McGeorge Law Review

Volume 24 | Issue 1 Article 6

1-1-1992

No Security in Bankruptcy: The Argument against Applying the Federal Securities Laws to the Trading of Claims in Bankruptcy

Anthony Michael Sabino
University of the Pacific; McGeorge School of Law

No Security In Bankruptcy: The Argument Against Applying The Federal Securities Laws To The Trading Of Claims In Bankruptcy

Anthony Michael Sabino*

PREAMBLE

As many of the megamergers and leveraged buyouts of the Nineteen Eighties sink into the abyss of bankruptcy--Nineteen Nineties style, a new species of predator has come into being. Be they called "vulture" investors or funds, "bottom-fishers" or just plain bargain hunters. These carnivores are more than just in town with a few days to kill. They hunt for the "turnaround play," that is, taking control of a bankrupt company for as cheaply as possible, and resurrecting it into a profitable enterprise.

As the emerging trend of cases have amply demonstrated, their weapon of choice is trading in claims against the debtor.[1] One court recently observed:

> [S]ince the recent filings of "megacases" the trading in claims has become a brisk business which involves millions of dollars. Numerous articles and bankruptcy law seminars have addressed the trading of claims that has come about as a result of these cases. Several

---

* Anthony M. Sabino is an Associate Attorney with Marks & Murase in New York, New York. Mr. Sabino is also an Adjunct Professor of Law at St. John's University College of Business and Administration. Mr. Sabino was formerly Judicial Law Clerk to the Honorable D. Joseph DeVito, United States Bankruptcy Court for the District of New Jersey. Mr. Sabino received is B.A. (1980) from St. John's University College of Business Administration and his J.D. (1983) from St. John's University School of Law.

The author dedicates this article with deepest affection to Michael Anthony Sabino, and to all his hopes and dreams.

1. The penultimate case in this realm is *In re* Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990), while probably the most erudite discussion of the general issue is found in Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990).

bankruptcy judges have also expressed concern over the increased claims trading.[2]

Given the similarities of trading in claims for the purpose of taking control of a debtor to the trading in securities of solvent companies for the same purpose, the question naturally arises as to how the former burgeoning market should be regulated, if at all. On one side, some noted veterans of this new order of battle in the bankruptcy court have stated that "[t]he securities laws do not, either on their face or as interpreted by recent decisions, define trade claims in bankruptcy as "securities.""[3] In contrast, others have concluded that the federal securities code is readily adaptable to the claims trading process in the bankruptcy court.[4]

To be sure, this writer has not shied away, in the past, from advocating a greater confluence of the Bankruptcy Code[5] and the federal securities laws in matters where business entities subject to securities regulation are brought into proceedings governed by bankruptcy law.[6] Notwithstanding that history, the author must nonetheless veer from that course today, for it seems apparent that a number of reasons exist why federal securities laws[7] should not apply to the trading of claims in bankruptcy. This Article will explore the reasoning underlying that conclusion, in the hope of advancing the debate on this critical issue to a just result.

---

2. *In re* Odd Lot Trading, Inc., 115 B.R. 97, 100 (Bankr. N.D. Ohio 1990) (White, J.).
3. Fortgang & Mayer, *supra* n. 1, at 47.
4. James D. Prendergast, *Applying Federal Securities Law to the Trading of Bankruptcy Claims*, 3 F&G BANKR. L. REV. 9, 17 (Winter 1992).
5. 11 U.S.C. §§ 101-1330 (1992).
6. *See* Anthony M. Sabino & Sabino, *The Role of the SEC in Bankruptcy*, 2 F&G BANKR. L. REV. 5 (Winter 1991); Anthony M. Sabino, *The Role of Bankruptcy Courts in Stockbrokerage Liquidations*, 16 SEC. REG. L.J. 227 (1988).
7. The federal securities laws referred to herein are the Securities Act of 1933, *codified at* 15 U.S.C. §§ 77a-77bbb (1992), and the Securities Exchange Act of 1934, *codified at* 15 U.S.C. §§ 78a-78lll (1992), also known as the 1933 and 1934 Acts, respectively.

I. THE EXISTING CLAIMS TRADING PROCESS

A. The Controversy Begins

While not dispositive of the precise issue here, *In re Allegheny*[8] must be examined as the precursor to the present controversy. In this case, the debtor was the target of an attempted takeover by Japonica Partners, a limited partnership created by two former investment bankers.[9] "Japonica had been a stranger to Allegheny - neither a creditor nor a shareholder of the company . . . Unable to negotiate a takeover, Japonica decided to pursue the company in a different way."[10] In short, Japonica went on a spree of purchasing creditors' claims, in order to both block the debtor's reorganization plan and ensure the acceptance of Japonica's own plan for control.[11] Although the insurgent's campaign was stopped cold by the bankruptcy court,[12] Japonica ultimately settled with all parties and brought the debtor out of bankruptcy.[13]

Allegheny has become the most notorious example of the trading in claims for our times. Indeed, the case rises to the level of infamy, given Bankruptcy Judge Cosetti's excoriation of the erstwhile takeover mavens at Japonica. Whatever the outcome, however, *Allegheny* is looked to as the catalyst of the present debate over the desirability of claims trading, including the instant question of applying the federal securities laws to the trading of claims in bankruptcy.[14]

Moreover, the herald to the landmark *Allegheny* case was an earlier decision in that same proceeding, wherein the court strictly circumscribed the conditions under which creditor claims could be

8. *In re* Allegheny Int'l, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990).
9. *Id.* at 285.
10. John J. Jerome & Richard C. Tufaro, *Mergers and Acquisitions in Bankruptcy Court: The Allegheny Experience*, 3 F&G BANKR. L. REV. 12, 13 (Spring, 1991).
11. *Id.* at 13; *see Allegheny*, 118 B.R. at 286-87.
12. *Allegheny*, 118 B.R. at 303.
13. John J. Jerome & Richard C. Tufaro, *supra* note 10, at 16-17.
14. *See generally* Prendergrast, *supra* note 4, at 17; Fortgang & Mayer, *supra* note 1, at 45-46.

purchased by a potential acquiror.[15] Notably, there were the grave concerns expressed by the court as to the very propriety of claims trading.[16] Clearly, the *Allegheny* court forewarned of the momentous decision yet to come, and, as shall be seen herein, thereby compelled the subsequent revision of the relevant Federal Rules of Bankruptcy Procedure to their present form.

B. The Revised Rule 3001

A significant event which resulted at least in part from the debate over the trading of claims in bankruptcy was the most recent revision of Federal Rule of Bankruptcy Procedure 3001.[17] Previously, the Rule called upon the bankruptcy judge to play a major role in supervising the transfer of any claim against the debtor.[18] Indeed, some courts looked to the then-existing rule as support for the "heightened scrutiny of transfers of claims."[19]

In the Preliminary Draft of Proposed Amendments to the Bankruptcy Rules, presented in August of 1989,[20] the Advisory Committee Note to Rule 3001 made it clear as crystal that the judiciary had decided it was time for bankruptcy judges to depart from the task of overseeing the trading of claims.[21]

---

15. *In re* Allegheny Int'l, Inc., 100 B.R. 241, 243-44 (Bankr. W.D. Pa. 1988).

16. *Id.* at 243. Judge Cosetti opined:

> By the filing of a bankruptcy case, a market in nonpublicly traded securities is created. Claimants are not protected by a disclosure statement. It is an undesirable practice . . . . We do not believe that Congress intended the trafficking in claims such as has occurred in this case and others . . . . Although this case does not involve inside knowledge, it is colored with superior knowledge, and thus the assignments are similar to contracts of adhesion. We hope that Congress will address these concerns in the future.

Id.

17. *See* Act of July 10, 1984, Pub. L. No. 93-353, § 354, 98 Stat. 333 (amending FED. R. BANKR. P. 3001); Prendergast, *supra* note 4, at 9.

18. *See* Act of July 10, 1984, Pub. L. No. 93-353, § 354, 98 Stat. 333 (amending FED. R. BANKR. P. 3001); Prendergast, *supra* note 4, at 10.

19. *See, e.g., In re* FRG, Inc., 124 B.R. 653, 656-57 (Bankr. E.D. Pa. 1991).

20. *See generally* Anthony M. Sabino, *New Bankruptcy Rules for the New Decade*, 1 F&G BANKR. L. REV. 22 (Winter 1990) (discussing the Preliminary Draft of Proposed Amendments to the Bankruptcy Rules).

21. Fed. R. Bank. P. 3001(e), Advisory Committee's Note, *reported at* 126 F.R.D. 193-94 (1989). The Note stated:

As could be expected, the text of the present Rule accurately reflects the intent of the Note,[22] by making the entire process quite automatic and mechanical, with court participation allowed only in exceptional cases.[23] As stated by Bankruptcy Judge White even before the amended Rule 3001 took effect, "the purpose of the amendment is to lessen the [c]ourt's involvement when claims are transferred."[24]

In sum, "[t]hese revisions have eliminated any statutory support for the bankruptcy court's ability to involve itself in the trading of claims" pursuant to the Rule.[25] Beyond question, much of the *Allegheny* ruling would not be possible today under the structure of the new Rule 3001. The amended provision has taken away the power of the bankruptcy court to inject itself into the claims trading process, negating the precedent of *Allegheny* for judicial control over trading in claims. As in nature, the law abhors a vacuum, and it is this delimiting of Rule 3001 that has incited the instant debate.

C. *The Aftermath of the New Rule 3001*

In some circles, the retreat of the bankruptcy court from this arena has given rise to fears that the law of the financial jungle

---

> *Subdivision (e)* [of Rule 3001] is amended to limit the court's role to the adjudication of disputes regarding transfers of claims. If a claim has been transferred prior to the filing of a proof of claim, there is no need to state the consideration for the transfer or to submit other evidence of the transfer. If a claim has been transferred other than for security after a proof of claim has been filed, the transferee is substituted for the transferor in the absence of a timely objection by the alleged transferor. In that event, the clerk should note the transfer without the need for court approval. 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. "After notice and a hearing" as used in subdivision (e) shall be construed in accordance with paragraph (5).

Id. (emphasis added).

22. *See* Fed. R. Bankr. P. 3001(e), *reported at* 135 F.R.D. 279-82 (1991).

23. *See In re* Ionosphere Clubs, Inc., 119 B.R. 440, 444 (Bankr. S.D.N.Y. 1990) (holding that the amended rule "takes the bankruptcy court out of the administrative loop").

24. *In re* Odd Lot Trading, Inc., 115 B.R. 97, 101 (Bankr. N.D. Ohio 1990).

25. Prendergast, *supra* note 4, at 10.

will take hold, with sophisticated, yet unscrupulous "sharks" devouring more diminutive claimholders.[26] Left unchecked, they say, parties who seek to take control of a debtor by buying up creditors' claims will prey upon weaker stakeholders, who simply want to see some recovery today and extricate themselves from the often times painful process of bankruptcy.[27]

Focusing upon the Committee's statement that the changes to Rule 3001 are not intended to affect any non-bankruptcy remedies that a deceived claims seller may have against a misrepresenting buyer, well-intentioned prophets of doom have cried out for the insertion of an appropriate regulatory scheme.[28] To that end, the federal securities laws, a proven watchdog of another kind, have been offered as having the greatest adaptability to the problem at hand.[29] While the goal here is laudable, and the federal laws are inarguably potent tools for enforcement, the viability of this proposal remains to be tested. The adaptability and effectiveness of the securities laws will constitute the next phase of this analysis.

II. WHAT IS A SECURITY? THE *REVES* TEST

Whether making the argument for or against the application of the federal securities laws to the trading of claims in bankruptcy cases, commentators have heretofore relied heavily upon the jurisprudence of the Supreme Court in deciding what constitutes a security regulated by the federal statutory scheme.[30] Most recent and powerful in that realm is the high Court's decision in *Reves v. Ernst & Young*.[31] Following the trail already blazed by others, this article likewise heads in a similar direction.

The facts of the case are relatively straightforward. Writing for the Court, Justice Marshall posited that the question before the

26. For a general commentary on the growth of "vulture investing" in reorganizing companies, see David G. Heiman & Shawn M. Riley, *Are Vulture Investors Changing the Face of Chapter 11?*, 2 F&G BANKR. L. REV. 5 (Fall 1990).

27. *See generally* Fortgang & Mayer, *supra* note 1, at 84; Prendergast, *supra* note 4, at 17.

28. Prendergast, *supra* note 4, at 17.

29. *Id.* at 11.

30. *Id.* at 11-12.

31. 494 U.S. 56 (1990).

tribunal was whether certain demand notes issued by a farmers' cooperative constituted securities within the meaning of section 3(a)(10) of the Securities Exchange Act of 1934.[32]

Of paramount relevancy here were the facts that the alleged "securities" were promissory notes payable upon demand, paying a variable rate of interest adjusted monthly, and that the scheme was marketed as an "investment program."[33] Although the co-op did warn that the notes were not federally insured, the investment was touted, nevertheless, as safe, secure, and readily available.[34] Unfortunately, the co-op went into bankruptcy, leaving over 1,600 persons holding notes worth a total of $10 million.[35] After the noteholders prevailed at trial,[36] the Court of Appeals for the Eighth Circuit reversed, agreeing with the defendants that the demand notes were not securities, and therefore, the federal securities statutes did not apply.[37]

The Supreme Court reversed, and found for the noteholders.[38] In setting forth its reasoning,[39] the high Court first acknowledged that "Congress painted with a broad brush" in creating the

---

32. *Id.* at 58. *See* 15 U.S.C. § 78(a)(10) (1992). The statute reads as follows:

> The term "security" means any note, stock, treasury stock, 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 like-wise limited.

Id.

33. *Reves*, 494 U.S. at 58-59.
34. *Id.* at 59.
35. *Id.* at 58-59.
36. *Id.* at 59.
37. Arthur Young & Co. v. Reves, 856 F.2d 52, 55 (1988).
38. *Reves*, 494 U.S. at 60.
39. It should be noted that although the Court divided elsewhere, the Justices were unanimous in the rationale. *Id.* at 58.

securities acts, "recogniz[ing] 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.'"[40] *Per force*, the Congressional vision of a security is "sufficiently broad to encompass virtually any instrument that might be sold as an investment."[41]

Yet it is also true, continued Justice Marshall, that the lawmakers did not intend to provide a pervasive federal remedy for all fraud.[42] Ultimately, it is for the courts to define a security within the ambit of the securities code,[43] a task in which the judges must "take account of the economics of the transaction under investigation," and not its mere formalities.[44] Going forward, the high Court contrasted stock, which it viewed as the quintessence of a security,[45] with a note, which can be used "in a variety of settings, not all of which involve investments."[46] Rejecting the applicability of the "investment contract" test it devised in *SEC v. W.J. Howey Co.*[47] to the instant "note" controversy,[48] the Justices adopted the "family resemblance" test pioneered by the Court of Appeals for the Second Circuit in *Exchange Nat. Bank of Chicago v. Touche Ross & Co.*,[49] adding the new presumption "that every note is a security."[50]

Importantly, the Supreme Court agreed with the list of items identified by the appellate tribunal in *Exchange National Bank* as

40. *Id.* at 60-61 (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946)).

41. *Id.* at 61. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847-48 (1975) (discussing the congressional interpretation of what constitutes a security).

42. *Reves*, 494 U.S. at 61 (quoting Marine Bank v. Weaver, 455 U.S. 551, 556 (1982)).

43. *Id.* The Court added that it has consistently held that the definition of a security is the same under both the 1933 and 1934 Acts. *Id.* at 61 n.1; *see* S. Rep. 792, 73rd Cong., 2d Sess. 14 (1934) (stating that the Senate Report on the 1934 Act stated that the definition of a security therein was "substantially the same" as the 1933 Act's definition).

44. *Reves*, 494 U.S. at 61.

45. *Id.* at 62 (citing Landreth Timber Co. v. Landreth, 471 U.S. 681, 693 (1985)).

46. *Id.*

47. 328 U.S. 293 (1946).

48. *Reves*, 494 U.S. at 64.

49. 544 F.2d 1126, 1137 (2d Cir. 1976).

50. *Reves*, 494 U.S. at 65 (footnote omitted).

not being securities, including notes delivered in consumer financing, notes secured by a mortgage on a home, short-term notes secured by a lien on a small business or some or all of its assets, notes evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, notes which simply formalize 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), and notes evidencing loans by commercial banks to borrowers for sustaining operations.[51] Finding a need for more guidance, however, Justice Marshall elaborated by setting forth the standards of the new "note as a security" test.[52]

Thus, the Supreme Court promulgated the modern test for determining whether a note is a security actionable under the federal securities laws. Commencing with the presumption that a "note" is a security, that presumption is only to be rebutted by a demonstration that the instrument bears a strong "family

51. *Id.* (citations omitted).

52. *Id.* at 66-67. Justice Marshall opined:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."

Id. at 66. For the second and third prongs, the Court instructed:

> [W]e examine the "plan of distribution" of the instrument, SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943), to determine whether it is an instrument in which there is "common trading for speculation or investment," *id.*, at 351. Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.

Id. Finally, the last point for scrutiny under this new test would be:

> [W]hether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

Id. at 67.

resemblance'' to one of the foregoing exceptions or represents a new category worthy of exemption under the same test.[53]

Applying the foundling test to the controversy at hand, the high Court had ''little difficulty'' in concluding the co-op's notes were in fact securities.[54] Examining the co-op's distribution scheme for the notes, the Court pointed out that they were offered and sold to a ''broad segment of the public,'' thus establishing the ''common trading'' facet referred to in earlier holdings.[55] Next, ''the public's reasonable perceptions - also supports a finding that the notes in this case [were] 'securities,''' given that the co-op explicitly characterized them as investments.[56] Lastly, the Court found that the notes did not possess a ''risk-reducing factor,'' by way of another applicable regulatory scheme, to suggest they were, in fact, not securities.[57]

The Justices furthermore rejected the argument that, because the notes were payable upon demand, they therefore could not be securities.[58] Noting that common stock, ''the paradigm of a security,'' is readily convertible to cash, the Court went on to find that the same is true of ''publicly traded corporate bonds,

---

53. *Id.*

54. *Id.* Justice Marshall wrote:

> The Co-Op sold the notes in an effort to raise capital for its general business operations, and purchasers bought them in order to earn a profit in the form of interest. . .[T]hen, the transaction is most naturally conceived as an investment in a business enterprise rather than as a purely commercial or consumer transaction.

Id. at 67-68 (footnote omitted).

55. *Id.* at 68. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 693 (1985) (discussing the "common trading" aspect of the definition of a security).

56. *Reves*, 494 U.S. at 68-69.

57. *Id.* at 69. Justice Marshall compared and stated:

> [U]nlike the certificates of deposit in *Marine Bank, supra*, at 557-558, which were insured by the Federal Deposit Insurance Corporation and subject to substantial regulation under the federal banking laws, and unlike the pension plan in *Teamsters v. Daniel*, 439 U.S. 551, 569-570 (1979), which was comprehensively regulated under the Employee Retirement Income Security Act of 1974, 88 Stat. 829, 29 U.S.C. § 1001 *et seq.* (1982 ed.), the notes here would escape federal regulation entirely if the [securities] Acts were held not to apply.

Id.

58. *Id.*

debentures, and any number of other instruments," all of which fall within the clear provisions of the federal securities code.[59]

In view of all the above, the Supreme Court held that the notes at issue in *Reves* were securities within the term "note," as found in both the 1933 and 1934 Acts, and, therefore, subject to the federal securities laws.[60] *Reves* presents the most recent wisdom of the Supreme Court on the question of what constitutes a security subject to federal regulation. Thus, the decision will play a key role here, for to employ the federal securities laws to regulate the trading in claims means we must determine if a bankruptcy claim is a security under *Reves*.

III. DISCUSSION

As previously explained, the *Reves* formulation of what qualifies as a security constitutes the most critical phase of our analysis. To be sure, however, to answer the question of whether claims trading in bankruptcy should be subject to the federal securities laws demands a comprehensive review of other important aspects of the issue as well. Sensibly, we should therefore commence by examining the letter of the law itself.

A. Statutory Analysis

Key to this calculus is the overall perception of the bankruptcy claim that is to be traded. Is it simply a creditor's claim for payment or is it more like a security? At least one commentator theorizes that the filing of the bankruptcy petition transmutes even the ordinary trade claim into a security, because the claimant now has the right to a "dividend," that is, in bankruptcy parlance, a right to participate with other creditors in any payout from the debtor's estate.[61]

---

59. *Id.*
60. *Id.* at 69-70.
61. *See* Prendergast, *supra* note 4, at 12.

However, it is submitted here that such a facile analysis of the so-called bankruptcy "dividend" is flawed when compared to the statutory provisions of the Bankruptcy Code. First, it does not account for a claimant in bankruptcy that is a member of an unimpaired class. A creditor fortunate enough to have its claim left unaltered by the proceeding, in short one receiving full value, is deemed unimpaired.[62] In this writer's view, it is beyond cavil that such a claim is constant throughout the bankruptcy process, and thus could never be transformed into a security.

Moreover, if the creditor body is comprised of impaired claimants as well as claims that survive unimpaired, as is often the case, is it not inequitable, if not irrational, to further segregate those stakeholders into unimpaired straight claimants and impaired "security" holders? Added to this tempestuous brew is the frequent occurrence of differing degrees of impairment amongst the creditor classes in anything other than the most simple of bankruptcy reorganizations. While not an overriding concern, one can appreciate the potential for an Orwellian absurdity here, as claimants devolve into a "some claims are more like securities than others" scenario.

The second flaw in this claim-as-security theorem is that a claim against the debtor is far different from the typical commercial transaction originally underlying the pre-bankruptcy debtor-creditor relationship. At the outset, the Bankruptcy Code defines a "claim" as a:

> (A) right to payment, whether or not such right is reduced to judgment, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) 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 an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.[63]

62. *See* 11 U.S.C. § 1124 (1992).
63. *Id.* § 101(5) (1992).

Indeed, the corollary to the foregoing is the Code's definition, in relevant part, of a creditor as an entity with "a claim against the debtor that arose at the time of or before" the bankruptcy commenced.[64]

Neither the letter nor the spirit of the foregoing unambiguous definitions lend support to the hypothesis that a claim can be metamorphosized into a security on the event of a bankruptcy filing. Indeed, the recent demands of the Supreme Court that the provisions of the Bankruptcy Code be given their plain meaning[65] militates strongly against what could only be characterized as this tortured extension of those basic definitions. Specifically, Justice Marshall subsequently opined that the scope of the definition of a bankruptcy claim "is a straightforward issue of statutory construction to be resolved by reference to 'the text, history, and purpose' of the Bankruptcy Code."[66] In sum, a claim stays a claim.[67] If so, it never becomes a security, and any application of the federal securities laws would be in error.

To be sure, it has been argued that the buyer of a claim is usually a "financial acquiror seeking to obtain a position in the case, or perhaps a strategic buyer wanting to control the plan process, all of which are investment motivations and not the promotion of a commercial purpose."[68] No doubt this is true, but it ignores the relevancy of the claim *seller* under the same test.

The transferee of a claim is a straightforward creditor of the debtor. Almost invariably, it sells out because it no longer wishes to wait to satisfy its claim via the bankruptcy process. The claimant presumably makes a commercial business decision to convert its claim into cash, as offered by the claims buyer. The claimant does this because it certainly does not want to "invest" in the debtor--it

---

64. *Id.* § 101(10)(A) (1992).

65. *See* United States v. Ron Pair Enter., Inc., 489 U.S. 235, 241-42 (1989) (discussing pressures to interpret Bankruptcy Code provisions in the context of their plain meaning), *followed by* Connecticut Nat'l Bank v. Germain, 112 S.Ct. 1146, 60 U.S. L.W. 4222 (March 9, 1992).

66. Johnson v. Home State Bank, 111 S. Ct. 2150, 2153 (1991) (quoting Farrey v. Sanderfoot, 111 S. Ct. 1825, 1830 (1991)).

67. *Cf.* Pennsylvania Dep't of Public Welfare v. Davenport, 495 U.S. 552, 558 (1990) (Congress intended to adopt the broadest possible definition of "claim").

68. Prendergast, *supra* note 4, at 13.

wants to walk away under the best possible circumstances. If so, why then would the mere fact of the transfer convert the claim into a security, merely because of the differing motivations of the parties? While the claims trader is no doubt bent on takeover, is that enough to surmount the obvious lack of the same investment and/or control purpose on the part of the claims seller?

This writer thinks not, and concludes that such an interpretation flies in the face of the statutory provisions of the Bankruptcy Code. As such, the letter of the law itself does not support the application of the federal securities laws to the trading of claims in bankruptcy; if anything, it stands against that proposal.

B. Under the New Rule 3001

Previously we noted the impact of the revisions to Federal Rule of Bankruptcy Procedure 3001.[69] What is generally overlooked, but is, nevertheless, quite implicit in this seemingly innocent rule change is that the bankruptcy court is clearly taken out of the game of overseeing the transfer of claims. This must give one pause, for if the judicial rulemaking bodies were so intent on excluding any hint of such supervisory powers from the very rules that guide the bankruptcy courts' daily functioning, is it not sheer folly to think that another regulatory scheme, such as the federal securities code, should quickly be installed in its place?

All concerned agree that the prior attempts of bankruptcy judges to involve themselves in regulating claims trading, such as in *Allegheny*, have been effectively prohibited by the revisions to Rule 3001.[70] The natural conclusion one is left to is that if the bankruptcy courts cannot intervene in the trading of claims pursuant to the Federal Rules of Bankruptcy Procedure, why should they suddenly retake that now-forbidden power, by borrowing the basically unrelated provisions of the federal securities laws? The

---

69. *See supra* notes 17-29 and accompanying text (discussing the revisions to Rule 3001 and the implications thereof).

70. Prendergast, *supra* note 4, at 9-11; Fortgang & Mayer, *supra* note 1, at 42-43. *See* FED. R. BANKR. P. 3001.

obvious answer, of course, is that such a situation cannot be permitted. And so, the changes to Rule 3001 also argue against the application of the federal securities laws to trading in bankruptcy claims.

C. The Reves *Standard*

As indicated above, the decision of the Supreme Court in *Reves v. Ernst & Young*[71] is paramount to this discussion of the claim as a security. In this writer's view, the inability of a creditor's claim against a debtor to be deemed a security pursuant to the *Reves* formulation would foreclose any possibility of applying the federal securities laws to the trading of bankruptcy claims. To be sure, a failure to qualify under *Reves* is exactly the result obtained in the following analysis.

1. Factual Distinctions

Consider first the factual predicates for the Court's landmark ruling, as set forth by Justice Marshall. Importantly, the opinion emphasized that the notes were explicitly sold to a broad range of the public as an investment program.[72] Safety, security, and liquidity were the tag lines for the co-op's promotion.[73]

Are such characteristics typical of claims trading in bankruptcy cases? This author thinks not.

Claims in bankruptcy may be an investment for the acquiror, but the term does not apply full force to a creditor seeking to cut its losses, let alone recoup its receivable from the debtor. Next, it is the claims purchaser that approaches the finite group of claimholders, and even then, the acquiror may be quite selective in what claims it seeks to purchase.

Moreover, it is the rare case indeed for claimants to openly peddle their rights to payment from the bankrupt. Such offers to

71. 494 U.S. 56 (1990).
72. *Id.* at 59.
73. *Id.*

sell are almost invariably triggered by the presence of an entity bent on taking over the debtor. And, as is true of the limited universe of sellers, the buyers constitute an even more select group, making both sides quite unlike the general public targeted in *Reves*.

Finally, what is safe, secure, and liquid about claims against debtors, at least for the original holders? Fraught with risk, with recovery speculative as to both time and amount, and availability of payment absolutely forbidden until a plan is confirmed,[74] at a minimum from a stakeholder's perspective, a claim in bankruptcy is nothing like a security, even a high-risk one. Again, the factual dissimilarities are overpowering and almost dispositive of the question by themselves.

2. *The General Legal Standard*

Turning to the law of *Reves*, the ruling begins by explaining the underlying philosophy of federal securities regulation--to police the capital markets.[75] While the trading of claims in bankruptcy connotes, at bottom, a "market" of sorts, it is vastly different from the true equity and debt instrument markets of today. Even allowing for the dynamicism of the financial world, claims trading is a commercial venture and not a true securities exchange, notwithstanding that control of the debtor may be the ultimate goal of the acquiror.

This fundamental distinction is shown abundantly in *Reves*, with the observation that when it enacted the securities laws, Congress nevertheless did not intend to provide an all encompassing federal remedy for all fraud.[76] By these words, the Supreme Court made it crystal clear that even this new test in *Reves* has limits.

Such a caveat by the high Court cuts against interpreting *Reves* in support of classifying a bankruptcy claim as a security. Again, and in the same breath, Justice Marshall tells us the purpose of the

---

74. *See, e.g.*, *In re* Allegheny Int'l,Inc., 118 B.R. 282, 296 (Bankr. W.D. Pa. 1990).
75. *Reves*, 494 U.S. at 60-61.
76. *Id.* at 61.

federal securities laws is to regulate *investments*,[77] something the previous discussion herein has argued a bankruptcy claim is most certainly not.

Continuing in this vein, *Reves* is careful to point out that not every "note" is a security, as the demand notes in that case were ultimately found to be.[78] This holding debunks the notion that since a claim may be like a note payable (a suspect characterization in itself), it is therefore a security.[79] *Reves* tells us that while notes do come in all shapes and sizes, and for all sorts of purposes, they are not all securities, even under the new standard.[80]

In adopting the "family resemblance" test to determine if a note is a security, the high Court specifically enumerated a variety of notes that it ruled were not securities, several of which are identical to or closely mimic the transactions underlying a creditor's claim in bankruptcy.[81] These include mortgage notes, notes financing a business and secured by a lien on the borrower's assets, notes secured by pledged accounts receivable, and simple commercial finance transactions.[82]

Logic dictates here that if *Reves* excludes such notes from the realm of securities, bankruptcy claims created in the same or a similar fashion must likewise be denied status as securities. It then follows that the application of the federal securities laws to such claims is not at all proper under the *Reves* standard.

D. The Reves *Four-Point Test*

The case against the claim as a security becomes even more convincing as we apply the Supreme Court's further test for determining if a note is a security. The *Reves* factors are commonly

---

77. *Id.*

78. *Id.* at 62.

79. *Cf. In re* Standard Oil & Exploration of Delaware, Inc., 136 B.R. 141, 153 (Bankr. W.D. Mich. 1992) (holding that pursuant to 11 U.S.C. § 364(f), notes issued by a Chapter 11 debtor post-petition to raise fresh capital are exempt from the registration requirements of the federal securities laws).

80. *Reves*, 494 U.S. at 62.

81. *Id.* at 65.

82. *Id.*

used by federal courts, and this analysis will discuss the *Reves* test as recently applied in *Banco Espanol de Credito v. Security Pacific National Bank.*[83] First, the motivational test asks if the "seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments."[84] Here, there is a not so subtle distinction between a true security thereunder and a creditor's claim against a debtor.

While the seller's purpose in trading its claim is undoubtedly to raise money, it does so to create cash for its, the creditor's, business. It does not trade its claim to raise money for the debtor's business, which is what this prong of the *Reves* test demands. Additionally, the creditor sells not to invest in the debtor, but to extricate itself from the debtor's insolvency. Note that even though the buyer of the claim may satisfy the profit motivation *Reves* requires, the test is conjunctive, with a notable emphasis on the seller, and, *per force*, the failure on this threshold aspect should end the inquiry.[85] Nevertheless, let us proceed with the remaining points of the test.

Second is the "common trading" requirement.[86] While the Court's perfunctory mention of this facet is open to interpretation, for reasons elaborated upon above, claims trading in bankruptcy would seem to still fall far short of the commonality requirement, given the relative bounds of its use.[87] Even the staunchest advocate of applying the securities code to claims trading would find itself on a slippery slope when arguing that this common trading prerequisite is met when trading bankruptcy claims. Such

---

83. 763 F. Supp. 36 (S.D.N.Y. 1991).

84. *Reves*, 494 U.S. at 66.

85. *Accord* Banco Espanol de Credito v. Security Pacific Nat'l Bank, 763 F. Supp. 36, 42-43 (S.D.N.Y. 1991) (holding that loan participation is not a security under the *Reves* motivational prong because the creditor/seller's goal was to reduce the risk of non-payment by the debtor, in other words simply "the promotion of commercial purposes and not investments"). This Case was recently affirmed by the Second Circuit on June 24, 1992. *See* Banco Espanol De Credito v. Security Pacific Nat'l Bank, 61 U.S.L.W. 2027 (July 14, 1992).

86. *See Banco Espanol*, 763 F. Supp. at 43.

87. *See id.* The court found that the purchasers of loan participations were "sophisticated financial and commercial institutions," not unlike the "vulture" investors who buy bankruptcy claims. *Id.*

trading is, by any measure, far more uncommon than the pervasive trading in true securities.

Third, there is the matter of the reasonable expectations of the investing public.[88] One must first ask if trading in claims is truly public? That concept has been refuted at length hereinbefore. Even today, the universe of claims sellers and buyers is a far cry from being considered a truly public market. As to the other half of this point, the broad public of investors would, in any event, probably not hold the same reasonable expectations when trading claims as when transacting in the more traditional investments presently subject to the federal securities laws.[89] Again, the bankruptcy claim fails to measure up as a security.

The last factor of *Reves* is whether the existence of some other regulatory scheme preempts the federal securities code, by regulating the purported "investment."[90] Nothing could be more true than the fact that the trading of claims in bankruptcy cases is already subject to a highly regulated scheme that clearly preempts application of the federal securities laws. That body of law is, of course, the Bankruptcy Code.[91] An elaboration of this point is found below.

In sum, the new edict of the Supreme Court demands that any instrument alleged to constitute a security be tested against the four-pronged test of *Reves*.[92] When a claim in bankruptcy is so evaluated, it cannot pass muster on any of those several points. Thus, if the result of applying the high Court's standard to a claim is its failure to qualify as a security, *Reves* must be taken as opposing the employment of the federal securities laws to the trading of claims in bankruptcy.

---

88. *Id.*

89. *Id.* The court opined that there was "no indication that the general public was even aware of the existence" of the loan participations. *Id.*

90. *Id.*

91. 11 U.S.C. §§ 101-1330 (1992).

92. *See supra* notes 83-90 and accompanying text (discussing the standards articulated by the court in *Reves*).

E. The Bankruptcy Code - The Existing Regulatory Scheme

As we have seen, advocates for the extension of the federal securities laws to the trading of claims in bankruptcy generally argue under the rubric that such an application will insure full and adequate disclosure of all matters pertinent to the valuation of a claim, prevent the misuse of "insider"[93] information, and shall assure the presence of a level playing field.[94] However, the borrowing of the federal securities code to achieve those aims would be redundant here, since the laws of bankruptcy already go far in attaining those worthwhile goals.

In its general provisions, the Bankruptcy Code has long required a meeting of creditors,[95] and an examination of the debtor there at,[96] ostensibly to assure that all creditors have an opportunity to be as fully informed about the debtor's affairs as

---

93. The Bankruptcy Code definition of an "insider" is:
(A) if the debtor is an individual--
(i) relative of the debtor or of a general partner of the debtor;
(ii) partnership in which the debtor is a general partner;
(iii) general partner of the debtor; or
(iv) corporation of which the debtor is a director, officer, or person in control;
(B) if the debtor is a corporation--
(i) director of the debtor;
(ii) officer of the debtor;
(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or person in control of the debtor;
(C) if the debtor is a partnership--
(i) general partner in the debtor;
(ii) relative of a general partner in, general partner of, or person in control of the debtor;
(iii) partnership in which the debtor is a general partner;
(iv) general partner of the debtor; or
(v) person in control of the debtor;
(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
(F) managing agent of the debtor;
11 U.S.C. § 101(31) (1992).
94. Prendergast, *supra* note 4, at 17.
95. 11 U.S.C. § 341(a) (1992).
96. *Id.* § 343 (1992).

possible.[97] The debtor is dutybound to file with the bankruptcy court schedules listing its creditors, assets and liabilities, income and expenditures, and a statement of its financial affairs, the latter being rather intricate in its required detail.[98] Failure by the debtor to adequately comply with this structure is grounds for dismissal of its bankruptcy case.[99] The Code thereby maximizes full and adequate disclosures by the debtor as a matter of public record, a functional equivalent of the disclosure mandated under the securities laws.

The specific requirements of Chapter 11 proceedings are even more arduous for the reorganizing debtor. There, multiple committees of creditors watching over the debtor are the norm,[100] and these committees wield significant power. Specifically, the committees may employ professionals, subject to court approval,[101] to assist in their statutory tasks of investigating the debtor's financial condition and operations, participating in the formulation of a plan of reorganization, and such other services that are in the interests of the creditors on that committee.[102] Added scrutiny emanates from the involvement of the United States Trustee, a quasi-judicial official whose statutory duty is to "supervise the administration" of all bankruptcy cases, regardless of the particular chapter under which they are filed.[103]

It is in the disclosure and solicitation of approval for a plan of reorganization that the debtor truly has its work cut out. First, the disclosure statement must be disseminated.[104] As stated, essential

---

97. *See* Carlson v. Boucher (*In re* Boucher), 728 F.2d 1152, 1155 (8th Cir. 1984) (explaining the scope of a section 343 examination). *Cf. In re* Gold Strike, Inc., 122 B.R. 803, 804 (Bankr. S.D. Fla. 1990) (upholding the dismissal of a bankruptcy case for reason of debtor's unexcused failure to attend the first meeting of creditors).

98. *See* 11 U.S.C. § 521 (1992).

99. *See In re* Clark, 76 B.R. 218, 219 (Bankr. S.D. Fla. 1987); *In re* Cohoes Indus. Terminal, Inc., 65 B.R. 918, 921 (Bankr. S.D.N.Y. 1986).

100. 11 U.S.C. § 1102 (1992).

101. *Id.* § 1103(a) (1992).

102. *Id.* § 1103(c) (1992).

103. 28 U.S.C. § 586(a)(3) (1992).

104. 11 U.S.C. § 1125(b) (1992). The statute provides:

> 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

here is that the disclosure document contain statutorily "adequate information."[105] Admittedly, devices such as the disclosure statement and the plan of reorganization may very well not come into being until after there has been some trading in claims. While this may undermine the efficacy of these procedures to some degree, the more thoughtful of claimants will undoubtly refuse to act hastily until they have had the benefit of adequate information via these or other avenues.

In the same stroke as demanding such prodigious disclosure by any erstwhile plan proponent, the Code likewise makes it plain that it retains exclusive jurisdiction. The same statute explicitly states that the adequacy of information as required above "is not governed by any otherwise applicable nonbankruptcy law."[106] Notably, any plan proponent is not liable on account of its participation in promoting the plan for violation of the securities laws.[107] The paramountcy of the Bankruptcy Code in these matters was recently exemplified in the case of *In re Applegate Property, Ltd.*[108] Notably, *Applegate* has even greater significance here because it is also a post-*Allegheny*, post-Rule 3001 amendment decision.

Applegate arose from a dispute between the debtor and the Resolution Trust Corporation over a vote for competing plans of

---

> holder the plan or a summary of 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.

Id. (emphasis added).

105. *Id.* § 1125(a)(1) (1992). Adequate information is defined:

> [I]nformation of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan.

Id.

106. *Id.* § 1125(d) (1992). Notably, while an agency or official whose duty it is to administer or enforce such non-code law may be heard from on this issue, that party cannot appeal from or seek review of the bankruptcy court's decision if the court deems the disclosure statement to be in conformity with the law. *Id.*

107. *Id.* § 1125(e) (1992); *see id.* § 1145 (1992) (providing "exemption from securities laws").

108. 133 B.R. 827 (Bankr. W.D. Tex. 1991).

reorganization.[109] Interestingly, it seems that a related entity of the debtor "was covertly purchasing claims in order to gain an advantage in the [plan] voting process."[110] Among other things, the RTC complained that said claims acquisitions should have been revealed in the disclosure statement propounded by the debtor in support of its plan to reorganize.[111]

Bankruptcy Judge Leif Clark first addressed whether the disclosure statement met the statutory requirement for adequate information. Such a decision, opined the tribunal, "is left largely to the discretion of the bankruptcy court."[112]

Moreover, the *Applegate* court held that disclosure statements were not required to meet the rigorous standards of their securities counterparts.[113] To be sure, the judge added that the Bankruptcy Code does not prohibit seeking guidance from the federal securities laws as to what constitutes appropriate disclosure in any given situation.[114] Nevertheless, Judge Clark clearly placed his reliance upon the supremacy of the relevant bankruptcy law in these matters. Citing primarily to section 1125, the court found the debtor's disclosure statement deficient under that statute because it did not contain adequate information about the claims purchases.[115] While the court surprised no one in condemning the flagrantly improper acts of the debtor in the case at hand,

---

109. *Id.* at 828.

110. *Id.*

111. *Id.*

112. *Id.* at 829 (citations omitted).

113. *Id.* at 829-30. The court stated:

> [A] disclosure statement need not meet the extensive disclosure requirements of the securities laws for registration statements and the like. Indeed, Section 1125(d) provides that the adequacy of a disclosure statement is not governed by any otherwise applicable non-bankruptcy law, rule or regulation.

Id.

114. *Id.* at 830.

115. *Id.* at 831. Indeed, this debtor was twice doomed, because the court went on to find that the purchasing of claims by the debtor's affiliate for the purpose of blocking the RTC's competing plan was an "obstructionist tactic" that could not be condoned. *Id.* at 835.

parenthetically it was made clear that claims trading in other proceedings need not carry the same stigma.[116]

Not unlike certain other decisions in this area, the *Applegate* holding is probably more significant for what it does not decide. This recent case, having the benefit of the earlier debate, and itself firmly ensconced within the new Federal Rule of Bankruptcy Procedure 3001, neatly states the priority and comprehensiveness of the Bankruptcy Code in matters of ensuring full disclosure to claimants, without resort to the securities acts.[117] The court intervened here not to prohibit claims trading as a general proposition, but to rectify a specific wrong in an individual case. Certainly, *Applegate* cannot be construed as favorable to applying the federal securities laws to the trading of claims in bankruptcy.

In sum, not only does the existence of the Bankruptcy Code as the pre-empting regulatory scheme mean that there is a failure to qualify a claim as a security under the fourth prong of the *Reves* test,[118] the pragmatic result is that it demonstrates the federal securities code is not needed to regulate trading in claims. The Bankruptcy Code already governs claims trading, by policing the bankruptcy process, ensuring that accurate and "adequate" information flows to creditors, and that equitable treatment for all parties is achieved.

F. The Howey Test

In addition to the *Reves* scenario above, it should be noted that the test promulgated by the Supreme Court in *SEC v. W.J. Howey Co.*[119] can be dismissed as inapplicable in the context of determining whether to apply the federal securities code to trading

---

116. *Id.* at 836. Judge Clark stated in an important aside that:

> This is not to say, however, that there are never legitimate grounds for buying claims. Under the proper circumstances, the purchasing of claims may well be a legitimate tactic. What those legitimate grounds are is not presently before the court nor is the court inclined to embark on such a discussion.

Id. at 836 n.7.

117. *Id.*

118. *See supra* note 90 and accompanying text (discussing the fourth prong of the *Reves* test).

119. 328 U.S. 293 (1946).

in bankruptcy claims.[120] As point in fact, by the Court's own words, the *Howey* test was created to avoid "unrealistic and irrelevant formulae" in characterizing a transaction as a security cognizable under the federal securities code.[121]

Notwithstanding the broad sweep of *Howey*, it is clearly inapplicable to the claims trading genre, simply because it envisions profits to be made from the efforts of others. Certainly, those trading in claims do so to control or to at least influence the management of the bankruptcy enterprise. The direct "hands-on" stance of claims purchasers quickly eliminates them from the *Howey* formulation. Needless to add, the claims seller divests itself of the debtor when selling its claim, thereby failing to rely upon the efforts of others to make a profit, likewise failing under the *Howey* rule.

In addition, *Howey* demands that an investment be made.[122] Certainly, even a creditor arguably "invests" in the debtor, because he expects to be paid, and the payment presumably includes the creditor's profit margin. This principle is as true for basic trade suppliers as it is for major bank lenders. Nevertheless, one must question the validity of equating creditors of such diverse stripes with true investors. Admittedly, this argument is but a small supplement to the foregoing refutation of *Howey*, but it does merit consideration.

In sum, since a claim in bankruptcy is not a security under this formulation, the *Howey* test does not advance one iota the argument in favor of applying the federal securities laws to trading in bankruptcy claims.

---

120. *See id.* at 298-99. That longstanding regimen holds that:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

Id.

121. *Id.* at 301.

122. *Id.* at 298-99

G. Other Factors

Finally, any remaining points do not support the regulation of claims trading by the imposition of the federal securities code. Putting aside *Allegheny*,[123] courts have historically taken an active role in reviewing the transfer of claims only in limited circumstances. Under the former Bankruptcy Act of 1898, the predecessor to the modern Bankruptcy Code, courts intervened in claims trading only to ensure that parties with inside information could not take advantage and purchase claims they knew to be worth significantly more than the price they offered the selling creditor.[124]

Similarly, in more recent times, courts have imposed restrictions on non-insider purchasers who possessed greater information than was available to general creditors.[125] In *In Re Revere Copper & Brass, Inc.*,[126] Bankruptcy Judge Abram's concern "that the assignor-creditors have not been plainly advised of their options" clearly arose from the fact that the investment firm buying the claims for cash made its solicitation just before an article appeared in the *Wall Street Journal* "outlining the details of a plan of reorganization" to be proposed by the debtor at some uncertain future date.[127] Obviously, *Revere* is highly fact-specific, and has little utility in answering the instant controversy, except for one oblique reference by the court therein.

In a footnote, the bankruptcy court cautioned the reader what this case was *not* deciding.[128] The court chose not to address key

---

123. *See supra* notes 8-16 and accompanying text (discussing the holding of the court in *Allegheny*).

124. *See, e.g.*, American United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 144 (1940).

125. *See, e.g.*, *In re* Revere Copper & Brass, Inc., 58 B.R. 1, 2-3 (Bankr. S.D.N.Y. 1985).

126. 58 B.R. 1 (Bankr. S.D.N.Y. 1985).

127. *Id.* at 2.

128. *Id.* at 3 n.2. Judge Abram stated:

> Nothing in this opinion should be construed to hold that a disclosure statement as contemplated by Code § 1125 is required before Phoenix may buy claims. Nor is anything herein to be construed as condoning Phoenix's solicitation to the extent that it may violate any statutory or regulatory provision. Rather, the court is concerned here simply with ensuring that overreaching, if indeed it has occurred, is not condoned in performing the

issues, such as the timing of the claims buyer's offer or its propriety under law, implicitly non-bankruptcy as well as under the Bankruptcy Code. Indeed, the court did not go so far as to criticize the concept of trading in claims, interjecting itself therein only to prevent overreaching by sophisticated buyers in that process.[129]

On a different note, the court policed claims trading in the contentious Eastern Airlines bankruptcy purely for administrative reasons.[130] In *In re Ionosphere Clubs, Inc.*,[131] Chief Bankruptcy Judge Lifland exerted a strong hand over such matters.[132] The senior jurist declared it was well within the bankruptcy court's inherent power to regulate the trading of claims "where taking such action is in furtherance of the court's exclusive jurisdiction over the administration of the debtor's estate and will relieve the debtor and its estate from a great administrative burden."[133] Notably, Judge Lifland had even issued an individual rule of his court to assist in overseeing the claims trading process.[134] Critical here is that the *Ionosphere* court relied exclusively on the Bankruptcy Code, and most certainly not the federal securities laws, in this regulatory endeavor.[135]

> somewhat ministerial task of approving an assignment. Other issues, if they exist, are left for another day.

Id.

129. *Id.*

130. *See generally* Carol M. Cropper & Rifka Rosenwein, *Disrobing Debtor's Paradise*, MANHATTAN LAW., July-Aug. 1990, at 33, 34 (discussing the Eastern Bankruptcy and Judge Lifland's involvement in the case).

131. 119 B.R. 440 (Bankr. S.D.N.Y. 1990).

132. *Id.* at 444. The judge recited his *raison d'etre* as follows:

> [O]ne of the "evils" spawned by bankruptcy claims trading in "mega" cases, the size of Eastern, is the substantially increased burden associated with monitoring, administrating and objecting to claims which have been filed against the estate. This increased administrative burden diverts the limited resources of the Debtor's estate and has the potential for impeding the reorganization process. Moreover, the Assignment, and other transactions similar in kind, has the effect of uncontrollably multiplying claims which, in turn, significantly increases the administrative burden imposed on these estate associated with claims administration.

Id.

133. *Id.* at 445.

134. *Id.* at 443.

135. *Id.* at 441-47.

In sum, the foregoing cases addressed the matter of claims trading while it was still in its embryonic stage. Both on the facts and the law, the continued vitality of said holdings is not certain. Even so, none of these instances, individually or in the aggregate, go so far as to justify the engrafting of the federal securities laws onto the Bankruptcy Code.

To be sure, a decision not to apply the federal securities code to the trading of claims in bankruptcy does not necessarily mean the absolute exclusion of those laws from the bankruptcy arena.[136] While the Securities and Exchange Commission is still reviewing its policies as to its proper role in bankruptcy proceedings,[137] it is undisputed that the Commission has a right to be heard from in reorganization cases.[138]

Although the regulators are there to first ensure the integrity of the stock markets, by policing trading in a debtor's true public securities, logic tells us this must positively affect the trading of claims. By its customary efforts to, *inter alia*, detect and punish fraud and trading on inside information, compel disclosure, and basically maintain a level playing field, the agency promotes the flow of reliable information to all involved in the case, while preventing the misuse of the same. While admittedly tangential to the matter of claims trading, these protections still inure to the benefit of any claimant who seeks to be as informed as possible when contemplating an offer to sell its claim.

In addition, the seller of a claim may be quite content *not* to have the federal securities code be the law of that nascent market. One reason for that is the Supreme Court's recent endorsement of a strict, and remarkably short, uniform statute of limitations for

---

136. By way of comparison, a legitimate existing intersection between the Bankruptcy Code and the federal securities laws occurs when the debtor *issues* securities. *See generally* Richard J. Morgan, *Application of the Securities Laws in Chapter 11 Reorganizations Under the Bankruptcy Reform Act of 1978*, 1983 ILL. L. REV. 861 (1983).

137. *See generally* Sabino & Sabino, *The Role of the SEC*, *supra* note 6.

138. *See* 11 U.S.C. § 1109(a) (1992) (enumerating that the SEC "may raise and may appear and be heard on any issue" in a Chapter 11 case).

securities fraud actions.[139] In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[140] the high Court decreed that actions pursuant to the anti-fraud sections of the federal securities laws must be commenced no more than one year from the date of discovery and no more than three years from the date of the occurrence of the alleged fraud.[141]

While *Lampf* thankfully eradicated a confusing crazy-quilt pattern of differing limitary periods borrowed from individual state laws, it also cut off more generous statutes of repose found in various jurisdictions. For a disgruntled claims seller residing in such a forum, obviously that party would prefer to pursue local law, and not come under the foreshortened federal limitary rule. Thus, given the potential for superior remedies outside the federal securities code, another argument can be made not to apply that securities law to claims trading in bankruptcy.

CONCLUSION

The matter of trading claims in bankruptcy is a crucial issue for an already overwhelmed bankruptcy system. Even as the recessionary pressures of this decade ease, as inevitably they must, in good times, as well as bad, bankruptcy will be a constant for the business community. How parties shall interact as buyers and sellers of claims against bankrupt entities will, therefore, remain important.

As this marketplace for claims now develops past its infancy, the question arises of how to regulate it, if at all. At least one school of thought proposes that the federal securities laws be carried over as the most appropriate regulatory scheme to achieve this enforcement function.[142] Given that the securities code is well known and established, its proponents contend that it is a

139. Primarily, fraud in the sale or purchase of a security is punished under section 10 of the 1934 Act and the well-known Rule 10b-5. *See* 15 U.S.C. § 78(b) (1992); 17a C.F.R. § 240-10b-5 (1992) (providing general anti-fraud regulation).

140. 111 S.Ct. 2773 (1991).

141. *Id.* at 2782.

142. *See* Prendergast, *supra* note 4, at 17.

natural candidate for an easy transition to policing bankruptcy claims as if they were securities. To be sure, this proposal is not wholly without merit.

However, in view of the foregoing analysis, this Article concludes that the federal securities laws cannot be transplanted to watch over the trading of claims in bankruptcy. In the first instance, past attempts by the courts to intercede in the claims trading process have been thwarted by changes to the Federal Rules of Bankruptcy Procedure.[143] If the amended Rules do not accommodate judicial intervention under the Bankruptcy Code's own procedural guidelines, why should the federal securities laws be looked to in their place?

Next, the Bankruptcy Code itself does not support such an interface between the laws of insolvency and the securities code. The Supreme Court demands the terms of the Bankruptcy Code be given their "plain meaning."[144] To read the statutes therein in such a way as to call bankruptcy claims "securities" is to do violence to the letter of the law. That simply cannot be condoned, thus reinforcing the notion that securities laws have no place in bankruptcy.

Above all, the Supreme Court in *Reves* recently pronounced its view of what is a security for purposes of applying the federal securities laws.[145] Since the high Court's decrees must be obeyed, a claim is not a security, and *per force* the securities code cannot apply, unless a claim can qualify under *Reves*.

As elaborated upon at length hereinabove, a claim traded in bankruptcy fails the *Reves* test.[146] Likewise, a bankruptcy claim fares no better under the traditional *Howey* test,[147] and cannot be

143. *See supra* notes 17-28 and accompanying text (discussing the effect of amendments to the Federal Rules of Bankruptcy Procedure on court's intervention in the claims trading context).

144. United States v. Ron Pair Enter., Inc., 489 U.S. 235, 241 (1989).

145. *See supra* notes 83-90 and accompanying text (analyzing the process of defining a security under the *Reves* criteria).

146. *See id.* (discussing the analysis of claims trading under the *Reves* standard).

147. *See supra* notes 119-122 and accompanying text (discussing the criteria embodying the *Howey* analysis).

deemed a security on any other point.[148] Given all the above, *a fortiori*, the federal securities laws do not apply when that claim, a non-security, is bought or sold in a bankruptcy proceeding.

This is not a poor result, for the protections already in existence under the Bankruptcy Code make borrowing from the federal securities laws unnecessary here. The Code's provisions mandate and enforce full disclosure relevant to the claims trading process, prohibit abuse of insider or superior information, and otherwise ensure fair treatment for all parties. In short, the functional equivalents of the Code achieve the same ends as the federal securities laws, making any proposed application of the latter to claims trading superfluous.

Under the presently controlling laws of both the bankruptcy and the securities acts, it would be wrong to attempt to regulate the trading of claims in bankruptcy by means of applying the existing federal securities laws. If such regulation is to come to pass, it should be created anew. Elements of both statutory bodies can be meshed to create a cohesive and workable codification. But the point remains that the process must start fresh.

In conclusion, the imposition of such an enforcement scheme must be authorized by the Congress, and not be a creation of the courts, especially given the recent withdrawal by the judiciary from the claims trading process. One can only hope that the inevitable bankruptcy reforms will competently address this issue in the near future. Until that date, however, the separation of the federal securities laws and the trading of claims in bankruptcy must be maintained.

148. *See supra* notes 121-138 and accompanying text (discussing the classification of claims trading under criteria other than *Howey* and *Reves*).