Applying Federal Securities Law to Chapter 11 Claim Conversions

Blake Brockway
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“Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”

I. INTRODUCTION

Many view bankruptcy as the death of an investment, but to a keen-eyed vulture investor it is the birth of opportunity. A bankruptcy filing is also among creditors’ worst fears. The value of their debt and the timing and amount of repayment is uncertain. Some creditors, especially those unfamiliar with bankruptcy, are willing to sell their claims against the bankrupt debtor for pennies on the dollar. Sophisticated investors who recognize the value of the claims stand willing to purchase. A transaction is normally encouraged when two parties disparately value an object; this is the essence of a market economy. But what happens when a buyer has access to material, non-public information that the seller lacks? Or when the buyer sits on a protective committee and breaches a fiduciary obligation to the seller?

Selling claims in bankruptcy is not new; neither are the accompanying problems. Following the crash of 1929, Wall Street extensively traded distressed debt. The Securities and Exchange Commission (“SEC”) described this trading in its depression era report on protective and reorganization committees. In a prior iteration of the Bankruptcy Code, Chapter X explicitly punished fiduciaries, such as

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4. Fortgang & Meyer, supra note 2, at 8.
5. Id. at 4.
members of protective committees, for trading claims. But regulation gave way to administrative convenience and the benefits of claims trading, and Chapter 11 of the Bankruptcy Code does not punish those who trade claims.

Regulation tends to chase regulatory problems. However, the problems that result from claims trading have been faced before and can be solved. Market regulators must remember the problems of the past and use them to shape the future. Acting now could prevent the need for reactionary regulation and could aid creditors facing an increasing number of bankruptcy cases. During the twelve month period ending June 30, 2009, over 1.3 million bankruptcy cases were filed. In addition, business-related bankruptcy filings rose 63% from 33,822 for the twelve month period ending June 30, 2008, to 55,021 for the twelve month period ending June 30, 2009. As our country endures one of the longest recessions since the Great Depression, now is the ideal time to revisit the treatment of claims trading, and if needed, implement anticipatory regulation.

When it comes to regulating claims, scholars differ on how bankruptcy claims ought to be treated. Advocates of the current system argue that creditors benefit from the ability to liquidate their claims and that current Bankruptcy laws provide adequate remedies to prevent abuse. Some opponents of the current regime suggest that trading claims has an adverse effect on the reorganization process; therefore, the creditors' ability to transfer claims should be limited.

7. Id. at 11.  
8. Id.  
9. Historically, our country has adopted regulation in response to regulatory failures. For example, the Great Depression was followed by the Securities Act of 1933 and the Securities and Exchange Act of 1934 and the Enron and World Com scandals led us to implement Sarbanes Oxley. 
10. John Kenneth Galbraith said it best, "As protection against financial illusion or insanity, memory is far better than law. When memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and memory serves the same purpose as the SEC and, on the record, is far more effective." JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, ix (Houghton Mifflin Company 1972).
12. Id.  
Others have suggested that federal securities laws might be applied to bankruptcy claims.\textsuperscript{16}

In an attempt to find a middle ground, this article argues that federal security laws ought to apply when a bankruptcy claim is purchased and converted to an equity position in the reorganized entity. Whether claims are securities when they are not converted into equity depends on the nature of the claim. If the instrument on which the claim is based is a security, then securities laws should apply. If the claim arose from debt that was not a security and is not sold and converted into an equity position, then the claim is not a security and ought to be regulated under the current bankruptcy regime.

This article begins by reviewing the statutory definitions of the term "security" and applicable Supreme Court cases to answer the question: What is a security? The article then discusses how bankruptcy claims arise and are transferred. Section four illustrates how claims are converted into an equity position in the reorganized entity and discusses an investment firm that acquired a bankrupt company by purchasing its claims. The fifth section develops some of costs and benefits associated with claims trading. Section six discusses some of the solutions that have been proposed to deal with problematic claims trading. Finally, the seventh section applies the definition of a security to determine when bankruptcy claims are considered securities and introduces a proposed regulatory scheme.

\section{II. What Is a Security?}

To determine whether federal securities laws should apply to bankruptcy claims, the term "security" must first be understood. The definition of a security is murky, and it ought to be.\textsuperscript{17} The term must

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\bibitem{footnote17} Critics of this statement may argue that a bright line rule for determining whether an instrument is a security would be easier to follow and would allow for more effective planning. Unfortunately, a bright line rule is also easier to evade. As the \textit{Reves} Court observed: An approach founded on economic reality rather than on a set of per se rules is subject to the criticism that whether a particular note is a "security" may not be entirely clear at the time it is issued. Such an approach has the corresponding advantage, though, of permitting the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition.
\textit{Id.} at 63 footnote 2.
\end{thebibliography}
account for the "virtually limitless scope of human ingenuity." The definition begins to haze at the statutes, because the term security is defined differently by three relevant statutes. In interpreting the term security, the Supreme Court has added to the uncertainty by developing tests that expand the definition to account for some non-traditional investment vehicles, and has limited it to exclude some instruments specifically identified as securities in the definitions. When these decisions are viewed as a whole, a spectrum arises that sheds light on the Court's judgment.

A. Statutory Definition of Security

The term "security" is defined by three statutes: the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Bankruptcy Code. Each of these definitions starts by defining specific in-

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whether an instrument is a security, like the materiality standard, requires judgment in the light of all of the circumstances. In both cases, the ease of applying a bright line rule is outweighed by the need to protect our securities markets. 18. *S.E.C. v. Howey Co.*, 328 U.S. 293, 299 (1946).
19. Securities Act of 1933 § 2(a)(1) The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
20. Securities and Exchange Act § 3(a)(10) The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.
21. 11 U.S.C. §101(49)
Instruments as securities. For example, all three statutes define any note, stock, treasury stock, bond, or debenture as a security. Each definition also includes more general language such as investment contract and certificate of interest. The phrase “evidence of indebtedness” appears in the definition of a “security” in the Securities Act of 1933, but is omitted from the definition of a “security” in the Securities and Exchange Act of 1934, and expressly excluded from the definition of a “security” in the Bankruptcy Code.

The application of the Bankruptcy Code’s definition of security is limited to the Bankruptcy Code, and is not meant to supersede the securities laws’ definition. This article discusses the application of securities laws to converted bankruptcy claims. Bankruptcy Rule 3001(e) left an opening for non-bankruptcy law to be applied to claims transfers. Therefore, the definition of security Bankruptcy Code has little value for determining whether a converted bankruptcy claim is a security, because applying federal securities laws to claim conversions is the type of non-bankruptcy remedy anticipated by Rule 3001(e).

The term “security” (A) includes – (i) note; (ii) stock; (iii) treasury stock; (iv) bond; (v) debenture; (vi) collateral trust certificate; (vii) pre-organization certificate or subscription; (viii) transferable share; (ix) voting trust certificate; (x) certificate of deposit for security; (xii) investment contract or certificate of interest or participation in a profit-sharing agreement or in an oil, gas, or mineral royalty or lease, if such contract or interest is required to be the subject of a registration statement filed with the Securities and Exchange Commission under the provisions of the Securities Act of 1933, or is exempt under section 3(b) of such Act from the requirement to file such a statement; (xiii) interest of a limited partner in a limited partnership; (xiv) other claim or interest commonly known as “security”; and (xv) certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell, a security; but

(B) does not include – (i) currency, check, draft, bill of exchange, or bank letter of credit; (ii) leverage transaction, as defined in section 761 of this title; (iii) commodity futures contract or forward contract; (iv) option, warrant, or right to subscribe to or purchase or sell a commodity futures contract; (v) option to purchase or sell a commodity; (vi) contract or certificate of a kind specified in subparagraph (A)(xii) of this paragraph that is not required to be the subject of a registration statement filed with the Securities and Exchange Commission and is not exempt under section 3(b) of the Securities Act of 1933 from the requirement to file such a statement; or (vii) debt or evidence of indebtedness for goods sold and delivered or services rendered.

11 U.S.C.A §101(49) (West 2007).
22. 15 U.S.C.A, § 77b (West 2000) (Securities Act § 2(a)(1)).
24. 11 U.S.C. §101(49)(“The term 'security' . . . does not include . . . debt or evidence of indebtedness for goods sold and delivered or services rendered.”)
25. Drain & Schwartz, supra note 14 at 610.
26. See Section III infra.
27. Id.
When determining whether an instrument is a security, the Court typically begins by determining the congressional intent behind federal securities laws.\textsuperscript{28} Congress enacted federal securities laws “to eliminate serious abuses in a largely unregulated securities market.”\textsuperscript{29} “In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of ‘countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.’”\textsuperscript{30} Congress did not intend to provide a remedy for all fraud, but rather, it sought to regulate all forms of investments.\textsuperscript{31} To effectuate the purpose of the federal securities laws, Congress adopted a broad definition of the term security, which included numerous general terms that were broad enough to cover nearly any investment vehicle.\textsuperscript{32}

The Supreme Court has articulated several tests to determine whether or not an instrument is a security. Outside the specific fact patterns that they address, these tests should not be applied rigidly, but should be viewed as collective lessons to develop the range of instruments that are securities. In order to be effective, some non-traditional investment schemes must fall within the definition of a security, and the \textit{Howey} test sets the lower bound of the security spectrum.\textsuperscript{33} The upper bound is found in the most obvious security - a traditional publicly traded investment vehicle such as a publicly traded stock.\textsuperscript{34} However, not all of the instruments specifically defined as a security by the statutes are considered securities.\textsuperscript{35} In order to fall within the definition of a security, the specific instrument must possess the usual characteristics of that instrument.\textsuperscript{36} The economic reality, not the names given to the instrument, guides this inquiry.\textsuperscript{37} Finally, the family resemblance test limits the application of securities laws to some specific instruments.\textsuperscript{38}

\begin{thebibliography}{9}
\bibitem{28} See \textit{e.g.} \textit{Reves}, 494 U.S. at 61.
\bibitem{29} United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975).
\bibitem{30} \textit{Reves}, 494 U.S. at 60-61 (quoting \textit{Howey}, 328 U.S. 293 at 299 ).
\bibitem{31} \textit{Id.} at 61.
\bibitem{32} \textit{Id}.
\bibitem{33} \textit{Howey}, 328 U.S. at 293.
\bibitem{34} \textit{See} \textit{Reves}, 494 U.S. at 62 (“common stock is the quintessence of a security”).
\bibitem{35} \textit{See} \textit{e.g.} \textit{Forman}, 421 U.S. at 848.
\bibitem{36} \textit{Id.} at 851.
\bibitem{37} \textit{Id}.
\bibitem{38} \textit{Reves}, 494 U.S. at 65-66.
\end{thebibliography}
The Supreme Court has interpreted the term security to include some non-traditional investments or mechanisms. In *Howey*, a company that operated a citrus grove and hotel resort offered to sell plots of land and a service contract as an investment alternative to patrons of its resort. The Court held that the land sale and service contract constituted an investment contract for purposes of the Securities Act of 1933. In reaching this decision the Court found that an investment contract exists when a person invests money in a common enterprise and is led to expect profits solely from the efforts of others. The Court exercised sound judgment in finding that the securities laws must apply to some non-traditional investments. To hold otherwise would open the door to evasion of the federal securities laws.

The *Howey* test does not always apply. In *Landreth*, a buyer purchased all of the outstanding stock in a lumber business, and later brought a federal securities suit against the seller. The district court found that the stock was not a security because managerial control passed to the buyer; therefore, he did not expect profits solely from the efforts of others. The Supreme Court reversed and found that the *Howey* test did not apply stating, "[w]hen an instrument is both called a stock and bears stock's usual characteristics, a purchaser [may] assume that the federal securities laws apply.' Under *Landreth*, an instrument that is a security when it is publicly traded, is also a security when exchanged in a privately negotiated transaction.

However, an instrument that is called a stock is not always a security. In *Forman*, tenants purchased an instrument labeled a stock, which allowed them to rent an apartment in a newly developed, state-subsidized housing cooperative. When the rental rates exceeded the

40. *Id.* at 294-297.
41. *Id.* at 293 (Investment contract is included in the definition of a security in § 2(1) of the Securities Act of 1933).
42. *Id.*
44. *Id.* at 683.
45. *Id.* at 685.
46. The characteristics of common stock are: "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights to the number of shares owned; and (v) the capacity to appreciate in value." *Id.* citing United Housing Foundation, Inc. v. *Forman*, 421 U.S. 837, 851 (1975).
48. *Id.*
50. *Id.* at 840.
original estimates, the renters sued under federal securities law.\textsuperscript{51} The Supreme Court held that labeling an instrument a stock is not sufficient for federal securities laws to apply.\textsuperscript{52} The Court looked to the economic reality of the transaction and found that the instrument did not have the common characteristics of a stock.\textsuperscript{53} The tenants did not purchase the stock as an investment, but rather, purchased it in order to acquire an apartment in state-subsidized housing.\textsuperscript{54} Unlike the stock in \textit{Landreth}, the instruments in \textit{Forman} were not negotiable, could not be pledged or hypothecated, did not convey voting rights, and could not appreciate in value.\textsuperscript{55}

\textit{Landreth}'s holding cannot apply to all instruments, because a literal application could extend securities laws too far.\textsuperscript{56} The Court faced this problem in \textit{Reves v. Ernst \& Young}.\textsuperscript{57} In \textit{Reves}, an agricultural cooperative sold demand notes to its patrons in order to raise capital.\textsuperscript{58} The notes paid a slightly higher interest rate than rates offered by local banks.\textsuperscript{59} An advertisement for the notes contained a statement indicating that the cooperative had $11 million in assets to stand behind the investments and that they were safe, secure, and available.\textsuperscript{60} The cooperative filed for bankruptcy and the note holders filed suit against Ernst \& Young alleging that they violated the antifraud provisions of the Securities and Exchange Act of 1934 by failing to follow generally accepted accounting principles when conducting an audit.\textsuperscript{61}

The Court held that the demand notes issued by the cooperative were securities.\textsuperscript{62} To reach its holding, the Supreme Court developed the family resemblance test.\textsuperscript{63} Under the family resemblance test, a note is presumed to be a security unless the issuer can show that the note bears a strong family resemblance to an item on a judicially crafted list of exceptions\textsuperscript{64} or convinces the court to add something to

\begin{itemize}
  \item \textsuperscript{51} \textit{Id.} at 844.
  \item \textsuperscript{52} \textit{Id.} at 848.
  \item \textsuperscript{53} \textit{Id.}
  \item \textsuperscript{54} \textit{Forman}, 421 U.S. at 848.
  \item \textsuperscript{55} \textit{Id.}
  \item \textsuperscript{56} For example, if all notes were considered securities, then home mortgages and credit cards would be covered by the federal securities laws.
  \item \textsuperscript{57} \textit{Reves}, 494 U.S. 56.
  \item \textsuperscript{58} \textit{Id.} at 59.
  \item \textsuperscript{59} \textit{Id.}
  \item \textsuperscript{60} \textit{Id.}
  \item \textsuperscript{61} \textit{Id.}
  \item \textsuperscript{62} \textit{Reves}, 494 U.S. . at 60.
  \item \textsuperscript{63} \textit{Id.} at 67.
  \item \textsuperscript{64} The list of judicially crafted exceptions includes:
    \begin{itemize}
      \item a note delivered in consumer financing,
    \end{itemize}
\end{itemize}
that list. The Court applied the following factors to determine if a note bears a strong family resemblance to a security: (i) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (ii) the instruments plan of distribution; (iii) the reasonable expectations of the investing public, and (iv) some other factor such as the existence of an alternate regulatory scheme that reduces the risk of the instrument making the use of federal securities laws unnecessary.

In applying the family resemblance test to the demand notes purchased by the cooperative patrons, the Court started with the presumption that the notes were securities. The parties agreed that the demand notes did not resemble any of the judicially crafted exceptions so the Court proceeded with the four-factor test. In terms of the motivation of the buyers and sellers, the Court found that the notes raised capital and were purchased to earn a profit - traditional aspects of securities. The notes were broadly distributed to members of the public. The demand notes were also perceived by buyers and advertised by the sellers as an investment. Finally, the court did not find any risk-reducing factors such as alternate federal regulation, collateral, or insurance.

At first glance, these cases provide a rigid framework, but they are best understood as revealing a spectrum of instruments that resemble the form of a security. The strongest form of a security is publicly traded stock. Publicly traded stocks are widely distributed, heavily traded, raise capital, are negotiable, and investors trade them expecting a profit. The closer an instrument is to resembling that form, the more likely that it is a security. Judgment guides the inquiry and case law provides the framework and boundaries. With these principles

ii. a note secured by a mortgage on a home,
iii. a short-term note secured by a lien on a small business or some of its assets,
iv. a note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or
v. a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).

Id. at 65 (citing Exchange Nat. Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).

65. Id. at 67.
66. Id. at 66-67.
67. Id. at 67.
68. Reves, 494 U.S., at 67-68.
69. Id. at 68.
70. Id. at 68.
71. Id. at 69.
72. Id.
established, the article will now proceed to discuss how bankruptcy claims arise, and are transferred and converted into equity in a reorganized entity. This transaction, on the whole, so closely resembles the form of a security that securities laws ought to apply.74

III. The Automatic Stay and Bankruptcy Claims

When a company files for bankruptcy its creditors are issued an automatic stay.75 The automatic stay prevents creditors from collecting debts and grants them a claim against the bankrupt entity.76 A claim is defined in the Bankruptcy Code as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, legal, equitable, secured, or unsecured . . ."77 Claims against the debtor arise from secured debt, unsecured debt, bonds, trade claims, contract claims, wage, salary and benefits claims, and other claims incurred in the ordinary course of business. Generally, a creditor who wishes to recover for a debt owed by a Chapter 11 entity must file a notice of claim.78 Once established, a claim against a bankrupt entity is freely tradable.79 Many creditors sell their claims, sometimes at a steep discount.80 In fact, the market for bankruptcy claims has been estimated as high as $300 billion dollars.81 Buyers of these claims include hedge funds, private equity firms, banks, and other sophisticated financial entities.82

Bankruptcy Rule 3001(e) governs the mechanics of claims transfers.83 This rule was amended in 1991 to streamline the claims trading process and limit the Bankruptcy Court’s involvement in claims trading.84 Under the current rule, publicly traded notes, bonds and debentures are not subject to the transfer restrictions articulated in Rule 3001(e).85 However, the explanatory comments expressly provide:

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74. See Section VII infra.
76. Id.
77. 11 U.S.C. § 101(5)(A) (2008). See also 11 U.S.C. § 101(5)(B) (The term claim also means a “right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to a equitable remedy is reduced by judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured”).
81. Tung, supra note 12, at 1685.
83. Bankr. R. 3001(e).
84. Drain & Schwartz, supra note 14, at 569.
85. Bankr. R. 3001(e)(2-4) ("If a claim other than one based on a publicly traded note, bond, or debenture has been transferred . . . ").
Subdivision (e) is amended to limit the court’s role to the adjudication of disputes regarding transfers of claims. . . . If a timely objection is filed, the court’s role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law. This rule is not intended either to encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.\textsuperscript{86}

As the above comment indicates, Rule 3001(e) was amended to eliminate the need for up front approval of claims transfers while allowing the court to review a claim transfer when a party later objects. The plain language of this comment would allow a bankruptcy court to apply federal securities laws to claims transfers. This language could prove especially useful when claims are purchased and converted into an equity position in the reorganized entity.\textsuperscript{87}

\section*{IV. Japonica Partner’s Acquisition of Allegheny International: The Paradigm Case of a Claims Conversion}

As a part of a Chapter 11 reorganization plan, a company can provide payment for claims by issuing equity in the reorganized entity to claim holders. Bankruptcy courts have permitted this type payment under Bankruptcy Code § 510(c).\textsuperscript{88} Some investors have utilized this feature to acquire a controlling interest in the reorganized entity.\textsuperscript{89} Perhaps the most renowned example was Japonica Partners’ acquisition of Allegheny International.\textsuperscript{90} Although the acquisition occurred nearly two decades ago, it remains one of the best examples of a claims trading takeover.\textsuperscript{91} The increased number of business-related bankruptcy filings and illiquid credit markets may set the stage for another similar takeover.

Japonica’s quest for Allegheny began in the early stages of the bankruptcy proceeding. Japonica was interested in the strength of Al-

\begin{enumerate}
\item Advisory Comments to 1991 Amendments of Bankr. R. 3001.
\item Drain & Schwartz, supra note 14, at 593.
\item Section 510(c) ("the court may under the principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all of an allowed interest.").
\item See infra text accompanying notes 28-55.
\item See Hilary Rosenberg, The Vulture Investors 165 (John Wiley & Sons, Inc. 2000).
\item The Allegheny International decision continues to add value, because it has been highly scrutinized by legal and economic scholars. Further, few companies have been taken over while in bankruptcy. As one observer noted, “most bankrupt companies were bankrupt for a reason: They were lousy companies.” Id. at 173.
\end{enumerate}
legheny’s brands, and believed the company had manipulated its financials to make it appear worse than its actual condition. When Japonica’s principals offered to purchase the bankrupt entity for $700 million, the company’s board members and creditors were unimpressed by the brazenness of Japonica’s principals and were not convinced that the hedge fund could find financing. However, the United States Trustee and one company official convinced the creditors and board of directors to furnish Japonica with information to solidify its bid. But relations rapidly deteriorated as the company became increasingly suspicious of Japonica’s financing, and the hedge fund accused the company of failing to provide it with adequate information. Undeterred, Japonica’s takeover strategy turned hostile.

The company filed its Chapter 11 reorganization plan on December 29, 1989, and the bankruptcy court approved its disclosure statement on February 5, 1990. Japonica filed a competing reorganization plan on January 24, 1990. The company’s plan offered creditors stock valued at $7.00 per share, while the Japonica plan offered the cash equivalent of $6.42 per share. From March 15, 1990 until June 11, 1990, Japonica performed due diligence in Allegheny’s office using Allegheny’s facilities. After filing its plan, Japonica purchased claims in three ways. From February 23, 1990 through March 30, 1990, Japonica negotiated directly with banks and other unsecured debt holders to purchase nearly $65 million in claims at 80-95% of their face value. Japonica also purchased around $20 million of claims from a creditor in a separate class for about 66% of their face value. Finally, Japonica commenced a tender offer on April 14, 1990, which was to remain open until May 16, 1990, to purchase the

92. Allegheny manufactured household products under two very well known brand names: Sunbeam and Oster. Id. at 174.
93. Id.
94. Id. at 177.
95. Id. at 177-78.
96. ROSENBERG, supra note 90, at 184.
97. Id. at 197.
98. See id. at 187-96.
100. Id. To become a party of interest, Japonica purchased $10,000 of subordinate debentures for $2712. Id. Under Bankruptcy Code § 1121 the debtor or any party of interest may file a plan. Bankruptcy Code § 1121.
102. Id. at 295.
103. Id. at 286-87, 294-95. See also Fortgang & Thomas Mayer, supra note 2, at 83-84.
105. Id.
subordinate debt of one of Allegheny's subsidiaries.\textsuperscript{106} By purchasing at least one-third of the claims in two impaired classes, Japonica was able to secure a blocking position, which would make it difficult for the company to confirm its plan.\textsuperscript{107} However, the court used its equitable powers to designate Japonica's votes, and found that allowing a plan proponent to purchase claims to block an alternate plan rendered other creditors' votes meaningless.\textsuperscript{108}

By designating Japonica's votes, Judge Cossetti confirmed the company's plan over Japonica's objections.\textsuperscript{109} He found that Japonica acted in bad faith by commencing a tender offer before its disclosure statement was approved, purchasing claims to obtain a blocking position, and misusing inside information.\textsuperscript{110} The company's plan created another problem, a "Control Transaction" provision allowed any holder to exercise a put option to sell its shares to a controlling person, which was defined as any person holding in excess of 45% of the reorganized entity's common stock.\textsuperscript{111} At this juncture, Japonica fell within that definition.\textsuperscript{112} To solve the problem, the court held Japonica's shares in trust without voting rights unless Japonica demonstrated that it was able to respond to puts from all shareholders at a price of $7.00 per share.\textsuperscript{113} If Japonica failed, its shares were to be held in trust for three years.\textsuperscript{114}

After the decision, Japonica negotiated to purchase the banks claims for $1.05 on the dollar, which translated to approximately $6.60 per share, and agreed to pay all other classes $7.00 per share.\textsuperscript{115} The court approved the settlement and the parties closed on September 28, 1990.\textsuperscript{116} In total, Japonica paid $660 million for the company and around $15 million in fees.\textsuperscript{117} The hedge fund's principals took management roles in the company and implemented aggressive cost-cut-

\textsuperscript{106} Allegheny Int'l, 118 B.R. at 294-95.
\textsuperscript{107} Id. at 290.
\textsuperscript{108} Id.
\textsuperscript{109} Id. at 285.
\textsuperscript{110} Id. at 294-99.
\textsuperscript{111} Id. at 300.
\textsuperscript{112} Id. at 300-01. Here, the court treats the claims as if they were stock, because the control provision defines a controlling person as a person who "acquires beneficial ownership in excess of 45% of the Common Stock of the Corporation." Id. at 300. The court noted, "Japonica has voluntarily purchased claims in various classes which are to receive stock and warrants." Id. at 301. Therefore, the court is treating the claims as if they were stock.
\textsuperscript{113} Id. at 303
\textsuperscript{114} Id.
\textsuperscript{115} Rosenberg, supra note 90, at 221.
\textsuperscript{116} Id. at 223-24.
\textsuperscript{117} Id. at 225.
Japonica cut the company's headquarters staff from sixty to fifteen and introduced ten new products by the spring of 1991. The reorganized company, Sunbeam-Oster went public in August 1992 raising $250 million and still leaving 77% in the hands of Japonica's investors. Japonica's purchase of the troubled company and ability to turn it around was, in many ways, a success. However, part of that success may have come at the cost of some of Allegheny's creditors.

V. COSTS AND BENEFITS OF CLAIMS TRADING

Japonica's acquisition of Allegheny International is illustrative of the costs and benefits of claims trading. The benefits of claims trading, such as increased liquidity and economies of scale, are a major driving force for those who support less restricted claims trading. However, the costs of deregulation can be significant. Claims trading can result in purchasers utilizing inside information or breaching of fiduciary duties owed to the sellers. And Bankruptcy courts, despite their equitable powers, may not have the resources or expertise to adequately address these problems.

Allowing investors to purchase bankruptcy claims provides many benefits to creditors. Claims trading increases market liquidity, and enables creditors to sell their claims at a discount rather than endure a bankruptcy proceeding. Creditors can also obtain tax advantages and manage regulatory risks by selling their claims. By purchasing claims, an investor can achieve economies of scale and reduce the administrative costs associated with a bankruptcy proceeding. In addition, reducing the number of interested parties can lead to a more rapid, better structured reorganization.

But the advantages of claims trading do not come without cost. Often claims are traded by members of protective committees or other parties that owe a fiduciary duty to the sellers. In addition, these parties may obtain material, non-public information about the

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118. Id. at 225-27.
119. Id. at 225-26.
120. Id. at 228.
121. Drain & Schwartz, supra note 14, at 575.
122. Fortgang & Meyer, supra note 2, at 4.
123. Drain & Schwartz, supra note 14, at 575.
124. Fortgang & Meyer, supra note 2, at 6-7 (noting that an investor who acquires a large number of claims has more of an incentive to invest time and money in the bankruptcy process than a smaller claimant).
126. See e.g. Allegheny Int'l, 118 B.R. at 297.
bankrupt entity that has a profound effect on the value of the claims.\textsuperscript{127} Claims trading also has a harmful effect on the reorganization process when claims are purchased in an attempt to manipulate a reorganization effort.\textsuperscript{128}

Japonica's acquisition of Allegheny International raised many of the problems that arise from claims trading. Japonica was permitted to conduct in depth due diligence because of its status as a plan proponent.\textsuperscript{129} Pursuant to an order of the court, Japonica entered Allegheny's corporate headquarters from March 16, 1990 until June 11, 1990 to conduct the due diligence.\textsuperscript{130} Implanted in the headquarters, Japonica had direct contact with company employees and was permitted to interview management.\textsuperscript{131} In addition, the hedge fund received a large volume of information that was not available to creditors, shareholders, or the general public.\textsuperscript{132} As the court observed, "Japonica had vast knowledge of the most intimate details of this company unmatched by any other creditor."\textsuperscript{133}

Japonica's ability to acquire inside financial information was particularly important, because the hedge fund believed that Allegheny's management had manipulated the company's financial information.\textsuperscript{134} Japonica suspected that Allegheny's pre-bankruptcy management team overstated the severity of the company's condition in order to make themselves look better after the company re-emerged from bankruptcy.\textsuperscript{135} One example of a potential misrepresentation was an off-balance sheet asset that Japonica discovered after acquiring the company.\textsuperscript{136} Based upon its extended access to material, non-public information and its status as a plan proponent, the court found that Japonica was an insider and a fiduciary.\textsuperscript{137} And temporary insiders owe a fiduciary duty to shareholders.\textsuperscript{138}

After receiving the keys to the castle, access to employees, and volumes of material, non-public information, Japonica continued to purchase claims.\textsuperscript{139} Japonica's status as an insider meant that it owed

\begin{thebibliography}{99}
\item \textsuperscript{127} Id.
\item \textsuperscript{128} Tung, supra note 15, at 1686.
\item \textsuperscript{129} Allegheny Int'l, 118 B.R. at 298.
\item \textsuperscript{130} Id.
\item \textsuperscript{131} Id. See also Rosenberg, supra note 90, at 209.
\item \textsuperscript{132} Allegheny Int'l, 118 B.R. at 298.
\item \textsuperscript{133} Id. at 296.
\item \textsuperscript{134} Rosenberg, supra note 90, at 174.
\item \textsuperscript{135} Id.
\item \textsuperscript{136} Id. at 226-27.
\item \textsuperscript{137} Allegheny Int'l, 118 B.R. at 299.
\item \textsuperscript{138} Dirks v. SEC, 463 U.S. 646, 655, n. 14 (1983).
\item \textsuperscript{139} Allegheny Int'l, 118 B.R. at 286-87.
\end{thebibliography}
fiduciary duties to other creditors while it was purchasing claims.\textsuperscript{140} Between March 23, 1990 and March 30, 1990, Japonica purchased claims with a face value of nearly $25 million for 82-95\% of their face value.\textsuperscript{141} Japonica also arranged to purchase senior unsecured claims from Swiss Volksbank for 66\% of their face value sometime between March 19, 1990 and March 30, 1990.\textsuperscript{142} On June 8, 1990, Japonica attempted to modify its plan to pay approximately 95\% of the face value for the claims that it had just acquired from Swiss Volksbank – a move that the court called "chutzpah with a vengeance."\textsuperscript{143}

The court also found that Japonica manipulated the bankruptcy process in an attempt to gain control of the company.\textsuperscript{144} Before Japonica’s disclosure statement was approved it launched a tender offer for subordinate debt and general unsecured claims of Allegheny’s subsidiary.\textsuperscript{145} The tender offer was not approved by the court and discriminated between members of the same creditor class in violation of 11 U.S.C. \S\ 1123(a)(4).\textsuperscript{146} Japonica’s strategic purchase of claims to advance its position as plan proponent constituted bad faith and hindered the reorganization process.\textsuperscript{147} Japonica’s acquisition of Allegheny International created benefits for creditors who were looking to exit, but it raised numerous regulatory concerns.

\textbf{VI. PROPOSED SOLUTIONS FOR CLAIMS TRADING}

Bankruptcy courts and commentators have struggled to find an appropriate method for regulating the harmful effects of claims trading. Given the positive effects, a complete prohibition on claims trading is not an appropriate solution.\textsuperscript{148} Still some regulation is needed to limit the effects of insider trading, breaches of fiduciary duties, and manipulation of the reorganization process. Bankruptcy courts have attempted to regulate claims trading by using their broad equitable powers to limit claims purchasers’ recovery to the amount they paid for their claims.\textsuperscript{149} Some commentators have called for the use of “big boy letters” and “Chinese Walls” to improve disclosure, limit reliance

\footnotesize
140. \textit{Id.} at 299.
141. \textit{Id.} at 287.
142. \textit{Id.} at 287, 292-93.
143. \textit{Allegheny Int’l}, 118 B.R. at 297.
144. \textit{Id.} at 299.
145. \textit{Id.} at 294-95.
146. \textit{Id.} at 295.
147. \textit{Id.} at 296.
based claims, and eliminate fiduciary liability. However, these mechanisms have failed to protect individual creditors.

One of the proposed remedies for dealing with problematic claims trading is to allow bankruptcy courts to exercise their equitable powers to regulate claim purchasers. Commentators suggest that the bankruptcy code provides adequate protections even when claim purchasers are seeking to gain control of the reorganized company. Bankruptcy courts have relied upon Bankruptcy Code Sections 1123(a)(4), 1125(b), and 1126(e) and their equitable powers to regulate claims trading. For example, as observed in Japonica’s acquisition of Allegheny, bankruptcy courts can utilize their equitable powers to designate votes of claim purchasers who acted in bad faith. Commentators who favor this approach believe that bankruptcy courts should be granted the flexibility to allow claims trading and determine whether an entity that is acquiring claims is actually harming creditors. They have also suggested that bankruptcy courts can protect creditors from the same abuses that securities laws protect against.

One way that bankruptcy courts have sought to protect the market against claims trading by insiders is to utilize their equitable powers to limit claims purchasers’ recovery to the amount they paid for their claims. In Citicorp, an investment firm, which was deemed an insider, acquired claims “at a significant discount” without disclosing its

150. Drain & Schwartz, supra note 14, at 620.
151. Id. at 621.
152. 11 U.S.C. § 1123(a)(4) (2005) (“Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest . . . ”).
153. 11 U.S.C. § 1125(b) (2005) An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor’s assets.
154. 11 U.S.C. § 1126(e)(2005) (“On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.”)
156. See supra part IV.
158. Id.
159. Citicorp, 160 F.3d at 991. See also Drain & Schwartz, supra note 14, at 589-90.
fiduciary status or obtaining approval from the board of directors, creditors’ committee, or bankruptcy court.\textsuperscript{160} The investment firm then opposed the reorganization plan and sought to introduce its own plan until it saw the bankruptcy court’s adverse reaction.\textsuperscript{161} The district court and Third Circuit upheld the bankruptcy court’s decision to use its equitable powers to limit the investment funds recovery to the aggregate purchase price of the claims.\textsuperscript{162}

Although the \textit{Citicorp} court made a valiant effort, its actions did not protect individual claim holders, but rather, protected the market by imposing a penalty designed to discourage future abusive practices.\textsuperscript{163} The \textit{Citicorp} decision may leave unsophisticated individual claim sellers unprotected. \textit{Citicorp} is also illustrative of another claims trading problem: insiders may purchase claims without disclosing their status.\textsuperscript{164} Some have suggested that this problem could be remedied by amending Rule 3001(e) to require purchasers to disclose their insider status.\textsuperscript{165} Again, at least one commentator has suggested that these problems could be solved by the combined use of big boy letters and Chinese Walls.\textsuperscript{166}

Big boy letters state that either or both parties to the claim transfer may have access to inside information and are used as a defense to insider trading liability.\textsuperscript{167} Big boy letters attempt avoid claims based on Rule 10b-5 by contractually eliminating reliance, a requirement of private Rule 10b-5 actions.\textsuperscript{168} Although some courts have upheld such contracts,\textsuperscript{169} the anti-waiver provision of Rule 10b-5 seems to preclude non-reliance letters.\textsuperscript{170} Even when they are allowed, big boy letters are only effective when they provide full disclosure and when both parties to the transaction are sophisticated. Proponents of big

\footnotesize{\textsuperscript{160} \textit{Citicorp}, 160 F.3d at 985.  
\textsuperscript{161} \textit{Id.} at 986.  
\textsuperscript{162} \textit{Id.} at 991.  
\textsuperscript{163} See \textit{Drain} \& \textit{Schwartz}, \textit{supra} note 14, at 589.  
\textsuperscript{164} \textit{Citicorp}, 160 F.3d at 985.  
\textsuperscript{165} See \textit{e.g.} \textit{Drain} \& \textit{Schwartz}, \textit{supra} note 14.  
\textsuperscript{167} \textit{Drain} \& \textit{Schwartz}, \textit{supra} note 14, 533.  
\textsuperscript{168} Sullivan, \textit{supra} note 166 at 560.  
\textsuperscript{169} See \textit{e.g.} \textit{id.} (citing Harsco v. Segui, 91 F.3d 337, 339 (2d Cir. 1996)).  
\textsuperscript{170} 15 U.S.C. § 78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."). \textit{But see AES Corp. v. Dow Chemical Co.}, 325 F.3d 174, 180 (3d Cir. 2003) (holding that a non-reliance clause did not bar a Rule 10b-5 claims, but may be considered as evidence on the issue of reliance).}
boy letters recognize that they are not sufficient to solve problematic claims trading, because they do not address fiduciary liability.\textsuperscript{171}

To eliminate fiduciary liability, some suggest implementing Chinese Walls to separate an entity's fiduciary activities from its claims purchasing activities. Bankruptcy courts have permitted the use of Chinese Walls to establish a defense for claims trading.\textsuperscript{172} In theory, Chinese Walls have some value when they separate an entity's purchasing activity from its role on a creditors committee. However, as observed in Japonica's acquisition of Allegheny, sometimes an investment firm's status as a fiduciary is derived from its status as a plan proponent; a role that is inextricably linked to the value of bankruptcy claims.\textsuperscript{173} In addition, Allegheny illustrates a practical problem—hedge funds are often small, closely held entities and there is no guarantee that a Chinese Wall would remain effective.

Big boy letters can improve disclosures between claims purchasers and sellers, and Chinese Walls can separate fiduciary activities from purchasing activities.\textsuperscript{174} But these mechanisms are designed to limit liability for claims purchasers.\textsuperscript{175} While they may aid purchasers in limiting their liability, they do not adequately protect sellers from fraud. Even if they are combined, big boy letters and Chinese Walls should not replace a bankruptcy court's ability to engage in equitable subordination or offer rescission through the imposition of federal securities laws.

\textbf{VII. Applying Securities Laws to Bankruptcy Claims}

This section begins by reviewing when claims should be considered securities. Bankruptcy claims do not instantly become securities once a bankruptcy proceeding is filed. However, sometimes claims clearly fall within the definition of a security. The second subsection develops the proposed regulatory regime for bankruptcy claims. This article envisions shared responsibility for claims regulation between the bankruptcy court and Securities and Exchange Commission. The bankruptcy courts would have the primary responsibility for regulating claims transactions, but could call upon the expertise of the Commission if securities laws were invoked.

\textsuperscript{171} Sullivan, \textit{supra} note 166, at 559.
\textsuperscript{172} See id. at 556 citing In re Federated Dep't Stores, Inc. 1991 WL 79143, *2 (Bankr. S.D. Ohio).
\textsuperscript{173} Allegheny \textit{Int'l}, 118 B.R. at 299.
\textsuperscript{174} Sullivan, \textit{supra} note 166, at 533.
\textsuperscript{175} Id.
A. Converted Claims Are Securities

Securities laws ought to apply when claims are purchased and converted into an equity position in the reorganized entity. The economic reality of this transaction on the whole cannot be distinguished from one that involves a security. If bankruptcy claims are not converted, they ought to be classified based on their underlying instruments. Bankruptcy claims that arise from securities must be treated as securities at all times. Some claims are based on instruments that are not securities, such as claims based on judgments, trade debt, contracts, and wages. Federal securities laws should not apply to these claims unless they are purchased and converted into an equity position in the reorganized entity.

When a buyer purchases a bankruptcy claim with the intent to convert it, and succeeds in converting it into an equity position in the reorganized entity, the buyer has purchased a security. Landreth and Forman stand for the proposition that the name given to the instrument is not as important as the economic reality of the transaction. Stated differently, the substance of the transaction is more important than its form. In purchasing and converting a claim, the buyer invests to earn a profit and receives a tradable, negotiable instrument that performs a capital raising function for the seller. The economic reality of this transaction, on the whole, so closely resembles the form of a security that it must be treated as one. This is especially true when claims are purchased after a reorganization plan that converts those claims into equity in the reorganized entity being filed. Even opponents of applying securities laws to bankruptcy claims have acknowledged that this type of transaction presents a strong case for imposing federal securities laws.

Japonica's acquisition of Allegheny International represents the paradigm case of an investor purchasing and converting claims to which federal securities laws ought to apply. Japonica purchased claims with the intent of controlling the debtor and converting the

176. Compare Landreth, 471 U.S. at 686 with Forman, 421 U.S. at 2059. See also supra Part II.B.

177. Forman, 421 U.S. at 2059.

178. Fortgang & Mayer, supra note 2, at 8 ("By paying cash for claims and, in effect, converting claims to securities, postpetition investors perform a capital raising function.").

179. See supra Part VI.B.

180. This transaction closely resembles a call option, because the purchaser can hold the claim until a certain date and obtain equity or resell it in a secondary market.


182. See supra Parts III and IV.
claims into an equity position in the reorganized entity.\footnote{183}{Allegheny Int'l, 118 B.R. at 289-90.} The court inferred this intent from Japonica's long standing interest in acquiring the debtor and the manner in which the claims were purchased.\footnote{184}{Id. at 295.} The court noted that Japonica began purchasing claims at 80\% of their face value, increased this percentage to 85\%, and eventually paid 95\% of face value in order to obtain a blocking position.\footnote{185}{Id. at 287.} Once the blocking position was obtained, Japonica purchased claims at 82\% of the face value.\footnote{186}{Id.} This pattern revealed Japonica's true motive: to secure a blocking position that would aid its acquisition efforts. In addition, Japonica did not begin purchasing claims until after a reorganization plan, which converted the claims into an equity position in the reorganized entity, was filed. After purchasing the claims, Japonica was able to convert them into equity ownership of the reorganized entity. The economic reality of Japonica's purchase closely resembles a stock purchase.

Whether securities laws should apply when a claim is not converted to an equity position depends on the nature of the underlying instrument. Securities laws ought to apply to claims based on instruments that were securities before the petition date. Examples of these types of instruments include the company's prepetition stock, bonds, and debentures.\footnote{187}{Securities and Exchange Act § 3(a)(10).} As observed in \textit{Landreth}, when an instrument purports to be an item that is specifically defined as a security and possesses the characteristics of that instrument, it is a security.\footnote{188}{Landreth, 471 U.S. at 686.} Put differently, claims based on stocks, bonds, and debentures bear a strong resemblance to the form of a security. If securities laws did not apply to these instruments, then filing bankruptcy would come with the unfortunate consequence of eliminating the protections of federal securities laws.

Not all of the instruments that give rise to bankruptcy claims are based on securities. These types of claims should not be treated as securities unless they are purchased and converted into equity in the reorganized entity. Claims based on trade debt (or trade claims) are one example of this category of claims. To determine whether unconverted trade claims are securities we must apply the \textit{Reves} test to the underlying instrument.\footnote{189}{Reves, 494 U.S. at 65-66.} The Second Circuit decision that first articulated the family resemblance test found that a note which simply
formalizes an open-account debt incurred in the ordinary course of business, such as a trade claim, was presumptively not a security.\textsuperscript{190}

However, the four-factor \textit{Reves} test must also be applied to the underlying trade claims. In terms of motivations, trade claims arise to facilitate purchases and sales in the ordinary course of business. They are not designed to fulfill investment goals or to perform traditional capital raising functions. Trade claims are not typically distributed to the public and are not commonly traded. In addition, trade debts are not viewed or portrayed as investments. Finally, trade debts may be secured by collateral. Given that at least three of the four \textit{Reves} factors favor the finding that trade debts are not securities and that they were on the judicially crafted list of exceptions, claims based on these instruments should not be treated as securities unless they are purchased and converted into equity in the reorganized entity.

In conclusion, bankruptcy claims based on securities, and claims that are purchased and converted into equity in the reorganized entity, fall within the definition of a security. Other bankruptcy claims such as claims based on trade debt, wages, and liens do not fall within this definition.

\textbf{B. Regulating Claims Transactions}

The goal of any regulatory scheme applied to bankruptcy claims is to allow creditors and debtors to obtain the benefits of claims trading while preventing the abuses that can arise from these transactions. The proposed regime permits claims transfers but regulates them in two ways. First, bankruptcy courts would utilize their equitable powers to regulate claims transfers that did not qualify as securities. Second, federal securities laws would be applied to claims that are based on securities or to claims that are purchased and converted into equity in the reorganized entity.Treating these claims as securities does not invoke all federal securities laws, because certain exemptions would continue to apply. Rather than conduct an expansive review of securities law implications, this article reviews how the disclosure requirements and insider trading laws could be applied. A key advantage of the proposed resolution is that it allows bankruptcy courts to continue to operate efficiently but permits securities law experts to enforce insider trading laws.

Even though converted bankruptcy claims fall within the definition of a "security," not all of the federal securities laws apply. Section 1145(a) of the Bankruptcy Code provides an exemption that allows a

reorganizing entity to issue securities without fulfilling the disclosure and registration requirements of the Securities Act. One of the justifications for this exemption is that the Bankruptcy Code already requires debtors to make significant disclosures and obtain court approval of its disclosure statement. This exemption also allows debtors to avoid the costs and time consumed by preparing and filing a registration statement. Section 1145(b) exempts certain creditors and shareholders from being considered underwriters for purposes of the Securities Act. As legal scholars Fortgang and Mayer observed, "The SEC has liberally interpreted these provisions in various no-action letters." The current bankruptcy disclosure regime and securities law exemption should continue to be applied even when claims are converted into equity.

Recognizing that converted claims are securities allows the Securities and Exchange Commission, as well as private plaintiffs, to enforce insider trading laws. Purchasing claims can involve many of the elements of traditional insider trading. The "deceptive device" provisions of Section 10(b) and Rule 10b-5 are violated when corporate insiders trade their company's securities on the basis of material, non-public information. Corporate insiders owe stockholders a duty to disclose or refrain from trading in order to prevent them from taking advantage of uniformed parties. This duty arises from the relationship of trust and confidence that exists between shareholders and corporate insiders. Classical insider trading theory also applies to temporary corporate insiders who become fiduciaries.

Japonica’s acquisition of Allegheny International presented many of the elements of insider trading. The bankruptcy court found that Japonica was an insider, because it had vast knowledge of the most intimate details of the company. Japonica was positioned inside Allegheny's corporate office and was given access to material, non-public financial information. As a temporary insider, Japonica was placed in a position of trust and confidence and owed other creditors a

191. 11 U.S.C. § 1145(a). For greater detail on the technical aspects of this provision see Fortgang & Mayer, supra note 2, at 57 and Drain & Schwartz, supra note 14, at 624.
195. Id. at 652.
196. Id.
199. Id. at 298.
fiduciary duty. Therefore, the firm needed to make adequate disclosures in order to avoid insider trading liability. If Japonica failed to make adequate disclosures and federal securities laws were applied, the firm could have faced civil and criminal penalties.

When claims are not considered securities, the bankruptcy courts should continue to utilize their equitable powers to seek remedies for abusive transactions. Bankruptcy courts have broad power to enforce equitable remedies. If abusive trading occurs, courts may use equitable subordination to limit purchasers’ ability to recover and protect the market as a whole. Courts should also consider offering former claim holders the right to rescind their sales in order to protect individual creditors. Offering securities law remedies, such as rescinding a sale, has been classified by some commentators as applying securities laws by analogy. Bankruptcy courts should utilize these remedies in order to protect the market as well as individual claims sellers.

One advantage the proposed regime is that it permits a dual regulatory effort under which both bankruptcy courts and the Securities and Exchange Commission could regulate claims trading. Bankruptcy courts would have the primary responsibility for regulating claims transfers, but they could contact the Commission if securities laws were implicated. Several statutory provisions support this type of dual regulatory regime. An explanatory comment to Bankruptcy Rule 3001(e) states that the claims transfer provisions are “not intended to either encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under nonbankruptcy law...” This provision seems to support the application of federal securities laws to claims transfers. In addition, section 1109(a) states “The Securities and Exchange Commission may raise and may appear and be heard on any issue in a case under this chapter,...”

The proposed regime allows creditors and debtors to continue to sell their claims rather than endure a bankruptcy proceeding. Purchasers are free to accumulate claims; however, if the claims are converted into an equity position, federal securities laws will apply. Applying federal securities laws should not change bankruptcy's disclosure requirements, but would allow the SEC and claims sellers to

200. Id. at 298-99.
202. 11 U.S.C. § 105 (“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the title.”).
203. Drain & Schwartz, supra note 14 at 574-75.
205. But see Drain & Schwartz, supra note 14 at 579-80.
pursue securities fraud and insider trading actions. This remedy will encourage purchasers who have inside information, and are plan proponents or creditors committee members, to make complete disclosures prior to purchasing claims. If purchasers fail to abide by the anti-fraud provisions of the Securities and Exchange Act, claims sellers will be able to seek civil damages such as rescission of the sale or disgorgement of profits. Criminal sanctions could also be imposed on purchasers who trade based on inside information.

VIII. Conclusion

Greed is the fundamental driver of a market economy, but greed comes in two forms. Greed can be helpful when it spurs innovation and renewal, but greed is harmful when it seeks gain solely at the cost of others. The job of market regulators is to separate beneficial greed from harmful greed. The problem with regulating claims trading is that it can be difficult to determine whether a purchaser is motivated by a helpful or harmful form of greed. For example, Japonica’s greed was beneficial in that the firm relentlessly sought to acquire a company, oust an ineffective management team, and rebuild a struggling manufacturer. But Japonica’s greed was also harmful, because it utilized inside information to acquire claims from creditors to whom it owed a fiduciary duty. The transaction on the whole was beneficial, but the means may have harmed some creditors. Any effective regulatory regime should separate the two forms of greed by allowing claims trading transfers that benefit all of the parties involved and penalizing transfers that have harmful effects.

The most important purpose of this article is to renew the discussion of the regulatory problems of claims trading at a time when our nation’s creditors are facing a tremendous increase in the number of bankruptcy filings. The proposed regulatory regime recognizes that purchasing claims and converting them into equity in a reorganized entity is clearly an investment to which federal securities laws ought to apply. Applying securities laws provides creditors with additional remedies, including rescission, to insure against abusive claims trading practices.