

Bankruptcy Claims Trading Orders: Who Is Watching

Law360, New York (August 29, 2011) -- Currently, negotiation and documentation of claims trades remain largely unregulated, with only limited oversight from bankruptcy courts and the U.S. Securities and Exchange Commission. Generally, the bankruptcy court's, or the claims agent's, involvement in claims trading is ministerial, i.e., maintaining the claims register and recording transfers if the form complies with the rule. Only if there is an objection to a claims transfer does the bankruptcy court become involved in the substance of a transfer. Bankruptcy courts do, however, have the ability to control the actual transfer mechanics if a trading order is issued. These orders are increasingly common in large bankruptcy cases and may restrict trading in the debtors' debt and equity securities and claims.

From a trader's perspective, compliance with the trading order is a prerequisite to recognition and effectuation of transfers by the court and debtor. Once a trading order is entered, the bankruptcy court is the gatekeeper of claims transfers and traders need to ensure compliance. Failure to comply with a trading order can have severe results. Indeed, trading orders often specify that a purchase or sale of a claim not in compliance with the trading order is null and void.

From the debtor's perspective, one of the main objectives of a trading order is to allow the debtor to monitor the ownership of the claims so that it can protect itself from triggering a change in control that could jeopardize certain of the debtor's tax advantages such as net operating losses (NOL) carryforwards under section 382 of the Internal Revenue Code. Given the growth in claims market participation and the valuable tax attributes often at stake, courts increasingly issue trading orders restricting trading in the debtor's equity, debt securities and claims.

The consequences of not complying with a trading order can be harsh. For instance, in an early 2011 opinion in the Mesa Air bankruptcy case, the Bankruptcy Court for the Southern District of New York held that a claim holder's failure to comply with the trading order meant that the claim holder did not have standing to object to the confirmation of the debtor's plan.^[1] The claim holder had sought to object to confirmation of the plan on various grounds, principally related to post-emergence governance. It argued that certain modifications to the plan after tabulation of the votes were material changes to the plan requiring resolicitation of votes.

The Mesa Air trading order required any transferee to file a Notice of Intent to Purchase, Acquire or Otherwise Accumulate a Claim (a "Claim Acquisition Notice") if such transferee was, or would become as a result of the transfer, a holder of more than \$25 million in claims. The trading order also imposed a 30-day period between the filing of the Claim Acquisition Notice and the effectiveness of the transfer, unless the 30-day period was waived by the debtor at its discretion. This requirement of the Claims Acquisition Notice was in addition to the requirements of rule 3001(e) of the Federal Rules of Bankruptcy Procedure, that transferees file evidence of a claims transfer with the court, a filing followed by a 21-day notice period during which either party or the debtor may object to the transfer.

The transferee in the Mesa Air case filed the notice of transfer pursuant to rule 3001(e) only after the debtor raised the standing issue in its pretrial memorandum. The transferee, however, had not filed a Claim Acquisition Notice prior to the confirmation hearing, even though its claims purchase totaled \$115 million. Because the 30-day period had not begun to run, the transfer was not yet effective in the eyes of the court, resulting in the court's denial of the transferee's standing. Although the court still considered and overruled the transferee's objections as a part of its independent analysis of whether the plan complied with the confirmation requirements as set out in section 1129 of the Bankruptcy Code, such independent analysis may not be appropriate for all issues and another court may not have considered the transferee's objections at all.

Bankruptcy courts have also used trading orders to protect those claim holders who may be perceived to be less sophisticated than more experienced claims-buying firms. For example, the trading order issued in the SIPA liquidation proceeding for Bernard L. Madoff Investment Securities LLC imposes a nonwaivable 21-day notice period during which the transferor or transferee may object.[2]

Typically, in claims transfers, the parties may waive the statutory 21-day notice period in the purchase documents and in the claim transfer notices and papers filed with the court. Instead of praising claims traders as providers of, perhaps, much-needed liquidity and facilitators of the transfer of risks that may not be suitable for an individual claim holder, the nonwaivability of the notice period appears to be due to the Madoff court's view of claims traders as operating in a "bottom feeding area" and in need of a "big brother." [3]

Even accepting the reasonableness of the Madoff court's concern that more flexible trading procedures could lead to the Madoff claim holders being "victimized twice," [4] the nonwaivable notice period also applies to secondary trades between sophisticated claims traders. Notice periods, particularly nonwaivable notice periods, require additional consideration when structuring back-to-back transfers because they can lead to delays in settlement.

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[1] In re Mesa Air Group Inc. (Bankr. S.D.N.Y. Jan. 20, 2011).

[2] Order Granting Trustee's Motion for an Order Establishing Procedures for the Assignment of Allowed Claims, Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff), Ch. 7 Case No. 09-11893, Adv. Pro. No. 08-01789 (Bankr. S.D.N.Y. Nov. 10, 2011) (No. 3138).

[3] Transcript of Record at 19-20, Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff), Ch. 7 Case No. 09-11893, Adv. Pro. No. 08-01789 (Bankr. S.D.N.Y. Nov. 10, 2010) (No. 3194).

[4] *Id.* at 19.

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