ABI Commission Declines to Recommend Any Changes to Laws Impacting Distressed Debt and Claims Trading

In the more than thirty-five years since the U.S. Bankruptcy Code was enacted, lending practices, players in financial and credit markets, and the global economy have changed dramatically. Not surprisingly, some restructuring professionals believe that the U.S. Bankruptcy Code, even as presently amended, is not adequately equipped to address these myriad changes nor will it be able handle future innovations and transformations.

In response, in 2012 the American Bankruptcy Institute formed its *Commission to Study the Reform of Chapter 11* (the "Commission") to evaluate the current state of the U.S. Bankruptcy Code and to determine what reforms, if any, may be necessary or advisable. The Commission was a significant undertaking, made up of some thirteen advisory committees comprised of approximately 150 practitioners, judges, and academics, including an international working group with experts from more than a dozen countries, who considered both the effectiveness of the current U.S. Bankruptcy Code and numerous reform proposals. The Commission recently released its full report, which was approximately 400 pages long and discussed nearly 250 recommendations and proposals (the "Report").[1]

Among the many topics covered in the Report, the Commission considered whether existing rules impacting debt trading should be reformed or if any new rules should be adopted. This is obviously of particular interest to market participants who trade distressed bank loans, bankruptcy claims and other forms of distressed or illiquid debt instruments in the secondary market. While the practice of trading distressed debt is not new, it has grown dramatically in the decades since the U.S. Bankruptcy Code was adopted, with frequent trading of large, complex claims in cases such as *Lehman Brothers* becoming commonplace. The Commission went so far as to identify claims trading as a driving force behind the changing landscape of Chapter 11 cases, and estimated that distressed investors bought more than $41 billion[2] worth of bankruptcy claims in the last year.

With the increasing presence (and arguable influence) of the trading markets in Chapter 11 cases, the Commission considered whether new or increased regulation and disclosure were necessary to mitigate some perceived problems. The Commission's study of secondary market trading focused on matters concerning transparency and disclosure, with some experts arguing for increased disclosures and even restrictions on claims trading. These considerations posed a very real risk that measures taken by the Commission could chill markets and curb trading activities for hedge funds, investment banks, and claims brokers.

1 The full Report is available for download at http://commission.abi.org/.
2 Report at 242 (citing Dow Jones Daily Bankr. Rev., Jan. 28, 2013).

Ultimately the Commission determined that increased regulation of claims trading activities would be of "little benefit."[3] Significantly, the Commission's consensus was that the secondary market for distressed debt and claims trading "enhances liquidity opportunities for both debtors and creditors: it provides an exit strategy for creditors, which can induce credit extensions to potentially distressed companies in the first instance."[4]

In making its determination, the Commission considered whether increased disclosure requirements might benefit any parties in interest, *i.e.,* participants in the Chapter 11 case and players in the secondary market. As part of this process, the Commission specifically reviewed Bankruptcy Rules 2019 and 3001(e), focusing on the changes to Rule 2019 in 2011 and Rule 3001(e) in 1991. Interestingly, these rules are seemingly at odds with each other, with the former requiring additional disclosure by claims purchasers and the latter shielding the parties to a claims transaction from making much public disclosure.

The recent amendments to Rule 2019 increased the disclosure obligations for creditors acting collectively in a Chapter 11 proceeding. Parties that are members of *ad hoc* committees, groups, or investors otherwise acting collectively in a bankruptcy case are required to disclose identifying information about themselves and the amount of each "discloseable economic interest" they hold against the debtor. The Commissions acknowledged that "although not targeted at claims traders *per se*, investors actively engaged in claims trading and potentially taking positions in, or trying to influence a Chapter 11 case are within its scope."[5]

Meanwhile, Rule 3001(e), which governs the notice requirements for a transfer of claims, was specifically drafted to limit the court's role in a transfer only to adjudicating any disputes concerning such transfer. The rule protects the confidentiality of these transactions in that the transferor is not required to disclose the price at which the claim was bought and sold, nor any of the key negotiated business terms in the purchase and sale agreement.

The Commission examined whether any additional disclosures by claims traders would benefit the parties in a Chapter 11 case and determined that "in many circumstances, what an investor paid for a claim or why it purchased the claim would be irrelevant to the merits or substantive legal issues in a dispute in the [Chapter 11] case."[6] The Commission also noted that when price or motive may be of consequence, the U.S. Bankruptcy Code already contains provisions that give courts the means to determine and sanction inappropriate conduct, including reducing the amount of a claim, subordinating a claim, or designating the vote of the claimholder.[7] The Commission also rejected any specific restrictions on claims trading or on the participation of claims traders in Chapter 11 cases.

Most participants in the secondary markets would agree that the Commission's decision to refrain from recommending any changes to the rules governing debt and claims trading is a positive and comforting result. Without any changes to existing policies and procedures nor any additional (and potentially onerous) disclosure requirements, these robust markets can continue to operate efficiently and grow, generating returns for investors, providing liquidity and exit strategies to creditors, and supplying debtors with access to debtor-in-possession and exit financing opportunities.

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3 Report at 246.

4 *Id*.

5 Report at 245.

6 *Id*. at 246.

7 If a court determines the primary motivation behind a secondary market purchase of bankruptcy claims is to obtain control of the underlying Chapter 11 process, that may constitute cause to "designate," or not count, the votes cast by the purchasers in connection with a Chapter 11 plan. *Dish Network Corp. v. DBSD North America, Inc. (In re DBSD North America, Inc.)* 634 F.3d 79 (2d Cir. 2010). *See also,* for example, Buyer Beware: Courts Put Claims Trades Under a Microscope, January 31, 2014, Clifford Chance Client Briefing.

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