (e).
Broadly-speaking, then, the transfer of a claim is not limited temporally.111 The fact that bankruptcy courts retain the ability to preside over other actions, which incorporate claims trading before or after T1, reinforces this assertion.112 For example, § 1126(b) of the Code grants the option for claims trading to take place at T0 as part of a “pre-packaged” plan.113 Under this provision:

a holder of a claim or interest that has accepted or rejected the plan before the commencement of the case . . . is deemed to have accepted or rejected such plan, as the case may be, if — (1) the solicitation of such acceptance or rejection was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or (2) if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information. . . .

Simply put, a soon-to-be debtor can solicit votes in support of a reorganization or repayment plan “from the appropriate creditor groups prior to the filing of the petition.”115 Given the Code’s acknowledgement of and the court’s acceptance of such a pre-petition action by the debtor and its creditor groups, claims trading at T0 is a true possibility.

Similarly, because “the Bankruptcy Court retains jurisdiction to interpret, enforce, or aid the operation of a plan of reorganization” after plan confirmation, claims trading at T2 is also a possibility.116 The advisory committee notes of the 1991 amendment to Rule 3022,117 as well as other provisions of the Code under chapter 11, reiterate how bankruptcy courts indeed retain jurisdiction over and may take further actions in the bankruptcy proceeding even post-plan confirmation.118 In short, “[t]he continuing force of these provisions contradicts the generalization that the post-confirmation phase is entirely ‘after

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111 See e.g., 11 U.S.C. §§ 501(b)–(c), 1125, 1129 (2012); FED. R. BANK. P. 3001(a), (e).
112 See e.g., 11 U.S.C. § 1126(b) (2012).
113 See id.
114 Id.
117 See FED. R. BANKR. P. 3022 (“A final decree closing the case after the estate is fully administered does not deprive the court of jurisdiction to enforce or interpret its own orders and does not prevent the court from reopening the case for cause pursuant to § 350(b) of the Code.”).
bankruptcy.”

Therefore, the T2 timeframe operates as a strong option for when claims trading might yet still occur.

The T1 timeframe, nevertheless, dominates the bankruptcy timeline with regard to when the greatest number of claims trades tends to occur. Although there is no definitive reason for why T1 presents itself with the greatest volume of claims trading activity, the predominant hypothesis reflects the belief that any creditor would rather avoid the associated risks, costs, and delays inherent in a bankruptcy proceeding than endure them. As previously stated, creditors never anticipate having to build “their business model . . . around tying up capital in bankruptcy proceedings.”

And even in instances where the creditor is a sophisticated bank or institutional lender, the preference is to sell off the “risky securities that tend to decrease the value of their investment portfolios.” Thus, once a debtor files for bankruptcy, creditors often pursue strategies, such as claims trading, to relinquish their stake in the case as soon as possible.

A related justification for the increased frequency of claims trading at T1 is that at the same time when creditors are looking to exit, distressed-debt investors are looking to enter. Investors pursue a claim, especially at T1, because temporally this is when the highest stakes occur within the bankruptcy process. Critical negotiations and voting takes place then, which allows the owner of a claim to heavily influence the bankruptcy outcome. Investors looking to ensure a return on their own investment rightly conclude then that influencing the plan proposal and voting process provides for the greatest opportunity through which to manage other creditors’ rights and guide the debtor’s restructuring or repayment schedule.

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120 Hammer, supra note 23 (“Instead of waiting for confirmation of the reorganization plan to determine the value of the claim and authorize its payment . . . the creditor may choose to sell its claim to a third party.”); see also Brumby, supra note 23 (discussing that as the bar date on the filing on a proof-of-claim approaches, claim trading volume should pick up); AMR Update, supra note 23 (“Typically, bankruptcy claims trading increases as the proceedings get closer to a plan of reorganization.”).
121 Baird, supra note 47, at 660.
122 Alexander, supra note 74, at 1415.
123 See Levitin, supra note 26, at 87 (“Creditors can wait for years to receive a payout in a large Chapter 11 case and the expected payout at the end is highly speculative. The ability to sell bankruptcy claims provides an exit opportunity for creditors who do not wish to incur the hassle and expense of the reorganization process.”).
124 See generally Alexander, supra note 74.
125 Id. at 1415.
126 See Levitin, supra note 34, at 73 (discussing how investors have historically focused on purchasing claims after the debtor proposed a plan but before creditors voted, yet acknowledging that investors are pursuing purchasing claims earlier in the process).
The frequency of claims trading during these pivotal moments in bankruptcy cases continues to rise.128 A recent empirical study underscores this conclusion, noting that “the overwhelming majority of the distressed debt respondents intend to maintain or increase their investments in the distressed debt market . . . .”129 Unfortunately, with increased claims trading activity comes more intense competition between the creditor and other bankruptcy participants for control in the proceeding.130 In acknowledging the possibility for claims trading at both T0 and T2, courts can begin to envisage how pushing claims trading to occur at these margins may limit the disruption stemming from the claims trading process.131

B. The Benefits of Claims Trading at the Margins

Pushing claims to the margins can limit the level of disruption both debtors and opposing creditors experience when a trade occurs, and thereby enhance the likelihood of a successful bankruptcy.

1. Leveraging Claims Trading at T0

Leveraging claims trading at T0, especially in an effort to secure votes for acceptance of a pre-petition plan, enhances the likelihood that the chapter 11 process will be short and smooth.132 Importantly, claims trading at T0 helps reframe the situation as one involving committed partners in pursuit of joint progress rather than one involving contentious opponents participating in a zero-sum game.133 Furthermore, seeking out claims trading during the T0 timeframe decreases the likelihood that the entire bankruptcy process will be delayed or stalled by holdouts.134

128 Harner, supra note 69, at 73.
129 Id. at 72–73.
130 Id. at 73.
131 See Alexander, supra note 74, at 1454.
133 Id.
134 Id.
a. A Short and Smooth Process

According to § 1121(a) of the Code, a “debtor may file a plan with a petition commencing a voluntary case, or at any time in a voluntary case or an involuntary case.” 135 The Code thus grants the debtor the right to file a petition and a plan for bankruptcy relief simultaneously. 136 The bankruptcy courts often acknowledge and may even confirm this “pre-packaged” plan, so long as, prior to the petition for relief, the debtor has solicited and obtained the requisite amount of acceptances from its creditors in support of the plan. 137 The debtor must also have disclosed adequate information to its creditors in soliciting such support. 138

During this pre-petition timeframe, soliciting votes in support of a plan is critical. 139 Unfortunately, creditors, foreseeing the looming struggles of bankruptcy, often turn hostile during this pre-petition timeframe. 140 This hostility breeds delays and adds other unnecessary costs to the bankruptcy proceeding, such as time-consuming litigation between the parties. 141 Negotiations, especially when done during the pre-petition timeframe, may forestall the above undesirable interactions and outcomes, as a debtor that negotiates “with its major creditor constituencies” is better able to determine whether “these groups will support its plan.” 142

While negotiations are prevalent in many (if not all) bankruptcy cases post-petition, negotiations associated specifically with a pre-packaged plan offer unique opportunities. 143 Importantly, they help a potentially hostile creditor fathom the inherent tensions and costs associated with a bankruptcy proceeding. 144 Armed with this information, many creditors then prefer to avoid

136 See id. § 1121(a).
137 See id. § 1126.
138 Id. §§ 1126(b)(1)–(2).
139 See id. § 1126(c).
140 See Suniati Yap, Investing In Chapter 11 Companies: Vultures Or Whiteknights?, 2 SW. J.L. & TRADE AM. 153, 158 (1995) (“[R]elations between the debtor and its creditors may not always be friendly by the time a company is in need of reorganization.”).
142 Carter, supra note 132, at 310.
143 See generally Yap, supra note 140.
144 See id. (“[B]y taking aggravated and sometimes hostile creditors out of the picture, the debtor can focus on negotiations with parties who will listen to what makes financial sense.”).
the bankruptcy process entirely with the sale of their pre-petition rights to a
distressed-debt investor.\textsuperscript{145}

Claims trading as part of a prepacked plan thereby leads to a more
concentrated community of claims owners, predominantly a select few
distressed-debt investors.\textsuperscript{146} Since fewer investors mean fewer fights and a
greater degree of compromise in negotiations, the claims trading process thus
becomes “associated with . . . faster restructurings and more going-concern
sales.”\textsuperscript{147} Simply put, claims trading during the pre-petition timeframe both
smooths disruptions and promotes efficient outcomes in the bankruptcy case.

\subsection*{b. Partners in the Bankruptcy}

The “symbiotic relationship between debtor and creditor” in chapter 11 cases
allows for the debtor to reorganize for the betterment of interested parties.\textsuperscript{148}
With claims trading, the identities of claimholders constantly shift; they “are not static.”\textsuperscript{149} A revolving door of creditors drains value from property of the estate,
frustrates negotiations between the debtor corporation and potential creditors,
and adds layers of confusion to the entire process.\textsuperscript{150} These resultant issues often
hinder the going-concern value of the debtor corporation and cause for chapter
11 recidivism (also known as “chapter 22” or “chapter 33”).\textsuperscript{151}

The Code’s drafters initially contemplated bankruptcy filings involving only
two factions: the debtor and its “traditional creditors,”\textsuperscript{152} all of whom had a long-
standing and ongoing relationship with each other.\textsuperscript{153} Yet the arrival of claims
trading allowed for a third party to enter into the bankruptcy dynamic: the
distressed-debt investor.\textsuperscript{154} While some distressed-debt investors truly intend to
integrate as if they belonged with the initial faction of creditors, the majority

\begin{itemize}
\item \textsuperscript{145} David C. Smith, \textit{Claims Trading Promotes Ownership Concentration}, 30-3 AM. BANKR. INST. J. 1, 71
\textit{(April 2011)}.
\item \textsuperscript{146} \textit{Id.}
\item \textsuperscript{147} \textit{Id.}
\item \textsuperscript{148} Richard D. Thomas, \textit{Tipping The Scales in Chapter 11: How Distressed Debt Investors Decrease
\item \textsuperscript{149} \textit{Id.} at 221.
\item \textsuperscript{150} \textit{Id.}
\item \textsuperscript{151} \textit{Id.}
\item \textsuperscript{152} A “traditional creditor” routinely came in the form of a single institutional lender. That lender often
already had a long-standing relationship with the debtor and backed the deserving debtor by supplying much-
needed capital for routine business operations.
\item \textsuperscript{153} Thomas, \textit{supra} note 148, at 239.
\item \textsuperscript{154} \textit{Id.} at 240.
\end{itemize}
merely desire to extract value from its claims trade. As such, “the participation of vulture funds [also termed distressed debt investors] cause[s] reorganization to be more of a zero-sum game . . . [where t]he gain of a vulture fund engaging in claim flipping is counterbalanced by the loss of some other party-in-interest.” That party-in-interest may be either a competing creditor or the debtor corporation itself.

A distressed-debt investor adds value by helping all parties involved in the bankruptcy efficiently navigate plan formation and confirmation; however, this value only lasts only up until the moment that the distressed debt investor itself exits the bankruptcy process by re-selling the claim to another claims purchaser. Because liquidity is paramount to many distressed-debt investors and hedge fund groups, these entities often seek a short-term interest in the bankruptcy process and quick exit so as to remain liquid.

Continuous negotiations between the debtor and new creditors take a toll on all involved parties. Building relationships between the debtor and its creditors takes time; however, in bankruptcy, time is a luxury that the debtor and its creditor cannot afford to waste. Time amounts to money spent on professional fees and plan negotiations. Participants in a chapter 11 reorganization intend for the expense of building these relationships to go toward “preserving the going-concern value of the business.” Yet every time that the debtor must form a new relationship with a creditor due to claims trading, the debtor’s equity as between its going-concern value and liquidation value is eroded.

“The knowledge and familiarity that the selling creditor acquires in negotiation is debtor-specific”; it is an “idiosyncratic investment—highly specialized and not transferable.” When a creditor sells its claim to a distressed-debt investor, that creditor exits the bankruptcy with its idiosyncratic relationship with the debtor. A distressed investor, who is typically a stranger

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155 Id. 156 Id. 157 See id. at 240–41 (“When the debtor suffers the losses resulting from vultures funds’ gains, the debtor’s chances for success after emerging from bankruptcy are diminished along with the going-concern value of the business.”). 158 Id. at 227–28. 159 Id. at 228. 160 Id. at 229. 161 Id. 162 Id. 163 Id. 164 Id. at 227, n. 117. 165 Id. at 227.
to the debtor corporation, replaces the original creditor. As a result, the distressed investor adds no relationship value to pending negotiations regarding plan formulation and confirmation. Simply put, there is a “net loss in value within the forum.”

Repeated and continuous negotiations also cause the debtor corporation to disengage from the reorganization process entirely:

[T]he [debtor-in-possession] has no incentive to negotiate with an investor looking to flip its claim because the [debtor-in-possession] has no confidence that the claimholders on day one will be the same parties the [debtor-in-possession] speaks to on days three, five, twenty, and so on; indeed “even the potential for trading deters parties from investing in relationships and from cooperating.”

As a result, the estate’s value wanes. Less and less becomes available for use by the debtor toward a fresh start and alternatively for repayment to other creditors post-plan confirmation.

By pushing claims trading to the pre-petition timeframe of T0, creditors are encouraged to acknowledge the imminent bankruptcy and to evaluate whether they want to collaborate with the debtor as a long-term partner in the bankruptcy process or exit the process via a transfer of claim. A limitation or restriction on claims trading at T1 would “bar[] entry for [distressed-debt investors] that would engage in claim-flipping while simultaneously allow[ing] a creditor that does not wish to engage in negotiations to exit.” Therefore, courts should support holding the identity of claimants relatively stagnant at T1 so as to beget productive negotiations during that timeframe and preserve value for all bankruptcy participants.

In addition, the less time the debtor spends battling with creditors in the bankruptcy process, the more likely the plan is to move forward and creditors are to be repaid. Any “delay in productive negotiations has serious cost consequences, such as causing the debtor to languish in bankruptcy longer than necessary or increasing the probability of a sub-optimal plan being confirmed.” Committed creditors, identified at T0, afford the debtor the

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166 Id.
167 Id. at 235.
168 Id. at 227.
169 Id.
170 Id. at 248.
171 Id. at 241.
172 Id. at 236.
opportunity to focus on restructuring efforts rather than waste time and money on continuous rounds of negotiations with new claimants. As such, the amount of time that a debtor remains in bankruptcy shrinks. Creditors are invested in the debtor, and in return likely receive faster repayment terms, at a higher amount.

c. **Holdouts**

When a corporation can no longer service its debt obligations, it must face the reality of either restructuring its debt under applicable non-bankruptcy law provisions or restructuring its debt using the tools offered as part of the bankruptcy process.\(^{173}\) The distressed corporation may either: (1) make a tender offer to a creditor in the open market “at a price somewhat over the trading price, but well below the face amount, of the outstanding debt securities”; or (2) “seek approval of a ‘prepackaged’ plan of reorganization under the Bankruptcy Code.”\(^{174}\)

In the instance where the debtor pursues a tender offer strategy, concerns around creditor “holdout” arise.\(^{175}\) A tender offer under non-bankruptcy law usually demands that ninety to ninety-five percent of the corporation’s debtholders consent to and accept the proposed exchange offer.\(^{176}\) This high percentage requirement means that any debtholder that owns greater than ten percent of the debt is able to holdout from the agreement for debt restructuring, harming both the distressed corporation and fellow debtholders.\(^{177}\) In effect, holdouts “impede the ability of the majority of the bondholders to achieve a consensual scaling down of the debtor corporation’s over-leveraged capital structure that demands a pro rata sacrifice by each bondholder to avoid the greater losses incident to bankruptcy.”\(^{178}\)

In the alternative, the debtor may pursue a strategy at the T0 timeframe of developing and soliciting votes in support of a pre-packaged plan.\(^{179}\) Although all actions related to a pre-packaged plan occur before the filing of a petition for relief (i.e., during when non-bankruptcy law typically governs), the plan bases

\(^{173}\) *Coffee, supra* note 132, at 1208.

\(^{174}\) *Id.* at 1209.

\(^{175}\) See *id.* at 1214 (“Both the corporate debtor and the other bondholders realize that if a significant percentage of the debtholders spurn the proposed recapitalization then any savings realized by the corporation will simply go on maturity to pay off the claims of these holdouts.”).

\(^{176}\) *Id.* at 1247–48.

\(^{177}\) See *id.* at 1216 (“The bondholder must fear both the issuer’s threats and its fellow bondholders’ opportunism.”).

\(^{178}\) *Id.* at 1214.

\(^{179}\) *Id.* at 1209
its procedural operations off of applicable bankruptcy laws most commonly utilized at time T1.\textsuperscript{180} As previously mentioned, the pre-packaged plan requires the approval of each class of claims.\textsuperscript{181} The Code demands that “at least two-thirds in amount and more than one-half in number” of claims approve the proposed plan before the courts confirm that plan.\textsuperscript{182}

Any attempt by the debtor to establish a pre-packaged plan signals to the distressed corporation’s creditors that the corporation may soon file for bankruptcy.\textsuperscript{183} Such a threat pressures “the bondholders into a kind of prisoner’s dilemma, thereby coercing [them] to accept an amendment to their indenture that in their unconstrained choice they would reject.”\textsuperscript{184} While the hostile creditor may initially desire to holdout, the creditor’s individual bargaining power becomes greatly diminished after a pre-packaged plan at the T0 timeframe is approved by a simple- and super-majority. Although the creditor may still pursue a holdout strategy, the option to instead exit the imminent bankruptcy with a claims trade becomes appealing. Thus, trading at T0 may provide the debtor an opportunity to more readily achieve a favorable recapitalization of its debt without the obstacle of a holdout.

In total, practicing claims trading at the T0 timeframe rather than the T1 timeframe offers a multitude of benefits to those entwined in the bankruptcy process. It helps the debtors to establish a pre-packaged plan by removing otherwise hostile creditors from the equation and replacing them with distressed-debt investors. Since these new entrants desire a return on their investment, they are often more accommodating and committed to negotiating with the debtor on best practices to restructure and reorganize as compared to the otherwise hostile claimants. The debtor, in turn, is better equipped to develop and get approval for a pre-packaged plan. Given that a pre-packaged plan developed during the T0 timeframe has the tendency to decrease the both the time and attendant costs of bankruptcy, claims trading during the T0 timeframe can be said to promote efficient outcomes and reduce the amount of disruption to the overall process.

\textsuperscript{181} Id. §§ 1126(c)–(d).
\textsuperscript{182} Id.
\textsuperscript{183} Id. at 1212.
\textsuperscript{184} See generally Coffee, supra note 132, at 1207.
2. Applying Claims Trading at T2

Limiting claims trading to the T2 timeframe can also be instrumental to plan confirmation. The benefits of such a restriction are heightened in instances where a claims trade has the potential either to damage the debtor corporation’s market value or to harm a proposed plan’s third-party beneficiaries.

Damage to a debtor corporation’s market value generally means that the debtor has less funds available for compensation or is in a weakened state to then payout on various claims against the estate. Any damage done to a debtor’s market value hence harms not only the debtor in its own ability to be rehabilitated through the bankruptcy process, but also the collective body of creditors that rely on a potential payout on their claims. Equally so, damage to a debtor’s market value harms those other beneficiaries that the debtor owes due to tort-related action.

Courts have historically placed injunctions on claims trading during the T1 timeframe to forestall harm to the debtor, especially where such harm stems from the associated tax consequences that arise from a claims trade. Courts have also enjoined a distressed-debt investor from trading on a claim when the creation of a trust was deemed necessary to resolve asbestos or other products liability claims as part in the bankruptcy case. A delay in claims trading, until the T2 timeframe, thus allows bankruptcy participants to more thoughtfully analyze the impact that a trade may have on each party’s rights, obligations, and overall success of reorganization.

a. Injunction for the Protection of Third-Parties

While claims trading most routinely affects the rights of those traditionally involved in the bankruptcy proceeding (i.e., debtors and common creditors, such

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185 See In re Armstrong World Indus., 348 B.R. 136, 169 (Bankr. D. Del. 2006) (where “approval and entry of the claims trading injunction . . . was essential to the formulation and implementation of the plan as provided in 11 U.S.C.S. § 1123(a)(5).”)

186 See Jean Morris, Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor’s Chapter 11 Case to Preserve the Debtor’s Net Operating Loss Carryforward: Examining the Emerging Trend, 77 AM. BANKR. L.J. 285, 287 (2003) (where “restrictions on the ability of the debtor to carry forward existing NOLs to future profitable years . . . motivated debtors to attempt to obtain orders from the bankruptcy court restraining trading . . . that could, even unintentionally, adversely affect this potential value.”); see In re Prudential Lines, 928 F.2d 565, 573 (2d Cir. 1991); see Erik Stegemiller, Winning Losses: Trading Injunctions and the Treatment of Net Operating Loss Carryovers in Chapter 11, 32 YALE J. REG. 161, 173 (2015).

187 See generally Morris, supra note 186, at 186; In re Prudential Lines, 928 F.2d at 573; Stegemiller, supra note 186, at 176.

188 See generally In re Armstrong World Indus., 348 B.R. at 160.

189 See generally Stegemiller, supra note 186, at 196.
as lenders, suppliers, etc.), in some circumstances the proposed plan may impact third-parties as well. In *In re Armstrong*, the Bankruptcy Court for the District of Delaware strictly enforced its powers to govern a specific group of claims that distressed-debt investors sought to purchase as simple securities in the bankruptcy market.

Before its filing, Armstrong World Industry, Inc. (“AWI”) had suits pending against it for asbestos-related personal injury and property damage. In filing a petition for relief, AWI showcased in its disclosure statement that it had paid over $500 million in settlement payments for asbestos-related personal injury claims and wrongful death charges. Further, “[a]s of September 30, 2000, approximately 173,000 asbestos-related personal injury and wrongful death claims were pending against AWI within the tort system in a multitude of jurisdictions.” AWI thus met with creditors to establish a plan for repayment of allowed claims belonging to those creditors harmed by its asbestos-containing products.

The confirmed chapter 11 plan specified that a special trust would be created, and that all asbestos-related personal injury claims would be channeled into that trust. To effectuate this plan, the court relied on the equitable powers granted to it under § 524(g) and § 105(a) of the Code to issue an injunction that would “permanently and forever stay, restrain, and enjoin any Entity from, directly or indirectly, purchasing, selling, transferring, assigning, conveying, pledging, or otherwise acquiring or disposing of any Asbestos Personal Injury Claim.” Any attempt to act on such an enjoined trade was deemed immediately void.

In effect, the injunction assisted in the creation of the “Asbestos Channeling Trust” so that the exact amount of legal liability could be determined and so that the debtor could continue to operate post-bankruptcy with ease (i.e., without the administrative burden of tracking and managing the payout on claims to the more than 170,000 claimants). It further kept distressed-debt investors from

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190 See, e.g., *In re Armstrong World Indus.*, 348 B.R. at 186.
191 See generally id. at 157.
192 *Id.* at 141.
193 *Id.*
194 *Id.*
195 *Id.* at 142.
196 *Id.* at 152.
197 *Id.* at 156; see 11 U.S.C. §§ 105(a), 524(g)(1).
198 *In re Armstrong World Indus.*, 348 B.R. at 156.
199 See *id.* at 152 (“With respect to any Asbestos Personal Injury Claim that is allowed by the Asbestos PI Trust in accordance with the Asbestos PI Trust Agreement and the Asbestos PI Trust Distribution Procedures, such allowance shall establish the amount of legal liability against the Asbestos PI Trust in the amount of the
trading on these channeled claims, which would have irreparably harmed the bankruptcy process due to the sheer volume of channeled claims that could be traded on within the T1 timeframe. The injunction issued during the T1 timeframe thus not only helped the debtor achieve a “fresh start,” but further protected creditors with unliquidated and contingent claims.

Although the injunction discussed in In re Armstrong indefinitely restrained all claims trading activity, not all such forms of equitable relief need be equally permanent. The relief should “be tailored as much as possible to the complexion of the particular case, with an eye to preserving benefits that might be realized from claims trading to the extent not incompatible with the rehabilitative goals of [chapter 11].” Consequently, courts should likewise contemplate temporary injunctions related to claims trading that produce similar outcomes to that of permanent injunctions: helping the debtor achieve a “fresh start” while simultaneously protecting creditors with unliquidated and contingent claims.

The benefits of diverting claims trading away from the T1 timeframe and toward the T2 timeframe therefore can, and likely does, produce desirable results within the bankruptcy process. With a temporary injunction, a debtor corporation is able to focus on producing a quality plan and continue running its business as a debtor-in-possession, until plan confirmation. Importantly, third-party beneficiaries also benefit from the injunction. A delayed bankruptcy proceeding due to the continuous shifting of claim ownership and litigation over those claims within bankruptcy may forestall payout or even drive the debtor to liquidate rather than reorganize under chapter 11. If the debtor were to liquidate, the creditors would receive less in repayment. Incentivizing the debtor to remain and successfully utilize the chapter 11 process, which may include the assistance of a temporary injunction on claims trading at T1, maximizes value for all participants.

b. Injunction for the Maintenance of a Debtor’s Fair Market Value

Besides a petition for relief under chapter 11 of the Code, a debtor corporation frequently will file a simultaneous series of first day motions. These motions are “designed to obtain orders of the bankruptcy court that will preserve the value of the debtor’s operations as it enters the reorganization process, allow normal operations to continue, and provide financing for the

200 Tung, supra note 29, at 1750.
201 Morris, supra note 186, at 285.
debtor’s business."\textsuperscript{202} Typical first-day motions include: permission for the debtor to continue making payroll allowances to its employees; allowance for alternative financing mechanisms; approval of methods or options for notifying creditors and other interested parties; preservation of the cash management systems; and the continuance of core business functions.\textsuperscript{203}

In recent years, debtor corporations have also moved for a restraint on “trading in the debtor’s equity and debt securities by large holders of such instruments.”\textsuperscript{204} The basis for this injunctive relief stems from the debtor corporation’s claim that “the transfer of such securities might impair the debtor’s right to utilize a net operating loss (‘NOL’).”\textsuperscript{205} NOLs arise when a taxpayer’s allowed deductible expenses for a given tax year are greater than the taxpayer’s net income generated during that same tax year.\textsuperscript{206} When the taxpayer incurs more expenses than income, the taxpayer may either apply its NOLs to the prior three years (“carry-back”) or to the future fifteen years (“carry-forward”).\textsuperscript{207} If the taxpayer elects to utilize its carry-back NOLs, the taxpayer is entitled to a tax refund; if the taxpayer elects to utilize its carry-forward NOLs, it is entitled to a speculative offset on potential future earnings. Either way, these NOLs accrue to the benefit of the taxpayer by reducing the overall tax burden incurred over the life of the corporation’s existence.

Although the Internal Revenue Code (IRC) defines how NOLs arise and are preserved by a corporation, the IRC also notes how NOLs may be lost or restricted under certain circumstances.\textsuperscript{208} Two such circumstances include when the debtor corporation changes ownership via the transfer of stock or alternatively via the conversion of debt to equity.\textsuperscript{209} As routinely happens in bankruptcy, claims trading affords a distressed-debt investor the ability to demand a debt for equity conversion on a recently-acquired claim. However, the “fear of lost value, through restrictions on the ability of the debtor to carry forward existing NOLs to future profitable years, has motivated debtors to attempt to obtain orders from the bankruptcy court restraining trading in debt and equity interests that could, even unintentionally, adversely affect this potential value.”\textsuperscript{210}

\begin{itemize}
  \item[202] Id.
  \item[203] See id. (listing the various first-day motions available to a debtor company).
  \item[204] Id.
  \item[205] Id.
  \item[206] 26 U.S.C. § 172(c) (2012).
  \item[207] Id. § 172(b)(1)(B).
  \item[208] See id. §§ 269, 381, 383, 384.
  \item[209] Morris, supra note 186, at 286; see 26 U.S.C. § 382(g) (2012).
  \item[210] Morris, supra note 186.
\end{itemize}
Most courts have agreed to comply with a debtor’s injunctive requests against claims trading on the basis that NOLs fold into the bankruptcy process by being deemed property of the estate.\textsuperscript{211} The Code defines property of the estate to encompass “all legal or equitable interests of the debtor in property as of the commencement of the case.”\textsuperscript{212} Bankruptcy courts have elaborated on this subject, indicating that “virtually all property of debtor . . . becomes property of estate; debtor’s contingent interest in future income . . . . [I]n fact, every conceivable interest of debtor, future, nonpossessory, contingent, speculative, and derivative, is within reach . . . .”\textsuperscript{213} These findings support the conclusion that NOLs, whether contingent, unliquidated, or speculative, indeed fall under property of the estate in a bankruptcy proceeding.

Importantly, a creditor may not exercise any form of control over property of the estate, including NOLs, per the automatic stay limitations found in the Code.\textsuperscript{214} In instances where an NOL may be harmed or limited by claims trading, the claims trading may be construed as a creditor’s attempt to exercise control over property of the estate.\textsuperscript{215} Per § 362 of the Code, the creditor is automatically stayed from such action.\textsuperscript{216} Therefore, courts have reasoned that an injunction on claims trading is appropriate.\textsuperscript{217}

\textit{In re Prudential Lines} stands as the leading authority on the court’s issuance of an injunction for the reasons specified above.\textsuperscript{218} In \textit{In re Prudential Lines}, the appellant, debtor corporation’s parent company PSS Steamship Company, Inc., (“PSS”) sought review of an order restricting claims trading on the debtor’s debt and equity interests.\textsuperscript{219} Since 1976, the debtor Prudential Lines, Inc. (“PLI”) and its parent (along with two other affiliates) filed consolidated income tax returns as allowed by the IRC under 26 U.S.C. § 1501.\textsuperscript{220} Collectively, the group had a combined amount of $75 million worth of NOLs generated in 1988 to offset either prior or future income.\textsuperscript{221} PLI’s pre-bankruptcy operations contributed to nearly $74 million of that total amount.\textsuperscript{222} The initial proposed plan for

\textsuperscript{211} Id. at 293.
\textsuperscript{213} Id. § 541.
\textsuperscript{214} Id. § 362(a)(3).
\textsuperscript{215} See e.g., \textit{In re Prudential Lines}, 928 F.2d 565, 573 (2d Cir. 1991).
\textsuperscript{217} See e.g., \textit{In re Prudential Lines}, 928 F.2d at 573.
\textsuperscript{218} See generally id.
\textsuperscript{219} Id. at 566.
\textsuperscript{220} Id. at 567–69.
\textsuperscript{221} Id. at 567.
\textsuperscript{222} Id.
reorganization contemplated that these NOLs would be retained by PLI and consequently would be available to offset the reorganized debtor’s income in future years.223

In February 1989, tax counsel informed PSS that it could take a $38.9 million income deduction on its 1988 federal tax return.224 The stock deduction stemmed from the company’s “worthless stock” holdings in the subsidiary, PLI.225 Taking the deduction, though, would cause a chain reaction, leaving PLI bereft and without its potential carryforward NOL.226 Even so, in November, PSS decided to pursue taking the deduction.227 The appellees, the Official Committee of Unsecured Creditors and others, in response sought to enjoin PSS and thereby shelter Prudential’s NOLs.228 “The bankruptcy court held that the NOL generated by PLI was property of PLI’s bankruptcy estate and that the worthless stock deduction was an attempt to exercise control over that property in violation of the automatic stay” under § 362(a)(3) of the Code.229 The court issued a permanent injunction prohibiting PSS from taking the worthless stock deduction as part of its federal tax return because of the associated harm to the debtor’s value post-bankruptcy.230

On appeal, the Second Circuit Court of Appeals affirmed the holding.231 In short, the filing of a consolidated tax return does not give rise to the transfer of any asset from the affiliate or subsidiary to its parent company.232 As such, the Second Circuit held that “at the commencement of the bankruptcy case against it, PLI had an interest in the $74 million NOL attributable to its pre-bankruptcy operation.”233

Previous courts have been known to support carryback NOLs as property of the estate; however, until In re Prudential, courts remained silent on the status of carryforward NOLs.234 The Second Circuit went on to hold that “the speculative nature of carryforwards does not place them outside the definition

223 Id.
224 Id.
225 Id.
226 Id.
227 Id. at 567–68.
228 Id. at 568.
229 Id.
230 Id.
231 Id. at 566–71.
232 Id. (“The fact that a subsidiary’s NOL ultimately may be used to offset another corporation’s income does not mean that the subsidiary loses any interest in its NOL.”).
233 Id. at 571.
234 Id.
of property of the estate. “The term ‘property’ has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.” Congress also contemplated that unused tax benefits, such NOLs (for individual debtors), are to be transferred back to the debtor from the estate upon closure of a case. While § 346(i) of the Code does not expressly encompass corporate debtors, “Congress’ failure to include corporate debtors in that provision does not imply . . . that Congress meant to treat NOL carryforwards of corporate debtors differently than those of individual debtors.” Consequently, the $74 million NOL fully belonged to PLI’s estate in bankruptcy.

As a result, the Second Circuit enjoined PSS from taking the stock deduction. Because the PSS’s stock deduction was so heavily intertwined with PLI’s interest in its NOL, any attempt by PSS to exercise that worthless stock deduction would adversely harm PLI’s ability to use its carryforward NOL. Therefore, such an attempt was impermissible.

Recent court opinions have questioned the validity of this type of injunctive motion made by the debtor. Courts often cite how these injunctions arguably limit the liquidity of claims in the bankruptcy market. Consequently, a creditor seeking to exit the bankruptcy has no choice but to enter the bankruptcy proceeding with the debtor, regardless of what the Federal Rules of Bankruptcy Procedure discuss on the transfer of a claim.

Nonetheless, the use of an injunction to preserve the value of a debtor corporation is a recognizable right that may help push claims trading away from T1. In looking to shift claims trading to T0 or T2, the courts may encourage bankruptcy participants to deeply analyze whether the trade makes economic sense—both for the distressed corporation and its creditors. Instead of focusing on an individual creditor’s opportunities to the exclusion of other creditors, the injunction helps bolster the likelihood that a creditor acts for the betterment of the collective group of creditors. Moreover, the injunction increases the

235 Id. at 572.
237 Id. at 572–73.
238 Id.
239 Id. at 574.
240 Id. at 573–74.
241 Id. at 574.
242 Morris, supra note 186, at 286.
243 Id.
244 Id.
likelihood that the debtor corporation receives a fresh start post-bankruptcy, as additional value is saved for operating the company post-reorganization or post-repayment.

Because claims trading defeats the debtor’s ability to fully utilize these tax benefits post-bankruptcy, courts should issue injunctions on trading at T1 and push such trading to either T0 or T2 when a change of ownership and its resultant impact on the value of the corporation can be more comprehensively evaluated. At T0, creditors are more likely to pursue strategies that maintain as much value as possible for restructuring purposes—especially given that restructuring offers greater returns than mere chapter 7 liquidation. At T2, creditors are better able to forecast the likely success of the debtor’s ability to comply with its confirmed plan, and thus whether the debtor can afford to lose its potential tax offsets in favor of other beneficial financing or alternative ownership structures. Limiting trading at T1 creates stability and allows for maximum value to be preserved in favor of the debtor corporation and distributed to deserving creditors.

C. How to Encourage Claims Trading at the Margins

While the primary focus of this Comment remains on the simple acknowledgement that claims trading at T0 and T2 minimizes disruption, a few strategies for achieving these ends are worth mentioning. Accordingly, participants in the chapter 11 process can deter distressed-debt investors from trading, or disincentivize such trading from taking place between the filing date and plan confirmation, by requiring compliance with procedural formalities under Rule 3001(e)(2) or challenging a trade’s occurrence under §§ 1126(e), 524(g), and 105(a) of the Code.

1. Rule 3001(e)(2)

Rule 3001(e)(2) of FRBP should be rolled back to its pre-1991 amendment version so as to grant courts, once again, the \textit{sua sponte} power to dampen the disruptive effects that claims trading has on an already-volatile time period. The Rule, amended in 1991, discusses the procedural requirements for the transfer of a claim. In accordance with this provision, a transferee must file evidence of the transfer with the court after said transfer has taken place.245 Upon filing by the transferee, the court will notify the transferor of the transfer.246 So long as the claim is not “one based on a publicly traded note, bond, or debenture” and it

246 \textit{Id.}
has been transferred other than for security,” the court will substitute the transferee for the transferor with regard to ownership of the claim.247

Under the current Rule, only the transferor of a claim may object to a claims trade made to an alleged transferee.248 If the transferor elects to “file[] 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.” 249

While the amended Rule limits the range of parties (i.e., those with the requisite standing to act) to the transferor and transferee, courts were previously allowed to “condition trading in response to particular perceived abuses” sua sponte.250 For instance, in In re Revere Copper & Brass, Inc. and In re Allegheny Intl', Inc., the courts intervened and reversed the claims trades because of informational asymmetries.251 The concern here in each case was that the transferee was taking advantage of the transferor because the traded claim failed to meet minimum disclosure “requirements.”252 The court thus demanded “taking of remedial measures to provide full disclosure to assignors.”253

Another bankruptcy court pursued similar remedial measures in In re Ionosphere Clubs, Inc., where a transferee sought to split a claim.254 There, the parties agreed to split a claim and transfer only a partial interest rather than a full interest in the claim.255 Because such a partial claims trade “would increase administrative burdens on the estate,” the court refused to approve the transfer unless the transferor and transferee agreed to specific remedial measures. 256

The Federal Rules should thus be amended such that Rule 3001(e)(2) grants standing to courts to bring an action or object to a claims trade. By demanding the claims seller and purchaser comply with the procedural requirements under

247 Id.; see Goldschmid, supra note 4, at 206 (“The amended language of Rule 3001(e)(2) vastly reduced court interference with the transfer of bankruptcy claims by making it clear that only the transferor has standing to object to a transfer, and by eliminating the need for a court hearing and court order to effect a transfer.”).

248 Tung, supra note 29, at 1703.

249 FED. R. BANKR. P 3001(e)(2).

250 Tung, supra note 29, at 1704.


252 Tung, supra note 29, at 1703 n. 96.

253 Id.

254 Id.


256 Tung, supra note 29, at 1703 n. 96.
the Rule, the courts can inhibit rampant and unfettered trading. In doing so, the courts can help force claims trading to occur outside of the T1 timeframe, where traders are less likely to trade on asymmetrical information or attempt to purchase derivative-like interests in claims. Traders at these margins are not incentivized to overzealously take advantage of one another or construct inappropriate methods for purchasing a claim but instead are encouraged to pursue strategies that enhance the likelihood of a successful exit from bankruptcy. Therefore, the Federal Rules should be amended to allow the courts more discretion in pushing claims trading to occur at T0 and T2 in the transfer of a claim between a transferor and transferee.

2. Section 1126(e)

Courts can induce claims trading at the margins rather than during pivotal moments in the bankruptcy case by use of § 1126(e). Section 1126(e) permits a party in interest to petition the court to “designate” or disqualify a vote that would otherwise impact a plan’s formation. Courts typically designate votes for a lack of “good faith.” Although the Code does not define “good faith” as part of its definitions section in chapter 1, various courts have made suggestions to its meaning. For instance, one court designated a vote because the creditor sought to block plan confirmation to garner leverage in support of its own restructuring plan, whereby it would ultimately acquire control over the debtor corporation post-bankruptcy. Another court designated a creditor’s vote for the creditor’s desire to inhibit the business’s potential to succeed in the future. Over time, the courts have developed key factors that help distinguish an action of good faith versus an action of bad faith. While none of these factors are controlling, both time of acquisition and price paid by the transferee are considered most relevant.

The Securities and Exchange Commission reframed these two factors and brought them under a broader standard test based around a creditor’s motive in

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257 See Goldschmid, supra note 4, at 206 (noting how the amendment “paved the way for the growth of distressed debt funds by lowering both the transaction costs of claims trading and diminishing the uncertainty over the legitimacy of claims acquired after bankruptcy filing.”).
259 Tung, supra note 29, at 1704.
260 Id. at 1703–04.
261 Id.
262 Id.
264 Id.
the bankruptcy process: “if assent is withheld to serve some ulterior selfish purpose, good faith is wanting.” While creditors are obviously understood to act in their own best self-interest, “pure malice, ‘strikes’ and blackmail, and the purpose to destroy an enterprise to advance the interests of a competing business, all plainly constituting bad faith [sic], are motives which may be accurately described as ulterior.”

Hedge funds and other distressed-debt investors seek to quickly purchase a claim at a steep discount for the express purpose of aggressively participating as a new creditor in the bankruptcy process. As an active investor, the creditor may pursue complex strategies that may or may not be aligned with the Code’s twin purposes of offering the debtor a fresh start and distributing claims pro rata to similarly situated creditors. In frustrating the Code’s purposes, these vulture investors often act in bad faith.

The most pivotal time to affect a bankruptcy case is at T1, right before plan confirmation. Courts thus must aggressively use § 1126(e) to push claims trading to T0 or T2, where the incentives for blocking or shifting a reorganization or restructuring plan are lessened because the plan has been approved as part of a pre-packaged deal or because the plan has already been confirmed and may only be modified thereafter. Courts thereby limit the degree of disruption to the bankruptcy process while at the same time respecting the need for liquidity in the bankruptcy market.

3. Section 524(g)

Courts routinely justify the use of this injunctive relief on the grounds that such an injunction is “essential to the formulation and implementation of the Plan as provided in section 1123(a)(5) of the Bankruptcy Code . . . .” With the frequency of claims trading on the rise and its concurrent disruptive impact on the bankruptcy process, courts should begin employing § 524(g) of the Code to push trading to the margins and away from processes essential to the formulation and implementation of the plan.

Section 524(g) indicates that “after notice and hearing, a court that enters an order confirming a plan of reorganization under chapter 11 may issue, in

265 Id. at 1405.
266 Id.
connection with such order, an injunction.” 269 The purpose of the injunction is to enjoin "entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any claim . . . [that] is to be paid in whole or in part by a trust . . . ." 270 As an essential component to the formulation and implementation of a chapter 11 plan, the injunction bestows upon both the debtor corporation and its creditors measureable benefits. 271 These benefits include preservation of value for the debtor, ease of channeling the creditors’ interests into the trust, and fulfillment of the terms of the plan to allow for discharge. 272

By acknowledging prior precedent entailing the issuance of an injunction, courts may begin to embrace or become more comfortable issuing injunctions in other broader settings and scenarios in which claims trading is involved. As previously mentioned, courts have issued injunctions on claims trading to preserve either the debtor’s market value or the debtor’s ability to protect third-parties from predatory investors. In examining the facts surrounding these two cases, it becomes evident that any case involving a large body of creditors that hold either unliquidated or contingent claims, or any case in which the debtor’s fair market value may be diminished by a claims trade, would constitute the use of an injunction during T1 to quiet the trading on claims and thereby limit disruption to the overall bankruptcy process.

Section 105(a) importantly mirrors this proposition, indicating that an injunction for these purposes is appropriate to carry out the twin-aims of the Code.

4. Section 105(a)

Courts should rely on § 105 of the Code to issue an injunction or other equitable relief for the purpose of diverting the majority of claims trading activities to the margins. 273 Section 105(a) permit a court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 274 The courts may enforce these orders, processes, and judgments sua sponte. 275 However, § 105 “does not authorize [] bankruptcy courts to create

270 Id.
271 In re Armstrong World Indus., 348 B.R. at 169.
272 See id. (“such injunction . . . confers material benefits on AWI’s estate [and] is in the best interests of holders of Claims against AWI.”).
274 Id. § 105(a).
275 See id.
substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.”

Section 105 often gets cited by the courts when there is a need for the issuance of an injunction or related equitable remedy. Especially with regard to claims trading, “[c]ourts have explicitly relied on Section 105(a) . . . responding to the threat of imposition of externalities on the estate.” Courts often note their concerns regarding the administrative demands placed on the estate and the debtor when claims are traded over and over again. The estate and the debtor must expend time and money to monitor, administer, and object to the sale and purchase of a claim—all of which constitute a drain on the limited resources of the estate and debtor, which may otherwise be spent on paying back creditors.

Section 105 therefore authorizes the bankruptcy courts to “fashion appropriate remedies to protect against threatened harm to or interference with the sound administration of the estate.” Claims traders can be stopped from trading whenever the court elects to find the claims trading process a burden on the estate and the debtor, or a detriment to the restructuring process as a whole. An injunction on claims trading at T1 would no doubt diminish the burden on the debtor in its efforts to present a comprehensive reorganization plan. Conversely, at T0 the debtor operates as a proactive party persuading its creditors to vote in favor of a proposed pre-packaged plan. At the opposite extreme of T2, the debtor is merely executing on the performance of its post-confirmation obligations under the plan. The potential for disruption from claims trading at T1 is heightened as compared to T0 and T2.

As such, the courts should use § 105 of the Code to issue an injunction or other equitable relief so as to shove the majority of claims trading activities to the margins.

276 Tung, supra note 29, at 1741.
277 See generally In re Prudential Lines, 928 F.2d 565, 573 (2d Cir. 1991); In re Armstrong World Indus., 348 B.R. at 169.
278 Tung, supra note 29, at 1741.
279 Id. (“In In re Ionosphere Clubs, Judge Lifland discussed as one of the ‘evils’ spawned by bankruptcy claims trading in ‘mega’ cases, . . . the substantially increased burden associated with monitoring, administering and objecting to claims which have been filed against the estate.”).
280 Id. at 1742.
CONCLUSION

The timing of a claims trade drastically influences the inquiry into the perceived benefits and harms associated with that trade’s occurrence. As such, claims trading may be less disruptive to the bankruptcy process than commentators have previously assumed. The practice may in fact further the purposes of bankruptcy when executed during the pre-petition and post-plan confirmation timeframes. Thus, legal reform that promotes claims trading prior to a petition for relief and after plan confirmation carries benefits for the debtor, other creditors, and even the distressed-debt investor.

Specifically, courts should implement strategies within the Code and an amended Federal Rules of Bankruptcy Procedure that drive claims trading to the outer bands of the bankruptcy timeline at T0 or T2. Drafters of the Code may have intended for claims trading to lend itself in support of bankruptcy’s twin aims, yet it failed to anticipate the degree by which trading perhaps now overrides these objectives. As one commentator aptly states:

This unbalanced situation is not necessarily the fault of the distressed debt investor. The investor has no duty to act on behalf of the debtor’s other creditors or shareholders, but does have a duty to act in the best interests of its own partners. The challenge then is to create a more balanced playing field in bankruptcy to provide an effective check on investors’ activities and a meaningful fiduciary to protect the interests of the debtor’s estate.281

Identifying the disruption caused by claims trading at T1 and encouraging trading at the margins will restore equilibrium and reinforce the Code’s objectives.

No doubt fewer distressed-debt investors will participate in the purchasing of claims because any such “restriction on resale [will] contract[] the size of the market.”282 However, bankruptcy is first and foremost about offering the debtor a fresh start and maximizing value for creditors. To safeguard these ends, bankruptcy participants should consider restrictions on claims trading at T1 and contemplate legal reforms that encourage claims trading at T0 and T2.

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281 Harner, supra note 69, at 107–08.
282 Thomas, supra note 148, at 248.
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