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What Is Bankruptcy Claims Trading? Evidence from Bond Trading

Jared A. Elias

UC Hastings College of the Law, elliasjared@uchastings.edu

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Financial Statements

By JARED A. ELLIAS

What Is Bankruptcy Claims Trading? Evidence from Bond Trading

The rise of claims trading is one of the most important changes in bankruptcy practice over the past 30 years. Many critics contend that claims trading has made chapter 11 much harder to administer. Chapter 11 is built on the assumption that the debtor will have lengthy and contentious negotiations with creditors that ultimately culminate in a consensual settlement and a fully supported reorganization plan.

However, chapter 11 practice began to drift further and further away from this classic paradigm in the late 1990s, as, so the story goes, a robust secondary market developed in the debt and equity of chapter 11 debtors. Some creditors decided not to negotiate with debtors and instead sold their claims to a new type of investor that both helped to create the secondary market and grew along with it: distressed hedge funds that specialize in activist investing in chapter 11. Over the years, there have been many calls to change bankruptcy law or practice to accommodate what many see as a disruptive change, including an *ABI Journal* article.¹

In a recent paper,² the author conducted the first empirical study of the one of the largest markets for bankruptcy claims: trading in the corporate bonds issued by chapter 11 debtors. The study relied on the entire record of bond-trading for all chapter 11 debtors that filed for bankruptcy between 2002-12, which were then matched to important dates and case information from the court dockets. The data source used for the study has a key limitation, however.³

First, a note about the author's methodology. Consider a hypothetical trade of a small amount of a bond issued by a debtor prior to the debtor's bankruptcy. Assume that one hedge fund sells the right to receive \$100 from the debtor to another investor for \$10 (or 10 cents on the dollar) on March 1, 2005. In the dataset, the author observed the fact that a trade of \$100 of the debtor's bond issue happened on March 1, 2005, with a sale price of \$10. However, the author is unaware of the buyer or seller's identity. While this limits the empirical conclusions,

the data can still be informative about bankruptcy claims-trading.

This article summarizes some of the study's main findings. As further explained herein, the author found that the market for chapter 11 bonds is very active but perhaps less important for the administration of bankruptcy law than many critics have feared.

The chapter 11 bond sample consists of all bonds issued by chapter 11 debtors that traded while the issuing firm was operating in chapter 11, or 389,154 individual trades on 54,536 trading days in 494 bonds issued by 204 firms with an aggregate face value of \$512 billion and an aggregate market value of approximately \$280 billion. These bonds often trade at a substantial discount to par, which explains the difference between the face value and market value of the trades. As the numbers suggest, the chapter 11 bond market is a large market.

One important question is how active the market for chapter 11 debt actually is. While the literature commonly speaks of a "robust" secondary market, it is also common for courts and commentators to assume that chapter 11 debt trades in an "illiquid" market. Obviously, both descriptions are right some of the time, but the advantage of this empirical approach is that it enables the author to say on average who is right more often. On average, 94 percent of chapter 11 debtors that file for bankruptcy with outstanding bond debt experience trading in their bonds while the firm is in chapter 11. In fact, chapter 11 bonds average among the most heavily traded bonds in the corporate bond market as a whole. The median chapter 11 bond experiences turnover during the bankruptcy case — where turnover is defined as the total volume of trading scaled by the face value of the bond — that places it in the top 15 percent of all outstanding corporate bonds. In other words, the median chapter 11 bond trades more actively than 85 percent of the corporate bond market.

While most chapter 11 bonds are actively traded, the sample reveals a wide distribution of trading. For the median bond, aggregate trading is equivalent to more than 113 percent of the outstanding face value of the bond between the petition date and the approval of a reorganization plan. This is not to say that 113 percent of petition date holders of the bond sold their claim to a new investor. As the author did not observe the identity of the traders, one cannot



Coordinating Editor
Jared A. Ellias
UC Hastings College
of the Law
San Francisco

Jared Ellias is an associate professor at the University of California, Hastings College of the Law in San Francisco. While in private practice at Brown Rudnick LLP in New York, he represented financial institutions and ad hoc and statutory creditor committees.

1 See, e.g., Aaron L. Hammer and Michael A. Brandess, "Claims Trading: The Wild West of Chapter 11s," *XXIX ABI Journal* No. 6: cover, 62-64, July/August 2010, available at abi.org/abi-journal (unless otherwise specified, all links in this article were last visited on Oct. 22, 2018).

2 Jared A. Ellias, "Bankruptcy Claims Trading," *Journal of Empirical Legal Studies* (forthcoming 2018), available at papers.ssrn.com/sol3/papers.cfm?abstract_id=3215701.

3 The study relies on the FINRA TRACE dataset, which is a record of all over-the-counter secondary market transactions in fixed income securities, as reported by FINRA member broker-dealers.

know whether one is observing, for example, three trades of approximately 40 percent of the issue with the other 60 percent held by a patient investor, or whether 113 percent of the bond issue traded once.

The tails of distributions are very different than the medians, with the 25th percentile bond only seeing 27 percent aggregate turnover and the 75th percentile bond seeing more than 345 percent aggregate turnover during that same period. Thus, while the majority of chapter 11 cases involve heavy trading, the level of trading in the most actively traded bonds is qualitatively different from the median case.

Trading also appears, on average, to be the heaviest at the beginning of the bankruptcy case. On average, 3 percent of an outstanding bond issue trades on every trading day between a firm's petition date and the approval of debtor-in-possession (DIP) financing. Trading drops sharply, to about 1 percent of the outstanding bond issue, for every day of the case subsequent to the approval of DIP financing, and the average level of trading falls again once the disclosure statement has been approved. This pattern of trading suggests that, on average, the market for chapter 11 debt is most active relatively early in the bankruptcy process.

An interesting pattern in the data is that trading across levels of a firm's capital structure is relatively uncorrelated. To illustrate, consider a firm with senior bonds and subordinated bonds. In general, the level of trading in the senior bonds does not predict the level of trading in the subordinated bonds, and vice versa. On the other hand, when multiple bond issues are outstanding at the same level of claim priority — for example, two issues of senior unsecured bonds — trading in those bonds is highly correlated. This pattern suggests that traders tend to focus on one level of a firm's capital structure at any given time. Trading does not appear to be statistically significantly heavier in the bonds that receive a distribution of equity at the end of the bankruptcy case, as opposed to bonds that receive a distribution of cash or debt.

These results demonstrate that there is an active market for the claims of chapter 11 debtors, but an important question remains unanswered: How much value (if any) are selling claimholders giving up by selling their claims? The classic story of bankruptcy claims-trading involves the sale

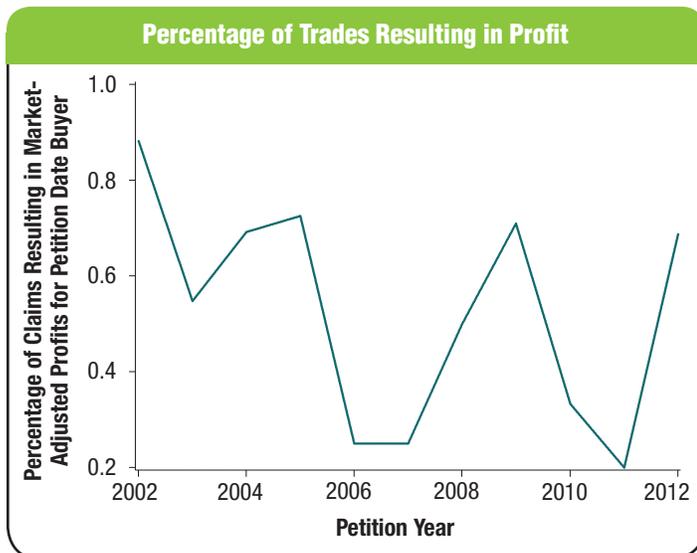
of claims issued by bankrupt firms from traditional institutional investors to nontraditional investors, such as hedge funds, with expertise in bankruptcy. If the result of this trade involves a systematic transfer of value to specialized risk-bearers, it could suggest that the liquidity provided to pre-bankruptcy creditors presents something of a trade-off. To learn more about how selling claimholders fare, the author studied the subsample of claims that he could price around the petition date and near plan confirmation to measure the market value of the distribution the claimholder receives under the reorganization plan.

To make the comparison more realistic, market-adjusted returns were calculated for the buyer of claims by assuming that the seller reinvests the proceeds of the sale in an S&P 500 index fund on the same day that the claim was sold and sells the index fund on the day the plan is confirmed. The exhibit shows the percentage of trades resulting in profit by the year the firm filed for bankruptcy. For purposes of this exhibit, each bond in the dataset is equally weighted, and the Y-axis shows the percentage of all chapter 11 bonds issued by firms that filed for bankruptcy in each sample year that resulted in a market-adjusted profit for the buyer. For example, 80 percent of the chapter 11 bonds that traded around the petition date for the firms that filed for bankruptcy in 2002 offered market-adjusted profits to the buyer if the buyer bought the claim on the petition date and sold it at the end of the bankruptcy process for the then-market price.

As a threshold matter, the buyers of claims at the beginning of the bankruptcy process only do better than a selling claimholder about 61 percent of the time. There also appears to be a pattern in the data where hypothetical petition-date purchasers do better than sellers when the economy is emerging from a recession, and sellers do better than purchasers when the economy is doing well. This is consistent with distressed-debt hedge funds bidding down returns in good times, while the sheer supply of distressed debt in bad times leads to large profits for skilled investors.

None of the evidence so far bears on perhaps the most important question of all: What does all this activity mean for bankruptcy governance? After all, bankruptcy law is not terribly concerned with arm's-length trades in bankruptcy claims and whether buyers or sellers do better more often. What actually matters is how those trades impact the way that chapter 11 is administered. Debtors do not generally negotiate with all of the holders of a bond issue; they negotiate with the activist investors who seek to influence the bankruptcy case. While some large investors might buy all of a bond issue on their own, for the most part groups of funds participate in the bankruptcy case together as "ad hoc groups." Rule 2019 of the Federal Bankruptcy Rules of Procedure requires these ad hoc groups to file disclosure statements identifying, among other things, the names of the group members and how much they held.

In order to learn more about how ad hoc groups change over the course of chapter 11, the author examined every Rule 2019 statement filed by ad hoc groups holding bonds



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for the firms in the sample.⁴ The initial sample of Rule 2019 consists of 100 Rule 2019 statements, of which the median statement was filed 42 days into the bankruptcy case — on average, around the time that DIP financing was approved.⁵ Rule 2019 requires *ad hoc* groups to file amended disclosure statements when the groups change. Of these initial 100 groups, 42 of them never filed an updated Rule 2019 statement. Of the groups that did file updates, the changes to group composition and holdings tended to be relatively slight, and very few groups changed in a material way over the course of the chapter 11.

For the updating groups, the group members from the original Rule 2019 statement held, on average, 86 percent of the debt held by the final group in the last Rule 2019 statement filed with the court, showing that the initial group members nearly always remained in control of the *ad hoc* group by the end of the case. *Ad hoc* groups tend not to acquire new members, and the existing members rarely buy additional debt during the bankruptcy case.⁶

This finding presents a puzzle: How do we reconcile the heavy level of trading in bond debt with the fact that *ad hoc* groups tend to enter early and seldom change very much by the end of the case? One hypothesis is that the claims-trading occurring during a bankruptcy case is much more about passive speculation than it is about influencing the outcome of the bankruptcy case. In other words, claims-trading is less a route for activist entrance and exit, and more an opportunity for nonactivist investors to make passive investments. Of course, some of those nonactivist funds might have the ability to become activists if it became necessary to defend their claims. Moreover, the mere existence of a claims-trading market clearly casts a shadow on the bankruptcy bargaining table.

In addition, the composition of creditor groups on the petition date probably reflects the claims-trading that occurred prior to the firm's chapter 11 filing, meaning that claims-trading is still important for bankruptcy governance. However, the results in this study cast doubt on the argument that new regulation is needed in order to deal with the churn created by claims-trading during the chapter 11 case itself — in other words, there appears to be less churn than was previously understood. **abi**

⁴ This method certainly misses the cases where one hedge fund owns nearly all of the bond issue and acts on their own, outside of the scaffolding of an *ad hoc* group. However, those cases are relatively rare, and the case where that one investor then sells to another single investor are probably rarer still, so it is unlikely that this biases the overall findings in a way that renders them unreliable.

⁵ There was a slight lag between the *ad hoc* group's initial appearance in the case (on average, 24 days after the petition date) and the filing of a Rule 2019 statement (on average, 42 days after the petition date), so most groups were probably active and negotiating earlier than the initial Rule 2019 disclosure.

⁶ The study also examined the Rule 2019 statements filed by *ad hoc* groups holding loans (101 groups) and found that these *ad hoc* groups also showed the same underlying patterns of group stability.

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