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Trading in distressed debt in Swiss insolvency proceedings: restriction on information appropriate?

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"You shall not use any information obtained from the inspection of the files in the debt restructuring liquidation proceeding to contact the creditors and to make offers to purchase their claims."

In some of the recent major insolvency cases in Switzerland it has become practice that the liquidator[1] requests a respective consent declaration in writing from third parties, such as distressed debt investors, or even from creditors who want to inspect the documents of the proceeding before they get access to the documents.[2] What relevance does such an undertaking have, is it justified and legal? This question is significant for parties who want to invest in distressed debt.

Nowadays, in Swiss insolvency proceedings involving a liquidation of the debtor's business substantial distressed debt trading can be witnessed. As examples, in the proceeding of Swissair in Debt Restructuring Liquidation at the time of the (first) presentation of the creditors' schedule in February 2007 of the 20 largest unpriorited claims of roughly CHF 3.66bn only one debt trader was registered with a fairly small claim of CHF 36.4m; ten years later, in March 2017, out of the largest 23 unpriorited claims 14 were represented by debt traders with a total of roughly CHF 1.72bn representing more than half of the largest claims.[3] In the parallel case of Flightlease AG in Debt Restructuring Liquidation a large amount of original trade claims were transferred to debt traders, which now represent more than 50% of the total third class (i.e. unpriorited) claims of roughly CHF 1.9bn. Similar shifts can be traced in the insolvency proceedings of Petroplus Marketing AG in Debt Restructuring Liquidation and Petroplus Holding AG in Liquidation.

Swiss legislation has not established specific rules to regulate trading of claims inside or outside of an insolvency proceeding.[4] Why then should restrictions be imposed in an insolvency?

Outside of insolvency ordinary business creditors usually rely on the expectation that their claim will be paid in full when becoming due. For reason of protection of business secrets their inspection rights to view the financial statements and

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audit reports of a Swiss debtor can be limited; the names of the holders of claims are not public information; hence, such creditors are difficult to be reached and the opportunities for trading claims are by nature limited.[5]

Matters change with the opening of a debt moratorium or bankruptcy proceeding. The receiver or liquidator hardens the liability side of the debtor on the basis of the debtor's books and of the result of the claims call; further, with the establishment of the creditors' schedule the names of the creditors and details of their claims are recorded and both, the creditors' schedule and the inventory with the assessment of the assets become accessible for inspection.[6] The Federal Debt Collection and Bankruptcy Act ("DCBA") in its article 8a) recognises as a fundamental procedural principle that any person who credibly claims to have an interest is entitled to view not only the inventory and the creditors' schedule but also the underlying documents, such as minutes kept by the receiver/liquidator. Actually, the inspection right applies to all files of the proceeding. This is true, at least, for the recognised creditors and it is further true that critical information, such as e.g. the status of negotiations of responsibility actions, can be withheld by the liquidator. Also, it is conceivable that business secrets of the debtor require protection. Quite some case law has been developed providing further guidance on the exercise of inspection rights. In reality the liquidator evaluates on a discretionary case by case basis whether the interest claimed is considered sufficient to open the file. Thereby a denial of inspection should not occur simply because its handling is not practicable and the request is for a large volume of documents. On the other hand requests for inspections which prove to be abusive will not be heard.

In this discussion it is often overlooked what the interests of the original creditor and of the interested debt investor are: at latest as soon as the creditors' schedule becomes accessible a new market for the non-publicly traded debt is created. More often than not, the insolvency proceedings have locked up the claims for years. The debt trader sees a new opportunity for investment and the original claim owner finds an opportunity to divest itself from a claim which was frozen for a considerable period of time.[7] With a trade sale banks can find an occasion to ease their underlying capital positions by selling the claim. The Swiss legislator has not dealt with this new situation; rather the notion prevails that a creditor is loyal to the very end of a lengthy liquidation. Swiss securities laws would apply only if the debt instruments are publicly traded. The trade sale is considered a private commercial transaction which does not require approval from any third party[8], the bankruptcy court nor from the receiver/liquidator.[9] It is up to the parties to define the specific trade terms. For perfection a declaration of assignment (ideally established pursuant to Swiss law) is required followed by a written notification given to the receiver or liquidator. Thereupon it is up to the liquidator to record the assignee as new holder of the claim. The terms of the trade sale will not be disclosed; the claim is acquired on a "as is" basis i.e. as it has been filed and eventually be adjudicated in the proceeding. Typically, the assignee, whose claim status is of derivative nature, will rely on the representations and warranties regarding the claim provided by the seller, but, in addition, the assignee will want to verify the information received by conducting a due diligence examination of the proceeding files and documents submitted. It is, therefore, essential that the assignee obtains the same information the original claim holder does have or at least could have obtained from the receiver/liquidator.[10] Following that principle the trade can occur on a transparent basis and will allow equal treatment of the assignee and the assignor as to their status of information. Most importantly the change of hands of a claim does not affect the debtor's position. The claims traded remain recorded at par value.

According to current case law, as mentioned, impracticalities should not allow the liquidator to restrict access to distressed debt traders. One argument sometimes used is that the forces of the liquidator's office may be unduly absorbed, or their efforts be diverted from acting in the interests of the creditors at large. These arguments are valid but should be addressed by asking from the requesting debt trader reasonable contributions to actual costs caused being understood that if a trade is realised the trader will proportionately share in these expenses of the proceeding.

It appears obvious that original claim holders and bona fide debt traders alike have a sound interest to participate in the new market for the distressed claims; therefore, at least seriously interested parties should be given the same right to access the documents of the insolvency proceeding as a

recognised creditor and they should be allowed to identify potential assignors. It should not be the task of the liquidator to intervene in the market by either disallowing access to the files nor to prohibit the interested party to contact the existing creditors. It seems that this questioned attitude has been copied from the procedural rules imposed pursuant the bank insolvency proceeding, an attitude which is not justified.

For insolvency proceedings involving a bank or a securities dealer the Swiss Financial Market Supervisory Authority "FINMA" on its own initiative has enacted special rules. Article 5 of its Banking Insolvency Ordinance ("BIO-FINMA") explicitly states that any person making a credible claim that their financial interests are directly affected by the restructuring or the bankruptcy is entitled to inspect documents; just to add that such right may be restricted to specific stages of the proceeding or limited or refused when opposing interests take precedence. And to further continue that any person to whom the right to inspect documents is granted may only use the information to protect its own immediate financial interests, the information should be treated confidentially and may not be shared with other parties. Inspections would be granted upon execution of a respective written undertaking, only.[11] In the event of failure to comply criminal penalties could be faced. These self-made rules demonstrate that creditors are sincerely exposed to discretionary handling by the liquidator with a supervisory authority who has a clear preference for conducting a bank insolvency proceeding "in camera". As result, the creation of a market for distressed debt trading with claims in a Swiss bank insolvency proceeding is seriously jeopardized. A more relaxed attitude also in bank insolvency proceedings towards allowing the trade in distressed claims should be encouraged instead.

Footnotes:

1 For the ease of reading the term liquidator stands for liquidator in a debt restructuring liquidation and for the bankruptcy officer in a bankruptcy proceeding.

2 A similar text was used in the liquidation proceeding of Petroplus Marketing AG in Debt Restructuring Liquidation; the declaration used in the proceeding of Lehman Brothers Finance AG in Liquidation requested that "any information obtained from the file inspection will only be used for the protection of [the respective creditor's] own financial interests, will be handled confidentially and will not be shared with other parties. An infringement under Article 48 FINMAG and Article 292 of the Criminal Act carries a fine of up to CHF 100,000".

3 The largest claim of CHF 930m resulting from the bridge loan stayed with the Swiss Confederation.

4 Swiss securities laws for listed debt instruments such as bonds apply however. Also note the special situation under the Banking Insolvency Ordinance ("BIO-FINMA"). Further, contractual undertakings not to assign a claim can exist.

5 Specific prior disclosure exists, of course, if the debtor makes use of the capital market or is subject to disclosure covenants as part of its financing. Note Articles 958e) and 716b) of the Swiss Code of Obligations ("CO").

6 Article 249 para 1 DCBA.

7 In case of a debt moratorium proceeding leading to a liquidation it can take one to two years for the confirmation of the creditors' agreement alone, which will then be followed by the actual liquidation proceeding. Such liquidation may last a couple of years in complex cases; the same is true for an ordinary bankruptcy proceeding.

8 Article 164 et seq. CO; the choice of law governing the assignment may however not be detrimental for the debtor (Article 145 para 1 Federal Act on Private International Law).

9 They can intervene in case of abuse; e.g. the assignment of fractions of a claim is acceptable but may to be used to influence the voting rights available.

10 The receiver/liquidator may retain certain information because of their confidential nature or strategic importance, such as e.g. ongoing litigations, settlement discussion on liability cases etc.

11 See FN 2 above. Respective declarations were requested e.g. in the liquidation proceeding to Lehman Brothers Finance AG in Liquidation even though this company was not subject to license.

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