Claims Traders Rejoice: Sixth Circuit Reverses Original Document Ruling

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Participants in the multibillion-dollar bankruptcy claims-trading market breathed a collective sigh of relief on January 25, 2010, when the Sixth Circuit Court of Appeals handed down its highly anticipated ruling in *B-Line, LLC v. Wingerter (In re Wingerter)*. The court of appeals reversed lower-court rulings sanctioning a company engaged in the business of buying and selling consumer bankruptcy claims for failing to make "a reasonable pre-filing inquiry" to ascertain whether an acquired claim was bona fide. Had the Sixth Circuit ruled otherwise, claims traders (principally in consumer cases) faced the unwelcome prospect of increased costs associated with ensuring that each proof of claim is supported by actual documentation, rather than information more easily accessible from electronic databases, and an inability to rely on industry-standard warranties of a claims' validity by intermediate sellers.

Claims Trading

The proliferation of vulture, hedge, and private equity funds and other traders in distressed "securities" provides a ready market for creditors and shareholders who want to cut their losses without waiting until the end of a bankruptcy case to realize a recovery on their claims. Although trading in public securities issued by a debtor is regulated by disclosure and other requirements contained in federal securities laws, transfers of creditor claims are not subject to such regulation. Astute claims traders can profit considerably if claims acquired at a steep discount later reap significant recoveries. Whether such speculation turns a profit depends on the quality of an

acquiror's investigation of the debtor's affairs and an educated bet on the likely outcome of the case—information and expertise that few creditors have or are willing to develop.

The disparity in resources and expertise between creditors and sophisticated claims speculators has been perceived as creating a potential for abuse in this unregulated market, which, according to some recent estimates, may involve claims totaling anywhere from $500 billion to as much as $1 trillion in both business and consumer bankruptcy cases. For this reason, bankruptcy courts have sometimes played a role in monitoring and even preventing claims trading (*e.g.*, in cases where a significant volume of trading will jeopardize a debtor's ability to preserve valuable tax attributes due to a change in control). Court scrutiny also has been brought to bear because buying claims against a corporate debtor may be a means of acquiring a controlling stake in the company if the company converts its debt to equity as part of a chapter 11 plan.

Bankruptcy Rule 3001

Neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") expressly give the bankruptcy courts the power to regulate claims trading once a company files for bankruptcy protection. Bankruptcy Rule 3001(e) contains certain notification requirements that vary according to when a claim is transferred and for what purpose (*i.e.*, for security or otherwise) to ensure that the court has an accurate record of the identity of the holder of the claim and, in a chapter 11 case, to ensure that the actual holder of the claim has an opportunity to vote to accept or reject a plan. It does not provide for any court involvement in the trading process.

Under Rule 3001(e), if a claim has been transferred for purposes other than security prior to the filing of a proof of claim, there is no need to disclose the consideration for the transfer or to submit other evidence of the transfer. If a claim has been transferred for purposes other than security after the original claimant files a proof of claim, the transferee is substituted for the transferor in the court's records in the absence of a timely objection by the transferor. The Advisory Committee Note accompanying the 1991 amendment to Rule 3001, which significantly curtailed court oversight of claims transfers, states that, in the event the transferor makes a timely objection, the "court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law." It further notes that "[t]his 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."

Proof of a transferred claim must be filed in accordance with the other requirements set forth in Bankruptcy Rule 3001. For example, Bankruptcy Rule 3001(a) provides that a proof of claim shall conform substantially to Official Bankruptcy Form 10, which, among other things, instructs claimants to "[a]ttach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, judgments, mortgages, and security agreements." In addition, Bankruptcy Rule 3001(c) provides that when a claim "is based upon a writing, the original or a duplicate shall be filed with the proof of claim." If the documentation cannot be filed with a proof of claim because it has been lost or destroyed, "a statement of the circumstances of the loss or destruction shall be filed with the claim."

Claims Trading in the Electronic Age

Extraordinary growth in the industry devoted to the trading of claims in both business and consumer bankruptcy cases has been aided by the implementation of electronic case filing ("ECF") and other technological developments, such as Public Access to Court Electronic Records (PACER), Automated Access to Court Electronic Records (AACER), and legal research programs such as Westlaw and Lexis. Before these innovations, companies engaged in the business of providing information on new bankruptcy filings sent personnel to the bankruptcy courts on a regular basis to compile lists of newly filed petitions. Thus, although the incidence of a bankruptcy filing and all pleadings filed in each case have always been matters of public record, these technologies make identifying debtors much easier than in the era of paper filing. In the ECF age, search firms need only do a computer search for each bankruptcy-court location throughout the U.S.

The ECF system also streamlines the filing of proofs of claim for claims purchasers. Where ECF is used for proofs of claim, creditors are no longer required to mail an original hard copy of claims for filing, nor do they need to request return of file-stamped copies of the filed documents. However, automated "mass filing" procedures implemented by many traders in consumer bankruptcy cases, which involve bare-bones information concerning the details of an acquired claim and little, if any, supporting documentation, arguably conflict with the claims procedures set forth in Bankruptcy Rule 3001 and Official Bankruptcy Form 10. This apparent inconsistency was the subject of the Sixth Circuit's ruling in *Wingerter*.

Wingerter

Gerald Wingerter and his wife, Janet, filed a chapter 13 case in February 2006 in Ohio. B-Line, LLC ("B-Line"), timely filed a proof of claim against the debtors in the amount of $431.57. The proof of claim stated that the debt was originally held by an entity referred to as "GTE" and that B-Line had purchased the claim from another company, referred to as "Covenant Management LLC" ("Covenant"). B-Line submitted its claim on Official Bankruptcy Form 10. In addition to misstating that the basis for the claim was "money loaned," the proof of claim lacked detailed information concerning the basis for the claim and did not include copies of any original documentation or a statement in accordance with Rule 3001(d) that such documentation had been lost or destroyed. Instead, attached to the proof of claim was a printout from B-Line's electronic database that included Mr. Wingerter's name and address, the last four digits of his Social Security number, an account number, and the amount of the claim.

B-Line is one of the leading buyers of consumer bankruptcy accounts in the U.S., having purchased and serviced, by its own estimate, more than $45 billion of bankruptcy receivables since it was founded in 1997. Covenant, also a consumer bankruptcy claims trader, was one of B-Line's frequent customers. B-Line had purchased more than 1,000 claims from Covenant during the two years prior to purchasing the claim against Wingerter. Only five of these claims were ever disputed.

In acquiring claims, B-Line negotiates a standard purchase agreement with sellers. The agreement between B-Line and Covenant transferring the claim against Wingerter provided that "[a]s of the Closing Date . . . [Covenant] has used reasonable efforts in accordance with industry standards to create Computer Files which set forth each Account designated in the Term

Agreement, each of which meets the Eligibility Requirements as of the Cut-Off Date." The "Eligibility Requirements" included representations that "the Account represents a legal, valid and binding obligation of the related Debtor," that "the debt is not disputed by the Debtor or Trustee," and that "no proof of claim has been or will be rejected or successfully objected to by any person."

The Wingerters objected to B-Line's claim. After attempting unsuccessfully to locate copies of the original supporting documentation, B-Line withdrew its proof of claim. Even so, the bankruptcy court subsequently directed B-Line to explain its business practices generally, as well as its treatment of the purchased claim against Wingerter. It ultimately handed down a published ruling sanctioning B-Line under Bankruptcy Rule 9011(b) for failing to make a "reasonable pre-filing inquiry" that the claim was valid and supported by the evidence. In particular, the court held that any party filing proof of an unscheduled claim must include copies of "originating documents" or, when such documents are unavailable, an affidavit explaining why. However, the bankruptcy court declined to impose monetary sanctions on B-Line, given the "time and energy" that senior management devoted in responding to the court's directives. The ruling was upheld on appeal by a bankruptcy appellate panel for the Sixth Circuit, which declined to address the merits of the appeal, concluding that the issues were either moot or not final. B-Line appealed to the Sixth Circuit.

The Sixth Circuit's Ruling

A three-judge panel of the court of appeals reversed, by a margin of two to one (the dissenting judge voting to uphold the ruling below on jurisdictional grounds). At the outset of its discussion, the Sixth Circuit explained that B-Line's appeal was not moot because the bankruptcy court's

determination that B-Line's conduct was sanctionable set a precedent for future cases (and in fact has been cited as authority by other courts).

Addressing the merits, the Sixth Circuit faulted the bankruptcy court's conclusion that B-Line's conduct in investigating the basis for its claim was sanctionable under Rule 9011(b), which provides in substance that, by presenting any written pleading, motion, or other paper to the court, an attorney certifies that the allegations and other factual contentions contained therein have evidentiary support. According to the Sixth Circuit, contrary to the bankruptcy court's findings, the evidence clearly showed that B-Line received representations and warranties concerning the validity of the claim purchased from Covenant. In addition, the court erred by failing to consider all of the actions taken by B-Line to investigate the basis for the claim rather than focusing primarily on its "findings that B-Line had not only never seen the originating documents for the claim, but also had never received any warranty from Covenant that the claim was valid."

Given their long history of dealing and a "strong, consistent track record of Covenant providing enforceable claims," the Sixth Circuit explained, B-Line's reliance on Covenant's warranties was reasonable. Moreover, the bankruptcy court failed to consider evidence showing that Covenant had conducted its own thorough investigation into the claim before selling it to B-Line. Finally, B-Line did not "simply rest on Covenant's own research," but conducted an additional review of its own before purchasing the claim by, among other things, comparing the information that it received from Covenant with the electronic records of the bankruptcy court and other databases.

The Sixth Circuit ruled that B-Line's conduct was neither unreasonable nor sanctionable:

> Admittedly, as the bankruptcy court stressed, B-Line's proof of claim was submitted on an incomplete Form 10. This deficiency violated Rule 3001(c) . . . , which requires that a proof of claim based on a writing include a copy of that writing. The ramifications for this type of violation are well-established, however, and do not result in sanctions. . . . Not complying with Rule 3001 might be a factor in determining whether a Rule 9011(b) violation has occurred under different circumstances, but it is not a relevant factor in this case given the track record and warranties between Covenant and B-Line and the efforts that both businesses undertook to validate the Wingerter claim.
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> Finally, in light of what Rule 9011(b) requires before a court can impose sanctions, the bankruptcy court's categorical extrapolation of its holding—that the holder of an unscheduled, purchased claim will always have to attach copies of the claim's originating documents to its proof of claim or provide an explanation for their absence—is incorrect. Rule 9011(b) and this court's own precedents require bankruptcy courts, before imposing sanctions, to determine whether the specific conduct at issue was "reasonable under the circumstances" at the time the filing was submitted. . . . Such an analysis does not lend itself to categorical prescriptions, but rather will depend on the varying facts of each case. B-Line's prefiling conduct in the present case was clearly "reasonable under the circumstances." This is especially so because Rule 9011(b) itself contemplates that a creditor does not have to have conclusive proof of the claim at the time of filing—that a good-faith belief based on a reasonable inquiry is sufficient if the "factual contentions . . . are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery."

Outlook

Participants in the multibillion-dollar market for distressed claims and securities have had ample cause to keep a watchful eye on developments in the bankruptcy courts during the last five years. Controversial rulings handed down in 2005 and 2006 by the bankruptcy court overseeing the chapter 11 cases of failed energy broker Enron Corporation and its affiliates had traders scrambling for cover due to the potential for acquired claims or debt to be equitably subordinated or even disallowed, based upon the seller's misconduct. The severity of this cautionary tale was ultimately ameliorated on appeal in the late summer of 2007, when the district court vacated both of the rulings in *In re Enron Corp.*, holding that "equitable subordination under section 510(c)

and disallowance under section 502(d) are personal disabilities that are not fixed as of the petition date and do not inhere in the claim."

2008 proved to be little better in providing traders with any degree of comfort with respect to claim or debt assignments involving bankrupt obligors. In *In re M. Fabrikant & Sons, Inc.*, a New York bankruptcy court took a hard look for the first time at the standard transfer forms and definitions contained in nearly every bank-loan transfer agreement. The court ruled that a seller's reimbursement rights were transferred along with the debt, fortifying the conventional wisdom that transfer documents should be drafted carefully to spell out explicitly which rights, claims, and interests are not included in the sale.

2009's contribution to the bankruptcy claims-trading ordeal came in the form of a ruling handed down by the Second Circuit Court of Appeals. Addressing the matter before it as an issue of first impression, the court of appeals held in *In re Ames Dept. Stores, Inc.* that section 502(d) of the Bankruptcy Code does not mandate disallowance, either temporarily or otherwise, of administrative expense claims acquired from entities that allegedly received voidable transfers.

Wingerter adds yet another chapter to the story. The importance of the outcome is not limited to claims traders in consumer bankruptcy cases, where the cost associated with filing purchased claims would have risen considerably. Claims traders in both consumer and business bankruptcy cases increasingly rely on electronic information rather than original documentation in trading and filing bankruptcy claims. *Wingerter* indicates that where a purchaser takes reasonable steps to ensure that claims are legitimate and provable, the absence of original documentation attached to a filed claim will not be problematic.

B-Line, LLC v. Wingerter (In re Wingerter), 594 F.3d 931 (6th Cir. 2010).

In re Enron Corp., 379 B.R. 425 (S.D.N.Y. 2007).

In re M. Fabrikant & Sons, Inc., 385 B.R. 87 (Bankr. S.D.N.Y. 2008).

ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Dept. Stores, Inc.), 582 F.3d 422 (2d Cir. 2009).

Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U.L. REV. 1609 (2009).