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DEVELOPMENTS IN TRADING CLAIMS: PARTICIPATIONS AND DISPUTED CLAIMS

*Chaim J. Fortgang**
*Thomas Moers Mayer***

INTRODUCTION

The two years since our last paper on trading claims[1] have seen an explosion in the market for claims against Chapter 11 debtors. More institutions are involved in buying, selling, and brokering claims than ever before. Goldman, Sachs & Company, Salomon Brothers Inc., Lazard Freres & Company, Inc., and Kidder Peabody & Company have joined Oppenheimer & Company, and Bear, Stearns & Company as established Wall Street houses making markets in distressed claims. Commercial banks such as First National Bank of Chicago, ING Bank, and Citibank, N.A. now buy and sell bank claims against distressed debtors.

As more investors poured money into bank claims, they also poured money into the next best thing: participations in bank claims. Participations pose unique problems for buyers, sellers, and debtors, which we will examine in Part I of this Article.

The last two years saw several developments in trading whole claims. New Bankruptcy Rule 3001(e) took effect, and with it new procedures for trading claims.[2] The new rule was supposed to diminish litigation over claims trading,[3] and may represent the apogee of support for the claims market against Chapter 11 debtors. Unfortunately, several other developments put the market under siege. First, the effect of claims trading on the net operating loss carryforwards of Pan Am Corporation[4] and Ames Department Stores, Inc.[5] led those debtors to seek injunctions against trading. Second, Federated De-

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1 Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991).

2 FED. R. BANKR. P. 3001(e). New Bankruptcy Rule 3001(e) became effective August 1, 1991. For a discussion of the new rule and procedures, see *infra* notes 108-31 and accompanying text.

3 FED. R. BANKR. P. 3001(e) advisory committee's note.

4 *See infra* notes 109, 123-26 and accompanying text.

5 *See infra* notes 108, 121-22 and accompanying text.

partment Stores, Inc.,[6] Best Department Stores,[7] and the Insilco Corporation[8] have implemented strategies which could potentially discriminate against the buyers of trade claims and could adversely affect the market. We examine these developments in Part II.

I. PARTICIPATIONS

A. *Participations and the FDIC*

A participation is an interest in a portion[9] of a loan which entitles the holder ("participant") to receive a corresponding portion of the proceeds of the loan. The type of interest depends on the participation agreement.

Unfortunately, there is no standard form of participation agreement. The agreements vary from seller to seller.[10] Because of this variety, a participation in a loan could be:

—a simple *contract right* obligating the seller to turn over to the participant the corresponding portion of whatever the seller receives on its loan;
—a *security interest* in the corresponding portion of the loan and its proceeds; or
—*beneficial ownership* of the corresponding portion of the loan.

In each instance, the seller remains the nominal creditor on the books of the debtor for the entire amount of its claim. Distributions on the claim are accordingly made to the seller. The participant then has some kind of interest in, or right to, the distributions. The kind of interest (or right) the participant has is critical when the seller fails.

In the rare case where the participation seller is eligible for relief under the Bankruptcy Code, the participant will lose its rights to the proceeds of the seller's loan if the participant has a mere contract right or even a security interest. A contract right gives a participant, at most, an unsecured claim. A security interest purports to give the participant more, but usually fails in the bankruptcy case.

A loan is personal property; as such it is covered by the Uniform Commercial Code. If it is evidenced by a note, it is a "writing which evidences a right to the payment of money . . . of a type which is in ordinary course of business transferred by delivery with any necessary

[6] *See infra* notes 133-43 and accompanying text.
[7] *See infra* notes 145, 148 and accompanying text.
[8] *See infra* notes 90-91, 144-47 and accompanying text.
[9] The portion can be 100%.
[10] *See* Eric G. Behrens, Note, *Classification of Loan Participations Following the Insolvency of a Lead Bank*, 62 TEX. L. REV. 1115, 1124 (1984).

indorsement or assignment" and thus qualifies as an "instrument."[11] A security interest in an instrument can be perfected only by possession,[12] and sellers never (in the Authors' experience) yield possession of their notes to participants.

If the loan is secured by a security interest in goods, it will qualify as "chattel paper."[13] If the loan is not evidenced by a note and is not secured by a security interest in goods, it will fall outside the definition of instrument or chattel paper and it will be deemed a general intangible.[14] Chattel paper may be perfected by either possession[15] or by filing financing statements,[16] whereas a general intangible can be perfected only by filing a financing statement.[17] Unfortunately, most sellers will not permit participants to file a financing statement. Accordingly, in the rare situation where the seller becomes a debtor under the Bankruptcy Code,[18] a participation will be voidable if it is deemed to constitute a security interest.[19]

Only the third type of participation interest—the true sale of a beneficial interest in the loan—will withstand attack in a bankruptcy case.[20] Another way of describing this kind of participation interest is the creation of a trust relationship between the lead as trustee and the participant as beneficiary.[21]

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11 U.C.C. § 9-105(1)(i) (1992). This is true whether or not the note qualifies as a negotiable instrument.

12 U.C.C. § 9-304(1) (1992). Subsections (4) and (5) allow temporary perfection for 21 days under circumstances not relevant to this paper. U.C.C. § 9-304(4), (5) (1992).

13 U.C.C. § 9-105(b) (1992).

14 "General intangibles" include any personal property other than instruments, goods, accounts, chattel paper, documents, or money. U.C.C. § 9-106 (1992). As a bank loan does not purport to evidence title to goods in possession of a bailee, it cannot be a "document" under U.C.C. §§ 1-201(15) (1989), 9-105(1)(f) (1992). A loan is not "movable" and hence cannot be "goods" as defined by U.C.C. § 9-105(1)(h) (1992). Nor can a loan be an "account" because it does not purport to be money owed for the delivery of goods or the rendering of services. U.C.C. § 9-106 (1992).

15 U.C.C. § 9-305 (1992).

16 U.C.C. § 9-304(1) (1992).

17 U.C.C. § 9-302(1) (1992).

18 Banks without insured deposits can be debtors under the Bankruptcy Code. 11 U.S.C. § 109(b)(2) (1988).

19 11 U.S.C. § 544(a)(1) (1988) gives the bankruptcy trustee (and hence a debtor-in-possession) the rights of a creditor with a judicial lien on personal property. U.C.C. § 9-301(b) (1992) provides that such a levying creditor takes precedence over the holder of an unperfected security interest.

20 11 U.S.C. § 541(d) (1988). *See infra* notes 30-31 and accompanying text.

21 *See* Stratford Fin. Corp. v. Finex Corp., 367 F.2d 569 (2d Cir. 1966) (finding that the sale of unsecured notes created a trust relationship, not a debtor-creditor relationship, and therefore no preference existed); *see also* Behrens, *supra* note 10, at 1129-37; Mark E. MacDonald, *Loan Participations as Enforceable Property Rights in Bankruptcy—A Reply to the Trustee's Attack*, 53 AM. BANKR. L.J. 35, 54-66 (1979); David B. Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977, 1992-2004 (1976); William N. Stahl, *Loan*

Prior to 1979, the exact nature of participations was a hot topic precisely because participants were not sure whether their documents were sufficient to convey beneficial title, or create a trust relationship that would protect them against the bankruptcy of the lead.[22]

In the 1930s, two New York Court of Appeals cases upheld, against constitutional attack, legislation providing for state administration of participated mortgages on the ground that mortgage participations created mere security interests.[23]

Decades later, two celebrated cases decided in the United States District Court for the Southern District of New York came to the same conclusion. *In re Yale Express System, Inc.*[24] precluded Marine Midland Trust Company from offsetting funds on deposit by the debtor against Marine Midland's 40% participation in a claim against the debtor. *In re Alda Commercial Corp.*[25] ruled that the debtor finance company's sale of a participation gave the participant no more than an unperfected secured claim against the debtor. Both *Yale Express* and *Alda Commercial* held that the participant was merely a creditor of the creditor, and not an owner of the creditor's claim against the debtor.

In each case, however, the participation agreement had bizarre features. In *Yale Express*, Marine Midland's participation gave the nominal holder of the claim rights to extend maturity and to release collateral, without the consent of the participant.[26] In *Alda Commercial*, the participation agreement obligated the nominal holder of the claim to pay money to the participant.[27] Few, if any, bank participation agreements today contain either of these features.

By contrast, the Second Circuit recognized a mortgage participation as the outright sale of a loan sufficient to let the participant vote in the mortgagor's section 77B proceeding.[28] Thirty years later, the court held that a participation in a finance company's loan created an

Participations: Lead Insolvency and Participants' Rights (Part I), 94 BANKING L.J. 882, 890-92 (1977).

22 *Compare* W. Homer Drake, Jr. & Kyle R. Weems, *Mortgage Loan Participations: The Trustee's Attack*, 52 AM. BANKR. L.J. 23 (1978) (stating that loan participation must be defined and classified) *with* MacDonald, *supra* note 21 (stating that no controversy exists for the proper characterization of loan participation).

23 *In re* Westchester Title & Trust Co., 198 N.E. 19 (N.Y. 1935); People v. Title & Mortgage Guar. Co., 190 N.E. 153 (N.Y. 1934).

24 245 F. Supp. 790 (S.D.N.Y. 1965).

25 327 F. Supp. 1315 (S.D.N.Y. 1971).

26 *Yale Express*, 245 F. Supp. at 791.

27 *Alda Commercial*, 327 F. Supp. at 1316-17.

28 *In re* Westover, Inc., 82 F.2d 177 (2d Cir. 1936). For a discussion of Westover's reorganization proceeding pursuant to section 77B of the Bankruptcy Act of 1898, see *infra* text accompanying note 72.

enforceable trust between the lender and the participant.[29]

The debate regarding what interest exists as a result of a participation agreement is affected, at least as a matter of bankruptcy law, by the enactment of section 541(d), which provides:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.[30]

Congress's desire to protect the secondary mortgage market is evidenced by the legislative history of the section:

> Section 541(d) of the House amendment is derived from section 541(e) of the Senate amendment and reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property. . . . Even if a mortgage seller retains for purposes of servicing legal title to mortgages or interests in mortgages sold in the secondary mortgage market, the [bankruptcy] trustee would be required by section 541(d) to turn over the mortgages or interests in mortgages to the purchaser . . . .
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> . . . .
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> The purpose of section 541(d) as applied to the secondary mortgage market is therefore to make certain that secondary mortgage market sales as they are currently structured are not subject to challenge by bankruptcy trustees and that purchasers of mortgages will be able to obtain the mortgages or interests in mortgages which they have purchased from trustees without the trustees asserting that a sale of mortgages is a loan from the purchaser to the seller.[31]

Banks with insured deposits—which means most banks—are not eligible for relief under the bankruptcy laws.[32] In most instances, such banks are subject to conservatorship, receivership, and liquidation by the Federal Deposit Insurance Corporation ("FDIC"). In a perfect world, the FDIC would be subject to the same rules as a bankruptcy trustee with respect to participations. Some courts have held

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[29] Stratford Fin. Corp. v. Finex Corp., 367 F.2d 569 (2d Cir. 1966).

[30] 11 U.S.C. § 541(d) (1988).

[31] 124 CONG. REC. 33,999 (1978).

[32] 11 U.S.C. § 109(b)(2) (1988).

that the sale of a beneficial interest in specific, identified assets of the failed bank will be enforceable as some sort of "trust" against the FDIC.[33]

However, the law is far from clear. The FDIC enjoys tremendous power under 12 U.S.C. § 1823(e), which provides as follows:

> No agreement which tends to diminish or defeat the interest of the [FDIC] in any asset acquired by it under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the [FDIC] unless such agreement—
>
> (1) is in writing,
>
> (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,
>
> (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
>
> (4) has been, continuously, from the time of its execution, an official record of the depository institution.[34]

This statute grows out of the famous case of *D'Oench, Duhme & Co. v. FDIC*,[35] in which the Supreme Court held that a bank's "secret agreement" not to collect on a note from a borrower was not enforceable against the FDIC.[36]

A participation agreement is clearly not the kind of "secret agreement" that the *D'Oench* Court had in mind. However, the statute Congress enacted after *D'Oench*—and which has almost no legislative history—is much broader than the Court's holding, and by its terms will apply to any participation sold after the loan is made. Such a participation is an agreement which "tends to . . . defeat the interest of the [FDIC] in [a loan]"[37] which *by definition* was not entered into "contemporaneously with the [bank's] acquisition of the [loan]."[38]

The FDIC actually tried to use section 1823(e) to void a participation agreement in *Empire State Bank v. Citizens State Bank*.[39] Em-

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[33] *See, e.g.*, FDIC v. Mademoiselle of Cal., 379 F.2d 660 (9th Cir. 1967).

[34] 12 U.S.C. § 1823(e) (Supp. IV 1993).

[35] 315 U.S. 447 (1942).

[36] *Id.* at 458.

[37] 12 U.S.C. § 1823(e) (Supp. IV 1993).

[38] *Id.* As one of the Authors has noted elsewhere, section 1823(e)'s "contemporaneous" requirement would also allow the FDIC to disregard any work-out agreement between a borrower and the failed bank. Thomas Moers Mayer & Beatrice R. Kahn, *Enter Leviathan: The FDIC as Supercreditor, in* REAL ESTATE WORKOUTS AND BANKRUPTCIES 1992, at 9, 52-53 (PLI Real Estate Law and Practice Course Handbook Series No. N4-4564, 1992).

[39] 932 F.2d 1250 (8th Cir. 1991).

pire State Bank ("Empire") bought a participation in a Citizens State Bank ("Citizens") loan, evidenced by a participation certificate. Citizens failed. The FDIC collected on the loan and on Citizens' bankers blanket bond and excess employee dishonesty blanket bond.

When the FDIC refused to pay Empire its participation, Empire filed a claim in the Citizens receivership proceeding. The FDIC orally refused to pay Empire in any capacity other than as a general creditor. Empire then sued the FDIC in state court to impress a constructive trust or equitable lien on the proceeds of the loan and the bonds.[40] The FDIC removed the case to federal court and argued that section 1823(e) barred Empire's claims to the bonds. Empire in turn moved to remand to state court pursuant to 12 U.S.C. § 1819(b)(2)(D) as an action against FDIC-Receiver involving "only the preclosing rights against the State insured depository institution[41] . . . in which only the interpretation of the law of such State is necessary."[42]

The technical issue in *Empire*, then, was whether section 1823(e) applied to this participation agreement for the purpose of remanding the matter to state court. The court's opinion is reassuring, if a bit confusing.

The Eighth Circuit noted that Empire's participation agreement did not apply to the proceeds of the blanket bonds, and therefore Empire's claim was not based on an agreement tending to defeat the interest of the FDIC in the bond proceeds.[43] After determining that the participation agreement did not apply to the bond proceeds, the Eighth Circuit observed:

> Moreover, the participation agreement involved in this litigation is not the sort of agreement to which section 1823(e) is directed. Section 1823(e) generally is accepted as representing the codification of the rule from *D'Oench*. There the Supreme Court held that when the maker of an instrument has " 'lent himself to a *scheme or arrangement* whereby the banking authority . . . was likely to be misled,' that scheme or arrangement could not be the basis for a defense against the FDIC." *Langley v. FDIC* (emphasis in *Langley*). Here we can find nothing supporting the conclusion that the participation agreement constituted an arrangement likely to mislead the FDIC or that Empire in any way "lent [itself] to a

40 *Id.* at 1252.

41 12 U.S.C. § 1819(b)(2)(D)(ii), (iii) (1989). A "State [insured] depository institution" is defined as an institution chartered and regulated under state law with deposits insured by the FDIC. 12 U.S.C. § 1813(c)(2), (c)(5) (Supp. IV 1993).

42 *Empire*, 932 F.2d at 1251 (footnote added).

43 *Id.* at 1252.

scheme or arrangement" likely to mislead the FDIC. Indeed, the FDIC has made no argument to this effect. In these circumstances, to apply section 1823(e) to Empire's claims upon the bond proceeds would be unwarranted.[44]

Empire's participation *did* assert an interest in the proceeds of the loans by Citizens to Duane Sather, and with respect to that interest the above-quoted passage would seem on point. However, the Eighth Circuit disposed of the FDIC's challenge to Empire's participation interest in the loans made by Citizens not by excluding participations from section 1823(e), but by noting that the FDIC had failed to raise the challenge in the district court.[45] The Eighth Circuit thus remanded the case to state court without ever holding directly that participation agreements are beyond the scope of section 1823(e).[46]

Section 1823(e) presents a difficult problem; its progeny make the problem worse. The Fifth, Sixth, Eighth, and Eleventh Circuits have extended section 1823(e) and *D'Oench* by holding that the FDIC enjoys the status of a "holder in due course" of any negotiable instrument held by the failed bank.[47] In the Eleventh Circuit, the FDIC is a "holder in due course" of any instrument held by the failed bank, whether such instrument is negotiable or not.[48] A holder in due course takes an instrument "free of the claims of any person"[49] such as a participant.

The only solution to the threat posed by the FDIC—and it is an imperfect solution—is for evidence of the participant's interest in the bank claim to be physically inscribed upon, or attached to, the documents comprising the claim itself. Such inscription or attachment will suffice to put the FDIC "on notice" of the participant's interest in the claim, which will prevent the FDIC from becoming a "holder in due course" of such documents. Physically marking the documents does not satisfy section 1823(e)'s "contemporaneous" requirement, but some courts have held that such physical alteration of the note is en-

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[44] *Id.* at 1252-53 (citations omitted).

[45] *Id.* at 1253.

[46] *Id.* at 1253-54.

[47] *See, e.g.*, FDIC v. Newhart, 892 F.2d 47, 50 (8th Cir. 1989); FSLIC v. Murray, 853 F.2d 1251, 1256-57 (5th Cir. 1988); FDIC v. Wood, 758 F.2d 156 (6th Cir.), *cert. denied*, 474 U.S. 944 (1985); Gunter v. Hutcheson, 674 F.2d 862, 874-77 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982); *cf.* FDIC v. State Bank of Virden, 893 F.2d 139, 142 (7th Cir. 1990) (FDIC could not be the holder in due course of a participation, because a participation is not a negotiable instrument). *See also In re* 604 Columbus Ave. Realty Trust, 968 F.2d 1332, 1350 (1st Cir. 1992); FDIC v. Bank of Boulder, 911 F.2d 1466, 1474-75 (10th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 904 (1991).

[48] FDIC v. Gulf Life Ins. Co., 737 F.2d 1513, 1518 (11th Cir. 1984).

[49] U.C.C. § 3-305(1) (1989), *revised by* U.C.C. § 3-306 (1990) ("[A] holder in due course takes free of the claim to the instrument.").

forceable against the FDIC notwithstanding section 1823(e).[50] The Seventh Circuit has reasoned that an agreement noted on the face of the note constitutes a prior alienation of rights by the failed bank, so that the FDIC could never acquire those rights from the bank.[51] The distinction between enforceable agreements "alienating" the bank's rights and unenforceable agreements "tending to defeat the interest of the FDIC" in such rights is not adequately explained.

B. *Participations and ERISA*[52]

Many large employers maintain pension plans for their employees. These pension plans are funded over time by employer contributions and, to some extent, employee contributions. Pension funds thus constitute enormous pools of capital, some of which has been invested in distressed bank claims. It is well known that pension fund investments are regulated by the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[53] It is less well known that the sale of a participation in a bank loan to a pension fund can subject the participant and the bank to exposure under ERISA.

ERISA regulates, among other things, investments in "plan assets."[54] If, for example, a pension plan were to invest in the stock of a bank, the stock would be a "plan asset" but the bank's own assets would not be.[55] However, there are two exceptions to this rule involving "significant investments" by pension benefit plan investors. Where pension benefit plan investors hold "25 percent or more of the value of any class of equity interests in the entity," their interest "in the entity" is deemed to be "significant."[56] If "the entity" is not an operating company, the "plan asset" regulated by ERISA is not merely the 25% owned by pension benefit plan investors but all of the assets of "the entity" itself:

> [I]n the case of a plan's investment in an equity interest of an *entity* that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undi-

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[50] *See, e.g.*, Howell v. Continental Credit Corp., 655 F.2d 743, 746-47 (7th Cir. 1981).

[51] *Id.*

[52] The Authors acknowledge their debt to Andrew I. Irving of Robinson Silverman Pearce Aronsohn & Berman, New York, New York, and Lowell G. Peterson of Meyer Suozzi English & Klein, Mineola, New York, attorneys specializing in labor and pension law, for their contributions to this portion of the paper.

[53] Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in various sections of 26 and 29 U.S.C.).

[54] 29 C.F.R. § 2510.3-101 (1992) defines "plan assets."

[55] 29 C.F.R. § 2510.3-101(a)(2) (1992).

[56] 29 C.F.R. § 2510.3-101(f) (1992).

> vided interest in each of the underlying assets of the entity, unless it is established that—
>
> (i) The entity is an operating company, or
>
> (ii) Equity participation in the *entity* by benefit plan investors is not significant.
>
> Therefore, any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan.[57]

We emphasize "entity" because the word does not refer to the bank that sells the participation in the bank claim. *It refers to the bank claim itself.* The regulations are explicit on this point:

> (g) *Joint ownership.* For purposes of this section, where a plan jointly owns property with others, or where the value of a plan's equity interest in an entity relates solely to identified property of the entity, such property shall be treated as the sole property of a separate entity.
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> . . . .
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> (j) *Examples.* The principles of this section are illustrated by the following examples:
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> . . . .
>
> (10) In a private transaction, a plan, P, acquires a 30 percent participation in a debt instrument that is held by a bank. Since the value of the participation certificate relates solely to the debt instrument, that debt instrument is, under paragraph (g), treated as the sole asset of a separate entity. Equity participation in that entity by benefit plan investors is significant since the value of the plan's participation exceeds 25 percent of the value of the instrument. In addition, the hypothetical entity is not an operating company because it is primarily engaged in the investment of capital (*i.e.*, holding the debt instrument). *Thus, P's assets include the participation and an undivided interest in the debt instrument, and the bank is a fiduciary of P to the extent it has discretionary authority or control over the debt instrument.*[58]

The problem gets worse when one notices that the 25% participation need not be bought by one pension plan.[59] If several pension benefit plan investors buy participations adding up to 25% of the bank claim, then the entire bank claim constitutes a plan asset and the bank administering the participation may be a fiduciary to the pension

[57] 29 C.F.R. § 2510.3-101(a)(2) (1992) (emphasis added).

[58] 29 C.F.R. § 2510.3-101(g), (j) (1992) (emphasis added).

[59] 29 C.F.R. § 2510.3-101(f)(1) (1992).

funds under ERISA.[60] Note that subsequent investors can get the bank in trouble: the original participants may not be pension plan investors, but if they sell their participations to pension benefit plan investors the bank could become a fiduciary as a result. Thus, every participation agreement should contain not only representations with respect to the participant's status as a pension benefit plan investor but should also preclude subsequent sales to those who are pension benefit plan investors.

In sum, if one or more pension plans invest in participations constituting 25% of a bank claim, the selling bank may become a fiduciary under ERISA to those participants if it exercises "discretionary authority or discretionary control"[61] over the bank claim. However, this "authority or control" is exactly what many, if not most, participation agreements provide!

A bank will not want to be an ERISA fiduciary merely by virtue of a participation agreement. An ERISA fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[62] A bank that sells a participation is not being compensated to undertake these burdens. Indeed, most banks will insist on being exculpated in the participation agreement from everything other than gross negligence and willful misconduct—an exculpation directly at odds with the "prudent man" rule set forth above.

Therefore, where the participation agreement specifically precludes the bank from modifying, amending, or terminating any loan document without the consent of the participant, and where the bank further agrees not to take any action without the written consent of the participant, the bank should not be a fiduciary because it lacks the requisite "discretionary authority or discretionary control" over the bank claim.[63]

However, that may not solve the bank's problems. Even if the bank is not a "fiduciary" with respect to a participation, it remains a "party in interest" with respect to a plan because it is "providing services" with respect to a plan asset.[64] Because the bank is a "party in interest," any of the pension plans that collectively hold 25% of the

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60 29 U.S.C. § 1002(21)(A) (1988); 29 C.F.R. § 2510.3-101(a)(2) (1992).

61 29 U.S.C. § 1002(21)(A) (1988); 29 C.F.R. § 2510.3-101(a)(2) (1992).

62 29 U.S.C. § 1104(a)(1)(B) (1988).

63 *See* Robbins v. First Am. Bank of Va., 514 F. Supp. 1183, 1189 (N.D. Ill. 1981).

64 29 U.S.C. § 1002(14) (1988); 29 C.F.R. § 2510.3-101(a)(2) (1992).

bank's claim will violate ERISA § 406(a)(1)(A) if it sells, exchanges, or leases property to or from the bank.[65] This violation can lead the Internal Revenue Service to levy on both the bank and its participant an excise tax equal to 5% of the amount involved in the transaction for each year from the date of the prohibited transaction to the date the notice of deficiency is mailed.[66] As a result, any bank that sells 25% of one claim to one or more ERISA pension benefit plan investors can never do another deal with any of those investors without violating ERISA and exposing itself to liability.

The regulatory scheme described above creates a nightmare and a trap for the unwary. A specific exemption allows broker/dealers, as brokers, to provide "services" to pension plans by holding securities in street name and still, as dealers, to buy and sell securities to the same pension plans without running afoul of ERISA.[67] A similar exemption should be enacted for participations, preferably before the existing regulations trap a bank that, unaware of the foregoing, sells two participations to the same pension benefit plan investor.

C. *Participations in Bankruptcy Court*

In 1984, Manufacturers Hanover Trust Company ("MHT") agreed to finance the acquisition, renovation, and development of the old W.T. Grant headquarters in Times Square by a limited partnership later known by the building's address: 1515 Broadway.[68] The financing had numerous components, only three of which are at issue here.

First, MHT loaned $270,000,000 bearing interest at a floating rate to 1515 Broadway Associates. Although MHT was the nominal lender for 100% of this loan, MHT actually sold participations to a group of other banks comprising approximately 75% of the beneficial interest in the loan. Second, MHT entered into an interest rate swap agreement whereby MHT periodically paid 1515 Broadway amounts equal to the floating rate on the loan, and 1515 Broadway paid MHT a fixed rate of interest. As floating rates fell, 1515 Broadway's fixed interest payments to MHT grew much larger than MHT's floating rate payments. Third, the Equitable Life Assurance Society of the United States ("Equitable") entered into a line of credit which 1515

65 29 U.S.C. § 1106(a)(1)(A) (1988).

66 26 U.S.C. § 4975(a) (1988).

67 Prohibited Transaction Exemption 86-128, 51 Fed. Reg. 41,686 (1986).

68 N.Y.C. Dep't of Fin. v. 1515 Broadway Assocs., L.P. (*In re* 1515 Broadway Assocs., L.P.), 153 B.R. 400 (Bankr. S.D.N.Y. 1993).

Broadway could use to pay interest and interest rate swap payments—but not principal on the MHT loan.

In 1991, with more than $100,000,000 remaining on the Equitable line of credit, 1515 Broadway filed a Chapter 11 petition. MHT filed two proofs of claim: one for $270,000,000 under the loan agreement, and one for approximately $40,000,000 in damages under the swap agreement.

For MHT's participants, the problem was obvious: MHT's $40,000,000 swap exposure had a better claim on the Equitable line of credit than did the MHT loan in which they were participants. However, when the participants sought to intervene in the case, Judge Lifland denied the motion:

> The participants themselves individually, and perhaps collectively, are not in privity with the Debtor here. It's Manufacturers Hanover that has rights against the Debtor as the claimant. I don't see any privity. They are parties that are removed sufficiently, so that for purposes of these proceedings I do not see that they enjoy party in interest status.[69]

Counsel to most claims buyers and sellers have usually assumed that participants do not have standing in bankruptcy court, so Judge Lifland's decision was not a surprise. However, unexamined precedents and the bankruptcy rules can be construed to give participants a direct role in Chapter 11 reorganizations, and recent practice in bankruptcy court indicates that such participants may in fact have such a role.

As noted above,[70] a correctly drafted participation agreement conveys to the participant an undivided beneficial interest in a claim. As the beneficial holder of the claim, the participant should be—and indeed, in the past has been—recognized as the true creditor. Almost sixty years ago, the Second Circuit said as much in *In re Westover, Inc.*, a case under section 77B of the Bankruptcy Act of 1898.[71]

Westover involved mortgage loan participations. In the 1920s, mortgage guaranty companies would raise funds needed for their mortgage loans by selling certificates evidencing participation interests in the loans to the general public. Westover was a borrower of a mortgage guaranty company. In Westover's section 77B proceeding, both the mortgage guaranty company and the participation certificate

[69] Hearing on Order to Show Cause for Use of Cash Collateral, *In re* 1515 Broadway Assocs., L.P., Case No. 90-B-13320 (Bankr. S.D.N.Y. Dec. 4, 1990).

[70] *See supra* notes 20, 30-31 and accompanying text.

[71] 82 F.2d 177 (2d Cir. 1936). Section 77B of the Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, as amended, was repealed in 1978 by the Bankruptcy Code, revised generally and enacted as Title 11, Bankruptcy, Pub. L. No. 95-598, 92 Stat. 2549.

holders sought to vote the claim under the mortgage loan. The Second Circuit held that the participants, not the nominal holder of the mortgage loan, were entitled to vote the claim—in part because the underwriter of the participation certificates had represented the certificates as outright assignments of the mortgage loan itself:

> The assignment of the mortgage . . . was in form absolute. . . . [The underwriter] sold [the participation] certificates . . . representing them to be what they appeared to be, i.e., assignments of undivided shares in the mortgage itself . . . .[72]

As mentioned previously,[73] *Westover* is usually contrasted with various cases holding that participations are nothing more than secured loans.[74] However, for purposes of determining the standing of the participant in bankruptcy court, *the distinction between an ownership interest and a security interest may not be relevant.* Either as the owner of a claim or the pledgee of a claim, the participant may have standing in bankruptcy court.

It is well known that Bankruptcy Rules 3001(e)(1) and (e)(2) govern transfers of claims in bankruptcy before and after proof has been filed;[75] however, it is often forgotten that Rules 3001(e)(3) and (e)(4) do the same for security interests in claims.[76] Rule 3001(e)(3) (governing transfer of a security interest before proof of claim has been filed) and Rule 3001(e)(4) (governing transfer of a security interest after proof) each contain the following sentence:

> If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and hearing, the court shall enter such orders respecting these matters as may be appropriate.[77]

The Advisory Committee Notes to the original 1983 Rule 3001(e)[78] indicate that the rule is no more than a codification of long-

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[72] *Westover*, 82 F.2d at 179-80.

[73] *See supra* notes 23-29 and accompanying text.

[74] *See, e.g.*, Jeffrey D. Hutchins, *What Exactly Is a Loan Participation?*, 9 RUT.-CAM. L.J. 447 (1978).

[75] FED. R. BANKR. P. 3001(e)(1), (2).

[76] FED. R. BANKR. P. 3001(e)(3), (4).

[77] *Id.*

[78] Subsections (3) and (4) of the 1984 Rule 3001(e) covered "conditional transfers" of claims, as opposed to the "unconditional transfers" governed by subsections (1) and (2). FED. R. BANKR. P. 3001(e). The 1984 Advisory Committee's Note indicates that "conditional transfers" means transfers of security interests. FED. R. BANKR. P. 3001(e) advisory committee's note (1984). The 1991 Amendment to the Rule, which discards any reference to "conditional" or "unconditional" transfers, should therefore not be read as effecting any substantive change. FED. R. BANKR. P. 3001(e).

standing precedent:

> Paragraphs (3) and (4) clarify the status of a claim transferred for the purpose of security. An assignee for security has been recognized as a rightful claimant in bankruptcy. *Feder v. John Engelhorn & Sons*, 202 F.2d 411 (2d Cir. 1953). An assignor's right to file a claim notwithstanding the assignment was sustained in *In re R & L Engineering Co.*, 182 F. Supp. 317 (S.D. Cal. 1960). Facilitation of the filing of proofs by both claimants as holders of interests in a single claim is consonant with equitable treatment of the parties and sound administration. See *In re Latham Lithographic Corp.*, 107 F.2d 749 (2d Cir. 1939).[79]

In other words, a party with a security interest in a claim can contract for the right to vote and otherwise administer the enforcement of that claim in bankruptcy, and the courts will enforce that contract. The fact that the security interest may ultimately be avoided should not matter as between the lead and the participant with respect to this issue.

If a *pledgee* of a claim can administer and vote the claim in bankruptcy court, then certainly the *beneficial owner* of a claim can administer and vote the claim in bankruptcy court. That proposition, which could stand without additional authority, is further buttressed by both Rule 3003(d)[80] and the recent decision in *In re Southland Corp.*[81]

Rule 3003(d) applies to the participant's closest and most common cousin: the beneficial holder of securities. Most securities are not held "of record" by their true owners. For debt securities issued under a trust indenture, the *initial* "record holder" is the indenture trustee, who files a proof of claim for all claims under all securities pursuant to Rule 3003(c)(5), which states:

> *Filing by Indenture Trustee.* An indenture trustee may file a claim on behalf of all known or unknown holders of securities issued pursuant to the trust instrument under which it is trustee.[82]

The *secondary* "record holder" is the holder "registered on the books" of the indenture trustee.[83] These holders are, for the most part, Cede & Company, Inc. as nominee for the Depository Trust Company—institutions set up to hold securities on behalf of broker-

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[79] FED. R. BANKR. P. 3001(e) advisory committee's note (1984).

[80] FED. R. BANKR. P. 3003(d).

[81] 124 B.R. 211 (Bankr. N.D. Tex. 1991).

[82] FED. R. BANKR. P. 3003(c)(5).

[83] As a technical matter, indentures often provide that "registered holders" are those holders recorded on the books of the "paying agent" appointed under the indenture to pay interest and principal. However, the indentures also provide for the initial appointment of the same institution as paying agent and indenture trustee, and it is rare for the two functions to be fulfilled by more than one institution.

age houses. The *tertiary* record holders are the brokerage houses. They hold securities for their customers "in street name." It is the customers—*four steps removed from the proof of claim filed in bankruptcy court*—who are the true "beneficial holders" of the securities, and to whom Rule 3003(d) applies:

> *Proof of Right to Record Status.* For the purposes of Rules 3017, 3018 and 3021 and for receiving notices, an entity who is not the record holder of a security may file a statement setting forth facts which entitle that entity to be treated as the record holder. An objection to the statement may be filed by any party in interest.[84]

Given the structure of Rule 3003(d), one could argue that the beneficial holder of debt securities must take affirmative action to preserve its right to vote its securities on a Chapter 11 plan, and that otherwise the right to vote will be given to the "record holder" under Rule 3018.[85] The Southland Corporation made such an argument in its Chapter 11 case, and lost. Bankruptcy Judge Abrahams held that section 1126 of the Bankruptcy Code entitles "the holder of a claim or interest" to vote that claim or interest, and that the true holder was the beneficial holder.[86] The beneficial holder was therefore entitled to vote its securities whether or not it had moved to be recognized under Rule 3003(d).[87] To the extent that Rule 3018 was to the contrary, Judge Abrahams held that the Rule abridged the "substantive right" of the beneficial holder to vote its claim under section 1126 and was therefore invalid.[88]

Rule 3003(d) specifically refers to the rights of beneficial holders under Rules 3017, 3018, and 3021, which deal with receipt of (and objections to) a disclosure statement, voting on plans, and receipt of distributions. Prior to *Southland*, one could argue that a beneficial holder was entitled to exercise rights only under those Rules. *Southland*, however, held that a beneficial holder was a creditor, and thus should be entitled to exercise all the rights of a creditor. A beneficial

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[84] FED. R. BANKR. P. 3003(d).

[85] FED. R. BANKR. P. 3018.

[86] *In re* Southland Corp., 124 B.R. 211, 225-27 (Bankr. N.D. Tex. 1991).

[87] Southland made the argument that Rule 3003(d) precluded beneficial holders from voting their securities unless they took action to be recognized as record holders. *Id.* at 224-25.

[88] *Id.* at 226. The statute authorizing the promulgation of the Bankruptcy Rules provides that the Rules may not abridge any substantive right. 28 U.S.C. § 2075 (1988). Even a rule dealing entirely with procedure cannot stand if it is in conflict with the Bankruptcy Code. Before the Bankruptcy Code took effect in 1979, 28 U.S.C. § 2075 (1976) contained a sentence providing that any provision of the Bankruptcy Act of 1898 in conflict with a Bankruptcy Rule would be superseded by the Rule. The Bankruptcy Reform Act of 1978 eliminated the sentence. Pub. L. No. 95-598, tit. II, § 247, 92 Stat. 2672 (Nov. 6, 1978). *See* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 31 & nn.154-55 (1990).

holder should therefore have standing to appear and be heard as a party in interest on any matter that comes before the bankruptcy court. If the law were otherwise, bondholders whose securities are held in "street name" would not qualify as "creditors" for the purpose of serving on creditors' committees.

Under a properly drafted participation agreement, a participant in a bank claim is no different than the beneficial holder of a debt security. Indeed, one could argue that the participant is only once removed from the bankruptcy court by the interposition of the nominal bank creditor, whereas the beneficial holder is, as noted above, three steps removed by the interposition of indenture trustee, securities depository, and broker.

Quite apart from the authority of rules and precedents, recognizing participants as the beneficial holders of claims may be desirable if not absolutely necessary. Take the common problem of a lead bank with many participants, one of whom is recalcitrant. Most participation agreements will prohibit the lead bank from taking any action that would compromise the loan's principal amount, interest rate, amortization, maturity, or security without the consent of the participant. As almost any plan of reorganization will affect one of those five elements of the loan, the standard participation agreement will give any participant—even the smallest—a contractual veto over the lead bank's vote on a plan of reorganization.

This outcome makes no sense. If a bank with a $1,000,000 claim in a $100,000,000 class cannot prevent the class from voting to accept a plan, why should the $1,000,000 participant in a $100,000,000 bank loan have veto power over the bank's vote? If the participants in the $100,000,000 bank loan are recognized as creditors in their own right—as they were in *Westover*—the recalcitrant $1,000,000 participant could be outvoted and the case could proceed.

The Rules give the bankruptcy court power enough to discover participants and treat them as creditors. Rule 2019(a) requires that any "entity or committee representing more than one creditor or equity security holder" file a verified statement setting forth, among other things: the names and addresses of the creditors or equity holders that the entity represents; the amount of the claims (or equity interests) held by the creditors (or equity holders) and when such claims (or equity interests) were acquired; and a copy of any instrument by which the entity is empowered to act on behalf of the creditors or equity holders in its group.[89]

[89] FED. R. BANKR. P. 2019(a).

This Rule was used to compel discovery of bank participants in the Chapter 11 reorganization of the Insilco Corporation, where the agent and largest member of the debtor's $248,000,000 bank syndicate sold a 100% participation in its $70,000,000 claim.[90] Two months after the agent bank sold its participation, the debtor moved to compel disclosure of who held participations under Rule 2019, contending that without such disclosure it did not know with whom to negotiate. Insilco's banks elected to disclose rather than fight.[91]

The use of Rule 2019 to compel disclosure of participation agreements brings us right back to where we started: Judge Lifland. In *In re Manville Forest Products Corp.*, where the nominal holder of a gas exploration contract held only a 39.0625% interest in the contract after assigning working interests to four other parties, Judge Lifland held that such holder could file a proof of claim only on behalf of the 39.0625% and not on behalf of the other four beneficial holders.[92] The nominal holder's failure to comply with Rule 2019—which Judge Lifland applied to the nominal holder and its working interest partners—was one of several reasons for the disallowance of the nominal holder's claim.

There appears to be no difference between a participant and either the beneficial holder of a security or *Manville*'s working interest holder.[93] If those holders have standing as "true creditors," so should a participant.

D. *Participations as Securities After* Security Pacific

Fifteen years ago, a commentator could raise, as a serious issue, whether participations qualified as securities under the federal securi-

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[90] The agent sold a 100% participation in its claim because the credit agreement restricted the sale of claims in such a way as to effectively prohibit the sale of a claim to Apollo Advisors, a hedge fund.

[91] *See* Debtors' Reply to "Bank Lenders Group's" Opposition to Debtors' Motion to Determine Rule 2019 Compliance, *In re* Insilco Corp., Case No. 91-70021-RBK (Bankr. W.D. Tex. Feb. 14, 1992). In the related context of the beneficial holder of debt securities, Rule 1007(i) allows the court to compel security depositories and brokerage houses to disclose the list of the beneficial holders of securities. FED. R. BANKR. P. 1007(i). As noted above, there is no meaningful difference between the unknown beneficial holder of securities and the unknown participant in a bank claim. Therefore, a bankruptcy court would seem to have ample power to compel the lead bank to disclose who its participants are.

[92] Gulf States Exploration Co. v. Manville Forest Prods. Corp. (*In re* Manville Forest Prods. Corp.), 89 B.R. 358, 362, 376-77 (Bankr. S.D.N.Y. 1988), *aff'd on other grounds*, 99 B.R. 543 (Bankr. S.D.N.Y. 1989), *aff'd on other grounds*, 896 F.2d 1384 (2d Cir. 1990).

[93] It is difficult to reconcile Judge Lifland's decision in *Manville* with his later decision from the bench in *In re* 1515 Broadway Assocs., L.P., 153 B.R. 400 (Bankr. S.D.N.Y. 1993). *See supra* notes 68-69 and accompanying text.

ties laws.[94] The securities cases of the time appeared to contain ample authority for bringing participations within the scope of the securities laws. The Supreme Court had held that oil and gas leaseholds[95] and orange groves sold with a servicing contract[96] constituted "an investment contract" and hence a security. Participations appeared to be investment contracts.

By the 1990s, however, the issue had been resolved. The Sixth, Seventh, Eighth, and Tenth Circuits had ruled that a participation in a commercial bank loan was not a security.[97] In 1992, the Second Circuit joined the pack in *Banco Espanol de Credito v. Security Pacific National Bank*.[98]

Security Pacific had loaned money to Integrated Resources, Inc. ("Integrated") and then sold participations in the loans pursuant to a "master partnership agreement." When Integrated filed its Chapter 11 petition, several participants sued Security Pacific for fraud under section 12(2) of the Securities Act of 1933. They alleged that Security Pacific stopped lending its own money to Integrated in April 1989, but continued to sell participations in Integrated bank loans from mid-April until June 1989 without letting its customers know about its own decision not to lend.[99]

For the Second Circuit, the decision was an easy one. The underlying loan was a commercial loan and not a security; therefore participation interests in the loan were also not securities.[100] The Second Circuit applied the four factor test discussed in the Supreme Court decision, *Reves v. Ernst & Young*.[101] According to *Reves*, the following factors determine whether a debt instrument constitutes a security: the motivations of the buyer and seller, the plan of distribution, the reasonable expectations of the investing public, and the existence of another regulatory scheme.[102]

The Second Circuit held that Integrated and Security Pacific each entered into its transaction with commercial purposes in mind,

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94 *See, e.g.*, Hutchins, *supra* note 74, at 447 (citing First Wis. Mortgage Trust v. First Wis. Corp., 422 F. Supp. 493 (E.D. Wis. 1976); *In re* Colocotronis Tanker Sec. Litig., 420 F. Supp. 998 (J.P.M.L. 1976)).

95 SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

96 SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

97 *See* Fortgang & Mayer, *supra* note 88, at 53 & n.243 (citing McVay v. West Plains Serv. Corp., 823 F.2d 1395 (10th Cir. 1987), which joined the Sixth, Seventh, and Eighth Circuits in concluding that loan participations are not securities).

98 973 F.2d 51 (2d Cir. 1992).

99 *Id.* at 54.

100 *Id.* at 54-56.

101 494 U.S. 56 (1990).

102 *Id.* at 66-67.

so that the buyer and seller were motivated, not by investment, but by commercial goals.[103] The court saw little, if any, "plan of distribution," and held that the participation agreement put buyers on notice that the participation was not a security.[104] Finally, the Second Circuit looked to regulations recently promulgated by the Office of the Comptroller of the Currency to hold that there was, indeed, a substitute regulatory scheme.[105] Accordingly, the court held that Security Pacific's participations were not securities.

The *Security Pacific* decision is more interesting for what it omitted than for what it discussed. This was no ordinary participation agreement where Security Pacific negotiated the sale of its loan pieces. Instead, Security Pacific ran what it called a "commercial loan note program" in which it used salesmen to sell the participations to a wide variety of financial and nonfinancial institutions. Security Pacific salesmen used the participations' higher yield—fifteen to thirty basis points above the rate for commercial paper—as a selling point.

As noted by Chief Judge Oakes in dissent, "[t]he program was created to allow Security Pacific to compete with investment bankers who could place short-term commercial paper . . . , that [paper] unquestionably being securities."[106] Security Pacific referred to its borrowers as "issuers" and offered the participations as "investments."

The Securities and Exchange Commission ("SEC") had filed an amicus brief in support of the plaintiffs which strongly urged the treatment of these participations as securities because they were so different from the norm.[107] Counsel for participation buyers and sellers should refer to that brief for the SEC's distinction between Security Pacific's participations and what the SEC perceives is the type commonly bought and sold in Chapter 11 cases.

II. Whole Claims

A. *Trading and Net Operating Loss Carryforwards: New Rule, New Form, New Procedure, and New Litigation*

On July 22, 1991, Ames Department Stores moved—and was granted an order—to subject all trading in claims (other than publicly traded debt securities) in its Chapter 11 case to a procedure which would give Ames notice and the opportunity to object to each

[103] Banco Espanol de Credito v. Security Pacific Nat'l Bank, 973 F.2d 51, 55 (2d Cir. 1992).
[104] *Id.*
[105] *Id.*
[106] *Id.* at 57 (Oakes, C.J., dissenting).
[107] Brief of the Securities and Exchange Commission, Amicus Curiae, Banco Espanol de Credito v. Security Pacific Nat'l Bank, 973 F.2d 51 (2d Cir. 1992) (Nos. 91-7563, 91-7571).

trade.[108] On September 24, 1991, Pan Am Corporation sought even broader relief.[109] The Ames and Pan Am motions sent ripples through the world of claims trading, for they represented both the end of one era and the beginning of another.

Ames and Pan Am moved against trading because trading threatened to eliminate the benefits of their net operating loss carryforwards for reasons examined below.[110] The fact that they had to move at all represents a change in the law. Before August 1, 1991, all trading in claims had to go through the bankruptcy court, and the bankruptcy court entered orders transferring (or not transferring) claims. Under those circumstances, Ames and Pan Am would not have needed an order to enjoin claims trading.

However, on August 1, 1991, new Bankruptcy Rule 3001(e) took almost all claims trading away from the judges and gave to the clerk the responsibility of recording the transfers.[111] The transfers became "automatic" from the point of view of the debtor; they became problematic from the point of view of the Clerk's Office, which has had to construct new procedures for claims transfers.

In response to the demands of the new Rule, the Clerk's Office for the Southern District of New York has adopted new forms and new procedures for processing claims which we will discuss below. Before dealing with new forms and procedures, we should take a look at the Rule that gave them birth.

1. *The New Rule*

New Rule 3001(e)(2) reads as follows:

> *Transfer of Claim Other Than for Security After Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If the alleged transferor files a timely objection and the

[108] Order, Under 11 U.S.C. §§ 105, 362 and Bankruptcy Rule 3001, Establishing Notification and Approval Procedures for Trading Claims Against the Ames Group, *In re* Ames Dep't Stores, Inc., Nos. 90-B-11233 through 90-B-11285 (Bankr. S.D.N.Y. Aug. 12, 1991) [hereinafter *Ames* Order].

[109] Verfied Complaint for Permanent Injunctive Relief Against Transfers and Trading of Certain Unsecured Claims, *In re* Pan Am Corp., Case Nos. 91-B-10080 (CB) through 91-B-10087(CB) (Bankr. S.D.N.Y. Sept. 24, 1991) [hereinafter *Pan Am* Complaint].

[110] *See infra* notes 121-26 and accompanying text.

[111] FED. R. BANKR. P. 3001(e).

court finds, after notice and a hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.[112]

The Advisory Committee Note clearly states that if no objection is filed by the alleged transferor, "the clerk should note the transfer without need for court approval."[113] Neither the Advisory Committee Note nor any official form shows the clerk how to do this. To fill this gap, the Clerk's Office for the Southern District of New York has adopted the following procedure.

2. *The New Procedure and New Form*

Any claims buyer, or "transferee," must file with the Clerk's Office three copies of a notice of transfer in the form set forth as Exhibit "A" at the end of this Article, together with a stamped envelope addressed to the alleged transferor. The Clerk's Office will mail one copy of the notice to the alleged transferor and docket a second copy on the date of mailing. The third copy will be sent to any claims processing agent retained in the Chapter 11 case, because that agent will be in charge of keeping track of claim ownership.[114] As a matter of prudent practice, the claims buyer should bring a fourth copy to be time stamped by the Clerk's Office as evidence of filing.

Before mailing the notice, the Clerk's Office will insert in the form the "internal control number" identifying the notice in the office's internal computer system. *It is not the docket number of the notice.*

If the alleged transferor does not object to the transfer, no further action will be taken by the clerk. The docketed notice will stand as the unchallenged "substitution of transferor for transferee" as required by new Rule 3001(e)(2).

3. *Less Litigation*

The new Rule, the new form, and the new procedure offer the potential for major changes in claims trading. First, the new Rule gives only the alleged transferor the right to object to the transfer under Rule 3001(e)(2). The Rule was adopted to prevent third parties

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[112] FED. R. BANKR. P. 3001(e)(2).

[113] FED. R. BANKR. P. 3001(e) advisory committee's note.

[114] *See* Clerk's Office Procedure Handbook for Lawyers and Others 24, sect. XIII.D. (Bankr. S.D.N.Y. Dec. 1991) (setting forth local rules for Mega Cases in the United States Bankruptcy Court for the Southern District of New York).

such as the debtor or other creditors from contesting consensual claims transfers for their own purposes.[115]

Second, the new Rule (and the new form) may give creditors the chance to split their claims among more than one buyer. The ability to split claims is very beneficial to the sellers and buyers of partially disputed claims and buyers of very large claims.

A buyer of a partially disputed claim wants to buy only the undisputed part. If the buyer has to buy the whole claim, it will do so at a price representing current payment for the undisputed portion and deferred or reduced payment for the disputed portion. As the facts relating to the allowance of such disputed portion are peculiarly within the knowledge of the original creditor, the disputed claim is worth less in the hands of the claims buyer than in the hands of the original creditor. Thus, if a claims buyer cannot buy only the undisputed part of a claim, it will pay the original creditor less than the creditor would receive if the creditor could sell the undisputed portion and retain the disputed portion.

A seller with a very large claim may not be able to find a buyer prepared to purchase the entire claim. If the seller cannot split the claim among multiple buyers, the buyers must either acquire participation interests in the claim or equity interests in a corporation, partnership, or trust formed to purchase the claim. Each of these methods of splitting up interests in a claim has its own problems. In none of them will the buyer automatically obtain a right to vote a claim in its own name, which again will depress the price a buyer pays.

Notwithstanding the clear benefits of claims splitting, Judge Lifland had adopted a "chamber's rule" denying orders under old Rule 3001(e)(2) allowing multiple buyers each to buy a piece of one claim.[116]

Judge Lifland had two concerns. The first involved voting on a Chapter 11 plan. Any Chapter 11 plan is voted on by creditors grouped into one or more classes. Section 1126(c) of the Bankruptcy Code provides that a class accepts the plan only if the votes in favor of the plan constitute two-thirds in amount and a majority *in number* of all claims that vote.[117] Judge Lifland was thus concerned that claims splitting affected the number of claims under section 1126(c). The second concern involved administrative inconvenience: Judge Lifland was concerned that claims splitting created an administrative burden

[115] *See* Fortgang & Mayer, *supra* note 1, at 2-8.
[116] *See In re* Ionosphere Clubs, Inc., 119 B.R. 440, 444 (Bankr. S.D.N.Y. 1990).
[117] 11 U.S.C. § 1126(c) (1988); *Ionosphere*, 119 B.R. at 444.

for the debtor.[118]

Splitting publicly traded securities creates the same multiplicity of votes under section 1126(c), but neither the Bankruptcy Code nor the Bankruptcy Rules has any problem with that. Why should private claims be different?

Judge Lifland's finding of "administrative burden" was not supported by testimony or other evidence at the hearing. Well-established claims processors have told the authors that keeping track of split claims is little or no problem to anyone with a personal computer.[119]

4. *NOL Litigation*

New Bankruptcy Rule 3001(e)(2) does not resolve all issues concerning claims trading. As indicated by the *Pan Am* and *Ames* cases, the most pressing open issue concerns the effect of claims trading on a debtor's tax net operating loss carryforwards, or "NOLs."

An NOL represents the accumulation of tax losses over past years. It can be used, to some extent, to shelter income in future years. Chapter 11 debtors often have substantial NOLs, and many hope to have substantial income after reorganization. However, many, if not most, Chapter 11 plans for large debtors result in issuing stock to creditors who were not previously stockholders. In that case (to grossly oversimplify a complicated tax matter), the debtor's ability to use its NOLs may be severely limited if the creditors receiving the stock are claims buyers rather than original, "old-and-cold" creditors.[120]

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[118] *Ionosphere*, 119 B.R. at 444.

[119] For example, Poorman-Douglas Corporation, the leading claims processor in the country and once an opponent of claims splitting, is now permitting claimants to split claims in the Chapter 11 reorganization of Columbia Gas.

[120] Section 382 of the Internal Revenue Code provides that upon an "ownership change" in the stock of a debtor corporation, the debtor may use only a fraction of its NOLs to shelter income in any year. 26 U.S.C. § 382 (1988). That fraction is equal to the long-term tax exempt bond rate at the time of the ownership change multiplied by the net worth of the debtor at the time of the ownership change. 26 U.S.C. § 382(b)(1) (1988). This limitation does not apply, however, if pre-confirmation shareholders and qualified "old and cold" creditors collectively receive 50% of the stock of the debtor under its plan. A qualified "old and cold" creditor is a creditor who either (a) has held its claim since a date 18 months before the filing of the Chapter 11 petition or (b) acquired its claim as a trade creditor and has continually held the beneficial interest in such claim at all times. *See* 26 U.S.C. § 382(*l*)(5)(E) (1988). Claims trading, by definition, substitutes an ineligible creditor for a qualified "old and cold" creditor.

The Internal Revenue Service on September 23, 1991 proposed regulations which will alleviate this problem by clarifying that a "qualified creditor" is any holder of a beneficial interest in less than 5% of a class of a debtor's bonds or debentures, regardless of when such holder acquired its beneficial interest. Prop. Treas. Reg. § 1.382-3(d), 56 Fed. Reg. 47,921 (1991) (effective for all ownership changes occurring on or after Sept. 20, 1991).

The need to preserve its NOLs led Ames Department Stores, Inc. to obtain an order in its Chapter 11 case requiring notice and a ten-day waiting period for all transfers of private claims to allow the debtor to determine the effect of the transfer on its NOLs.[121] Ames had an NOL problem that no one had focused on before: factors.

Retailers buy goods on credit from their suppliers. Their suppliers "factor," or assign, their receivables to financial institutions, such as Walter Heller Company or Congress Financial Corporation. As a result, the trade creditors no longer own their claims when the retailer goes bust. They have already assigned them before a proof of claim has been filed. The factors may file one or more proofs of claim evidencing the pre-petition transfer of millions of dollars of claims.

Where claims are transferred after a proof of claim has been filed, a debtor can track the trading by monitoring the docket for transfer filings. A pre-filing transfer, however, just shows up as a proof of claim filed by one party instead of another. Tracking these transfers requires the debtor to analyze all of its proofs of claim—a mammoth task. When Ames reviewed its proofs of claim, Ames realized it had to move immediately to stop further claims trading.

Ames obtained an order limiting trading because, after preliminary skirmishes, all of the objecting claims buyers settled.[122] A half-dozen claims buyers initially objected to the trading restrictions, but then settled for an order allowing their claims to transfer and providing that future trades would be allowed on a "first filed" basis. That is, if Ames could allow trades of claims totalling $10,000,000 without danger to its NOLs, and twenty trades totalling $11,000,000 were pending, Ames would allow trades to close based on the order in which the statement of transfer was filed.

Two months later, Pan Am moved for even broader relief: an order regulating all trading—including trading on the public markets.[123] This was something new. The Bankruptcy Rules had never given bankruptcy courts authority to regulate the trading of claims based on bonds or debentures, and the new Rule 3001(e)(2) specifically exempted publicly traded bonds, notes, or debentures from its scope.[124] Pan Am got its order, again because no one raised a sub-

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121 *Ames* Order, *supra* note 108.

122 *Id.* One original creditor who wanted to preserve its right to sell continued to object. The court took the objection under advisement and entered the negotiated injunction order with respect to all other parties, leaving the objection subject to a temporary restraining order pending decision. *Id.* at 2.

123 *Pan Am* Complaint, *supra* note 109.

124 *See supra* notes 112-13 and accompanying text.

stantive objection.[125]

There were two reasons why no one objected. One reason was the Internal Revenue Service's proposed regulations under section 382(*l*)(5).[126] The proposed regulations provided that buyers of claims in a class of "widely-held indebtedness" would still count as original "old-and-cold creditors" if they acquired less than 5% of the debt in the class. The Pan Am order allowed trading within the 5% exemption, which meant that passive investors in publicly traded debt securities could continue to buy and sell claims. Thus, any passive investor in Pan Am could still trade.

The other reason was that Pan Am was headed straight for liquidation, and potential buyers for its claims—any claims—were few and far between.

The most radical regulation of claims trading to preserve an NOL occurred in the prepackaged Chapter 11 reorganization of Munsingwear, Inc. in Minneapolis. Munsingwear did not obtain a court order restricting transfers. Instead, Munsingwear published a bar date notice in the *Wall Street Journal* which included a paragraph declaring that the debtor would sue any claims buyer—on the public market or not—for violating the automatic stay and seeking to subordinate its claim.[127]

The authority for all of these attempts to regulate claims trading stems from the Second Circuit's holding in *In re Prudential Lines, Inc.*, that an NOL was the property of a debtor's estate, and acts to destroy it would violate the automatic stay.[128] In *Prudential Lines*, the debtor's corporate parent threatened to write off its stock in the subsidiary as worthless—which would destroy the subsidiary's NOLs—if the subsidiary's creditors did not allow the parent to retain equity ownership. The creditors refused and sought an injunction to prevent the parent from taking the worthless stock deduction and destroying the subsidiary's NOLs. The Second Circuit held that the subsidiary debtor's NOLs were property of the estate.[129] Accordingly, the bankruptcy court had the power to enjoin the parent corporation from taking the fatal deduction under both the automatic stay

[125] Order to Show Cause with Temporary Restraining Order Enjoining Transfers of Certain Unsecured Claims, *In re* Pan Am Corp., Case Nos. 91-B-10080 (CB) through 91-B-10087(CB) (Bankr. S.D.N.Y. Sept. 24, 1991). Pan Am's indenture trustees objected to certain procedural aspects of Pan Am's freeze on trading.

[126] Prop. Treas. Reg. § 1.382-3(d)(3), 56 Fed. Reg. 47,921 (1991).

[127] WALL ST. J., July 30, 1991, at B11.

[128] Official Committee of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 574 (2d Cir. 1991).

[129] *Id.* at 575.

of section 362(a) and section 105.[130]

We cannot quarrel with *Prudential Lines* on its facts, but we do wonder about its application to the world of claims trading. *Prudential Lines* involved a willful, even malicious, destruction of the debtor's NOLs by its parent corporation. Such action should be prohibited by the automatic stay. Claims traders, on the other hand, have no intent to threaten an NOL, and usually have no idea whether their trades, in fact, do so.

The freedom to buy and sell one's property is a right not lightly trammelled upon in this country. The numerous laws prohibiting restraints on alienation attest to that.[131] If Congress wants to preserve NOLs from accidental destruction by claims trading, Congress has the power to do so. We question, however, whether a bankruptcy court should assume such power in the absence of specific statutory authority.

B. *Discrimination Against Claims Buyers*

For over eight decades, federal courts from the Supreme Court on down have unanimously held that a claim in the hands of a buyer is no different than a claim in the hands of a seller.[132] The entire market for claims against Chapter 11 debtors is based on that principle. Unfortunately, in 1992-1993, several debtors found ways to question that basic principle.

First, in *Federated Department Stores, Inc. v. Allied Stores Corp.*,[133] Federated and its affiliates (collectively referred to as "Fed-

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130 *Id.* at 574.

131 *See, e.g.*, U.C.C. § 9-318(4) (1992); RESTATEMENT (SECOND) OF CONTRACTS § 322(1) (1981).

132 *See* Fortgang & Mayer, *supra* note 1, at 13-14 & n.74. *See also* Shropshire, Woodliff & Co. v. Bush, 204 U.S. 186 (1907) (priority wage claims remained priority claims in hands of claims purchasers); Wilson v. Brooks Supermarket, Inc. (*In re* Missionary Baptist Found. of Am., Inc.), 667 F.2d 1244 (5th Cir. 1982) (store which had cashed payroll checks for debtors' employees was an assignee of the employees' claims).

133 The following description of events in *Federated* is taken from various documents and motions in *In re* Federated Dep't Stores, Inc. and Allied Stores Corp., Consol. Case No. 1-90-00130: [Debtors'] Motion for Order Disallowing the Partial Transfer of Claims, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Nov. 22, 1991) [hereinafter Motion for Order Disallowing Partial Tranfsers]; Objection of Debtors and Debtors in Possession to Certain Merchandise and Expense Payable Claims, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Feb. 3, 1992) [hereinafter Merchandise and Expense Payables Objection]; Response of Amroc Investments, Inc. to Merchandise and Expense Payables Objection and Cross-Motion, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Mar. 23, 1992); Response of Reorganized Debtors to Cross Motion of Amroc Investments, Inc. and Exhibits thereto, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Apr. 7, 1992); Motion to Strike Final 22 Pages of Cross Motion of Amroc Investments, Inc., No. 1-90-00130, 1992 WL 94883 (Bankr. S.D. Ohio Apr. 7, 1992); Reply of Amroc Investments, Inc. to Federated's Response in Respect of Cross-Motion Dated March

erated") filed their assets and liabilities schedules in May 1990, approximately four months after the commencement of their Chapter 11 cases. In the bankruptcy court's order establishing August 1, 1990 as the date by which creditors were required to file proofs of claim, those creditors whose claims were scheduled as not disputed, contingent, or unliquidated (the "Undisputed Claims") were not required to file proofs of claim.[134] Federated's actions were in accord with section 1111(a) of the Bankruptcy Code, which states:

> A proof of claim or interest is deemed filed under section 501 of this title for any claim or interest that appears in the schedules filed under section 521(1) or 1106(a)(2) . . . .[135]

Federated amended its schedules several times during the two years before confirming its reorganization plan, but none of the amendments affected the Undisputed Claims. Federated distributed disclosure statements and ballots on the basis of its schedules of Undisputed Claims, the holders of those claims voted based on those schedules, and the votes were tallied based on those schedules.

As is true in virtually every large case, Federated's schedules became the basis for a market in trade claims. Over time, various claims buyers acquired numerous Undisputed Claims. They also acquired certain claims whose amounts were disputed—that is, the Federated schedules listed the claims as Undisputed Claims in amounts less than the amounts claimed by the original trade creditors in their proofs of claim. In a few instances, the claims buyers purchased only the undisputed portion of a trade claim, leaving the original claimant with a disputed portion. However, the debtor objected to the purchase of the undisputed portions.[136]

23, 1992, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Apr. 13, 1992); Reorganized Debtors' Motion for Sanctions Pursuant to Civil Rule 11 Against Amroc Investments, Inc. and/or its Counsel, No. 1-90-00130, 1992 WL 94809 (Bankr. S.D. Ohio Apr. 14, 1992) [hereinafter Reorganized Debtors' Motion for Sanctions]; Response of Claims Resolution Committee to Cross Motion of Amroc Investments, Inc. and to Response of Reorganized Debtors', Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Apr. 16, 1992); Withdrawal of: (1) Response of Amroc Investments, Inc. to Merchandise and Expense Payables Objection, (2) Cross-Motion of Amroc Investments, Inc. and (3) Motion of Federated Department Stores, Inc. for Sanctions Against Amroc and Its Counsel, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio May 4, 1992); and Settlement Agreement, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio May 5, 1992).

It should be noted that one of the Authors, Mr. Mayer, represented Amroc Investments, Inc. in certain negotiations with Federated prior to confirmation, but was not involved in the post-confirmation litigation.

[134] Order Permitting Securities Trading in Certain Circumstances, *In re* Federated Dep't Stores, Inc., Case No. 1-90-00130 (Bankr. S.D. Ohio Mar. 7, 1991).

[135] 11 U.S.C. § 1111(a) (1988).

[136] Motion for Order Disallowing Partial Transfers, *supra* note 133.

Federated began making trouble for claims buyers in its plan of reorganization. If a claim was disputed in part, Federated's plan provided that no distributions would be made on the claim until the dispute was resolved; that was normal. However, the plan also provided that any creditor holding multiple claims would be deemed to hold one claim, and that *if any part of any claim was disputed* no distributions would be made to the creditor—even on account of its Undisputed Claims—until the dispute was resolved.[137]

The provision was highly discriminatory against claims buyers (and factors). If a trade creditor held an Undisputed Claim, that trade creditor would receive distributions on account of that claim on the effective date of the plan. However, the buyer of the same claim would not receive distributions on the effective date if any part of any other claim held by the buyer was disputed. The plan thus violated the basic principle enunciated above that a claim is as good (or bad) in the hands of a buyer as it was in the hands of the original claimant.[138]

After certain claims buyers threatened to object to confirmation of the plan, Federated amended the plan to remove the offending provision. On February 3, 1992, three weeks after the plan was confirmed, Federated filed a Merchandise and Expense Payables Objection which disputed in excess of eight thousand claims—including claims which had been scheduled as Undisputed Claims for almost two years.[139] In addition, Federated in its claims resolution procedures, demanded that the holder of a partly disputed claim furnish invoices proving its right even to the undisputed portion.

Federated's post-confirmation actions hurt trade creditors generally. Federated had solicited votes from trade creditors who relied on the debtor's schedules in determining that they would be paid on the effective date, and then disavowed those schedules when the time came to make distributions. Federated's invoice policy penalized those trade creditors who destroyed three-year-old invoices based on Federated's prior scheduling of their claims as undisputed.

However, Federated's actions were particularly damaging to claims buyers. Claims buyers rely entirely on a debtor's schedules. They avoid buying disputed claims. If a debtor can disregard its schedules—which is basically the position that Federated adopted[140]—there will be no market for trade claims. A group of

[137] Third Amended Joint Plan of Reorganization of Federated Department Stores, Inc., Allied Stores Corporation and Certain of Their Subsidiaries, Consol. Case No. 1-90-00130 (Bankr. S.D. Ohio Oct. 28, 1991) (on file with author) [hereinafter *Federated* Plan].

[138] *See supra* note 132 and accompanying text.

[139] Merchandise and Expense Payables Objection, *supra* note 133.

[140] Federated defended its actions as follows:

claims buyers, furious at Federated's disavowal of its own schedules, filed a response and cross-motion which, in the words of Federated's counsel, "accuse[d] Federated of acting in bad faith and deliberately deceiving its creditors in order to manipulate the vote on the Plan."[141] Federated in turn accused the claims buyers of violating Rule 11 and sought sanctions.[142] The matter was eventually settled in a stipulation by which the claims buyers and Federated withdrew their motions with prejudice and agreed to the allowance of the objectors' claims in negotiated amounts.

The damage done by *Federated* is obvious: the fact that a claim is scheduled as undisputed, liquidated, and non-contingent can no longer be relied on as evidence that the claim will, in fact, be allowed without further litigation. One can hardly blame claims buyers for viewing with great alarm Federated's post-confirmation objection to thousands of claims previously scheduled as undisputed. Given section 1125's requirement of "adequate information" to creditors, a debtor who knows that a creditor's claim may be disputed should be under an obligation to disclose the dispute to the creditor.[143] To do otherwise undermines the integrity of the disclosure process. If Federated's practice is permitted by the courts, nothing will prevent fu-

1. It had a vendor return policy that made striking a final balance of a trade payable difficult.
2. The May 1990 bar date notice provided that "[n]othing set forth herein shall be deemed to preclude Federated from objecting to any claim, whether scheduled or filed, on any grounds." Federated took the position that this language put holders of Undisputed Claims on notice that the debtor could object to claims it had scheduled as undisputed.
3. Federated told its creditors' committee that if Federated was unable to reconcile its claims prior to confirmation, the claims would be included in a mass objection filed before the effective date.
4. Federated sent stipulations to certain holders of Undisputed Claims to settle the discrepancy between the amount the debtor had scheduled as undisputed and the new lower amount on the debtor's books.
5. Federated's plan provided as follows:

> Unless another date is established by the Bankruptcy Court, all objections to Claims shall be Filed and served on the holders of such Claims by the later of (a) the Effective Date and (b) 180 days after a particular proof of Claim has been Filed. *If an objection has not been Filed to a proof of Claim or a scheduled Claim that relates to a Disputed Claim by the objection bar dates established in this Section* . . . the Claim to which the proof of claim or scheduled Claim relates shall be treated as an Allowed Claim if such Claim has not been allowed earlier.

Federated contended that the underlined passage gave the holders of Undisputed Claims notice that their claims could be objected to.

See Reorganized Debtors' Motion for Sanctions, *supra* note 133, at 2-4.

[141] *Id.* at 1.

[142] *Id.*

[143] 11 U.S.C. § 1125(a)(1) (1988).

ture debtors from improperly confirming plans based on acceptances from creditors that the debtor knows to be in dispute.

The second challenge to the equality of old trade creditors versus new claim buyers involved explicit discrimination under Chapter 11 plans in the cases of *In re Insilco Corp.*[144] and *In re Best Products Corp., Inc.*[145] In each of these cases, the debtor filed a plan which provided better treatment to trade creditors who agreed to provide "continuing trade credit" to the reorganized debtor than to trade creditors who did not provide continuing trade credit. In *Insilco Corp.*, no serious challenge was raised to this practice. Trade claims amounted to less than $12,000,000, and Insilco was able to list all of the continuing trade creditors in its disclosure statement.[146] One claims buyer who was denied the preferred treatment offered "necessary trade creditors" did object to confirmation. However, the claims buyer settled after Insilco agreed to deem that claims buyer a "necessary trade creditor" because its predecessors in interest—the trade creditors who sold—had in fact agreed to extend continuing trade credit to the reorganized debtor.[147]

In *Best Products Corp.*, however, the discrimination between continuing and non-continuing trade creditors became a hotly contested issue in the case because one claims buyer had accumulated a substantial position in trade claims.[148] As of this writing, no settlement or decision has been announced.

CONCLUSION

The dichotomy between "continuing" and "non-continuing" trade creditors created by *Insilco* and *Best Products* is dangerous for claims buyers, the more so because the propriety of the dichotomy is

[144] Third Amended Plan of Reorganization Jointly Proposed by the Debtors and the Official Joint Committee of Unsecured Creditors, *In re* Insilco, Case No. 91-70021-RBK, at § 5.5(b) (Bankr. W.D. Tex. Oct. 14, 1992).

[145] Debtors' First Amended Proposed Joint Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, *In re* Best Products Co., Inc., Case No. 91-B-10048-53 (Bankr. S.D.N.Y. Oct. 7, 1993).

[146] Second Amended Disclosure Statement in Support of the Plan of Reorganization Jointly Proposed by the Debtors and the Official Joint Committee of Unsecured Creditors, *In re* Insilco, Case No. 91-70021-RBK, at 59 (Bankr. W.D. Tex. Jun. 19, 1993).

[147] Richard Epling, Presentation at Fall 1992 Meeting of the Subcommittee on Trust Indentures, Claims Trading and Creditors' Committees of the Business Bankruptcy Committee of the American Bar Association, San Antonio, Tex. (Oct. 15, 1992).

[148] *See generally Creditor Group Blasts Best Products' Disclosure Statement*, DAILY BANKR. REV. (Nov. 1, 1993); *Best Products Creditors' Committee Blasts Dickstein Group's Bid to File Competing Plan*, DAILY BANKR. REV. (Nov. 2, 1993).

open to question.[149]

Although the dichotomy created by *Insilco* particularly affected claims buyers because they obviously could not, and would not, continue to do business with the debtor, this distinction did apply equally to any other trade creditor. Continuation of the provision of acceptable trade credit terms can be a proper basis for distinguishing between trade creditors, and usually is, especially in pre-packaged Chapter 11 proceedings. To the extent that claims buyers are treated exactly like other trade creditors who do not continue to do business, they should have no cause for complaint, assuming that this dichotomy was properly and timely disclosed. It is, in any event, a feature of a plan which is subject to negotiation by claims buyers, whether individually or through a creditors' committee.

On the other hand, the value offered is often illusory. The trade supplier who offers a continuation of credit to the reorganized debtor may in fact ship on credit whether or not it receives special treatment under the plan. Although unusually favorable credit terms would constitute real value, neither *Insilco* nor (to date) *Best Products* contain any record comparing the offered trade credit terms with credit terms offered to the debtor's competitors—so it is not possible to determine whether the "continuing trade" is really offering anything of value. The courts have appropriately scrutinized the "new value" offered by shareholders as justifying their retention of equity in an insolvent debtor,[150] and similar scrutiny may be appropriate for a subgroup of creditors claiming that their "new value" justifies preferred treatment under the plan.[151]

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[149] The Authors split on this issue. Mr. Fortgang takes the position set forth in the next paragraph; Mr. Mayer takes the position set forth in the last paragraph.

[150] *See, e.g.*, Kham & Nate's Shoes No. 2 v. First Bank of Whiting, 908 F.2d 1351, 1360-63 (7th Cir. 1990).

[151] 11 U.S.C. § 1129(b)(1) (1988) clearly prohibits "unfair discrimination" against similarly situated creditors; the prohibition against a "new value" plan by equity is far less clear. *See, e.g.*, *In re* Bonner Mall Partnership, 2 F.3d 899 (9th Cir. 1993) (holding that the Code does not prohibit shareholders of an insolvent debtor from retaining their equity interests by contributing "new value").

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

Chapter
Case Nos.
Claim No.

Debtors

NOTICE: TRANSFER OF CLAIM PURSUANT TO FRBP RULE 3001(e)(2) or (4)

To: (Transferor) ____________________

____

____

The transfer of your claim as shown above, in the amount of $__________ has been transferred (*unless previously expunged by court order*) to:

____

____

____

No action is required if you do not object to the transfer of your claim. However, IF YOU OBJECT TO THE TRANSFER OF YOUR CLAIM, WITHIN 20 DAYS OF THE DATE OF THIS NOTICE, YOU MUST:

FILE A WRITTEN OBJECTION TO THE TRANSFER with:
United States Bankruptcy Court
Southern District of New York
One Bowling Green
New York, New York 10004-1408

SEND A COPY OF YOUR OBJECTION TO THE TRANSFEREE.

Refer to INTERNAL CONTROL No. _________ in your objection.
If you file an objection, a hearing will be scheduled.
IF YOUR OBJECTION IS NOT TIMELY FILED, THE TRANSFEREE WILL BE SUBSTITUTED ON OUR RECORDS AS THE CLAIMANT.

Cecelia G. Morris, Clerk

FOR CLERK'S OFFICE USE ONLY:
This notice was mailed to the first named party, by first class mail, postage prepaid on __________, 199__.
INTERNAL CONTROL NO. __________
Copy: (check) Claims Agent ___ Transferee ___ Debtor's Attorney ___

____
Deputy Clerk

bc: objntc (5/13/93)
OBJECTION NOTICE FOR TRANSFEROR-PROOF OF CLAIM ON FILE

Exhibit "A"