2008

BANKRUPTCY MERGERS AND ACQUISITIONS IN THE U.S

Trading in debt claim against, and interests in, distressed companies during Chapter 11 Reorganization

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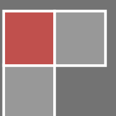

Marty Whitman

Michael Price

Ron La Bow

Carl Icahn

Leon Black

KKR

Sam Zell

Citibank

Goldman Sachs

"It seems that, in today's world,

The power to absolve debt,

Is greater than the power of forgiveness"

(The godfather III)

Balfour Investors

~~Lehman brothers~~

Morgan Stanley

Carlyle group

Fidelity Investments

Blackstone Group

Cerberus Capital Management

Providence group

J.P. Morgan

CVC Capital partners

Table of Contents

Introduction to Bankruptcy M&A *5*

Chapter 1: Entering Liquidation or Reorganization Procedures *7*

A.Reorganization and Liquidation 7

B.Reorganization & Liquidation and Claims Trading in the U.S 8

C.Criticism of the Reorganization Alternative 11

Chapter 2: Mergers & Acquisitions [M&A] *14*

A.Terminology 14

B.M&A History 15

Chapter 3: Incentives on the Acquiring Side *17*

Chapter 4: Bankruptcy M&A *22*

A."Vulture" Takeovers Through Chapter 11 22

B.Prepetition and postpetition investors 23

C.Techniques for Claim Trading 25

D.Debt for Equity 28

E.Voting on the Plan of Reorganization 29

Chapter 5: Competing for Control over the Debtor *31*

A.Control by the Purchase of Stocks During Chapter 11 31

B.Blocking control 32

C.Defenses Against Postpetition Investors 33

Chapter 6: Benefits of Bankruptcy M&A *35*

A.Debt Investors as Residual Actors 35

B.Flexibility 36

C.Overriding Management 36

D.Liquidity 37

E.Prepackaged Bankruptcies 38

F.Leverage in Negotiations 38

G.Creating Value 39

H.Positive Use of Asymmetric Information 39

I.Tax Benefits 39

Chapter 7: Negative aspects of Bankruptcy M&A ***41***

A.Negative aspects for a postpetition investor 41

B. LBO'S 42

C.Trading by Fiduciaries 43

D.Public Policy 44

E.Untimely End of the Reorganization Process 44

F.Asymmetric Information 45

Chapter 8: "Loopholes" in Securities and Anti-Trust Regulations ***46***

A.Claim Trading and Securities Regulation 46

B.Anti –Trust Regulations 49

Chapter 9: Possible Solutions for the Exploitation of the Reorganization process ***51***

A.Security regulation 51

B.The "city" code 52

C. Applying Duties on Debt Claim Buyers 53

D. Fiduciary Duty 54

E. A Desirable Arrangement 55

F.Exclusive period 56

Conclusions ***57***

Bibliography ***59***

Appendix ***65***

Introduction to Bankruptcy M&A

The fascinating osculation points of bankruptcy and M&A engages many different areas of law, including corporate, bankruptcy, securities, contracts, tax and antitrust law, as well as practical matters from other doctrines such as accounting and funding.

The most obvious point of osculation is extracted from the subject of this work -"Bankruptcy M&A". The area of bankruptcy law and the area of corporate law that is mergers and acquisitions are two different (sometimes opposite) stages in the life of a corporation. On the one hand the end of the corporate entity by a mean of bankruptcy, and on the other, the beginning of new "life" via merger or acquisition by another corporation.

Both of these broad subjects separately, do not exist in vacuum, but rather are found under heavy regulation by the securities law and antitrust laws, and bear grave implications in the area of tax law.

The purpose of this work is to provide the reader with an overview of the separate processes connected with bankruptcy M&A in the U.S, to review the main "players" in the market, and to provide the reader with the techniques for trading in debt claims against, and stocks in, the debtor, as well as describing the obstacles and benefits of the bankruptcy M&A process. This work will try to untangle the various ways in which an investor can take advantage of the collision of different areas of law, in order to create investment opportunities in distressed corporations undergoing Chapter 11 Reorganization, in addition to reviewing the reasons for corporate takeovers of corporations undergoing Chapter 11.

Chapter I is a review of the bankruptcy process in the U.S, and focuses on the reorganization process under Chapter 11, in order to provide basic knowledge and concepts as well as criticism of the process. Chapter II will review the terminology of mergers and acquisitions, along with its historical background. Chapter III will examine the different motives for acquisitions. Chapter IV presents the subject of bankruptcy M&A, including the different "players" and techniques for claim trading. Chapter V discusses the fight between the debtor's management and postpetition investors over the control of the debtor, and the various defenses management have against corporate "raiders". Chapter VI and VII describes the various benefits and evils of bankruptcy M&A, all sides concern including debtors, creditors, investors and public policy.

Chapter VIII is dealing with the loopholes of securities and antitrust regulation regarding bankruptcy M&A in general and debt claim trading specifically. The Chapter also reviews the repercussion of the securities definitions in the security law, the misuse by investors and the treatment of the courts. Finally, in Chapter IX, I tried to provide solutions for the problems raised in previous Chapters for the misuse of the bankruptcy process by vulture investors, in order to profit from distressed corporation. The solutions varied from the imposing of fiduciary duties, through the revision of the securities and antitrust laws, and by treating large scale purchases of debt claim like tender offers of stocks.

Chapter 1: Entering Liquidation or Reorganization Procedures

A. Reorganization and Liquidation

A business corporation is organized and carried on primarily to make profit for the stockholders[1]. This is known as the "shareholders primacy norm"[2].

In the Israeli law, the interests of the company's creditors, workers and the public can also be taken under consideration[3], only when it contributes to maximizing the company's[4] profit. In the normal course of a company's life, the company's assets are owned and controlled by its shareholders and their representatives[5] who have the power to steer the course of the company using their voting rights (via proxy meetings).

When a company reaches a point of financial distress, it can try to negotiate with its creditors in order to reach some sort of payment agreement (a "work out"). The "work out" might include reducing debt amounts, time extensions, and in case when the "work out" fails, liquidity can be achieved (by the debtor) by selling assets and by repaying its debts. If the debtor cannot liquidate equity to repay creditors, or reach a "workout" agreement with them, the company will turn to the bankruptcy law.[6]

When liquidation (Chapter 7) or a reorganization (Chapter 11) procedure begins, and in fact the corporation is insolvent (under any insolvency test, **A.Y**), two major changes occur in the corporation: **(1)** The control over the company is transferred to the liquidator in Chapter 7 or to a trustee in certain cases of Chapter 11, and by an element of coercion, changes the array of rights in the company in order to maximize the value of the company for the creditors. the control over the company's assets and decision making passes to the representatives of the creditors, who can decide (by voting on a plan) whether to operate the company or disassemble it and sell it in parts, so money can be paid to the creditors. The shareholders will be eligible for what is left of the company after all of its debts have been fully repayed. **(2)** The individual collection

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[1] Dodge vs. ford motors co. 170 N.W 668 (Mich. 1919)
[2] פרופ' עמיר ליכט, "תכליות החברה", משפט ועסקים א, התשס"ד
[3]The new israeli corporate law of 1999 § 11(a)
[4] Dr. Irit Haviv-Segal, Corporate law in Israel after the new corporation Act, 71, vol 2(2004) **(hereinafter: "Dr. Irit Haviv-Segal")**
[5] Id at 201
[6] Id.

procedure of the company's debt becomes a collective procedure. This manifests itself through an "automatic stay" of all individual collection procedures ("creditors race") and concentrating them under the collective legal procedure of the liquidation and reorganization law[7]. Under a collective procedure, the creditors will be represented by the liquidator (Chapter 7) or the trustee (Chapter 11), if one was appointed by the court. The rationale behind the collective procedure is that, when each creditor is "racing his way" to realize the company's assets, he is Actually decreasing the combined wealth and is Acting against the collective interest of all the creditors[8].

The reorganization process solves three main problems that arise regarding companies in distress. **First**, it defines what financial decisions and Action must the company take to achieve economic balance. **Second**, it defines the fair division of rights between shareholders and creditors. **Finally**, it sets a course for liquidation in case of failure to reorganize in a way that will maximize the recovery for all concerned parties[9].

B. Reorganization & Liquidation and Claims Trading in the U.S

When the bankruptcy Act was enacted in 1898, liquidation was the single solution for a bankrupt company. The liquidation solution has many disadvantages. Once the company is liquidated, the management and workers are out of a job, and the shareholders usually get nothing. For creditors, the liquidation alternative might bring less than they would get in a reorganization process of the company as a "going concern"[10]. The reorganization alternative may enable the participants to capture a greater value than they can obtain in liquidation, especially when the company's assets are worth more as a going concern than in piecemeal[11].

These devastating outcomes of the liquidation solution caused Congress to broaden the scope of the Bankruptcy Act by enacting Section 77B in 1934 as the first comprehensive corporate reorganization statute. When Chapter X of the Bankruptcy Act 1939[12] was enacted, Congress excluded small businesses from it, since they were provided with a simple composition for small businesses under Chapter XI of the Bankruptcy Act of 1898, in order to keep them from knocking on the district court's

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[7] Dr. Irit Haviv-Segal, 202
[8] See also: Thomas H. Jackson, "The logic and limits of bankruptcy law", 151, beard books [2001]
[9] Prof. Dale A. Oesterle, "The Law of Mergers, Acquisitions and Reorganizations",1080, West publishing [1991] [**hereinafter:" Prof. Dale A. Oesterle**]
[10] Prof. Dale A. Oesterle, 1044. **see also**: infra Chapter 1(B)
[11] Lucian A. Bebchuk, "A New Approach To Corporate Reorganizations", 101 Harv. L. Rev. 775 (1988)
[12] 11 U.S.C. X (1939)

door seeking for corporate reorganization. Since small businesses rarely had complex debt structure, Congress did not set any regulations regarding claims or stock claims for such corporations.

Chapter X was supposed to provide a corporate reorganization solution for big corporations with security holders, and provided simple guidelines for trading in claims and stocks against debtors[13]. Even so, what happened in the market place was, that the lack of regulation in Chapter XI made it the "proceeding of choice" for corporations of all sizes, and made Chapter X almost irrelevant (less than 10% of all reorganization cases were filed under Chapter X)[14].

The enactment of Chapter 11 in 1978 (as a consolidation of Chapters X, XI and XII)[15] gradually made The Reorganization alternative equal in strength to the Liquidation alternative[16]. "**Reorganizations are the processes by which financial decisions are implemented through legal mechanisms in attempt to produce stable, rejuvenated businesses**"[17].

In today's bankruptcy Act, insolvent companies have two alternatives: liquidation under Chapter 7[18], or reorganization under Chapter 11[19] (also known as orderly liquidation). If the company is going for liquidation, a liquidator is appointed by the court in order to collect all of the company's assets and sell them, while simultaneously trying to maximize the return for the creditors according to where they stand in the creditor's priority[20]. Normally, a company will not apply for liquidation when it has many assets or future profits it can rely on to repay its debts.

The **Absolute Priority Rule (APR)** provides that each creditor in a higher priority level has to be repaid fully by a plan (liquidation or reorganization), before a creditor from a lower priority level get his share or dividend of the estate. The priority levels are as followed: **first** come the secured creditors that have subordinations over assets of the corporation. **Second** come the unsecured creditors, with no subordinations, yet, they are protected by separate regulations or provisions (tax authorities, employees[21]).

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[13] Chaim J. Fortgang and Thomas M. Mayer, "Trading Claims and Taking Control of Corporations in Chapter 11",10, 12 Cardozo L.Rev (1990 – 1991) **[hereinafter: " Fortgang & Mayer"]**

[14] H.R. rep. No. 595, 95th cong, 1st Sess. 225 (1977)

[15] Richard E. mendales, "Intensive Care for the Public Corporations: Securities law, Corporate Governance, And the Reorganization Process", 989, Marquette L.rev 13 [2008]. **[hereinafter: " Intensive Care for the Public Corporations"]**

[16] Dr. Irit Haviv-Segal, 205

[17] Prof. Dale A. oesterle, 1026

[18] The bankruptcy Act 11 U.S.C Chapter 7

[19] 11 U.S.C Chapter 11

[20] Dr. Irit Haviv-Segal, 295

[21] Employees are protected by work laws, separated from the bankruptcy laws

Third are the contractual creditors, who have contractual agreements with the corporation. **Finally** the shareholders of the bankrupt corporation are the postponed creditors[22].

Under Chapter 11, the company has more chance to gain maximum recovery for creditors and shareholders, since the company is more knowledgeable about its business than any buyer of its assets. That is also the reason why the corporation would be better off under the debtors and creditors committee's of Chapter 11 than under a trustee appointed in Chapter 7, who might not have the relevant experience, interest or desire to gain maximum recovery[23].

The bankruptcy court can appoint a **trustee** (a strong arm[24]) "**in the interest of creditors [or] security holders**" due to "**fraud, dishonesty, incompetence**", or "**gross mismanagement of the affairs of the debtor by current management**"[25]. In practice, the trustee supplants the debtor's board of directors and CEO. The trustee takes control of the company and tries to cure it from the "illness" that caused the insolvency. The trustee may[26] try to make the company more efficient by[27] selling unprofitable assets, rejecting or assuming contracts, reorganizing the work force, changing management, recapitalizing and more[28]. It is rarely that the court appoints a trustee in Chapter 11 cases without a finding of any of the causes mentioned above[29]. The court can alternatively appoint an examiner, who will investigate the debtor's affairs but will not run the business[30].

In Chapter 11, the Bankruptcy Code grants the debtor "**exclusive period**" to file a plan of reorganization during the first 120 days of the case[31]. Management must first obtain an offer, and then notify the court, which then notifies the creditors and shareholders. The bankruptcy code invalidates any "no shop" agreements by the debtor. With the court's approval, and on the debtor expense, the creditors can retain advisors and seek other possible buyers. Any sale must be approved by a judge at a hearing. If there are a few possible bids, the judge will conduct an auction in the courtroom. The

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[22] Id.
[23] Prof. Dale A. oesterle, 1026
[24] Joseph W. Bartlett, "Equity Finance, Venture Capital, Buyouts, Restructurings and Reorganizations", 25,
volume 2, 2nd edition, [Panel Publication, 1995]
[25] 11 U.S.C §1104
[26] 11 U.S.C § 544
[27] Dr. Irit Haviv-Segal, 278
[28] Id. 248
[29] Fortgang & Mayer, 69
[30] Prof. Dale A. oesterle, 1088
[31] 11 U.S.C § 1121

court can extend the "exclusive period", but when it ends, bidders, directly or through stockholders or creditors can submit a competing plan (competing to the management's plan) for reorganization[32]. The court can force the plan on the creditors, yet, the tendency is to try and reach a reorganization plan, subordinated to a majority requirement[33] of 2\3 in dollar amounts (from the claims) and at least 50% in numbers do agree on the plan[34]. According to one approach, the reorganization process can be compared to a **fictitious sale of the company's assets** to its creditors and shareholders. Instead of selling the company in the market to the highest bidder, it returns it back to the hands of its creditors and shareholders in return for their investment in the new company's bonds or stocks. Under that approach, whether to liquidate the company or to go into reorganization will be decided according to whoever is offering more money for the company. If the current investors offer to purchase the new stocks for more than alternative investors will offer for the company in parts, than reorganization is preferred. Otherwise, the company will go for liquidation[35].

A second approach read that reorganization is actually the avoidance of the legal system from "breaking" or disassembling the connection between the company and the original investors.

Under that approach, it doesn't matter how much the alternative investors are offering, reorganization will still be the preferred way. In case of a failure to reorganize, the company will then head for liquidation[36].

C. Criticism of the Reorganization Alternative

The different economic and social approaches[37] to liquidation and reorganization bear much tension. The economic approach emphasizes the efficiency of the law, thus making the "pie" bigger for distribution. In the liquidation and reorganization context, the goal is to increase the value of what the creditors will get from a defaulted company,

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[32] Edith S. Hotchkiss and Robert M. Mooradian, "Acquisitions as a Means of Restructuring Firms in Chapter 11", 12, Journal of Financial Intermediation, 1998 **[hereinafter: "Hotchkiss (1998)"]**

[33] 11 U.S.C § 1126(c)

[34] Brodsky & Zweibel, "Chapter 11 Acquisitions: Payoffs for Patience", Mergers & acquisitions 47 (sept/oct 1990) **[hereinafter: "Brodsky & Zweibel"]**

[35] Dr. Irit Haviv-Segal, 250

[36] Id. at 250

[37] Id. at 206

while the social approach emphasizes the distributive justice of the "pie" among the individuals (the creditors) of the company[38].

There is much criticism of the massive intervention of the bankruptcy law in the relations between the creditors themselves and the shareholders of the insolvent company. The modern economical approach provides that the individuals will shape the solutions for the insolvency of the company by a contractual construction. Such a construction can be a subordination of the company's assets as a guaranty for debt return.[39]

A far more extreme criticism (Baird & Rasmussen) argues that today, the reorganization procedures are no longer used for the original goal of saving failed businesses. On the contrary, they are used by the company owners to sell their company for a better price than they would have obtained on the open market. According to that theory, most companies that enter reorganization procedures are being sold as a "going concern" to a buyer (a third party). They are no longer going through the normal reorganization, where they would still be owned by the original shareholders, but rather by transferring the failed company's assets to another for cash or equivalent (stocks in the new company). Baird & Rasmussen argue that, in the past, the firm had "specific assets" special to it, and when a company reached insolvency, taking it apart yielded much less profit than reorganizing it as a "going concern". A good example for that is the railroad companies that went bankrupt in the beginning of the 20th century. The value of the rails themselves was drastically lower than the value of the railroad company as an ongoing business. In today's companies, only a small percentage of the companies have "specific assets" that cannot be sold for a high value as the company itself [40].

The situation, according to opposers of Baird & Rasmussen's theory, is that in present economical reality, the market is divides to "winner" and "looser" players, and "the winner takes it all". Thus, the "losing" players in the game do not have "specific assets", and higher value will be achieved by selling the company to a "winning player"[41]. Response to that criticism argues that in modern times, relationships between the company and its clients, suppliers and human resources are the most important "specific value", which justifies the legal entity called a "corporation". All of the above

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[38] Id. at 207

[39] A. Schwartz, "A contract theory approach to business Bankruptcy", 107, Yale L.J, 1807, 1851 (1998)

[40] Douglas .G Baird & Robert Rasmussen, "The end of bankruptcy", 55, Stan L. Rev 751 (2002)

[41] Dr. Irit Haviv-Segal, 210

are reasons for giving priority to the reorganization process over liquidation. Moreover, the fact that just a minority of the companies in liquidation are being sold to third parties[42] "pulls the rug" under the rational of Baird & Rasmussen.

In the next Chapter I will review the Merger & Acquisition Activity briefly as a background for the bankruptcy M&A, discussed infra in Chapter 4.

[42]Id at 211

Chapter 2:
Mergers & Acquisitions [M&A]

A. Terminology

"Mergers and acquisitions [M&A] law refers to a particular kind of business Activity whereby one business decides to take control of – that is, to purchase, to acquire – the income producing operation of some other business entity"[43]

The legal vocabulary used to describe an acquisition varies with the regulatory system involved. The terms merger, acquisition and reorganization are defined differently in the different areas of tax, accounting, antitrust, corporate and securities law. The concept of a "statutory merger" under the state corporate code is not the same as the concept of "reorganization" under the Tax Code.

In a business point of view, it is all a question of **(1)** who has control over the company after the transaction is over,**(2)** how much the controlling individual pa id to gain control and **(3)** in what form (stocks, assets Etc.) control was obtained. The basic definition problem is then trying to distinguish between the sale of a firm as a business, and the sale of some of the firm's property or stocks before one can say it has been purchased[44]

As a way to distinguish the classification of a M&A, and as an introduction to bankruptcy M&A, I suggest Dr. Irit Haviv Segal's[45] main classifications for M&A transaction in the new Israeli corporate law[46]. **First**, the controlling shareholder is **selling the control block** to an acquirer[47] who's therefore making an **Acquisition**, with minimal interference in the procedure from the legal system. **Second**, the **Merger** transaction is the transfer of **all** assets and debts of the target company to the buyer, resulting in the elimination of the target company. The merger requires authorization from the target company's directorship and, therefore, I will treat it as a **friendly merger**. **Third, a tender offer** is a proposal to purchase a company's stocks that is addressed to the general shareholders of the company[48].

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[43] Therese H. Maynard, Mergers and Acquisitions: Cases, Materials and Problems, 1, Aspen Publishers [2005]

[44] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",37, West publishing [1991]

[45] Dr. irit Haviv segal, 400

[46] The new corporate law 1999 § 1

[47] Mentioned in: ע"א 817\79, 585\82 קוסוי נ' בנק פויכטונגר פ"ד לח (3) 257

[48] The corporate ordinance 1983

B. M&A History

Though the U.S has experienced several merger (using this term in the broadest way) "waves" in the last decade, **the first** great merger wave was at the end of the nineteenth century and lasted until the depression of 1904. **A second** wave began shortly after WW1 and lasted until the 1929 depression. A **third** wave began after WW2 and lasted all through the 60's, and was motivated by a strong stock market and financial innovations such as convertible proffered stocks and debentures[49]. **A fourth** wave started in the 80's, began in a depressed stock market. The cheap prices of companies presented big opportunities for takeovers. There was an explosion of bankruptcy M&A fueled by financial innovations such as junk bonds and LBO's[50].

In the 90's, M&A Activity changed as a result of the collapse of the junk bond market and the ensuing recessionary environment of the early 90's, since the junk bond market financed many of the hostile takeovers until that time[51]. A lot of the M&A Activity in recent years is funded by many sophisticated and complex securities instruments (SIV'S- Structured Investment Vehicle) such as CDO (Collateral Debt Obligations) and CDS (Credit Default Swaps) that were invented in the 70's but became trillion dollar markets in the late 90's[52].

There was a decrease of 27% in M&A Activity around the world in the first 7 months of 2008 (2.5 trillion dollars), in comparison to 2007 (3.46 trillion dollars). 2007 was a record year for M&A Activity in the sum of 4 trillion dollar, attributed to cheap interest rates. The decrease in M&A Activity is associated with a drop of 63% in private equity transactions to a mere 318.5 billion dollars[53]as a result of the global credit and subprime mortgages crisis[54]. Since the end of 2007, for the first time in history, we are witnessing the shift of M&A Activity from the U.S to Europe[55].

I think that the recent events in global economy will develop in a few ways: first, a decrease in M&A Activity due to lack of liquidity in the markets and the rise of interest rates. Second, in the short term we will see a decrease in M&A Activity also

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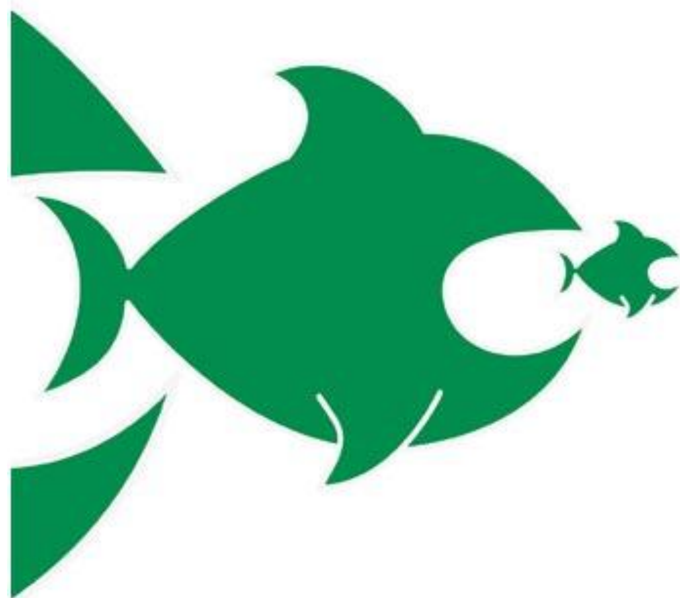
[49] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations", West publishing [1991]
[50] Therese H. Maynard, "Mergers & Acquisitions: Cases, Materials and Problems", 20, aspen publishing (2005)
[51] Id at 22
[52] Intensive Care for the Public Corporations, 981
[53] http://www.themarker.com/tmc/article.jhtml?log=tag&ElementId=nh20080903_03
[54] http://www.themarker.com/tmc/article.jhtml?log=tag&ElementId=dm20080331_05
[55] http://www.themarker.com/tmc/article.jhtml?log=tag&ElementId=tg20071220_31563

due to new regulation of complex investment vehicles, and thus, a decrease in the secondary market for distressed company's debt claims.



Chapter 3:
Incentives on the Acquiring Side

The activity of acquiring a company In distress, much like acquisitions outside of bankruptcy, hold in store many financial incentives for the acquirer[56]. In this chapter I will review those incentives broadly.

A. Elimination of competition

A main incentive is **elimination of competition in the market**[57]. By an acquisition, a company reduces the number of "players" in the market it is working in and thereby has the chance to acquire a bigger market share. The risk of reducing competition in the market is the creation of a monopoly in its sector. A monopoly in a sector is not a "price taker" as with companies in competitive markets, but rather set his own prices to for its products. A competitive producer will keep producing a product as long as the marginal cost is lower than the price that is set in the supply and demand market. A monopoly in a market is very bad for consumers, since the company will only manufacture an amount that covers the marginal revenues and, therefore, manufacture fewer items. By decreasing the supply, the price per product item will rise[58].

B. Synergy gains

The main motives for acquiring a company are "**synergy gains**". When two corporations with different strong points fuse into one, their combined sum is larger than the sum of the separate parts. "Operation Synergy" can be obtained if the resources or products of the two companies are close, compatible or completing. Such operation synergy can be seen by **horizontal** and **vertical integration** between companies. By manufacturing more products, a company can create internal vertical integration, and reduce the cost of the whole production process, therefore yielding more profit (Economies of scope)[59]. Synergy can be obtained also in many other aspects such as **tax benefits** and different tax calculation for the merged company.

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[56] Yedidia Z. Stern, "**Corporate Acquisition**" 151, Nevo Publisher INC. (1996) **[hereinafter: "Yedidia Z. Stern"]**
[57] William L. Cary & Melvin Aron Eisenberg, **CORPORATIONS**, CHAPTER X, 1445 (5TH Edition, 1980)
[58] יצחק אורון, נילי מארק וגליה עופר, **מבוא לכלכלה – מיקרו כלכלה**, פרק 14, 17 (מהדורה שניה מורחבת, 1995)
[59] Yedidia Z. Stern, 158

Mergers are sometimes following removal of branching restrictions, or **Deregulation** such as in the banking and telecommunication markets. Mergers are motivated in many times by the need to innovate and get new technologies, and we see convergence of companies in many fields such as communication and computers[60].

C. <u>Growth</u>

A company with excess cash (more than what it needs for operation and management) can either pay it as dividends to its shareholder or invest it back into the company for **growth**. In today's globalized world, acquisitions abroad are a very profitable ways for expansion and growth. Growth can be achieved in two ways: first, through **internal growth**, which means the company invests in the manufacturing processes, R&D or for acquiring of assets. A second kind is through **external growth**, through the acquiring of another company, which contains what is necessary for the company's growth.

External growth yields profits (ROI - Return On Investment) much sooner than internal growth, since the acquisition lowers significantly the uncertainty of a new investment, as well as the time and money spent on training, development or building. Moreover, by acquiring a company, the acquirer receives also the target's reputation in the market, which in case of internal growth, would otherwise have taken a long time to be achieved[61].

D. <u>Diversification</u>

Diversification[62] of the investment portfolio is a way to reduce the risk levels of the company's investment and that of local finance markets. Diversification can be achieved by acquiring another company from a different sector or economy (abroad). The best way to diversify is to acquire a company that differs from the acquirer in certain characteristics (sector or economy) in such a way that the correlation sigma (φ) between them is as closest to -1[63].

E. <u>Discount on market value</u>

When a company is poorly managed, it is very likely that the investors will have low expectations of the company and the market share value will drop. That will signal

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[60] Therese H. Maynard, "Mergers & Acquisitions: Cases, Materials and Problems", 19, aspen publishing (2005)
[61] Yedidia Z. Stern,151
[62] Id at 169
[63] אלי טלמור, איתי שרוני, "יסודות המימון" הוצאת דיונון [2007]

opportunist investors in the market that the company has unexploited economic potential, and that it is now cheap to buy. The investors will then buy enough of the company's shares or debt claims (in discount over the potential market value) so they can achieve a control block of the company, and replace current management. The investor's theory or belief is that under different management the performance of the company will get better, and the share price of the company will rise. It is acknowledged[64] that the markets are very efficient as a supervision tool over management in public companies. By acquiring a company that is run by **incompetent management**, the acquirer is investing at a discount in a company with reason to believe he will see **good return** on the investment.

A motive in acquiring a company could be an exploitation of a "**market failure**" regarding the company's value, meaning, for example that it is being traded undervalued or at a discount in comparison to other companies in the sector. A company might be traded undervalued when there is information about it that doesn't reach to all of the "players" in the market. A "**failure of information**" regarding the company might cause its price not to reflect fundamental information about the company. Asymmetry in information gives the holder of the information an advantage in acquiring the undervalued company. Another manifestation of "failure of information" is arbitrage profit. Arbitrage profits are the buying of the company in one market where it is undervalue (stock of the company) and selling it where it is valued higher in the asset market and, thus make a profit[65].

F. <u>Funding terms</u>

Sometimes, the motives in acquiring a company are connected to **funding terms**. When a company wants to take out a loan, it needs to collaterize the debt with securities so the debt can be repaid from the selling of assets in case of insolvency. The funding terms of creditors are connected directly to the risk of insolvency of the debtor. By acquiring a company, the sum of the joined assets is bigger, the risk of insolvency decreases and, therefore, the time value of the loan (interest) will be cheaper[66].

G. <u>Looting</u>

It is clear that when the acquisition extends over a 100% of a company, the acquirer has no incentive to harm the company. The company's interests are the same as its own.

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[64] Manne, "Mergers and the Market for Corporate Control", 73 J.Pol. Econ (1965) 110
[65] Yedidia Z. Stern, 175
[66] Id. at 167

On the other hand, when the acquisition only extends over a control block of the company's stocks, the acquirers can than **loot** the minority shareholders of the company. When the shares are widespread among the public, the number of shares needed for a control block decreases, and provide incentive for "activist investors" to acquire control blocks. There are many ways a control block share owner can loot a company. Among them are "**self dealing**" with the company for assets in discount, taking business opportunities from the company[67], and preventing the company from competing against companies that are fully owned by the acquirer [68].

H. "Bust-up" acquisitions

When an acquirer takes over a company with the intention to liquidate the company into pieces for the highest bidder, that is a "bust up" acquisition. A situation like this is likely when the value of the company as an "ongoing concern" is lower than the value of the sum of every separate part of the company. This action is taken many times against companies in distress, and to some extent represents economic efficiency[69]. For example, when the demand for a company's product shrinks, it might be a good target for liquidation by an investor. Moreover, when some of the company's product lines are not profitable, selling them through liquidation might be the way to go. Alternatively, a "bust-up" acquisition can occur without the management's consent, since the owner-acquirer and management often have different interests than stockholders.

Corporate law does not provide any arrangements for bust-up acquisitions. The main opposition to a "bust up" comes from the courts, which backs up adverse managements. The opposition lays on the estimate that the value of the company will raise as an "ongoing concern" more than the value in liquidation[70]. **The *Revlon* case**[71] is a good example of the tension between the acquirer and the target's management. In that case, the management of "Revlon" tried to oppose a bidder in a hostile takeover by turning to a friendly acquirer in order to arrange a friendly takeover. The price that the hostile acquirer offered was higher than that of the friendly takeover, but even though Revlon's management did everything in its power to prevent the hostile takeover. The hostile takeover turned to the court to issue a warrant to cease all defense tactics by the management. The court decided that the managers breached their fiduciary duties

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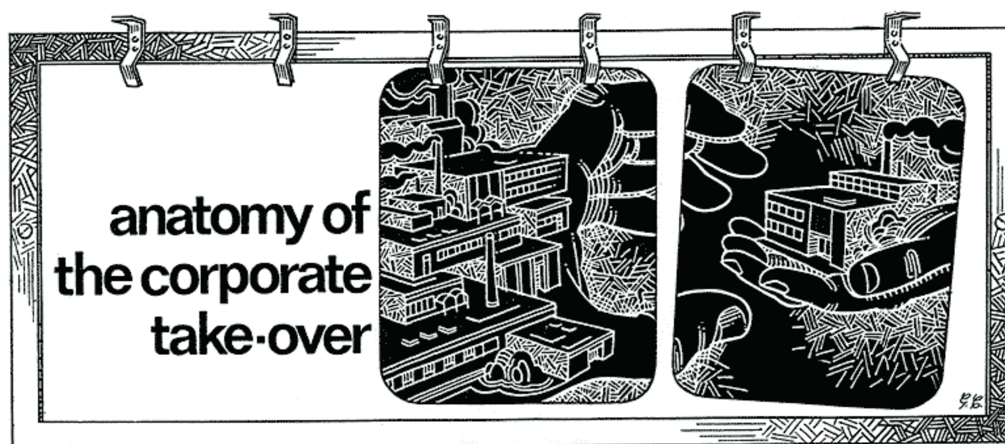
[67] Northeast Harbor Golf Club vs. Harris 661 A 2d 1146 (Me 1995)
[68] Yedidia Z. Stern, 174
[69] Irit Haviv segal, 537
[70] Id.
[71] Revlon vs. McAndrew & Forbs Holdings, 506 A.2d 173 (1986)

toward the company and shareholders, since the offer of the hostile takeover was higher. The court said that even though the hostile takeover was "inconvenient" for the management, they shouldn't have prevented it from happening[72].



[72] Irit Haviv segal, 568

Chapter 4: Bankruptcy M&A

A. "Vulture" Takeovers Through Chapter 11

Investing in distressed companies is a very lucrative field. Investors can generate huge returns of between twenty and thirty percent[73] by trading claims against or interests in distressed companies (before or after entering Chapter 11)[74]. The size of the secondary market for distressed companies grew dramatically from only $ 4.4 billion in face value in 1991 to whapping $ 31.82 billion in the year 2007[75], a growth of more than 700% [76] (that is without considering the peak of 57.15 billion between 2002/3). The growth in investment in distressed companies has a clear connection to the growth in the issuance of high yield bonds and highly leveraged bank loans, as well as the mentioned growth of the secondary market.[77]

These claims or interests include distressed debt securities that are traded on an exchange or "over the counter"[78] such as bonds and debentures, as well as debt claims that are not, such as privately placed debt securities, bank loan claims, trade claims, personal injury claims and claims for the rejection of executory contracts and finally, other interests against the debtor such as stocks[79].

A growing number of hedge funds and private equity (P.E) funds are investing in distressed companies as a mean of obtaining control over them[80]. Investors and funds that are involved in the bankruptcy process are called prepetition and postpetition investors, according to the time of the purchase of claim or interests (pre or post petition of a plan). The prepetition and postpetition investors are referred to in many names, some with negative connotations such as "vulture" funds and corporate "raiders", and

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[73] J.C. Coffee, Jr, A. Berle, W. Klein "BondHolder Coercion: The Problem of Constrained Choice in Debt
Tender Offers and Recapitalization", 2, 58 U.Chicago. L.Rev. 1207 (1991)

[74] Suniati Yap, "Investing in Chapter 11 Companies: Vultures or Whiteknights?", 2 Sw. J.L. & trade am. 153

[75] Reuters loan pricing corporation at www.loanpricing.com

[76] See infra appendix C

[77] Keven S. Buehler, "The allure of Distressed Debt", McKinsey Quarterly, [Apr. 14 2003]

[78] **In re Allegheny international Inc** 100 (Bankr. W.D. Pa. 1988) [**hereinafter: "Allegheny case"**]

[79] Chaim J. Fortgang and Thomas M. Mayer, "Trading Claims and Taking Control of Corporations in Chapter
11", 4, 12 Cardozo L.Rev (1990 – 1991) [hereinafter: "**Fortgang & Mayer**"]

[80] "Alternative" Investment Managers and Bankruptcy: The Brave New World of Chapter 11", 47 (hereinafter:"**The Brave New World of Chapter 11** ")

some with a positive connotation, such as "workout" or "turnaround" funds, "reorganization" and "recovery" funds and white knights[81].

Trading claims against distressed companies (both private and public)[82], has reemerged as a major Activity for investors[83], and has become a common feature of many Chapter 11 reorganizations.

B. <u>Prepetition and postpetition investors</u>

As mentioned earlier, in Chapter 11 bankruptcy the company usually would be run by its own management and in some cases by a trustee or administrator appointed by the court. This process would result in a reorganization plan that repays creditors some of their debt or exchanged it with equity in the newly reorganized company. The end result will be a company that is a "slightly pared down version" of its former self, in some cases under new ownership as a result of the reorganization plans[84].

Prepetition and Postpetition Investors are divided into **two categories**; The traditional **"Passive"** or **"return" investors**, which invest in a distressed company's debt or securities at low price ("bottom fishing") in order to make a profit when the company emerges from bankruptcy by reselling the new issued securities at a higher price (a spread or arbitrage. Purchase at discount, Redeem at par [85]). A classic example of a "return" investor's modus operandi is obtaining a list of bankrupt companies' creditors, and sending them blanket letters offering to buy all claims for a fixed percentage on the dollar. An unsophisticated creditorwho has no tools or desire to bargain in a Chapter 11 process, would be likely to trade his claims for immediate, risk free cash money (although for less than the original debt)[86]. The second kind are "**Activist**" or **"control" investors,** who do not merely hold the debt or securities of the company, but also participate in the negotiations of a reorganization plan, with intentions to increase the amount their class of claim would receive from the company after bankruptcy[87]. When an exchange of debt into equity is executed as a result of the reorganization, these investors can trade their debt claims with new issued securities,

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[81] The Art of M&A

[82] Fortgang & Mayer, 3

[83] **hereinafter: "prepetition or postpetition investors"**

[84] Suniati Yap, "Investing in Chapter 11 Companies: Vultures or White knights?", 2 Sw. J.L. & trade am. 153

[85] Joseph W. Bartlett, "Equity Finance, Venture Capital, Buyouts, Restructurings and Reorganizations", 337 ,
volume 2, 2nd edition, "Panel publication" [1995]

[86] The Brave New World of Chapter 11 ,49

[87] Frauman & Blauner, "Bankrupt Entities Targeted: Trading claims can serve as the basis of a takeover", N.Y Law J.p. 5, col .2 (June 2, 1990) (**hereinafter: "Frauman & Blauner**")

and in many cases would become a majority shareholder and therefore gain control of the company[88].

In recent years, we are witnessing a rise of the "**Activist**" **investors** in the bankruptcy process in the form of hedge funds, private equity funds, investment banks and also single investors that are taking an Active part in the Chapter 11 procedures. The targets of these funds are private or publicly held companies on the eve of bankruptcy under Chapter 11 or soon after Chapter 11 proceedings have commenced. The modus operandi of these investors is to perform an in-depth analysis of the claims they want to buy (valid and enforceable on the debtor) and also to estimate what kind of treatment these claims will receive by the court under a plan of reorganization. These investors purchase (or trade) in debt claims (or "any right to payment including contingent rights"[89]) against, or interest, in a company in bankruptcy as a technique for takeovers under Chapter 11[90]. These investors have intentions to influence the reorganization plan by sitting in official creditors' committees (usually composed of the seven biggest holders of the type of claim or interest that committee represents [91]) as well as "ad hoc" committees, since they are a large presence among claim holders[92], and therefore have the power to steer or to "carve out" the terms of the reorganization plan[93]. The mere treat by a creditor's committee to appoint a trustee will increase the committee's power significantly, since management would prefer to cooperate rather than step down[94]. The system has been formalized in such a way that bank debt and privately issued bonds are quoted and traded by brokers in a regular way[95].

Postpetition investors "bet" on two major "gambles"; **First,** the postpetition investor bets that a plan of reorganization will yield more than the price paid for the claims or stocks, and **second**, that a plan of reorganization will be confirmed and consummated before the interest paid for the funding of the purchase of the claims or

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[88] See supra Chapter 3 motives on the acquiring side

[89] Brodsky & Zweibel, "Chapter 11 Acquisitions: Payoffs for Patience", Mergers & acquisitions", 47 (sept/oct 1990) (**hereinafter: "Brodsky & Zweibel"**)

[90] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",1080, West publishing [1991]

[91] Richard E. mendales, "Intensive Care for the Public Corporations: Securities law, Corporate Governance, And the Reorganization Process" 995, Marquette L.rev 13 [2008] **[hereinafter: "Richard E. mendales"]**

[92] Paul M. Goldschmid, "More Phoenix Than Vulture",4 Colum. Bus L.Rev. 191 [2005]

[93] The Brave New World of Chapter 11, 48

[94] Lynn M. LoPucki & William C. Whitford, "Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies", 141 U. Pa. L.Rev 669, 787 (1993)

[95] The Brave New World of Chapter 11, 49

stocks (the time value of money) will lower the profit margins [96]. The legal advantages are mainly the ability to resolve uncertainties regarding the target, the opportunity to shape the reorganized target and the chance to overcome some traditional obstacles to hostile acquisitions[97].

C. Techniques for Claim Trading

It is a well based principle that when trading in claims against, and interests (stocks) in a debtor, the purchaser of a claim or interest has the same rights (to receive money from a distribution plan or to vote on a plan), and also the same "disabilities" (if debtor has a defense against the claim) as the original claimer or shareholder. Moreover, a plan of distribution to pay X amount of money would pay this amount even if a claim was purchased at a discount[98].

11 U.S.C § 3001(e) is governing the claim trading procedure in the bankruptcy Act and was enacted and revised in 1991 to "**assist the court in dealing with the evils that may arise out of post bankruptcy traffic claims against the estate**"[99], and relates primarily to the problems of insider trading in claims against the estate[100]. According to rule 3001(e), a claim may be transferred before a petition has been filed, and before either a proof of claim has been filed or the claim has been scheduled, without any judicial approval. An investor must file a **proof of claim**[101] In order **to Act** on claims he purchased **after** the debtor entered bankruptcy and a petition has been filed. A proof of claim is a proof that the transferring creditor acknowledged the transfer of the claim.[102] It is also the procedural way for the claim or interest to be recognized after Chapter 11 case has commenced[103].

After a proof of claim has been filed, the postpetition investor must provide the court with an evidence of the term of transfer[104]. The court then addresses the original claimant, which has 20 days to object to the transfer (a typical securities regulation remedy)[105].

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[96] Fortgang & Mayer, 5
[97] Brodsky & Zweibel
[98] Fortgang & Mayer, 13
[99] 11 U.S.C 3001 (1987)(advisory committee's note) see also: infra appendix A
[100] See supra Reverse case
[101] 11 U.S.C § 3001(e)(2)
[102] Frauman & Blauner
[103] Brodsky & Zweibel
[104] 11 U.S.C 3001(e)(2)
[105] Joseph W. Bartlett, 335

The reason to allow objection right to the original claimant is to protect him from being solicited to transfer his claims for less percent on face value than he would receive under the reorganization plan[106]; **"Solicited creditors may be unaware of their rights and options, and fall prey to the belief that the bankruptcy inevitably will result in their receiving the proverbial ten cents on the dollar or worse. Creditors may not be aware of the difference between a straight bankruptcy case under Chapter 7 and a reorganization case under Chapter 11 of the bankruptcy code"**[107].

According to rule 3001(e), the postpetition investor has the obligation to provide "sufficient information" to the transferee in order to make an "informed judgment"[108] on the offer, and as proof that the claim has been transferred to the postpetition investor unconditionally. After a proof of claim had been filed, a creditor could transfer claims against a debtor without court approval after a proof of claim had been filed[109]. After rule 3001(e)(2) was revised in 1991, there has been a considerable growth in investments in distressed companies, primarily because the amendment reduced the court's interference in debt claim trading. The revision cancelled the need for a hearing and approval of the court, and established that only the transferor has a stand to object to a transfer[110]. Notice that the code does not requires full public disclosure by a purchasers or sellers of claims, even though such purchases might transfer control over the reorganized company, in the form of voting power on a plan[111].

The court and any party interested learn about the condition of the deal from the disclosure statement. The Bankruptcy code § 1125[112], "**prohibits solicitation of <u>acceptance or rejection</u> of a filed plan <u>unless</u> the solicitation is accompanied or preceded by a disclosure statement"**. § 1125(a)(1)[113] read that "**the disclosure statement must contain <u>adequate information</u> which means information of a kind and in sufficient detail to enable a <u>hypothetical reasonable investor typical of holders of claims</u> to make an informed judgment about the plan**" [114]

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[106] 11 U.S.C 3001(e)
[107]Judge Abram **In re Revere copper & Brass Inc**., 58 B.R. 1 (Bankr. S.D.N.Y. 1985) [**hereinafter: "Revere case"**]
[108] In re Allegheny international inc 100 Bankr 241 (Bankr. W.D. Pa. 1989) [**hereinafter: "Allegheny case"**]
[109] 11 U.S.C 3001(e)
[110] Fredric Tung, "Confirmation and Claims Trading", 90 Nw, U.L. Rev. 1684, 1749 (1996)
[111] Richard E. mendales, 997
[112] 11 U.S.C § 1125
[113] 11 U.S.C § 1125(a)(1)
[114] Judge Abram in Revere case (my emphasis and edition, A.Y)

The remedy that was given by judge Abram in ***reverse* case** for the violation of 11 U.S.C § 1125 was, that the postpetition investor shall give each of its assignors a thirty days option to revoke the sale by giving the postpetition investor back the money paid for the them, thus expressing a will to take part in the authorized plan for reorganization. Under the plan of reorganization, more percent on the dollar was paid to the original creditor then in the postpetition investor's offer. Judge Abram suggested that in future assignment of claim "**[the court should] decline to approve the assignment unless it appears that the claimants have been advised at the time of the solicitation and again at the time a check in payment.....so that the solicited creditor may know where along the plan filing - disclosure statement hearing – confirmation line the case stand**"[115].

The remedy that is given in section 1125[116] for violation is a disallowance of the purchase, even though such a remedy hurts the buyer, it does not benefit the wronged claim seller. This raises an important questions regarding section 1125. In neither cases (*Revere* and *Alleghany*), did **any seller** objected to the transfer of its claims. **In *Reverse*** case the debtors objected and in ***Alleghany*** the court objected. Why should anybody else other than the seller have a stand in this matter?[117] The judges in both cases found authority for giving claim sellers the right to revoke the transaction under section 1125(b)[118], which regulates solicitation of claims in connection with plans of reorganization. But the fact is that neither of the buyers was connected with a plan of reorganization, but rather regular purchasers of claims. The judges apply the provision of claim trading in connection to a plan on the publicly debt securities in those cases. The two cases were attempts by the courts, to give claim sellers the private right of Action offered in section 1125, same right of Action given to securities sellers under the security law.[119]

Section 1123(a)(4) read that 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**"[120]. The prepetition investor who offer to purchase unsecure claims at a discount, and then intend to confirm a plan to pay himself and other unsecure creditors (who didn't sell their claims) a 100 cent on the dollar. This is a violation of section 1123(a)(4), by giving creditors who didn't sell

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[115] Judge Abram in Reverse case (my emphasis and edition, A.Y)
[116] 11 U.S.C § 502(a)
[117] Fortgang & Mayer, 42
[118] 11 U.S.C § 1125(b)
[119] Fortgang & Mayer, 46
[120] 11 U.S.C § 1123(a)(4)

better treatment than those who did sell their claims. In the *Chateaugay* case[121], judge Liflend's remedy was to **refuse the transfer** of such claims to a prepetition investor, since the prepetition investor (the buyer) did not disclosed vital information to the sellers, such as (1) the scope and the target of the purchase (achieving control), that (2) the buyer was Actually a shell company (front) for another and that (3) the buyer had intentions to propose a 100 cent plan after purchasing the unsecured debt. The judge Liflend treated the broad scale offer of the prepetition investor as a plan of reorganization, and by that applied section 1123(a)(4) in order to further protect sellers of debt claims[122].

Judge Cosetti in the ***Alleghany*** **case** noted that the debtor is prohibited to pay creditors outside of a plan of reorganization, and therefore held that a plan proponent (japonica) Acted in bad faith if he purchased claims during the balloting period of its own plan. The court concluded that such Activity is discriminatory toward members of same class debt claims, and therefore a violating section 1123(a)(4)[123]. This raises a problem, since the code does not protect creditors against their own ignorance or stupidity, and therefore, the court should not do so either. The claims were purchased after **a** plan has been approved, and therefore did not violate section 1123(a)(4) for equal treatment, and the creditors in *Alleghany case*, could have acquired the information regarding the authorized plans during the balloting time in the financial newspapers. Thus, the over paternalism of the court in this case was wrong[124].

The court In re *U.S. Truck Co.*[125] argued that it is impossible for an individual creditor to asset "**whether a 40% payment is more or less than the dividend in liquidation, or whether that such payment is offered in good faith or is a fair and equitable treatment?... that question can only be answered by an approved disclosure statement and confirmed plan**"[126]

D. Debt for Equity

In many cases under a plan of reorganization of large corporate debtors, the plan provides that securities will be issued to creditors and shareholders in addition, or instead of cash without the debtor's need to register those securities under the securities

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[121] In re Chateaugay, ch 11 Case Nos. 86 B 227342-405, slip op. at 2-3 (Bankr S.D.N.Y. Mar 11, 1988) [Hereinafter: " Chateaugay case"]

[122] Fortgang & Mayer, 79

[123] Joy F. Conti, Raymond F. Kozolwski, Leonard S. Ferleger, "Claim trafficking in Chapter 11—Has the Pendulum Swung to Far?", 6, 9 Bank. Dev. J. 281 (1992)

[124] Fortgang & Mayer, 41, 84

[125] In re U.S. Truck Co, 42 Bankr 787 (Bankr. E.D Mich, 1984)

[126] Id at 789

Act of 1933[127]. Exempt from such registration is "**A successor to the debtor under the plan**"[128]. The issuance of new securities will not require registration only if the securities are issued in exchange for a claim against, or stock in the debtor. An exception has been made to exclude "underwriters" from the "registration free" provisions[129], yet, Creditors and shareholders are not "underwriters" under the term in the securities laws, and therefore can sell their claims without registration[130]. Postpetition investors are also free to buy or sell claims without registration, only if they do not own more than ten percent in the debtor[131].

An Alternative way is for a postpetition investor can buy claims against, or stocks in a debtor, and can use the debt's face value as currency to purchase main assets ("trophy" assets) of the target company[132].

E. Voting on the Plan of Reorganization

Debt holders are entitled to vote on the plan of reorganization. An acceptance of a plan by same class creditor, requires two thirds in dollar amount (of debt) **and** more than 50 percent of the numbers of holders in that class (hereinafter:"number and amount" test)[133]. A class of shareholders accepts a plan if holders of at least two thirds in amount of the allowed interests represented by such shares have accepted the plan[134]. The "number and amount test" has a few targets. **First**, to empower small creditors which lack the resources to protect their interests against institutional creditors. **Second**, The "number and amount test" provides protection against oppressive tender offers, by forcing a claim buyer to buy all the claims in a class[135].

The law read that the purchaser of multiple claims is to be counted as having only one vote on a plan of reorganization[136]. a postpetition investor might try to distribute his claims among other people on his behalf, in order to meet the "majority in number", yet, there is a precedent judgment by the court that revoked such Action and considered all of the separate claims as one[137].the court have asserted that a purchaser of

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[127] 11 U.S.C § 1145(a)(1)
[128] Id.
[129] 11 U.S.C. § 1145(b)(3)
[130] Fortgang & Mayer, 58
[131] 11 U.S.C. § 1145(b)(1)(A)
[132] Joseph W. Bartlett, 335
[133] 11 U.S.C § 1126(c)
[134] 11 U.S.C § 1126(d)
[135] Fortgang & Mayer, 88
[136] Id.
[137] Lithographic Corp, 107 F.2d, 749, 751 (2d Cir. 1939) **[hereinafter:" Lithographic Corp"]**

two claims has one vote for each claim[138]. It also argued that an acquirer of two claims in two separate creditor's classes can, in good faith, Act in his own benefit and vote for claims in one class to support the claims in the other class[139].

Based on the Lithographic Corp case, one could argue that the "majority in number" rule may encourage postpetition investors to file a tender offer for the purchase of all claims in a class, since if even one claim in left in other ownership, a postpetition investor does not achieves the "majority in number", and therefore cannot approve a plan of reorganization[140].

On the other hand, the "number and amount test" may discourages claim trading in order to achieve control, since an investor needs to purchase **all** of the claims in a certain class in order to have more than 50% in number. This may result in the annihilation of the market for claims and a critical blow to the same unsecured creditors the law was enacted to protect[141].

In the next Chapter I will review the weapons provided to the debtor's management by the bankruptcy code, to "fight" "Active" Postpetition investors who seek control over the corporations under bankruptcy procedures.

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[138] In re Gilbert, 104 B.R. 206, 214 - 216 (Bankr. W.D. Mo 1989)
[139] Id.
[140] Fortgang & Mayer, 90
[141] Id at 91

Chapter 5: Competing for Control Over the Debtor

A. Control by the Purchase of Stocks During Chapter 11

By purchasing stocks in a corporation undergoing Chapter 11 reorganization, a postpetition investor might try to achieve control via a proxy fight. Shareholders usually have two reasons for arranging a shareholders' meeting; The **first** reason for arranging a shareholder meeting is to displace the debtor's operating management. This could be achieved by the substitution and election of directors on their behalf, and gaining de facto control of the company. This is not a legitimate reason for a shareholder meeting and is actually useless for shareholders, since the management and directors have fiduciary duty to treat both creditors and shareholders fairly and equitably. Thus, as fiduciaries which are exposed to personal liabilities in cases of a breach of duty, they are prevented from giving precedent to shareholders who elected them[142]. It has been stated that the debtor's management has the same fiduciary duties toward creditors as a trustee[143]. Shareholders meeting will not be permitted when it's used to displace management, especially when a trustee is appointed to run the company and file a plan of reorganization because it is done for the benefit of the creditors[144]. It seems that shareholders, the subsidiary beneficiaries of the estate, should not be permitted to displace management simply because creditors (the primary beneficiaries) are not permitted to do so for fear of delaying the reorganization[145]. Since creditors are the primary beneficiaries of the estate, The Supreme Court has expressed that the interests of shareholders (to hold a meeting) backs down in the face of creditor's interests to achieve quick reorganization of a bankrupt corporation[146] .

The **Second** reason for arrange a shareholder meeting is to coerce the debtor to file a different plan of reorganization or in a different time, than the time management has assigned for it. The Filing of a plan is not a legitimate goal for a shareholder meeting

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[142] Fortgang & Mayer, 71
[143] Wolf v. Weinstein, 372 U.S. 633 649-50 (1963)
[144] 11 U.S.C § 1104
[145] Fortgang & Mayer, 70
[146] Commodity Futures Trading Com v. Weintraub, 471 U.S 343, 355 (1985). (The supreme court cited Wolf v.
Weinstein)

and the court usually will not allow it during the "exclusive period".[147] A plan could be achieved without a shareholders meeting, by a judicial termination[148] of the "exclusive period"[149] given to the management. This is the way of shareholders to influence or to introduce their own plan, and by that resolves any "hold up" issues. The courts have usually permitted shareholders meetings[150] in any other matter, unless management can show that the meeting would constitute a "clear abuse", the reorganization will be jeopardized and that the corporation will suffer "irreparable harm"[151]. The "abuse" and "harm" to the reorganization process would be a result of a "hold up" tactics by shareholders in order to oppose or delay a plan.

B. Blocking control

In many Chapter 11 cases, investors seek to block reorganization plans introduced by management, by purchasing debt claims. Section 1126(e) read that: "**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**"[152]. Section 1126(e) was enacted to forestall the **"nuisance blocker"**[153] – thus, to prevent an investor from investing in claims as a "hold-up" in order to extract more by a threat to delay an acceptance of a plan when it is fully negotiated and sealed[154]. The section's scope is wide enough to condemn an acquisition of a blocking "position against" a plan. This can be concluded from looking at the legislative history of section 1126(e) in Chapter X, from the Supreme Court's verdict in *Young v. Higbee Co*[155] and finally, from SEC Commissioner William O. Douglas[156] testimony's in the 1937 House Hearing[157].

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[147] Fortgang & Mayer 64, 71
[148] 11 U.S.C § 1121
[149] See supra Chapter 1(c)
[150] See Manville Corp v. Equity Sec Holders comm. 801 F.2d 60
[151] In re johns-Manville Corp., 801 F.2d 69 (2d cir. 1986)
[152] 11 U.S.C § 1126(e)
[153] Revision of the Bankruptcy Act: Hearing on H.R. 6439 before the house comm. On the Judiciary, 75 Cong.,
1st session (1937), 183-184. **[hereinafter: "1937 House Hearing"]**
[154] In the Alleghany case, judge Cosseti disallowed the investors claim, since they were purchased as control
block, to defeat the debtor's plan.
[155] Young v. Higbee Co. 324 U.S. 204 (1945)
[156] later supreme court Justice
[157] hereinafter: "1937 House Hearing"

An investor who owns a "blocking position" in the debtor is referred to as a "**greenmail**"[158]. The code does not allow "greenmailing" by an investor in order to make profit from a blocking position against another plan of reorganization in a manner of receiving different treatment then other creditors or shareholders in his class. Moreover, a "greenmail" cannot profit from selling his control block to any interested party. In case of "debt for securities" exchange plan, a "greenmail" cannot sell his control block for cash equivalent (instead of receive securities). A control block owner cannot sell his vote while still remain with his claims. A creditor cannot trade his controlling position of the debtor, unless equity is distributed ratably to all members in his class[159].

In the *Alleghany* case, the court interpreted Chapter 1126(e) as prohibiting a potential acquirer of a Chapter 11 debtor who purchased debt claims from voting its purchased claims to defeat a competing plan, if the acquirer is proposing himself a plan that will provide him control of the debtor[160].

The court asserted[161] that creditor who used his vote on a plan in "bad faith" should be sanctioned by the criminal provisions of 18 U.S.C § 152, yet, the criminalization of the bankruptcy code has still remained in the margins later courts decisions , and have not become a mainstream sanction against misconduct by "control block" holder of claims[162].

C. Defenses Against Postpetition Investors

When the debtor wishes to defend itself from a postpetition investor, there are a few weapons at his disposal. "Lock up" agreements with particular parties in a Chapter 11 case, binds parties in order to support the debtor's plan. "Lock ups" are a dangerous weapon against postpetition investors, because such a "lock" is available to the debtor at any time against any investor seeking control. By creating a "lock-up", the debtor makes sure his plan will be approved, and therefore, cause the postpetition investor a great deal of loss since he finds himself left out of the reorganization plan[163].

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[158] "Greenmail": the practice of buying enough shares in a company to threaten a takeover, forcing the owners to
buy them back at a higher price in order to retain control. (taken from oxford English dictionary)
[159] Fortgang & Mayer, 96
[160] Joy F. Conti, Raymond F. Kozolwski, Leonard S. Ferleger, "Claim trafficking in Chapter 11—Has the Pendulum Swung to Far?", 6, 9 Bank. Dev. J. 281 (1992)
[161] Featherworks 25 Bankr. 634 (Bankr. E.D.N.Y, 1982)
[162] Fortgang & Mayer, 99
[163] Id at 107

On its surface, Section 1125[164] of the bankruptcy code seems to restrict, if not revoke the debtor from binding any party in such "lock-up" agreements. The section restricts primarily solicitations prior to the transmission of a disclosure statement[165]. Section 1125(b) read: **"An acceptance or rejection of a plan may not be solicited <u>after</u> 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".**[166] De facto, negotiations are made in simply every Chapter 11 case before a plan can be voted on, with entities such as unions, workers (pensions plans), various secured creditors and shareholders, government (environmental issues) and tax agencies. Courts do not consider such negotiations as prohibited under the section[167]. An example of a "lock–up" agreement was introduced in the *Texaco* case[168], when an agreement was made between Pennzoil (Texaco's multibillion dollar creditor) and Texaco itself (the debtor), to support only Texaco's plan of reorganization. Carl Icahn (Texaco's largest shareholder) attacked the settlement on the ground of prohibited solicitation under §1125, but the court asserted that it does not preclude as a prohibited "solicitation", because the agreement was that Pennzoil will support Texaco's plan **after** the approval of a disclosure statement as required, and not an agreement to take Action prior to the approval of a disclosure statement. The leniency of the court in the *Texaco* case opened the door for future solicitations by debtors[169].

In the next Chapter I will review the benefits of bankruptcy M&A for postpetition investors, debtors and the market's efficiency.

"I know they've been involved in a bitter takeover battle, so it's probably blood on the boardroom carpet."

[164] 11 U.S.C § 1125
[165] Fortgang & Mayer, 100
[166] 11 U.S.C § 1125(b)
[167] Fortgang & Mayer ,101
[168] Trance World Airlines v. Texaco Inc. (In re Texaco Inc.) 81 Bankr 813 (Bankr S.D.N.Y 1988)
[169] Fortgang & Mayer ,101

Chapter 6:
Benefits of Bankruptcy M&A

A. Debt Investors as Residual Actors

Postpetition investors and debtors share common interests. One of them is to consummate a reorganization plan sooner rather than later[170].

Supporters of postpetition investors argue, that the widespread phenomenon of the "vulture" fund and the growth of the resources gathered for the purpose of investing in distressed companies, narrows the discount from face value of these companies, meaning the stocks and bonds of the companies are valued higher, and the market becomes more Efficient[171]. Another argument read, that there is a benefit for the reorganization process by taking out the aggravated and hostile creditors, and replacing them with creditors who can focus on the negotiation process with a financial sense, free of emotions and hostility[172].

In some cases, these "vulture funds" might actually save the company from reaching liquidation by giving it new resources of finance (White Knight)[173]. Postpetition Investors might be a distressed company's only chance for a successful reorganization, since they are whiling to receive securities or equity in the reorganized company. On the other hand, creditors, such as banks or insurance companies, have a greater incentive to sell their claims, since they are compelled by regulation or accounting rules to write down the claim in their books as a total loss of 100% of the claim. That way, after selling the claim to the postpetition investor for X cents on the dollar, they can "generate" an accountant profit[174].

Banks are also unwilling to exchange debt with securities, since they usually have no interest in securities, and might even be prohibited by the regulator from taking securities under a plan of reorganization[175].

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[170] Fortgang & Mayer, 6
[171] Frauman & Blauner
[172] Suniati Yap, "Investing in Chapter 11 Companies: Vultures or White knights?",3, 2 Sw. J.L. & trade am. 153
[173] Hilary Rosenberg, "The Vulture Investors: The Winners and Losers of the Great American Bankruptcy Feeding Frenzy", 344 (1992) **[hereinafter: " Hilary Rosenberg"]**
[174] Fortgang & Mayer, 4
[175] 12 U.S.C § 1843(a) & (c)(2) ; 12 C.F.R §§ 1.12, 225.21

B. Flexibility

Under Chapter 11 proceedings, disadvantaged or compromised debt can be modified in the terms of the bond: principle amounts, interest rates, payment schedules, covenants, and subordination provisions. The flexibility in changing the reorganization plan afforded by Chapter 11, allows the acquirer (as subsequent purchaser of claims under Chapter 11) to modify the debts against the company to his own benefit. An acquirer can also use the debtor's existing indebtedness rather than raise new capital for the acquisition (issuance expenses are saved and covenants are reduced for fundraising in the market).

Another benefit is that the bankruptcy code allows the acquirer to maintain, terminate or assign executory contracts and unexpired leases and also to limit its liability for damage claims by paying less on the dollar under Chapter 11[176]. That is in contrast to normal acquisitions where executory contracts and unexpired lease are static. The remedy for rejection or termination of contracts under Chapter 11 will not result in a breach of contracts and damages law suits, like they would, outside of the Chapter 11 process. Moreover, when the company remerges from bankruptcy and exchanging debt for equity by issuing new securities, no registration process with the SEC[177] is necessary[178].

Finally, establishing tax loss for debt claim or stock may not be possible By a Prepetition creditors or shareholder until they can be sold, or that a plan for reorganization is confirmed. By the creation of a market for debt claims by postpetition investors, Prepetition creditors or shareholder can utilize the tax loss when it is suitable for them[179].

C. Overriding Management

Investors in distressed companies are a catalyst for management replacement. In many cases, the current management is the one responsible for the situation the company is in from the first place. The investors increase the accountability of management (in contrast to Chapter 11 reorganization, where management is in control

[176] Suniati Yap, "Investing in Chapter 11 Companies: Vultures or Whiteknights?",2, 2 Sw. J.L. & trade am. 153
[177] security regulation benefits are discussed later in Chapter 6
[178] Suniati Yap, 2
[179] Fortgang & Mayer, 4

of the reorganized company). An investor with a large claim block has motive and means to remove current management and replace it with a better one[180].

Generally speaking, mergers require the board of director's approval. In some cases management also has power to block hostile takeovers. Under Chapter 11 reorganization, management is less capable to resist such Actions by an acquirer. Moreover, the management's powers can be diluted or overridden by the appointment of a trustee or examiner via a proxy vote [181].

D. Liquidity

Postpetition investors have created a secondary[182] market for public and private debt claims, where creditors and shareholders can achieve liquidity. In fact, Postpetition investors perform a capital raising function which has a positive effect on the public security markets, and as a result, on the U.S economy.

Postpetition investors provides relief for **Creditors**, since they are usually willing to sell their claims for cash discount, rather than take a chance that a plan will be approved in an unknown amount will be approved at an uncertain period of time[183]. Postpetition investors benefit the **debtor** as well, since they broaden the pool of investors in distressed companies. In many cases, companies from same sector that are in distress as well[184], cannot either afford to acquire the distressed company, or the acquisition is done in lower prices[185]. Moreover, by purchasing large blocks of claims (consolidation), investors are Actually **reducing administrative burden** and **deliberation costs** for the debtor.

It is clear that less negotiation is needed with investor which has a large block of claims than with many small creditors, without no commune agenda[186] and are acting according to the prisoner dilemma[187]. The mean number of days a company spends under bankruptcy protection has decreased from 741 days in 1990 to 267 days in the year 2002[188]. According to one study, during the 1980's, 88% of the large businesses

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[180] Id.
[181] Discussed in Chapter 1(C)
[182] In re Wheeling-Pittsburgh Steel corp (Bankr. W.D. Pa Sept 1, 1989)
[183] Fortgang & Mayer, 4
[184] See infra subchapter H
[185] See Edith S. Hotchkiss and Robert M. Mooradian, "Acquisitions as a Means of Restructuring Firms in Chapter 11", 3, Journal of Financial Intermediation, (1998)
[186] Rosenberg, 344
[187] John C. Coffee, Jr, Adolf A. Berle, William A. Klein "BondHolder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalization",5, 58 U.Chicago. L.Rev. 1207 (1991)
[188] Lynn M. LoPucki & William C. Whitford, "Corporate Governance in the Bankruptcy Reorganization Of Large, Publicly Held Companies", 141 U. Pa. L.Rev 669, 787 (1993)

entered Chapter 11 without a clear reorganization plan. By the year 2002, that ration has decreased to 24%. The shorter time in bankruptcy and the increase in prepackaged bankruptcies are a distinctive business culture of distressed debt investors[189].

Small shareholders probably make out a large number of troubled companies security holders since they bear most of the risk in a bankruptcy. Thus, the presence of postpetition investors in the securities markets benefits those most of all others[190].

E. Prepackaged Bankruptcies

Prepackaged bankruptcy can take place when a majority of two thirds of the allowed claim holders and one half in numbers agree to the reorganization plan **before** entering the Chapter 11 process. The Prepackaged bankruptcy makes the time spent in bankruptcy much shorter (from years to months) and the debtor's costs on legal fees lower. The majority demand is an advantage for **debt security holders**, because approval of a plan in a class of bondholders requires 100% consent among bondholders, while in prepackaged bankruptcy, the minority can be coerced[191]. This binding of the minority benefits the company (reducing costs), the creditors and the prepetition investors themselves (quick returns on their money)[192].

F. Leverage in Negotiations

Some trade creditors may want to continue dealing with the distressed company in the future. Therefore, they would be willing to sell their claims and recoup their losses. For example, when a debtor rejects a collective bargaining agreement or pension plan under Chapter 11, the workers union can achieve much more by negotiation a new collective bargaining agreement. The union could obtain an initial recovery by arranging a sale of its member's claims before the plan is confirmed, and still be able to bargain with the debtor to maximize its member's recovery even more[193].

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[189] Douglas G. Baird & Robert K. Rasmussen, "Chapter 11 at Twilight", 56 Stan L.Rev. 673, 674 (2003)
[190] Fortgang & Mayer, 4
[191] J.Coffee, Jr, A.Berle, W.Klein "BondHolder Coercion: The Problem of Constrained Choice in Debt Tender
Offers and Recapitalization", 1, 58 U.Chicago. L.Rev. 1207 (1991)
[192] Hilary Rosenberg, 232
[193] Fortgang & Mayer, 5

G. Creating Value

There is evidence that acquisitions through bankruptcy procedures can create economical value for **bidders**. Post merger performances of acquired firms under Chapter 11 are better than firms independently **reorganized** under Chapter 11[194]. Moreover, stock returns were positive after an announcement of an acquisition for both bidder and target, in contrast to only positive stock return for targets in non-bankruptcy acquisitions[195].

H. Positive Use of Asymmetric Information

An empirical study of the economic gains from the sale of firms in bankruptcy shows, that takeovers can facilitate an efficiency enhancing redeployment of assets. It is consisting with the assumption that bidders that are operating in the same industry as the target firms have better knowledge and\or expertise in running and redeploying the assets efficiently[196].

I. Tax Benefits

Mergers and acquisitions are transactions in which two side are exchanging cash, stocks and assets between them. Normally, in a regular stock sale, the selling shareholder realizes and recognizes taxable gains or losses[197] under section 1001(a)[198] of the Internal Revenue Code (I.R.C)[199], unless it falls into the technical requirements of section 368[200], which contains selected statuary exceptions for selected transactions. Section 354(a)(1) [201] provides (under the definitions of section 368) tax free treatment for investors of corporations in reorganization which exchange stocks or securities between them as part of the reorganization process. The tax avoidance is on the shareholder level, as well as on the corporate level. The essence of section 368 is that **"The transaction doesn't change the position of the participants enough to warrant an immediate imposition of a tax"**[202]. The courts have imposed more observations on the

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[194] Edith S. Hotchkiss, "Post bankruptcy Performance and Management Turnover" 3-21, Journal of finance 50
(1995)
[195] Hotchkiss (1998), 22
[196] Hotchkiss (1998), 6
[197] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",36, West publishing [1991]
[198] 26 U.S.C §1001(a)
[199] http://www.irs.gov/pub/irs-drop/rr-01-24.pdf
[200] 26 U.S.C § 354(a)(1)
[201] 26 U.S.C § 368,
[202] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",923, West publishing

transaction in order for the tax free treatment to be given first. The "**continuity of interest**" test means that the shareholders of the target company must receive substantial equity interest in the bidder corporation, and thereby maintaining a continuing ownership interest. Second, "**Continuity of business enterprise**" requires bidder to assume and operate historic business of the target corporation. finally, the motives for the transaction have to be for a **valid business purpose**[203].

Another tax evasion is possible In **debt for stocks swap transaction**[204]. When the debtor (insolvent or in Chapter 11) swaps its own stocks (current or newly issued in the reorganized company, A.Y) for debt, and there is a difference between the fair market value of the stock swapped and the debt discharged, the difference will be not be taxable as gross income for the debtor.

Acquiring "pieces" of a liquidated company creates a step up basis for the acquirer's assets, more than acquiring a company as a "running concern". This allows the company to depreciate much more than it would in a smaller asset basis, and therefore pay fewer taxes. Moreover, the acquirer can offset losses of the acquired company with its taxable income, and therefore the total tax liability is smaller[205].

In the next Chapter I will review some of the negative aspects, as well as obstacles facing investors, when investing in distressed companies.

[1991]

[203] Therese H. Maynard, "Mergers and Acquisitions: Cases, Materials and Problems", 700, Aspen Publishers [2005]

[204] I.R.C. § 108(e)(10)(A)+(B)

[205] Auerbauch, Alan J., and Reishus, David, "The ImpAct of Taxation on Mergers and Acquisitions" edited by Alan J. Auerbauch. University of Chicago Press (1988)

Chapter 7:
Negative aspects of Bankruptcy M&A

A. Negative aspects for a postpetition investor

One of the negative aspects for postpetition investors investing in a distressed company is that the process has more judicial review than in a regular acquisition. It may be disruptive and interfering to an investor, yet, it is a main element of Chapter 11 acquisitions. Another negative aspect is that competing plans are being submitted to the court, and all classes (subjected to a cramdown, A.Y) must approve the plan. This creates much more negotiation and holdup problems for the buyer. As much as debt structure is more complex, gaining the consent of all creditors for the acquisition becomes more difficult, due to possible dispute over the division of the proceeds from the sale[206].

The current structure of Chapter 11 has discouraging affect on acquisitions. Since present management usually remains in control when entering Chapter 11[207], self interested managers might avoid from selling the firm even if it is in the best interest of the creditors and shareholder's[208]. On the other hand, the problem of negotiation a deal with a trustee raises other problems, which are discussed supra in Chapter 1(B).

Main down side for a postpetition investor is the lack of secrecy due to the publicity of the plans. Any understanding must be submitted to the court, and by the time the court makes a decision, the bidder is exposed to the possibility of a better offer or a "lock up" by management. The court will approve an offer only if there is "no better nor higher offer" that will be filed at a specified time after announcement of the proposed transaction[209].

The majority requirement (the "number and amount" test) of the bankruptcy law for the acceptance of a plan acts as an inherent "**shark repellent**". A bidder could purchase all but one claim, but he will only be 50% in number of holders (counted only as one creditor[210]) and therefore could not pass the plan[211].

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[206] Hotchkiss (1998), 2
[207] see supra Chapter 1(C)
[208] Baird, "Revisiting Auction in Chapter 11", 633-653, Journal of Law and Economics 36
[209] Brodsky & Zweibel
[210] Joseph W. Bartlett, "Equity Finance, Venture Capital, Buyouts, Restructurings and Reorganizations", 338, volume 2, 2nd edition, "Panel publication" [1995]
[211] Brodsky & Zweibel

B. LBO'S

Acquisitions of companies that filed for Chapter 11 after a failing Leveraged Buyout (**LBO**) are a good example of the hardship postpetition investors has to go through in order to realize debt claims. LBO debt is used in many cases to raise cash by the debtor for the purchase of its own stocks (buybacks, A.Y) and is issued either by the debtor corporation itself or by an SPV (Special Purpose Vehicle) that is set up by the company to raise money and later is merged into the debtor corporation[212]. Courts have been treating LBO's as fraudulent conveyance Acts (up to a year before the bankruptcy has began, and even longer[213]). Thus, both in the hands of pre-bankruptcy holder and the postpetition investor's, **the LBO debt claim might be void**, unless the holder can establish that he is a holder in good faith (bona fida) and that a holder in good faith is not subject to fraudulent conveyance attack[214].

Taking under consideration the characteristics of a postpetition investor, it is clear why in his hands a LBO debt claim might be **more voidable**: **First**, pre-bankruptcy holders litigate with the Management for the purchase of the LBO debt claims, and therefore management will avoid any accusation of Conveyance Act toward them, since they might bear personal liability[215]. The situation is different with postpetition investors. Management will bear no personal liability if filing a motion for the court to invalidate the postpetition claims on the ground of Conveyance Act since they did not litigate.

Second, a postpetition investor is a much easier target than numerous prepetition holders, and cannot establish a reliance on registration statement. Therefore, management will not hesitate to file a motion for the court to invalidate the claims.

Finally, a postpetition investor is risking antagonizing management as a result of a hostile takeover through the purchase of debt claim against the debtor. The post petition investor might actually drive the management to file a motion to invalidate the investor's claims (similar to defenses in a hostile takeover) [216].

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[212] Fortgang & Mayer, 15
[213] 11 U.S.C § 548
[214] Fortgang & Mayer, 15
[215] Securities Act 1933 § 11(a)(1); 15 U.S.C § 77k(a)(1)
[216] Fortgang & Mayer, 16

C. Trading by Fiduciaries

The bankruptcy Act lacks the remedies and sanctions regarding trading of claims by fiduciaries. Fiduciaries trading provisions were left out from after Chapter 11 when it was enacted, and replaced its predecessor, Chapter X[217]. Chapter X's provision authorized the judge to **"examine and disregard any provisions"** that were made by authorizations of the company (directors, management, and proxy, which bear fiduciary duties) to benefit any of the company's fiduciary figures **("agent, attorney, indenture trustee or committee to represent any creditor or stockholder")**[218]. The judge can examine and disregard any provisions **"which he (**the judge, A.Y**) finds to be unfair or not consistent with public policy and may limit any claim or stock acquired by such a person or committee in contemplation or in the course of the proceedings under this Chapter to the Actual consideration paid therefore**" [219]. Moreover, Congress enacted a provision to provide the denial of fees to trading fiduciaries in a way that **"no compensation or reimbursement shall be allowed to..... other person Acting in the proceeding in a representative or fiduciary capacity who at any time after assuming to Act in such a capacity has purchased or sold such claim or stock, or by whom or for whose account such claims or stock have, without the prior consent or subsequent approval of the judge, been otherwise acquired or transferred"** [220].

In today's bankruptcy Act, the remedy comes not from the applicable law (since Chapter X was replaced by Chapter 11), but rather from the equitable powers of the Court. The Supreme Court has already established that the Chapter X's provisions are applicable today as they were before, and therefore sanctions are being Acted against fiduciary trading[221].

Alternatively, the courts has also partially disallowed claims sold by fiduciaries on the ground that the claims do not lose the fiduciary "taint" when sold to a third party. If the third party had knowledge that the previous owner was a fiduciary, the third party may be held jointly and severally liable for any tort committed by the fiduciary[222]. When dealing with publicly traded debt (debt securities), such an argument cannot stand, and such remedy would be impossible to enforce. Instead, an Action against the director might recover more for the estate; however, there is no authority existing under the bankruptcy Act that can execute such a remedy[223].

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[217] Fortgang & Mayer, 29
[218] 11 U.S.C § 612 (**1976**)
[219] Id.
[220] 11 U.S.C § 649 (**1976**)
[221] Fortgang & Mayer, 35
[222] In re Los Angeles Lumber Products Co., 46 F. Supp 77, 92-94 (S.D. CAL 1941)
[223] Fortgang & Mayer, 29

D. Public Policy

From a **Public Policy** perspective, the Chapter 11 reorganization should not only provide benefits to investors and billion dollar funds, but mainly to the employees and suppliers of companies in distress, and of course to the economy of the U.S[224].

Other arguments read that debt investors are generally short term oriented, and do not invest in distressed companies in order to save an industry or some other Nobel cause, but rather to make a quick profit[225].

One argument read that the bankruptcy process is not very efficient to begin with. If it was more efficient, by representing the interests of public security holders, the purchase price might not drop when bankruptcy occurs, and the chance for easy profit by opportunists would have decreased[226].

E. Untimely End of the Reorganization Process

The success of a debt investor to achieve fast restructuring and spend less time in expensive reorganization process might result in the debtor emerging from Chapter 11 before it is ready for it. Untimely emerging from Chapter 11 will lead to the relapse of debtors to a second or third time. Distressed investors are more concerned IPO or a merger\acquisition of the distressed debtor (in order to liquidate the investment) and not on the rehabilitation of debtor's finance in the long run[227]. the tendency is to look at them as short term investors[228].

The reasons why debt investors are usually short sighted are the profit margins. Most debt investors are extremely time sensitive because they need to repay loans they took in order to fund claim trading. A delay in a reorganization plan will decrease profit or even result in a loss, due to interest payment on the loan (the time value of money). Most Hedge funds are obligated to provide "redemption at will" to their clients, which make them particularly prone to be "**battling against the clock from an IRR (internal rate of return) perspective**"[229].

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[224] For more criticism on the bankruptcy process See Baird & Rasmusson in supra Chapter 1(D).
[225] The Brave New World of Chapter 11, 51
[226] Frauman & Blauner
[227] Harvey R. Miller, "Chapter 11 Reorganization Cases and the Delaware Myth, 55 Vand L.Rev, 1987, 2013
(2002)
[228] Edith S. Hotchkiss and Robert M. Mooradian, "Vulture Investors and the Market for control of distressed
firms", 43 J.Fin. Econ. 407, at 5 (1997)
[229] Paul M. Goldschmid, "More Phoenix Than Vulture",7 Colum. Bus L.Rev. 191 [2005]

F. Asymmetric Information

A Study shows that **asymmetric information** may hinder acquisitions of distressed companies. In 66% of acquisition through Chapter 11[230], there is at least one matching primary line of business between the bidder and the target company. That is in contrast to only 35% match in non bankrupt acquisitions[231]. It might suggest that Potential bidders from outside of the target's industry may not be aware of the firm's value or to the best use of the target's assets[232].Asymmetric information might explain the fact that in bankruptcy acquisitions there are more multiple bidders from the same industry than in non bankruptcy acquisitions (18 and 11 respectively). It is likely that if a whole sector is in distress, the biddings of companies from that sector will be lower than the bidding of companies from other "healthy" sectors. The result is that bankrupt companies are being purchased on average at a 45% discount relative to prices paid for non-bankrupt companies[233].

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[230] **Hotchkiss** (1998) , 4

[231] Kaplan and Weisbac, "The Market for Corporate Control: The Scientific Evidence", 107-138, Journal of financial Economics (1992)

[232] Hotchkiss (1998), 3

[233] Id. at 5

Chapter 8:
"Loopholes" in Securities and Anti-Trust Regulations

A. Claim Trading and Securities Regulation

The main laws that regulate all the securities trading Activity in the U.S are the securities Act of 1933[234] and the securities exchange Act of 1934[235]. These laws were enacted to ensure, among other things, a "level playing field" for potential traders of securities[236], and that the markets are fair by prohibiting trading on inside information[237] and market manipulations[238].

Regulation requires[239] periodic (annual and quarterly) disclosure regarding financial data and other circumstances relevant to holders of securities[240] .

Reorganization plan can include the purchase or sale of the debtor's assets (including subsidiaries), important properties or even the entire business[241] (as part of an M&A), yet, the only disclosure duty of the debtor is to notice "parties in interest" (creditors, shareholders and the U.S trustee) that a hearing will be brought before the court. The bankruptcy Act lacks regulation found in the securities law of 1934 regarding acquisition or a sale of a control block in public corporations, which impose extensive disclosure duties[242]. Current securities laws provide protections and remedies only to holders of "**securities**". Debt claims however, are excluded from the definitions of securities by both language and judicial opinion[243].

The security Act of 1933 includes "**evidence of indebtedness**" in its definition of securities. One could argue that a debt claim is an evidence of indebtedness, but actually a debt claim is more of a pleading or a notice of a claim[244]. Even if a debt claim was an "**evidence of indebtedness**", it is still absent from the definition of "securities" in the

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[234]Securities Act of 1933 15 U.S.C 2A (**hereinafter: the securities Act 1933**)
[235] Securities Exchange Act of 1934 15 U.S.C 2B (**hereinafter: the securities exchange Act 1934**)
[236] Richard E. mendales, 999
[237] Id. §§ 10(b) ; 15 U.S.C §§ 78j(b); C.F.R § 240 10b-5
[238] Id. §§ 9,10(b); 15 U.S.C §§ 78i, 78j(b)
[239] Id.
[240] See also appendix D – sec form 8-k
[241] 11 U.S.C § 1123(a)(5)(B)
[242] Richard E. mendales, 999
[243] See Appendix B – the securities definitions of both the Securities Act of 1933 and the Securities Exchange Act of 1934
[244] Fortgang & Mayer, 48

security exchange Act of 1934, and therefore prone to be excluded from the definition of "securities"[245]. Thus, the lack of a clear definition in the two securities law, made the argument that debt claims against a Chapter 11 debtor qualifies as "securities" under the securities laws, very problematic and illusive[246].

The meaning of "securities" was construed liberally in early courts decisions[247]. According to the "Howey test", an instrument was an "investment contract" and therefore a security if it was a **"contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profit solely from the efforts of the promoter or a third party"**[248].

In later cases, the court excluded from the "securities" definition, investment instrument that were heavy regulated by other laws, such as banking regulation, employee and retirement regulations Etc[249].

The U.S supreme court have developed a **test** in the *Reves* case[250], that reduced significantly the chance that a claim against a debtor in Chapter 11 will qualify as a security unless it is already based on a debt instrument which itself qualify as a security ("**publicly traded corporate bonds or debentures**")[251]. The "Reves test"[252] held that an instrument is not a security unless it has a "family relation" to these exceptions:

1. **The motivation of the buyers and sellers:** if the investment instrument was issued to raise money for "general use" of a business enterprise or to finance a "substantial investment" then it **was a security**, but it **wasn't a security** if it is for the purpose of purchase or sale of a minor asset, consumer goods, to correct any cashflow difficulties or to advance a commercial or consumer purpose.
2. If there were any "**common trading for speculation or investment in the instrument**" an investment instrument shall constitute a "security". (This criteria could indicate that a debt claim in a Chapter 11 under plan of distribution is in fact a "security", yet it was not significant enough to overcome the other negative conditions)[253]
3. The "**reasonable expectations**" of the investing public.

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[245] Tcherepnin v. Knight 389 U.S. 332 (1967)
[246] Fortgang & Mayer, 50
[247] In Sec v. C.M Joiner leasing corporation 320 U.S. 344 (1943)
[248] In Sec v. Howey Co. 328 U.S. 293 (1946)
[249] For example the Employees retirement income security act of 1974
[250] Reves vs. Ernest & Young, 110 S. Ct 945 (1990).
[251] Fortgang & Mayer, 51
[252] The case was followed in 76 cases since, distinguished in 10, and criticized in one case. (see infra appendix G)
[253] Id at 52

4. The existence of **another regulatory system** shall reduce significantly the risk of the instrument, and therefore the protection of the security Acts is unnecessary.

The court's test in *Reves* did not cover the problem of debt claims since it focuses on the time of the issuance. Judge Cosetti in the *Alleghany* case[254] noted that the reality is that the filing of a Chapter 11 petition turns the claim into instrument with all the characteristics of a security, even though they were not issued as one; "**What was once a fixed right for cash payment within a short period of time has become a right to receive undefined consideration at some indefinite time. An instrument evidencing a commercial transaction has become a speculative instrument**"[255]

In other words, when a given interest in or a claim against the debtor was originally issued, it did not resembled an equity security (protected under severe regulation, A.Y), but under Chapter 11 proceedings, it may become a speculative instrument which entitles the holder to vote on the debtor future and may become a right to receive an securities[256] in the new reorganized company[257]. The issue becomes grave when "insiders" (the fiduciaries of the company) are the buyers or sellers of claims. By using inside information regarding the execution of the reorganization plan, a discount or par transaction in claims can be made. Even simple traders can buy and sell stocks at a fair price on the stock market, since it is an efficient market that is protected by the securities laws. Regulation and efficiency creates an Active and deep market for such securities. A-symmetry of information in the claim trade market harms its efficiency, "chill" the development of the secondary market and effects contrary to the intent of the reorganization law – to protect unsecure creditors[258]. in the long run, it will harm M&A bankruptcy from becoming the "procedure of choice", which the courts endorse in order to help companies in Chapter 11 procedures.

In order to preserve the integrity of the bankruptcy process, and fuel it even more, specific regulation is needed. Such regulation needs to be oriented to small unsophisticated investors (such in the *Revere* case[259]), and leave out those sophisticated investors which can take care of themselves[260].

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[254] See supta Chapter 6
[255] Fortgang & Mayer, 52
[256] See Sec v. Texas Int'l Co. 498 F.Supp. 1231 (N.D. ILL, 1980)
[257] Joseph W. Bartlett, "Equity Finance, Venture Capital, Buyouts, Restructurings and Reorganizations", 333, volume 2, 2nd edition, "Panel publication" [1995]
[258] Richard E. mendales, 1002
[259] see supra Chapter 6(C): "trading by Fiduciaries"
[260] Fortgang & Mayer, 52

B. Anti –Trust Regulations

As mentioned earlier, among the many reasons for mergers and acquisitions are eliminating competition in the market, growth, synergy gains and diversification[261]. Mergers play an important role in free market economy in the form of enhancing efficiency, which can increase the competitiveness of firms and result in lower prices for the consumers[262]. Putting aside the benefits of those transactions, one cannot ignore that there are implications on the general public, costs that are not internalized by the parties to the transaction. Public interest may be over looked, or even ignored intentionally in transactions of such kind.

The effect on public interest (the externalities) of the transaction mentioned above can result in reducing competition in the market or even create a monopoly. According to the U.S Department of Justice 1987 Merger Guidelines[263], mergers should not be permitted to create or enhance "market power"[264], or to facilitate its exercise. The reason why enhanced market power in the hands of one or more firms, is that single seller can maintain selling price higher than the price maintain in a competitive market. A small number of firms in the same sector of industry can coordinate their Actions in order to maintain the price higher than in a competitive market.

The basic antitrust statutes are few in number[265]: The Sherman Act of 1890; the Clayton Act[266], first enacted in 1914 and significantly amended in 1936 by the Robinson-Patman Act and in 1950 by the Celler-Kefauver Antimerger Act; and the Federal Trade Commission Act of 1914. In 1976 the Congress legislated the Hart-Scott-Rodino antitrust improvement Act of 1976[267] which set a waiting period (in which the transaction is examined in antitrust perspective) before any qualifying merger can be made[268].

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[261] See supra Chapter 3 The motives on the acquiring side"

[262] . Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",986, West publishing [1991]

[263] 52 anti-trust & trade reg. rptr. (BNA) special supplement (1987)

[264] "The ability of one or more firms profitably to maintain prices above competitive levels for a significant
period of time".

[265] http://library.**findlaw**.com/1999/Jan/1/241454.html

[266] 15 U.S.C.A § 18 (1914)

[267] 15 U.S.C.A § 7A (1976)

[268] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",979, West publishing [1991]

Defenses

As much as mergers of non bankrupt corporations are scrutinized carefully, before given an authorization by the department of justice, a doctrine was developed so that mergers may be allowed in cases where one of the parties is a "failing" corporations. The doctrine is called the "falling firm defense". An anticompetitive merger will not be challenged by the federal trade commission under certain conditions: (1) When the "failing" company is unable to meet its financial obligations in the near future, (2) when it's probably would not be able to reorganize successfully under Chapter 11 and (3) that less anticompetitive acquisitions have been sought in good faith[269].

Criticism

It is clear and obvious that acquisitions of failed companies are ways of bypassing antitrust laws. By acquiring a failing company, "market power" can enhance significantly and inflict externalities on the public just like any other anticompetitive transaction, for the simple reason that past performance of the company (downward curve) do not reflect future performances, and past market share doesn't reflect future "market power".

In order for the "failing company" defense to apply, attempts in good faith have to be made to find a less anticompetitive acquirer [270]. Many questions arise from this condition. **First**, what is good faith in this matter? When does an acquisition done in a way that is not in "good faith"? "Good faith" can be interpreted in many ways, and the answer varies between many possible answers, each could be very different and bear grave consequences. **Second**, how to measure the competitiveness of the purchaser, and how much is "less" competitive"? **Third**, the logic says that a less competitive purchaser will not pay as much as an anticompetitive purchaser for the company[271]. This means that companies will head for liquidations and be sold to a less efficient buyer, thus, decreasing the joint efficiency in the market (**my addition, A.Y**).

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[269] Prof. Dale A. oesterle, "The Law of Mergers, Acquisitions and Reorganizations",979, West publishing [1991]
[270] Id.
[271] Nanni, "Merger Enforcement at the Antitrust Division, 58 antitrust L.j. 329, 338-42 (1989)

Chapter 9:
Possible Solutions for the Exploitation Of the Reorganization process

A. **Security regulation**

In order to apply security and anti fraud regulations on debt claims under Chapter 11, the securities Act of '34 and antifraud section of the exchange Act of 1933 have to be revised in order to facilitate the debt claims, and include them specifically under the definition of "**securities**". By doing so, investors will not be able to take advantage of A-symmetric information in order to make profit from claim trading. Alternatively, the courts have to fill the void[272] by implementing a test that will focus on the **development and nature** of the investment instrument as a result of Chapter 11 petition, rather than on the nature of the instrument at the time of the issuance.[273] The U.S Supreme court[274] took a step in the right direction by providing remedies and sanctions from the securities laws on a non-security instrument. The court prevented an investor (using its equitable powers) from making a discount purchase of a mortgaged debt, by a cramdown of other creditors, and therefore unduly profit from it.

The securities law should be amended to include reporting duties on reorganizing corporations to their debt holders, as well as on buyers and sellers of such debt, in order to prevent both insiders trading and especially trade in potential control block of claims. Such provisions should not apply only on publicly held corporation, but also on corporations that are publicly held **De Facto**, since they have complex debt structure, held by various debt holders. (more than 500 holders of more than $ 100 million in amount, similar to the securities law[275])

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[272] Joseph W. Bartlett, 334

[273] Treating trade claim as a security will not be so different than including a non-security instrument such as a home mortgage under that term. A home mortgage is not a security when issued, but when it's resold on the secondary mortgage market it becomes a security [Fortgang & Mayer, 53]

[274] In re Gladstone glen 739 F.2d 1233 (7th cir, 1984)

[275] 15 U.S.C § 78(g)(1) at 12(g)(1) 17 C.F.R § 240. 12g-1.

B. The "city" code

The city code on takeovers and mergers (1968) [hereinafter: "The city code"] is a voluntary consent between the major players in the "city", the finance market of London, UK. The city code establishes rules regarding the governing and control of companies in the United Kingdom. It defines control of a company as owning 30% or more in voting rights (control De Facto is irrelevant). Rule number 10 read that: **"Where control of a company is acquired by a person or persons Acting in concert, a general offer to all other shareholders is normally required".** The code also determines that the price paid by the acquirer to the rest of the shareholders will be the highest price paid for the company's shares in the previous year[276]. It is clear that the "city code" is actually a "forced tender offer"[277].

I think that in order to minimize the ability of investors to take advantage of Chapter 11 reorganization by purchasing control block claims from some of the creditors at discount, a similar rule should apply on acquisitions of more than 30% of the total debt claims, since they might be a control block in the reorganized company De Facto, and allows the acquirer to achieve control of the reorganization plan and\or liquidation. To my opinion, The rule achieves two main goals. **First**, it gives other claim holders in the company an equal opportunity[278] to enjoy the benefits of claim trading, as big or small as they may be. **Second**, it allows other claim holders to transfer the risk, that they will not receive anything in a bankruptcy process, to sophisticated investors, with more negotiation skills, leverage power and finance.

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[276] Yedidya stern, 248
[277] Id at 253
[278] Similar to the "Equal Opportunity Rule" (Yedidya stern , 264)

C. Applying Duties on Debt Claim Buyers

In Chapter 4 I reviewed the duty of a bankruptcy investors to provide a discloser statement, and the remedies the courts provided to the wronged claims sellers. The proposition that unsecure claims constitute "securities" covered by the Williams Act has an authority in the reorganization of King Resources Corporation[279]. In that case, Texas International made a broad scale purchased of unsecure debt against King Resources Corporation, with a goal to achieve control in the new reorganized company. The offer looked like a tender offer, Yet, the offer was not made to all of the debtor's unsecured creditors, and was not filed with the SEC as required. The unsecured creditors, who did not get an offer to sell their clams, sued Texas International (in the Western District of Oklahoma) for making a tender offer to only some of the debtor's unsecured creditors and **lost**. The SEC sued Texas International (in the Northern District of Illinois) for the same cause, and **won**[280]. These two conflict decisions by the different courts were never resolved[281]. The judge's opinion in SEC v. Texas Int'l Co. was of course relevant to the case, but difficult to implement on other cases, since it is in contrast to the definition of "securities" in the securities laws[282], and wasn't followed in later cases[283].

The Williams Act[284] was legislated with the revision of the securities Act in 1968.

Chapter 13(d) provide an **enhanced disclosure duty** of investors who own (directly or indirectly) as a result of an acquisition of stocks, more than 5% of a public company. The disclosure duty applies on any intention to: (1) achieve control of the company in the future and\or to (2) lead mergers, restructure, reorganize or liquidate the company. The Williams Act applies also for "street sweep" of stocks from the public[285].

The bankruptcy jurisdiction over the tender offer is problematic, since the shares are owned by the shareholders and not by the insolvent corporation. The bankruptcy code does not apply on them[286]. This is why, in order to include tender offers of debt in a corporation undergoing bankruptcy, no change is necessary in the state law (corporate

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[279] Citibank v. Baer, 651 F.2d 1341, 1347 (10th Cir.1980)
[280] SEC v. Texas Int'l Co., 498 F.Supp. 1231 (N.D. ILL. 1980).
[281] Fortgang & Mayer, 81.
[282] See supra Chapter 8(A)
[283] Fortgang & Mayer, 82
[284] 15 U.S.C § 78m(d)-(e)
[285] Yedidya stern, 307
[286] Richard E. mendales, "Intensive Care for the Public Corporations: Securities law, Corporate Governance, And the Reorganization Process", 1015,, Marquette L.rev 13 [2008]

governance are a matter of state law), but rather should come from the revision of the federal securities laws[287].

To my opinion, the Williams Act's provisions should apply on trading claims of more than 5% of the total amount of claim against the company (by a revision of the securities laws). The logic is to provide claim owners with sufficient information on other "players" in the bankruptcy process, so they will be able to maximize their profit from selling at a good price, and protect them from wrongful sell of their claims, as well as provide adequate disclosure to the general public regarding any control changes in the corporation.

For example, an investor A, is "street sweeping" for claims in order to become a major creditor, and later on a major shareholder in the new reorganized company B.in current situation, A can buy claims from some of the creditors X to achieve sufficient control of the debtor, without buying any claims from other creditors Y. By applying the Williams Act on debt claim purchase, A will have to purchase, or at least make a fair offer to other creditors Y in exchange for their claims, since he cannot pay them less than other creditors.

Section 3001(e) of the Bankruptcy Act should be amended to require that when a transfer of a non-publicly traded claim is made, a filing must be made with the court's clerk, which contains the names of the traders, the amount and type of claim and the terms of the transfer. An insider to the corporation or the bankruptcy process must file a disclosure notice regarding his interests in the debtor.

D. Fiduciary Duty

A different solution, is inspired by two judgments: the first is *Perlman vs. Feldmann*[288] case, which is an anomaly in U.S court cases[289], since the court's decision was against "the market overt". In that case, the court decided that shareholder of a company's control block, cannot sell his shares of the company to a buyer with malicious intentions. The court also said that a buyer "**Has a duty not to transfer the power of management to such purchaser**". Moreover, the court asserted that the seller have to share the control premium with the minority shareholders, and made them entitled to recovery on their own right (and not for the company in a derivative Action). Now let's

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[287] Richard E. mendales, "Intensive Care for the Public Corporations: Securities law, Corporate Governance, And the Reorganization Process",1016, Marquette L.rev 13 [2008]
[288] Perlman vs. Feldmann 219 F.2d 173 (1955)
[289] Dr. Irit Haviv segal, 431

apply the *Perlman* case on the example of investor A, company B and other creditors Y. Investor A buys claims only from creditors Y in order to achieve a control block. As a result of my analysis in the *Perlmann* case in a bankruptcy perspective, creditors Y will have to share the control premium that was paid to them in exchange to their claims with the minority shareholders X.

We can clearly see that we have maximized the recovery of all of the creditors of the company, and there for, this is a positive and desirable rule. A second judgment is the Israeli *Kosoy*[290] case. In that case, the court said that a control shareholder has power and control over the company, and therefore has **fiduciary duties** (fairness, good faith) and the obligation to Act in the benefit of the company.

E. A Desirable Arrangement

The bankruptcy Act lacks regulation against fiduciaries trading in claims. In current situation, a postpetition investor with a major position in a debtors securities can sit on official a creditor's committee (appointed by the court), and take advantage of his power without any provision in the bankruptcy code[291]. The problem becomes graver since they are also not regulated by the securities Act[292]. By combining the court decisions in *Perlmann* and *Kosoy*, I will base my analysis is based upon the similarities between debt claims and securities, as discussed in Chapter 8 supra.

Debt holders in a distressed company have a duty toward other **claim holders** to avoid from selling their claim to buyers with malicious ("looter") intentions to pass a plan against the minority debt holder (exclude them from recovering any debt).

Claim holders in a distressed company also have a **fiduciary duty** toward **the company**, to avoid from trading claims with investors with malicious intentions.

This proposition is very extreme, and it shows that the court have a "**set of equitable tools**" in hand, that can be used in order to prevent "vultures" from taking advantage of the Chapter 11 process. A weak spot in applying duties on claim traders is that there is much need for judicial supervision, which in most cases is complicated and cumbersome[293].

[290] ע"א 817\79 קוסוי ואח' נ' בנק פויכטונגר, פ"ד לח(3) 253, **285**

[291] Fortgang & Mayer, 33

[292] See supra Chapter 7

[293] Yedidya stern, 288

F. Exclusive period

As discussed in Chapter 1, the debtor has an "exclusive period" to propose a reorganization plan to the court, and the court can extend it at will. I suggest an arrangement that automatically decreases or denies an extension of the "exclusive period", in cases where a claim purchaser has acquired blocking position. The debtor would have to propose a plan that deals with his creditor much more realistically and fairly before a position block has been acquired, instead of delaying the process so that creditors have to cut their losses[294].

[294] Suniati Yap, "Investing in Chapter 11 Companies: Vultures or White knights?",8, 2 Sw. J.L. & trade am. 153.

Conclusions

One can argue that any attempt to regulate claim trading under Chapter 11 bankruptcy procedures will result in the "chill" of the secondary market, and in harming the creditors of bankrupt corporations. This argument is proved false when considering how markets have adopted to other regulations such as the securities law (Williams Act in specific) and the United Kingdom's "city code".. The markets adapted to new regulations, and have become more efficient under them. The bankruptcy code is in need of an in-depth revision. The Chapter 11 process needs to contain provisions regarding claim trading. The securities law should take under consideration that the markets for such claims are getting bigger and more sophisticated, and therefore in need of regulation. As long as Congress does not enact adequate regulation for dealing with claim trading, and there will be no promulgation of bankruptcy rules dealing with disclosure issues and control contests of the debtor, the courts will have to exercise their equitable powers, and fashion remedies for misuse of bankruptcy process to and Thus, subjecting the development of the bankruptcy case law to inconsistency, uncertainty and ad hoc creation, dependent upon specific fact, situations and judge[295].

The questions that have been left open are few; Regarding claim transferability and the disclosure conditions of Chapter 3001(e), **first**, how much information should be given to creditors by an interested investor? Taking under consideration that in a bankruptcy case, facts circumstances change daily, information from yesterday might not be valid today.

Second, should rule 3001(e) apply on well informed creditor such as banks, as it did in the Allegheny case? Regarding fiduciary trading, this subject raises many interesting questions since the sanctions and remedies on fiduciary duties are not subjected to statutory provision, but rather have evolved pursuant to the general equitable standards, there is a grave risk of expansion beyond the desirable scope. **First**, can an erection of a "Chinese wall" in an organization be a recognized concept in fiduciary trading? And if so, will it be enforceable?[296]

Second, can an affiliate of a fiduciary, who plays no role in a Chapter 11 bankruptcy process and have no inside information, trade in claims against or interests in the

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[295] Joy F. Conti, Raymond F. Kozolwski, Leonard S. Ferleger, "Claim trafficking in Chapter 11—Has the Pendulum Swung too Far?"33, 9 Emory Bankr. Dev. J. 281 (1992)

[296] Fortgang & Mayer, 36

debtor? Will it put the fiduciary in jeopardize of fiduciary trading? If the answer for the last question is positive, can an affiliate of any Wall Street broker or dealer use as a participant in a creditor's committee?

One of the reasons for the current global financial crisis was the lack of regulation[297] on credit instrument that were traded in the secondary and third markets in the U.S. If the market for distressed companies will keep its growing direction[298], the next crisis is "right around the corner".

I am certain that courts will have to deal in the near future with many of the questions raised in this work by using the equitable tools available to them, and hopefully, the legislator will revise the securities and bankruptcy law, in order to facilitate adequate regulation for trading in claim against, or interest in distressed debtors.

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[297] See Alan Greenspan's testimony before Congress on the 23 of October: http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=1&hp&oref=slogin

[298] See appendix c infra

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Appendix

Appendix A - Rule 3001(e) – Notes of Advisory Committee on Rules—1983

Appendix B- The securities definitions of both the Securities Act of 1933 and the Securities Exchange Act of 1934

Appendix C – Reuters loan pricing corporations – the scale of the secondary loan market in the U.S

appendix D - The SEC'S 8–K disclosure form

APPENDIX A

11 U.S.C 3001

Source

(As amended Pub. L. 98–353, title III, § 354, July 10, 1984, 98 Stat. 361; Apr. 30, 1991, eff. Aug. 1, 1991.)

Notes of Advisory Committee on Rules—1983

This rule is adapted from former Bankruptcy Rules 301 and 302. The Federal Rules of Evidence, made applicable to cases under the Code by Rule 1101, do not prescribe the evidentiary effect to be accorded particular documents. Subdivision (f) of this rule supplements the Federal Rules of Evidence as they apply to cases under the Code.

Subdivision (c). This subdivision is similar to former Bankruptcy Rule 302 (c) and continues the requirement for the filing of any written security agreement and provides that the filing of a duplicate of a writing underlying a claim authenticates the claim with the same effect as the filing of the original writing. Cf. Rules 1001(4) and 1003 of F.R. of Evid. Subdivision (d) together with the requirement in the first sentence of subdivision (c) for the filing of any written security agreement, is designed to facilitate the determination whether the claim is secured and properly perfected so as to be valid against the trustee.

Subdivision (d). "Satisfactory evidence" of perfection, which is to accompany the proof of claim, would include a duplicate of an instrument filed or recorded, a duplicate of a certificate of title when a security interest is perfected by notation on such a certificate, a statement that pledged property has been in possession of the secured party since a specified date, or a statement of the reasons why no Action was necessary for perfection. The secured creditor may not be required to file a proof of claim under this rule if he is not seeking allowance of a claim for a deficiency. But see § 506(d) of the Code.

Subdivision (e). The rule recognizes the differences between an unconditional transfer of a claim and a transfer for the purpose of security and prescribes a procedure for dealing with the rights of the transferor and transferee when the transfer is for security. The rule clarifies the procedure to be followed when a transfer precedes or follows the filing of the petition. The interests of sound administration are served by requiring the post-petition transferee to file with the proof of claim a statement of the transferor acknowledging the transfer and the consideration for the transfer. Such a disclosure will assist the court in dealing with evils that may arise out of post-bankruptcy traffic in

claims against an estate. Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943); In re Philadelphia & Western Ry., 64 F. Supp. 738 (E.D. Pa. 1946); cf. In re Latham Lithographic Corp., 107 F.2d 749 (2d Cir. 1939). Both paragraphs (1) and (3) of this subdivision, which deal with a transfer before the filing of a proof of claim, recognize that the transferee may be unable to obtain the required statement from the transferor, but in that event a sound reason for such inability must accompany the proof of claim filed by the transferee.

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

Paragraphs (2) and (4) of subdivision (e) deal with the transfer of a claim after proof has been filed. Evidence of the terms of the transfer required to be disclosed to the court will facilitate the court's determination of the appropriate order to be entered because of the transfer.

Paragraph (5) describes the procedure to be followed when an objection is made by the transferor to the transferee's filed evidence of transfer.

Notes of Advisory Committee on Rules—1987

Subdivision (g) was added by § 354 of the 1984 amendments.

Notes of Advisory Committee on Rules—1991 Amendment

Subdivision (a) is amended in anticipation of future revision and renumbering of the Official Forms.

Subdivision (e) 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).

The words "with the clerk" in subdivision (e)(2) and (e)(4) are deleted as unnecessary. See Rules 5005 (a) and 9001 (3).

References in Text

The United States Warehouse Act, referred to in subd. (g), is Part C of Act Aug. 11, 1916, ch. 313, 39 Stat. 486, as amended, which is classified generally to Chapter 10 (§ 241 et seq.) of Title 7, Agriculture. For complete classification of this Act to the Code, see Short Title note set out under section 241 of Title 7 and Tables.

Amendment by Public Law

1984—Subd. (g). Pub. L. 98–353 added subd. (g).

Effective Date of 1984 Amendment

Amendment by Pub. L. 98–353 effective with respect to cases filed 90 days after July 10, 1984, see section 552(a) of Pub. L. 98–353, set out as a note under section 101 of this title.

Cornell University
Law School

APPENDIX B

The securities Act 1933 15 U.S.C § 77b(a)(1)

§ 77b. Definitions; promotion of efficiency, competition, and capital formation
(a) **Definitions**
When used in this subchapter, unless the context otherwise requires—

(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 interest or 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.

The securities exchange Act 1934 15 U.S.C 78c(a)(10)

§ 78c. Definitions and application
(a) **Definitions**
When used in this subchapter, unless the context otherwise requires—

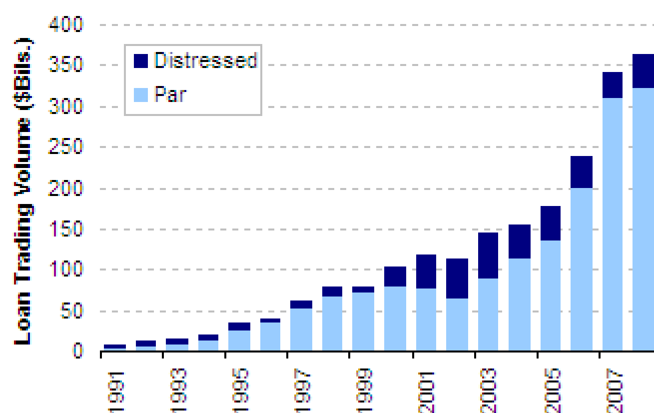
(10) The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, 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.

REUTERS
Loan Pricing Corporation

Appendix C

LPC DNA > U.S. Secondary Loan Market Volume

[1991 - LTM2Q08 (single-sided)]



Source: Reuters LPC Traders Survey

Below is single-sided secondary trading volume for 1991 - LTM2Q08 subdivided into par and distressed volume.

Year	**Par** *($Bils.)*	**Distressed** *($Bils.)*	**Total** *($Bils.)*
1991	3.60	4.40	**8.00**
1992	4.93	6.20	**11.13**
1993	6.29	8.75	**15.04**
1994	13.03	7.78	**20.81**
1995	25.61	8.21	**33.82**
1996	33.45	6.05	**39.50**
1997	51.62	9.02	**60.64**
1998	65.77	11.79	**77.56**
1999	70.17	8.93	**79.10**
2000	77.97	24.00	**101.97**
2001	75.82	41.70	**117.52**
2002	64.90	47.58	**112.48**
2003	87.42	57.15	**144.57**
2004	113.49	41.52	**155.01**
2005	135.52	40.82	**176.34**
2006	198.67	39.89	**238.56**
2007	310.20	31.82	**342.02**
LTM2Q08	322.65	39.82	**362.47**