AN INTRODUCTION TO *SHARĪʿAH* CONSIDERATIONS IN BANKRUPTCY AND INSOLVENCY CONTEXTS AND ISLAMIC FINANCE'S FIRST BANKRUPTCY (EAST CAMERON)

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INTRODUCTION

The reach of the modern Islamic finance and investment industry is now global. *Sharīʿah*-compliant financings are now frequent in both jurisdictions in which the *Sharīʿah* is an element of the secular law and in purely secular jurisdictions in which the *Sharīʿah* does not comprise an element of the secular law. The exceptional growth rates for the industry since its inception in the mid-1990s overshadowed concerns of the popular press regarding bankruptcies and insolvencies. But, financial professionals (particularly lawyers, distressed debt professionals and hedge fund managers) knew only too knew that the devastation of financial distress is an omnipresent consideration. And, in 2008, the consideration became a reality, the debate moved from the theoretical to the immediately practical, with the commencement of the first formal bankruptcy proceeding involving an Islamic finance instrument. Soon thereafter, with extensive fanfare, various *sukūk* issuances entered upon workout and restructuring modes. As the global financial crisis deepened, there was a significant increase in the discussion of issues pertaining to how secular bankruptcy and insolvency regimes will address *Sharīʿah*-compliant transactions.[1]

This paper is an introductory survey of three areas of bankruptcy and insolvency theory and practice that relate to the introduction of *Sharīʿah* principles into secular bankruptcy and insolvency regimes in *Sharīʿah*-incorporated jurisdictions and in purely secular jurisdictions. The objective of this survey is to focus attention on some initial policy issues in the context of bankruptcies and insolvencies of entities

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[1] This paper treats "bankruptcy" (a situation or system in which an entity or person that is subject to the bankruptcy code has done any of the acts that by law entitle creditors to have its, his or her estate administered by a court having jurisdiction or in which an insolvent person or entity has recourse to courts for the ordering or administration of its, his or her affairs; in common parlance, the term is often used interchangeably for the term "insolvency") and "insolvency" (the state of having liabilities in excess of a reasonable market value of assets (balance sheet insolvency) and being unable to pay debts as they fall due in the ordinary course of business (income statement or cash flow insolvency), in each case, whether or not the person or entity has committed an act of bankruptcy) as largely interchangeable concepts (with apologies to purist theoreticians and practitioners). This is a convenience for the purposes of this paper, and has been adopted because of the great range of secular bankruptcy and insolvency regimes that may be considered, eventually, as appropriate for the introduction of *Sharīʿah*-related bankruptcy and insolvency concepts. There will be plenty of time to make finer differentiations. The term bankruptcy is derived from the Italian "*banca rotta*", meaning broken bench or bank and referring to the practice of breaking a merchant's or a bank's bench in the market place when the merchant or bank became insolvent. See Thomas H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986), at 1.

Electronic copy available at: http://ssrn.com/abstract=1826246

having large capitalization.[2] This paper first summarizes some of the *Sharīʿah* principles that are applicable in the bankruptcy and insolvency context. Thereafter, the paper notes the general nature of the secular bankruptcy and insolvency regimes currently in use and summarizes some current practices that are of relevance in the distressed debt, bankruptcy, insolvency, reorganization, restructuring and workout markets, particularly in jurisdictions that have adopted or may adopt a reorganization restructuring methodology (such as "*Chapter 11*")[3]. Finally, the paper summarizes certain aspects of the bankruptcy proceeding involving the East Cameron oil and gas *sukūk* as an example of a secular bankruptcy/insolvency proceeding involving a *Sharīʿah*-compliant instrument and transaction.[4]

BANKRUPTCY AND INSOLVENCY (*IFLĀS* AND *TAFLĪS*) UNDER *SHARĪʿAH* PRINCIPLES

The Qurʾānic basis for bankruptcy and insolvency (*taflīs*) concepts, including embodied concepts of social responsibility and charity, is: "And if the debtor is in straitened circumstances, then [let there be] postponement to [the time of] ease. And if you give freely [*i.e.*, voluntarily forgive the debt] it will be better for you, if only you knew."[5] This conception is balanced by the Qurʾānic conception, interpreted to provide that it is a sin, not just a legal obligation, to not pay your debts (and perform your obligations) if you have the capacity: "O you who have believed, fulfill [all] contracts."[6]

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[2] Bankruptcies and insolvencies of entities having large capitalization (millions or billions of dollars) are fundamentally different than bankruptcies or insolvencies of entities having smaller capitalization. See Douglas Baird, Arturo Bris and Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* (draft of January 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=866865.

[3] "Chapter 11" is embodied at 11 U.S.C. § 101 *et seq.* (2006). The United Nations Commission on International Trade Law ("*UNCITRAL*") has proposed a model bankruptcy law, UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT (the "*UNCITRAL Model Insolvency Law*"), which was adopted by UNCITRAL on 30 May 1997 and is available at http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html, and has provided a LEGISLATIVE GUIDE ON INSOLVENCY LAW (2005), United Nations Publication, Sales No. E.05.V.10, available at http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html, as supplemented by LEGISLATIVE GUIDE ON INSOLVENCY LAW: PART THREE: TREATMENT OF ENTERPRISE GROUPS IN INSOLVENCY (pre-release 21 July 2010), available at (collectively, the "UNCITRAL Legislative Guide). The UNCITRAL Model Insolvency Law and the UNCITRAL Legislative Guide both adopt the restructuring approach embodied in Chapter 11. UNCITRAL has also published a practitioner's guide relating to cross-border insolvencies: UNCITRAL PRACTICE GUIDE ON CROSS-BORDER INSOLVENCY COOPERATION (2010), United Nations Publication, Sales No. E.10.V.6, available at http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2009PracticeGuide.html. Information on the jurisdictions that have adopted the UNCITRAL Model Insolvency Law is available at http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html.

Many of the topics addressed in the section of this paper entitled "BANKRUPTCY CONCEPTS AND DISTRESSED INVESTING" did not arise in the East Cameron bankruptcy, which was the first formal bankruptcy within the Islamic finance and investment industry. However, as the global financial crisis developed, it became clear that a much broader range of issues will arise in future bankruptcy and insolvency situations. And, of course, any effort to integrate *Sharīʿah* principles into secular bankruptcy and insolvency regimes will have to take a comprehensive approach. The objective, in this paper, is to introduce some of the legal, regulatory and market concepts that will need to be addressed in the future.

[4] The East Cameron bankruptcy proceeding is believed to be the only formal bankruptcy proceeding in the world, to the date of this writing, involving a *Sharīʿah*-compliant instrument and transaction.

[5] Qurʾān, 2:280.

[6] Qurʾān, 5:1. This is also translated as "O you who have believed, fulfill [all your] covenants."

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There is no concept that requires or justifies the discharge of debts under the *Sharīʿah* (other than payment and performance and certain doctrines of fraud, excuse and the like).[7] On the other hand, the amount of debt is not increased due to delay of payment (and, of course, the *ribā* doctrines prohibit increases in the debt over time, even where the debt is not paid when due).[8] Thus, if the debtor can repay, the debtor must repay. Repayment may be postponed if the debtor's wealth is insufficient, but the obligation to repay is never discharged (except by death or payment in full). If the debtor is not able to repay, there is no moral or legal requirement or penalty.[9]

Iflās, or bankruptcy, covers both (a) balance sheet insolvency, in which liabilities exceed assets, and (b) income statement or cash flow insolvency, in which there are insufficient liquid assets (including revenues) to pay debts on a current basis.[10] A *muflis* is a bankrupt person or entity (male, female or business entity). Under the *Sharīʿah*, there is no distinction between a business bankruptcy and an individual bankruptcy. And, under the *Sharīʿah*, there is no distinction between bankruptcies of large entities and bankruptcies of small entities.[11] *Muflis* status ends only by (a) repayment of the indebtedness or (b) death.

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[7] Sources, particularly English language sources, discussing the *Sharīʿah* principles applicable in the bankruptcy and insolvency context are difficult to locate. The author has consulted Ibn Rushd, THE DISTINGUISHED JURISTS PRIMER, VOLUME II, *BIDĀYAT AL-MUJTAHID W NIHĀYAT AL-MUQTASID* ("*Ibn Rushd*"), and Abed Awad and Robert E. Michael, *Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy*, 44 THE INTERNATIONAL LAWYER 975 (2010) ("*Awad & Michael*"), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1758020. Awad & Michael relies significantly upon Ibn Qudamah, 1 MUWAFFAQ AL-DIN ABU MUHAMMAD ABD ALLAH IBN AHMAD IBN MUHAMMAD, AL-MUGHNI FI FIQH IMAM AL SUNNA AHMAD IBN HABAL AL SHAYBANI (1988). The author has also consulted various contemporary *Sharīʿah* scholars with respect to discrete issues (any errors in understanding or conveying the positions of those scholars and the principles described in this paper is the sole responsibility of the author).

Classical principles of bankruptcy and insolvency under the *Sharīʿah* have not been adopted, as a matter of codification, by secular jurisdictions. However, courts applying the *Sharīʿah* may well apply such classical principles; that is difficult to confirm given the absence of published legal options in much of the Organization of the Islamic Conference (the "*OIC*"). This paper, when referring to *Sharīʿah* principles applicable to bankruptcy and insolvency, is referring to these classical principles, as enunciated by scholars.

[8] The nonperforming party will be responsible for actual damages (although not consequential damages) caused by a default or breach.

[9] Consider, however, *mulāzama* ("close attachment" or "clinging to" debtors), as discussed in Farhat J. Ziadeh, *Mulāzama or Harassment of Recalcitrant Debtors in Islamic Law*, 7 ISLAMIC LAW AND SOCIETY 289 (2000).

[10] Debt can be compliant with the *Sharīʿah* (*e.g.*, a rent obligation under an *ʾijāra*) or not compliant with the *Sharīʿah* (*e.g.*, an obligation to pay interest on a non-compliant loan). This paper does not distinguish these categories (although there is obviously much to distinguish), and assumes, for the moment, that all debt of the debtor is compliant with the *Sharīʿah* except as otherwise noted in this paper.

For examples of different conceptions of bankruptcy, insolvency, administration and liquidation, for different purposes and in different jurisdictions, see *Bankruptcy*, WIKIPEDIA, at http://en.wikipedia.org/wiki/Bankruptcy, *Insolvency*, WIKIPEDIA, at http://en.wikipedia.org/wiki/Insolvency, *Administration (law)*, WIKIPEDIA, at http://en.wikipedia.org/wiki/Administration_(law), THE INSOLVENCY SERVICE, http://www.insolvency.gov.uk/, *Definition: bankruptcy*, WEBSTER'S ONLINE DICTIONARY, available at http://www.websters-online-dictionary.org/definitions/bankruptcy?cx=partner-pub-0939450753529744%3Av0qd01-tdlq&cof=FORID%3A9&ie=UTF-8&q=bankruptcy&sa=Search#906, and *Definition: insolvency*, WEBSTER'S ONLINE DICTIONARY, available at http://www.websters-online-dictionary.org/definitions/insolvency?cx=partner-pub-0939450753529744%3Av0qd01-tdlq&cof=FORID%3A9&ie=UTF-8&q=insolvency&sa=Search#922.

[11] Classical interpretations of the *Sharīʿah* do not recognize corporates and other entities that limit personal liability. This is a complexity in considering the application of *Sharīʿah* concepts to secular bankruptcy and insolvency regimes. For example, does this render most partnerships into "general partnerships" for *Sharīʿah*

Under *Sharīʿah* principles, a bankruptcy or insolvency proceeding is commenced by one or more creditors. A debtor is obligated to pay in accordance with his, her or its agreement and is not entitled to initiate a proceeding, based upon bankruptcy or insolvency, to relieve the debtor of a repayment obligation. Thus, a bankruptcy or insolvency proceeding under *Sharīʿah* principles is always an "involuntary" proceeding. This, of course, is in in contrast to the voluntary bankruptcy alternatives embodied in many, if not most, secular bankruptcy and insolvency regimes.[12]

On creditors with respect to matured debt qualify as "creditors" that are entitled to initiate proceedings or make claims under *Sharīʿah* principles. In considering the nature of "matured" debt, it is important to consider that, in the usual case, at least historically, debt is not accelerated under applicable *Sharīʿah* principles; it becomes due in accordance with the original repayment schedule (even where payment is in default and remedies are being pursued).[13] This is in sharp contrast to the "claim" orientation of secular bankruptcy and insolvency regimes.

Under applicable *Sharīʿah* principles, upon initiation of a proceeding a judge may distrain the debtor pending a determination of whether the debtor is a *muflis*. This has the effect of freezing the debtor's assets pending the determination and subsequent sales. Distraint prevents the debtor from managing or disposing of, or encumbering, the debtor's assets. That approach is contrary to the concept embodied in the automatic stay provisions of secular regimes.[14] A debtor may also be interdicted (*maḥjūr*) from disposing of his, her or its wealth so as to preserve the ability of the judge (or a receiver) to sell the assets and apply the proceeds to the outstanding indebtedness of the debtor.[15]

In most cases, a receiver will be appointed: (a) to manage the debtor's business and assets (subject to judicial and creditor approval); and (b) then liquidate the business and assets of the debtor in an auction. The management of the debtor's assets during the pendency of the proceeding bears both similarities to and differences from different secular systems in which the manager or a trustee manages the debtor's business during the proceedings. The Qurʾānic injunctions noted at the beginning of this

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purposes? These principles will need to be carefully considered prior to attempting to incorporate *Sharīʿah* bankruptcy and insolvency principles in a secular system. Consider Timur Kuran, *The Absence of the Corporation in Islamic Law: Origins and Persistence*, THE AMERICAN JOURNAL OF COMPARATIVE LAW 785 (2005).

12 See, for example, 11 U.S.C. §§ 301 and 303(b).

13 Modern Islamic finance structures that include more than one nominate contract do have mechanisms to achieve the equivalent of "acceleration" of the *Sharīʿah*-compliant indebtedness. This is accomplished through the generation of a *Sharīʿah*-compliant debt that is additional to the original debt (and the original debt no longer continues to accrue as of the time of generation of the additional debt). See the discussions of the contemporary *ʾijāra* (lease) structure, and particularly the Understanding to Sell, in Michael J.T. McMillen, *Islamic Shari`ah-Compliant Project Finance: Collateral Security and Financing Case Studies*, 24 FORDHAM INTERNATIONAL LAW JOURNAL 1184 (2001) ("*McMillen: Islamic Project Finance*"), at 1237 to 1263 (the Understanding to Sell is discussed at 1255-57), and Michael J.T. McMillen, *Shariʿa-Compliant Financing Structures and the Development of an Islamic Economy*, in THE PROCEEDINGS OF THE FIFTH HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: ISLAMIC FINANCE: DYNAMICS AND DEVELOPMENT (2002), at 89-107 (the Understanding to Sell is discussed at 98-99).

14 The automatic stay provisions in the United States are set forth at 11 U.S.C. § 362, and consider 11 U.S.C. § 1104 with respect to the debtor, as debtor-in-possession, managing his, her or its property.

15 Alternatively, in the view of many jurists and under numerous secular systems currently in effect, the judge may imprison the debtor until the debtor pays to the creditors such amounts as may be agreed. Consider, for example, Ibn Rushd, *supra* note 7, at 341. Ibn Rushd, at 342 and 351 discusses *ḥadīth* with respect to imprisonment, observing that all four primary orthodox Sunnī *madhāhib* accept, and sometimes require, the practice in different situations. Interdiction is discussed by Ibn Rushd at 342-44.

section do not seem to mandate that liquidation be the only available outcome under relevant *Sharīʿah* principles. It would seem that reorganization and restructuring, at least as a matter of mutual agreement among the debtor and the creditors, should also be a permissible outcome. It is important to explore the doctrinal underpinnings, from a *Sharīʿah* vantage, of these alternatives given the current trend, under secular law, favoring reorganizations and restructurings in accordance with a Chapter 11" or renegotiation and reorganization format.

Upon commencement of a bankruptcy or insolvency proceeding under *Sharīʿah* principles, the creditor's rights attach to the debtor's property and the debtor is viewed as the equivalent of a minor, insane or incapacitated person for purposes of legal status. The debtor cannot manage and cannot dispose of his, her or its property. Each of these circumstances stands in stark contrast to secular principles.

There is no bankruptcy or insolvency "estate" under *Sharīʿah* principles.[16] The property of the debtor (the equivalent of the "estate" under secular law principles) is comprised of all assets of the debtor. Claims against that property are defined as all third party claims that are matured and due to the debtor, which is somewhat different from the "claims" concepts used under most secular bankruptcy and insolvency regimes.[17] As discussed in this paper, creditors that can locate his, her or its specific property have a greater entitlement to that property than other creditors, which is somewhat akin to secured creditors concepts under secular law.

As a general statement, creditors and debtors may voluntarily settle (*ṣulḥ*) or compromise, settle, reorganize and restructure the debt. However, different *madhāhib* (schools of Islamic jurisprudence) do not accept all kinds of settlements, a point that will need to be carefully investigated in connection with the implementation of any reorganization or restructuring or Chapter 11-based system. For example, some *madhāhib* do not accept settlements to avoid litigation, especially where the debtor does not dispute the validity of the debt and in every case where the debtor falsely or fraudulently denies owing the claim. As another example, and some *madhāhib t*reat a settlement where the debtor admits the validity of the debt as unlawful taking of the creditor's rights, except where the compromised debt is clearly a gift.

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[16] Except for the *waqf* (charitable trust), the concept of a trust was not developed under the *Sharīʿah*. See Michael J.T. McMillen, *Toward an Effective Legal Framework for Islamic Finance: Securities Laws, Trusts, Enforceability and Sukuk, Version 070407* (April 19, 2007), at 93-127 ("*McMillen: Trusts*") and the sources cited therein. McMillen: Trusts is a report that was prepared for the Islamic Financial Services Board and the International Organization of Securities Commissions, April 19, 2007, Kuala Lumpur, Malaysia; a copy is on file with the author. An earlier version addressing some of the trust, *waqf* and *irsad* concepts presented in McMillen: Trusts was co-authored by Michael J.T. McMillen and Sheikh Yusuf Talal DeLorenzo in a report to the Asian Development Bank ("*ADB*") entitled *Toward an Effective Legal Framework for Islamic Finance: Trust Concepts and Sukuk*. That earlier report, in turn, was incorporated into a larger report to the ADB prepared by V. Sundararajan and Centennial Group Holdings, LLC, and entitled *TA-6182-REG: Development of International Prudential Standards for Islamic Financial Services, Final Report, March 2007*, and appears in full as Appendix 4 to that report. With respect to the *waqf*, see, also, Henry Cattan, *The Law of Waqf*, in LAW IN THE MIDDLE EAST, Majid Khadduri & Herbert J. Liebesny, eds. (1955), at 203. With respect to the influence of the *waqf* on the development of the trust and educational structures in England, see Monica M. Gaudiosi, *The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College*, 136 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1231 (1987-1988).

[17] See note 29, *infra*.

For comparative purposes, it is interesting to consider the *Sharīʿah* principles applicable to certain types of creditors.[18] Reclamation creditors are creditors that are reclaiming specific property of that creditor that is in the possession of the debtor. Their priority for payment is second only to the receiver.[19] Return of property of that type requires satisfaction of five elements: (i) the debtor is alive at the time of the return of the property (if the debtor has died before return of the property, the reclamation creditor shares pro rata with other creditors upon liquidation of the debtor's assets); (ii) the property is undestroyed and undamaged; (iii) the property remains in the possession and control of the debtor; (iv) where the debtor has paid an installment in respect of the debt, the *madhāhib* differ, with some saying the creditor is no longer entitled to return of the property and others saying that return of the property is dependent upon such creditor returning installments previously paid by the debtor; and (v) there must be various satisfactions and elections under laws pertaining to modified property (*e.g.*, improvements to land in the possession of the debtor), which are complex.[20] Lessors, in a lessee bankruptcy or insolvency proceeding, can annul leases and take back their property. They also have various priorities to accretions to their property (e.g., a rent priority over proceeds of sale of crops from rented land). A lessee in a landlord bankruptcy, can continue the lease in accordance with its terms (on the basis that the lessee has a possessory interest like a *rahn*). Secured creditors have a priority against the collateral provided as security under the applicable *rahn*. These principles are quite similar to secular bankruptcy regimes, although the possessory nature of the *rahn* is different than most secular lien concepts.[21]

Similarly to secular bankruptcy and insolvency laws, various personal exemptions exist, such as those pertaining to certain living expenses, tools of trade, homes, and the like.[22] These are not usually of relevance in commercial bankruptcies and insolvencies. There are also various priorities of specific unsecured creditors, such as wages of farm workers, fees of an artisan for completed work, and fees for transporters of goods.

Regular unsecured creditors that share pro rata in the remaining assets of the debtor. It is important to note in this regard that, under the *Sharīʿah* principles, there is no final "discharge" of indebtedness: the debtor remains obligated to pay his, her or its debts until payment in full of those debts (or earlier death). This stands in stark contrast to most secular bankruptcy regimes.

The foregoing is a summary of only a few of the *Sharīʿah* principles and *Sharīʿah*-related issues that arise in the bankruptcy and insolvency context. A great deal more research needs to be done on the *Sharīʿah* principles pertaining to bankruptcy and insolvency. A rigorous comparison and contrasting with secular

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[18] See Awad & Michael, *supra* note 7, and Ibn Rushd, *supra* note 7, at 344-49. And see Ibn Rushd, at 349-51, with respect to different types of debt (particularly under the principles of the Mālikī *madhhab* (school of Islamic jurisprudence)). Characterization of the nature of the debt may influence the ability to undertake liquidation as a remedy.

[19] A reclamation creditor may opt, voluntarily, to share the assets with other creditors in many circumstances.

[20] See, for example, Ibn Rushd, *supra* note 7, at 346-47.

[21] See McMillen: Islamic Project Finance, *supra* note 13, at 1184 to 1232 (*rahn* interests are discussed at 1203-32), and Michael J.T. McMillen, *Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104 (which is a later draft of Michael J.T. McMillen *Rahn Concepts in Saudi Arabia: Formalization and a Registration and Security System*, in ISLAMIC CAPITAL MARKETS: PRODUCTS AND STRATEGIES, Kabir Hassan and Michael Mahlknecht, eds. (2010)), which summarizes and analyzes the currently proposed Saudi Arabian collateral security law.

[22] See, for example, Ibn Rushd, *supra* note 7, at 349.

legal systems cannot be undertaken until the *Sharīʿah* principles are more carefully explored, but is a necessity after these principles are further explored and prior to any effort to implement *Sharīʿah* principles in a secular system.

From my very preliminary discussions with *Sharīʿah* scholars, the general feeling seems to be that harmonization with secular systems is feasible on a wide range of matters and that some specifics may present issues that will need to be explored in detail. The consensus seems to be, however, that we are not yet at the point of being able to do the rigorous comparisons and contrastings. Fundamental research on the *Sharīʿah* principles should be the first order of the day.

BANKRUPTCY CONCEPTS AND DISTRESSED INVESTING

SOME FUNDAMENTAL PRINCIPLES

As a general and simplistic statement, secular bankruptcy and insolvency laws tend to be classified as either "creditor friendly" or "debtor friendly".[23] The insolvency and administration regime of the United Kingdom is often cited as the paradigm of a creditor friendly regime: a proceeding, once instituted against a business entity debtor, is directed toward the liquidation of the assets of the debtor and payment of the creditors. Chapter 11 of the United States Bankruptcy Code is often cited as the paradigm of a debtor friendly regime.[24] Chapter 11 is focused on renegotiating and reorganizing the

[23] See, for example, Robert R. Bliss, *Bankruptcy law and large complex financial organizations: A primer*, 47 ECONOMIC PERSPECTIVES 48 (2003), published by the Federal Reserve Bank of Chicago, at 50-52, available at http://www.chicagofed.org/webpages/publications/economic_perspectives/2003/1qeppart4.cfm, which notes that (a) most of the countries that derive their laws from the English common law tradition, most Commonwealth countries, the off-shore financial centers affiliated with the United Kingdom, Germany, Italy, China and Japan are pro-creditor, (b) countries whose legal frameworks have origins in the Napoleonic Code, such as Spain, Latin America, the Middle East and Africa, are generally pro-debt in bankruptcy and insolvency matters (the "Franco-Latin" approach), and (c) the United States of America, Canada and France have hybrid systems that are generally pro-debtor but have significant pro-creditor exceptions. The different systems are sometimes described as "equity-friendly" (the United States) and "debt-friendly" (the United Kingdom). See Viral V. Acharya, Rangarajan K. Sundaram and Kose John, *Cross-Country Variations in Capital Structures: The Role of Bankruptcy Codes*, January 16, 2010, available at http://ssrn.com/abstract=1515002. See also Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998), Stijn Claessens and Leora F. Klapper, *Bankruptcy Around the World: Explanations of its Relative Use* (July 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=405240, Viral V. Acharya and Krishnamurthy Subramanian, *Bankruptcy Codes and Innovation*, 22 THE REVIEW OF FINANCIAL STUDIES 4949 (2009), Elazar Berkovitch and Ronen Israel, *Optimal Bankruptcy Laws Across Different Economic Systems* (June 1998), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=140777&http://papers.ssrn.com/sol3/papers.cfm?abstract_id=140777#, and Oliver Hart, *Different Approaches to Bankruptcy* (2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=241066.

[24] Chapter 11 was originally introduced in the Bankruptcy Reform Act of 1978, Public Law Number 95-598, 92 Stat. 2549 (codified, as amended, as 11 U.S.C. 101 et seq. (2006) and in different sections of 28 U.S.C.). See, e.g., David A. Skeel, Jr., *Creditor's Ball: The "New" New Corporate Governance in Chapter 11*, 152 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 917 (2003-2004) ("*Skeel: Creditor's Ball*"), Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 THE BUSINESS LAWYER 441 (1984), Kenneth N. Klee, *Cram Down II*, 64 AMERICAN BANKRUPTCY LAW JOURNAL 229 (1990), Lynn M. LoPucki and William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 125 (1990), Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Michigan Law Review 336 (1993), Elizabeth Warren and Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*,

affairs of the debtor and giving the debtor a "second chance", after the reorganization, to continue to conduct its business and affairs.[25] Importantly, however, whatever the tendency of the regime, once an entity is in distress or financial trouble, the creditors exert considerable control and the equity holders

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107 MICHIGAN LAW REVIEW 603 (2009) ("*Warren & Westbrook*"), and Lipson, *infra* note 33, at 1612-14. Critics of this approach to bankruptcy and insolvency procedures include Michael Bradley and Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE LAW JOURNAL 1043 (1992); and see, in that regard, Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICHIGAN LAW REVIEW 79 (1992). See, also, Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 UNIVERSITY OF ILLINOIS LAW REVIEW 1 (1994).

See also the UNCITRAL Model Insolvency Law and the UNCITRAL Legislative Guide, *supra* note 3.

[25] Consider, for example, the conception of Douglas Baird posited as to traditionalists and proceduralists in Douglas G. Baird, *Bankruptcy's Uncontested axioms*, 108 YALE LAW JOURNAL 573 (1998), at 577-78:

> The traditionalists believe that bankruptcy law serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise, if the protections that bankruptcy law providers were unavailable. By contrast, the proceduralists deny that bankruptcy can work any special magic. Firms must live or die in the market. All bankruptcy can do is ensure that fights among creditors and other investors of capital do not accelerate the firm's liquidation. For them, one does more harm than good by doing anything more to protect a firm from the forces of the market.

The vast literature discussing policy aspects of Chapter 11 proceedings and the operation of Chapter 11 since its promulgation includes, in addition to other articles cited elsewhere in this paper that address discrete Chapter 11 topics: Edward I Altman, *Evaluating the Chapter 11 Bankruptcy-Reorganization Process*, 1993 COLUMBIA BUSINESS LAW REVIEW 1 (1993); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 THE JOURNAL OF LEGAL STUDIES 127 (1986); Douglas G. Baird and Robert K. Rasmussen, *Reply: Chapter 11 at Twilight*, 56 STANFORD LAW REVIEW 673 (2003-2005); Dan Bernhardt and Dennis Lu, *The Dynamics of Chapter 11 Bankruptcy* (draft of December 8, 1997), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=78785; Sreedhar T. Bharath, Venky Panchapegesan and Ingrid Werner, *The Changing Nature of Chapter 11* (draft of October 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102366; Arturo Bris, S. Abraham Ravid and Ronald Sverdlove, *Conflicts in Bankruptcy and the Sequence of Debt Issues* (draft of February 2009), available at http://ssrn.com/abstrat=1341443; Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WISCONSIN LAW REVIEW 729; Lynn M. LoPucki, *Chapter 11: An Agenda for Basic Reform*, 69 AMERICAN BANKRUPTCY LAW JOURNAL 573 (1995); Lynn M. LoPucki and Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICHIGAN LAW REVIEW 1 (2007-2008) ("*LoPucki & Doherty: Fire Sales*"); Stephen J. Lubben, *The Types of Chapter 11 Cases*, 84 AMERICAN BANKRUPTCY LAW JOURNAL 233 (2010); Raymond T. Nimmer and Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKRUPTCY DEVELOPMENTS JOURNAL 1 (1989); Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKRUPTCY DEVELOPMENTS JOURNAL 319 (1991); Skeel: Creditors Ball, *supra* note 24; Michael St. James, *Why Bad Things Happen in Large Chapter 11 Cases: Some Thoughts About Courting Failure* (draft of November 2, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=822344; Warren & Westbrook, *supra* note 24; and Elizabeth Warren and Jay Lawrence Westbrook, *Chapter 11: Conventional Wisdom and Reality*, available at http://ssrn.com/abstract=1009242.

Histories of bankruptcy and insolvency law in the United States, see C. Warren, BANKRUPTCY LAW IN UNITED STATES HISTORY (1935), Vern Countryman, *A History of American Bankruptcy Law*, 81 COMMERCIAL LAW JOURNAL 226 (1976), David A. Skeel, Jr., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001), Emily Kadens, *The Last Bankrupt Hanged: Balancing Incentives in the Development of the Bankruptcy Law*, 59 DUKE LAW JOURNAL 1229 (2009-2010), Kenneth N. Klee, *Legislative History of the New Bankruptcy Code*, 54 AMERICAN BANKRUPTCY LAW JOURNAL 275 (1980), David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARVARD LAW REVIEW 1075 (1999-2000), and David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 BANKRUPTCY DEVELOPMENT JOURNAL 321 (1998-1999). Each of Skeel: DIP Financing, *infra* note 45, at 1908-13, and Lipson, *infra* note 33, at 1634-38, includes a discussion of equity receiverships, an historical predecessor of DIP Financing arrangements.

are relegated to a distinctly secondary position.[26] This transfer of power generally tends to follow the conventional understanding of the priority that creditors have over shareholders in the repayment of the entity's obligations and the principle of "absolute priority". The absolute priority principle states that a debtor must provide for full payment to creditors before making any payment at all to shareholders.[27] Shareholders must surrender to creditors that portion of the shareholder's ownership necessary to compensate the creditors for the debt reduction. If total debts exceed the total value of the entity's assets, all equity will be surrendered and the creditors will become the owners of the entity through a debt-to-equity conversion.[28]

Bankruptcy and insolvency law was developed at a time when capital structures and the predominant and most commonplace types of financial instruments were quite different than they are today. When these laws were developed, the general categories of creditors were (a) secured creditors, (b) bondholders (generally holding publicly issued bonds), (c) trade creditors, and (d) holders of publicly traded stock. Conceptually, secured creditors were conceived of as desiring safety and being focused on repayment of the secured indebtedness out of the specific collateral afforded to those creditors. They were presumed to have relatively little regard for maximization of realization from the assets of the debtor beyond the amount of their secured indebtedness. Equity holders, on the other hand, were thought to have the greatest willingness to take risks during and after the bankruptcy and insolvency process. Being at the bottom of the capital stack in terms of their ability to receive payments of any type, they have the greatest motivation to see the debtor entity continue as a going concern. The unsecured creditors were conceived of as having a desire for value-increasing changes in the debtor and the capital structure so as to increase their returns out of future operations (returns from liquidation of most of the assets will be directed to repayment of the secured indebtedness). The bankruptcy and insolvency laws were, and remain, designed for the benefit of the unsecured creditors, primarily the general creditors.

Secured creditors were left to fend for themselves, and, as a matter of policy, that arrangement was thought quite acceptable and appropriate. The secured creditors had a claim on specific assets (their collateral security), and could protect themselves by foreclosing on the mortgage, deed of trust or other security interest in that collateral. That collateral was likely structured, at inception, to over-collateralize the secured claim. And it is likely, given the relative negotiating positions of the debtor and the secured creditor at the inception of the secured financing, that the secured creditor had a strong position that allowed it to maintain, through loan-to-value, collateral maintenance and other covenants, the desired degree of over-collateralization. The secured creditors were assumed to have a bias toward liquidation. Continuing operation of the business would expose them to greater risk of not realizing on their collateral. And, in any liquidation, it is believed that the secured creditor would not strive to realize full going concern value; that they would desire to obtain only enough to satisfy their own claims. If and to the extent that collateral security were insufficient to totally secure the outstanding secured

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[26] See, e.g., Douglas G. Baird and Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1209 (206) ("*Baird & Rasmussen: Private Debt*"), and Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 51 UNIVERSITY OF CALIFORNIA LAW REVIEW 115, 178-79 (2009).

[27] See, e.g., Northern Pacific Railway Company v. Boyd, 228 U.S. 482, 504 (1913), Douglas G. Baird and Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 UNIVERSITY OF CHICAGO LAW REVIEW 738 (1988), Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STANFORD LAW REVIEW 69 (1991), and Douglas G. Baird and Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty and the Reorganization Bargain*, 115 YALE LAW JOURNAL 1930 (2006).

[28] Sensitive, and intensely debated, valuations issues arise in connection with any such conversion.

indebtedness, the secured creditors became general creditors to the extent of the excess of such indebtedness plus expenses and damages in connection with a default over the amount realized on the collateral security.

During the pendency of the bankruptcy proceeding, secured creditors are allowed interest and fees arising from their claim if there is an "equity cushion" (the value of the property above the amount owed to the secured creditor that will shield the interest from loss due to any decrease in the value of the property). Secured creditors are entitled to "adequate protection" that the value of its collateral is and will remain undiminished (and adequate protection cannot take the form of equity in the reorganized business). If the security interest of the secured creditor is left intact under the reorganization plan, the secured creditor has no vote or voice in reorganization. Changes to the secured creditor's claim can affect only repayment terms (*e.g.*, the tenor of the secured claim may be increased, although only if the collateral is adequate).

Each creditor has a "claim" that can be reduced to judgment and that will entitle the claim holder to a pro rata claim against and a pro rata realization upon a portion of the bankruptcy estate.[29] The rules pertaining to the definitions of different classes of claims are intended to group and align similar types of claims and ensure that claims at the same priority level are treated alike, particularly in a bankruptcy and insolvency regime that provides for reorganization and restructuring (rather than only liquidation of the debtor's assets). Creditors within a specified class have the same legal rights and the same entitlements (pro rata treatment). Their entitlements and interests are thought to be sufficiently aligned so as to justify having the decisions of a specified percentage of the group bind the entire group. Thus, a small committee of the largest unsecured creditors can attend to the interests of all unsecured creditors and, because of the similarity of interests, the decisions of the group as a whole can bind all members of the group, including dissenting members.[30]

The decision-making authority of the unsecured creditor's committee is further justified by the informational flow to the creditor's committee, and thence to the unsecured creditors. The thinking is that the existence and functioning of the creditor's committee allows unsecured creditors to obtain information to make informed judgments. Creditors that sit on the creditor's committee have both a fiduciary duty and adequate economic interest to represent the unsecured creditor's group as a whole.

Expenses, including for experts retained by or on behalf of the creditor's committee, are shared and spread over the entire general creditor group.[31] The assumption of bankruptcy law is that secured creditors are paid in full out of their collateral and so residual amounts are for the account of the general creditors, who pay these expenses.

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[29] Claims are defined at 11 U.S.C. § 101(5) as a "right to payment". Claims for unmatured interest are disallowed at 11 U.S.C. § 502(b)(2). Under 11 U.S.C. §§ 101(5) and, regarding estimations, 502(c), contingent debts, obligations and causes of action are converted to "claims".

[30] 11 U.S.C. § 1102 (2006) provides for the committee of creditors; § 1122(a) provides for substantial similarity among claims in a class; § 1123(a)(4) provides for identical treatment of claims in a class; § 1103(c)(2) provides the committee with power to investigate the acts, conducts, assets, liabilities, financial condition and business of the debtor; § 1103(a) gives the committee the power to employ attorneys, accountants and other agents; and § 503(b)(3)(F) includes expenses of the creditor's committee as administrative expenses.

[31] Administrative expenses are paid after the secured creditors and before the general creditors. See 11 U.S.C. §506 (2006), relating to determination of secured status, and § 507, providing for priority of payment of the administrative expenses over most unsecured claims.

CREDITOR METAMORPHOSIS

Since the promulgation of the bankruptcy and insolvency laws recognizing debtor reorganization as a leading principle (*i.e.*, since 1978), there have been dramatic changes in both the nature of secured creditors and in the types, objectives and strategies of general creditors.[32]

Prior to 1978, there was frequently a single secured creditor to a commercial enterprise (or a very limited number of creditors). Often, that creditor was a bank that knew the debtor well and had, and intended to continue to have, an on-going relationship with the debtor. And then came syndication, trade claims trading, second lien positioning, debtor-in-possession financing, § 636 sales and derivatives, among other developments.

Banks and other financial institutions that act as lenders sought to sell off a portion of their secured loans, for very laudable risk diversification reasons. They determined that their risk diversified position was significantly sounder if they sold off – syndicated – (say) 80% of each loan or financing that they made, and retained only 20% of each such loan or financing. They used the cash obtained from selling that 80% portion to purchase positions (say, 20%) in loans and financings made by other banks and financial institutions. When a piece (say, 20%) of a loan or financing was syndicated to each of four other banks or financial institutions, each purchaser obtained voting rights and economic interests equal in percentage to the percentage interest purchased by that other bank or financial institution. Thus, between the mid-1980s and the mid-1990s large loan syndications increased from roughly US$ 100 billion to US$ 1 trillion plus.

The originating bank or financial institution, the lead arranger, would remain as the lead bank on the secured loan, holding the largest piece of the loan, and would continue to have the primary role in dealing with the debtor. However, it is clear that all the relationships between the debtor and each of the creditors had changed dramatically. The lead arranger had much less investment in, and a diminished relationship with, the debtor. The other creditors (the syndicants now holding 80% in total of the loan or financing in our example) had a fragmented, diminished relationship with the debtor, and may have had little or no direct relationship with the debtor. They would hold a portion of the obligations and rights of lenders, but in a diminished risk position and with different objectives than when they were sole lender. Further, they now had the ability to trade the syndicated piece in the secondary markets, which provided them with an early exit from the transaction should they so desire (it is worth noting in this regard that secondary market trading of syndicated loan pieces has increased

[32] Changes in the composition of creditor groups are discussed in numerous articles. Consider, for example, Chaim J. Fortgang and Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO LAW REVIEW 1 (1990) ("*Fortgang & Mayer: Trading Claims*"), which describes claims trading in bankruptcy actions as early as 1986, Robert K. Rasmussen and David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 85 (1995) ("*Rasmussen & Skeel*"), noting statistics on the growth of claims trading markets from the mid-1980s to the mid-1990s, and Douglas G. Baird and Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE LAW JOURNAL 648 (2010) (the version used by the author in the preparation of this paper was University of Southern California Law, Law and Economics Research Paper Series, USC CLEO Research Paper No. C09-8, University of Southern California Law, Legal Studies Research Paper Series Paper No. 09-9, and University of Chicago, Olin Law and Economics Program, Research Paper Series, Paper No. 470, available at http://ssrn.com/abstract=139827) ("*Baird & Rasmussen: Anti-Bankruptcy*"). The discussion in this paper follows Baird & Rasmussen: Anti-Bankruptcy.

by many multiples since 1987). Clearly, the dynamics of the financing and the relationship had changed. Secured loans have become more like unsecured general obligations.

The development of claims trading has had a significant impact on the nature of bankruptcy proceedings:[33]

> The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code's enactment in 1978. Claims trading has revolutionized bankruptcy by making it a much more market-driven process. Instead of serving as a forum for creditors to negotiate a restructuring of the debtor's finances with the goal of limiting their losses, bankruptcy is now a general investment opportunity.

The debate regarding the appropriateness of claims trading in different scenarios rages between supporters of claims trading activities[34] and those who argue against claims trading practices.[35] What is

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[33] The quoted language is from Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOKLYN JOURNAL OF CORPORATE FINANCE AND COMMERCIAL LAW 67 (2009-2010) ("*Levitin*"), at 69 (footnotes in the original text have been omitted). See also: Baird & Rasmussen: Anti-Bankruptcy, *supra* note 32, at 12: "The changing composition of creditors in Chapter 11 is due more than any other reason to the rise in claims trading"; Rasmussen & Skeel, *supra* note 32, at 104: claims trading "epitomizes the development of markets in connection with bankruptcy". See, also, Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 BOSTON UNIVERSITY LAW REVIEW 1609 (2009) ("*Lipson*"), as to the changing composition of creditors and the ramifications of that change in composition, including, at 1645-48, as to claims trading, and Levitin at 68. See also, Fortgang & Mayer: Trading Claims, *supra* note 32, Chaim Fortgang & Thomas Moers Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO LAW REVIEW 733 (1993), particularly as regards issues arising when claims are participated, Joy Flowers Conti, Raymond F. Kozlowski, Jr., & Leonard S. Ferleger, *Claims Trafficking in Chapter 11 – Has the Pendulum Swung Too Far*, 9 BANKRUPTCY DEVELOPMENTS JOURNAL 281 (1992), Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM LAW REVIEW 703 (2008), Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VANDERBILT LAW REVIEW 1987 (1987) ("*Miller*"), Harvey R. Miller and Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AMERICAN BANKRUPTCY LAW JOURNAL 153 (2004), Paul M. Goldschmid, *Note, More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUMBIA BUSINESS LAW REVIEW 191 (2005), Glenn E. Siegel, *Introduction: ABI Guide to trading Claims in Bankruptcy: ABI Committee on Public Companies and Trading* Claims, 10 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 567 (2002) (part 1), Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy: ABI Committee on Public Companies and Trading Claims*, 11 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 177 (2003) (part 2), Frederick Tung, *Confirmation and Claims Trading*, 90 NORTHWESTERN UNIVERSITY LAW REVIEW o1684 (1995-1996), and Tally M. Wiener and Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 UNIVERSITY OF PENNSYLVANIA JOURNAL OF BUSINESS LAW 35 (2009-2010).

[34] Levitin, *supra* note 33, at 72-74, summarizes the arguments in favor of claims trading as follows:

(a) Claims trading allows an exit for certain creditors prior to consummation of the bankruptcy proceeding, including those who desire to exit because of liquidity constraints, administrative expense and inconvenience, regulatory risk, a desire to avoid adversarial relationships with the debtor and/or the desire to establish a tax loss;

(b) Claims trading permits an entrance to the bankruptcy process for investors who have the appetite to monitor the debtor and contribute expertise to the reorganization process;

(c) Claims trading increases overall liquidity in the capital markets and lowers the cost of credit as the option of avoiding the uncertainty of being a creditor in bankruptcy increases the risk tolerance of originating lenders;

(d) Claims trading reduces transaction costs in the bankruptcy plan negotiation process by consolidating dispersed claimholders into a few large claimholders;

clear is that a particularly important effect of claims trading has been a marked change in the composition of creditors in Chapter 11 proceedings, particularly the increased involvement of hedge funds, private equity funds and banks and investment banks that have proprietary trading desks in distressed debt investing. These entities perceive opportunities to purchase the claims of bankruptcy debtors, realize immediate premiums, direct the results of bankruptcy proceedings, and effect control strategies, among others. These entities frequently have more knowledge of debtor situations and the likelihood of different bankruptcy outcomes. They have longer time horizons than the trade creditors. They seek to find overlooked value in the debtor's instruments. And, because of their knowledge, sophistication and resources, they are frequently able to use the ownership of trade claims as a yet another vehicle in their strategic efforts to obtain ownership and control of the debtor via the reorganization process.

Other aspects of claims trading have important ramifications for both direct and indirect *Sharīʿah*-compliant investments in distressed entities, including efforts to develop distressed debt investment vehicles and structures. These aspects relate to distinctions between bankruptcy claims and regular debt and to the nature of the distressed debt markets for business debt. Looking to those aspects pertaining to bankruptcy claims and regular debt, although

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(e) Claims trading reduces the administrative costs of bankruptcies by speeding up the reorganization negotiation process thorough consolidation of claimholders;

(f) Claims trading creates a market for control in bankruptcy that might not exist absent a cramdown plan or a § 363 sale;

(g) Claims trading can result in higher or quicker returns for creditors as a result of the market discipline that is imposed upon debtors (in a poorly run reorganization, creditors will sell their claims and buyers will push for liquidation or attempt to control reorganization);

(h) Claims trading ensures more efficient allocations of capital in the market by permitting entry and exits, allowing each participant to express their own "idiosyncratic" valuations;

(i) Claims trading can facilitate reorganizations by bringing in parties that are willing to infuse capital the fund the reorganization and the newly reorganized company (such as debtor-in-possession financing); and

(j) Claims trading may facilitate more sustainable reorganizations by enabling firms to emerge with lower leverage ratios.

And see Levitin at 93-94.

[35] Levitin, *supra* note 33, at 72-74, also summarizes the arguments in opposition to claims trading as follows:

(i) Claims trading hinders bankruptcy plan negotiations by raising transaction costs of negotiation (including as a result of investor churning, and attendant difficulties in reaching agreements), and imposing delay externalities on creditors that do not trade their claims, and thereby reduces the value of the debtor's estate;

(ii) Claims trading enables greenmail, insider trading and other unfair practices that allow particular creditors to extract surplus rents;

(iii) Claims trading hurts unsecured creditors by increasing the difficulty in finding creditors willing to serve on committees (many creditors will not serve on committees because of the increased restrictions on their ability to trade their interests and claims and others have preclusive conflicts of interests because they have purchased claims at different levels throughout the capital stack);

(iv) Claims trading encourages participation by creditors who value short-term returns on trades and quick monetization over longer-term value and debtor entity viability (which results in destruction of going concern value and may lead to debtor recidivism); and

(v) Claims trading destroys the "symbiotic relationship of debtor and creditor" that is the premise of Chapter 11 (quoting Miller, *supra* note 33, at 2014).

And see Levitin at 94-98.

> there is a distinction between a bankruptcy claim and a regular debt, they are both rights to use the legal system to collect value from another. The value of those rights depends on legal distinctions, such as whether the collection takes place through state law or federal bankruptcy law, whether or not a claim is ultimately allowable, and, if so, in what amount, with what priority, and with what voting rights. Buying or selling either a bankruptcy claim or a regular debt is a gamble on this constellation of risks, but the market is concerned about these distinctions only to the extent that they are meaningful markers of risk and value.[36]

The purchase of debt is problematic under the *Sharīʿah.* As general statements, interest-bearing indebtedness may not be purchased and there are limitations on the purchase of other indebtedness above or below par. However, those general statements may not put an end to the matter. For example, it may be possible to purchase interest-bearing debt that is not performing or that will be converted to equity or a *Sharīʿah*-compliant instrument. And it may be possible to purchase a wide range of debt instruments in the bankruptcy context, particularly in light of the fact that those instruments may be converted to equity or other compliant instruments through the bankruptcy process. Further, many bankruptcy claims do not constitute "debts" and will be subject to quite different principles and rules under the *Sharīʿah*.[37]

Another development in the bankruptcy claims - distressed debt market in recent years is the increase in second lien loan financings.[38] These financings increased from US$ 8 billion in 2003 to US$ 29 billion in 2006. These transactions involve a second lien loan that is made to the debtor with the consent of the first lien lender (the first lien holder has a lien on virtually all of the assets of the debtor). Payment on the second lien loan is not subordinated to the first lien holder; the debtor must make payment on both the first lien loan and the second lien loan. The second lien loan is second only in terms of its claim on the collateral package. There is a vibrant secondary market for second lien loans of this type. The primary purchasers in this secondary market are hedge funds, private equity funds and proprietary traders. Second lien holders are aggressive participants in bankruptcy and insolvency proceedings. They tend to push their rights to the limit, often objecting to the use of its collateral and seeking adequate

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[36] Levitin, *supra* note 33, at 80-81. Levitin also asserts a distinction between bankruptcy claims and regular debt and that the concept of a bankruptcy claim is broader than debt because of the inclusion of disputed, contingent and unliquidated claims. Levitin also observes that not all debts are enforceable in bankruptcy, that a bankruptcy claims carries rights that are distinct from those that are part of a debt, and that bankruptcy endows a claim with a relations aspect that does not exist in a debt. See Levitin at 80 and Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUMBIA BUSINESS LAW REVIEW 83 (2007), at 169-70.

[37] These are matters for a future transaction and a future paper. The easiest conception, from the vantage of Islamic investment funds, is investment in financial instruments of and certain other claims relating to an entity that is already in a bankruptcy proceeding. However, as indicated in Levitin, *supra* note 33, at 83-84 (footnotes in the quoted text have been omitted), the distressed debt markets have evolved such that

> bankruptcy claims do not constitute a distinct market from distressed debt … Now, investors trade in distressed debt well before bankruptcy. Instead of distinct markets based on whether the obligor is bankrupt or not, there is a general distressed debt market with a variety of investment strategies based on timing. The segmentation that exists in the market is not based on bankruptcy status, but rather on asset class.

The different types of conventional business debt (bond debt, bank debt, trade debt and tort debt) are discussed in Levitin at 85-90). *Sharīʿah*-compliant obligations are not considered.

[38] See Baird & Rasmussen: Anti-Bankruptcy, *supra* note 32, at 24-28. See note 37, *supra*, with respect to the unity of the market for bankruptcy claims and distressed debt.

protection of their secured interests (resisting the first lien holders). Their rights are derived from the intercreditor agreement with the first lien lender, which is often heavily negotiated at the time of the incurrence of the second lien loan. The intercreditor agreement frequently gives the first lien lender the right to sell collateral without the consent of second lien holder and provides the first lien lender with the right to provide debtor-in-possession financings ("*DIP Financings*"), with super-priorities in favor of the provider of the DIP Financing (the "*DIP Lender*"). The second lien lenders will frequently contest these rights, including the super-priority lien provisions.[39]

The identity and objectives of the other unsecured creditors have also changed markedly since 1978. Here again, hedge funds, private equity funds and banks have assumed a major role, particularly in "distressed debt investing" (which includes bankruptcy claims).[40] These investors (these unsecured creditors) are well-informed, experienced and sophisticated market participants that have their own agendas. They act independently in their own self-interest, rather than in common with the dispersed group of creditors (which may stress the fiduciary duty assumptions and requirements). Their objectives may be ownership (including via a "loan to own" arrangement), the ability to control bankruptcy proceedings, the ability to control the distressed or insolvent entity, and possibly take control of the entity as an ultimate matter (such as through DIP Financing arrangements), and the ability to acquire assets at exceptionally low valuations.[41]

In considering the role of these institutions and their actions in the bankruptcy and insolvency realm (broadly conceived), a debt holder's influence depends upon three factors: (1) the characteristics of the debt, such as its amount and type (bearing in mind, for example, that a holding of greater than 34% of a

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[39] Some other developments have also had a marked effect on the markets here under discussion. For example, credit default swaps came into widespread use during the period being discussed. Credit default swaps allowed banks to offload default risks outside the banking system. In a credit default swap, one party one party acquires a credit risk for a fee, and makes payment in the amount of the loan if a "credit event" (including a bankruptcy or insolvency) occurs. There is a fundamental difference between a credit default swap and a syndication: voting and control rights are not transferred in a credit default swap. In a credit default swap, a bank, hedge fund or other transferor may benefit from a default or a bankruptcy or insolvency (it gets paid under the credit default swap) and it may thus act against the interest of the credit holder, a moral hazard and a discontinuity. Total return swaps are another derivative instrument that came to prominence in the period under discussion. In a total return swap, an investor (a total return receiver) may enjoy economic rights in a loan without the control rights (the investor gets all economic exposure of the loan - both credit and market risks, not just credit risks). Investors call sell the total return swap positions in the secondary markets (often to hedge funds and other distressed debt professionals). The owner of a loan (the total return payer) exchanges the income from the loan and appreciation for a guaranteed income stream plus protection against capital depreciation. The owner off-loads economic risks associated with the loan, but retains the loan on its balance sheet and retains control rights. These contracts may not be settled in the event of default. These developments are discussed at Baird & Rasmussen: Anti-Bankruptcy, *supra* note 32, at 33-41.

[40] Distressed debt investing is variously defined. One definition is investing in the debt of a financially troubled company where that debt carries a high risk of default or non-payment and, consequently, a high rate of return. A narrow definition, and one that is considered in the *Sharīʿah*-compliant distressed debt context, is investing in the debt of a company that has commenced or is expected to commence a bankruptcy or insolvency proceeding. A broader, market-oriented definition is investing in debt with a yield to maturity of 1,000 basis points over the riskless rate of return. Historically, in Europe, distressed debt investing has been defined as investing in debt that is trading between 80% and 90% of par value, but more recently as between 90% and 95% of par value. See note 37, *supra*, with respect to the fact that there is no distinction between the market for bankruptcy claims and the market for distressed debt where conventional instruments are being considered.

[41] See note 34, *supra*.

class of debt constitutes a blocking position under many secular bankruptcy, insolvency and corporate laws (and company charters), and a position of greater than 50% constitutes a majority and controlling position); (2) relevant statutory rights (such as Chapter 11 reorganization rights under United States laws, or management, liquidation or trustee direction rights under applicable law); and (3) contractual rights that may supersede other rights (such as prepetition contractual rights and covenant and default rights under debtor-in-possession financings).

These institutions may take positions that are quite different than those assumed by the framers of the bankruptcy and insolvency laws. For example, they may not want further information regarding the debtor in which they invest as it may constitute insider information and restrict their ability to trade (so they may avoid committees and involvement with the debtor).[42] In other circumstances, they clearly do want the additional information. In some situations, they may not want to sit on committees and have fiduciary obligations to other creditors that might conflict with their own agendas. In other circumstances, they may use their position on a committee to control the bankruptcy proceedings.

And consider the various possibilities associated with ownership of different classes of debt and equity by a single investor institution. Multiple class ownership provides the creditor with a wide range of tools and options in the bankruptcy and insolvency context. As noted above, the creditor may opt not to use or exercise one or more of these tools or options: these are tactical determinations. However, the tools and options are valuable and comprise, individually and collectively, a powerful arsenal. They may disclose ownership in one class (say, equity) but not in others, which may mislead the public on their position with respect to a company. These holdings, and the absence of full disclosure, may allow them to mislead market participants and competitors. They may in fact own a competitor, and thus have competing interests that are unknown. As noted above, the creditor may be able to exert blocking positions by virtue of holding 34% of any given class of debt. This is a particularly important strategic consideration where each class must approve a given matter by ½ in number of debt holders and 2/3rds in amount of claims in that class. And consider that holding one or more classes of debt may also allow that creditor to play an instrumental role in defining the classes of debt, which, in turn, will afford that creditor greater flexibility in determining whether to pay a given class of debt or negotiate with a given class of debt as to how it votes on a given matter. Multiple class holdings also make it significantly more difficult for the debtor to weaken blocking positions by way of influencing definitions of the various classes. Multiple class holdings may allow the creditor to disguise its true objectives in holding any specified class of debt (or equity). And it may allow the creditor or equity holder to hedge its positions, even to the point where its primary incentive may be to induce bankruptcy or insolvency (for example, so that it can trigger a credit default swap on which it is the beneficiary), despite its holdings of other classes of debt and despite the fact that the debtor may be better off outside bankruptcy.[43] Multiple

[42] Marshall S. Huebner and Benjamin A. Tisdell, *As the Wheel Turns: New Dynamics in the Coming Restructuring Cycle*, in THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE 2008/2009 77 (2009), at 82, Baird & Rasmussen: Anti-Bankruptcy, *supra* note 32, at 19, Robert P. Enayati, *Undermining the Trading Wall: The ABPCPA's Affront on the Creditor's Committee's Duty of Confidentiality in Chapter 11 Bankruptcies*, 21 GEORGETOWN JOURNAL OF LEGAL ETHICS 703 (2008), and Levitin, *supra* note 33, at 73.

[43] See Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AMERICAN BANKRUPTCY LAW JOURNAL 405, particularly at 427-30 (2007), Frank Partnoy and David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 UNIVERSITY OF CINCINNATI LAW REVIEW 1019 (2007), and John T. Lynch, *Comment, Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention – A Model for the future of U.S. Regulation?*, 55 BUFFALO LAW REVIEW 1371, 1384 (2008).

class holdings may be an effort to realize a "fulcrum" capital structure position.[44] Multiple class holdings may be most effective where the position of the creditor is undisclosed (such that, for example, the creditor can realize upon arbitrage opportunities or even induce sales or purchases of classes of the debtor's securities or obligations).

Holding a class of indebtedness may give the holder a seat on the debtor's planning committee and on the unsecured creditor's committee. It may allow the creditor to make powerful motions, such as a creditor's motion for relief from the automatic stay provisions or to appoint (or remove) a trustee. It may allow the creditor to object to the use of cash collateral. It will allow the creditor access to financial information, business plans and other information (the secured creditors usually obtain this material pursuant to covenant rights in the secured financing arrangements).

Multi-class ownership will also allow the creditor a more flexible strategic position in addressing cramdown court approvals where not every class of debt approves a given matter. And, quite fundamentally, multiple class ownership will establish a larger stake in debtor entity and thus a greater voice in the decisions pertaining to that entity.

Taking a position in the secured debt also has some notable advantages. For example, secured creditors can demand payment in full of the secured debt before distributions are made to junior creditors. They can also block sales of assets that include their collateral. Secured creditors can "credit bid" their debt in asset sales involving their collateral.

DIP FINANCINGS

In bankruptcy, insolvency and distressed debt transactions in the United States (and other jurisdictions that allow or encourage financing of debtors), DIP Financings have assumed a particularly important role.[45] DIP Financings are post-petition loans to the debtor in the bankruptcy proceeding. Under the United States bankruptcy laws, the DIP Financing receives the benefit of a "super-priority" claim and is paid before other priority claims. In some circumstances, with the consent of the court and with certain qualifications, lenders that made pre-petition loans will make, or participate in the making of, the DIP Financings and will consolidate their pre-petition loans with the DIP Financings. This consolidation has the effect of trumping pre-petition secured creditors and bootstrapping the pre-petition position of the DIP Lender.

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[44] See, e.g., Mark S. Lichtenstein and Matthew W. Cheney, *Riding the Fulcrum Seesaw: How Hedge funds Will Change the Dynamics of Future Bankruptcies*, 191 NEW JERSEY LAW JOURNAL 102, January 14, 2008.

[45] Among the many discussions of DIP Financings and their ramifications, see Skeel: Creditor's Ball, *supra* note 24, at 923-26 and 935-42, Baird & Rasmussen: Private Debt, *supra* note 26, David A. Skeel, Jr., *The Past, Present and Future of Debtor-In-Possession Financing*, 25 CARDOZO LAW REVIEW 1905 (2003-2004) ("*Skeel: DIP Financing*"), Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UNIVERSITY OF CALIFORNIA LAW REVIEW 115 (2009-2010), Mark L. Prager, *Financing the Chapter 11 Debtor: The Lender's Perspective*, 45 THE BUSINESS LAWYER 2127 (1989-1990), Douglas Baird and Martin Bienenstock, *Debtor-in-Possession Financing (Pre-Petition & Lock-Up Agreements),* 1 DEPAUL BUSINESS AND COMMERCIAL LAW JOURNAL 589 (2002-2003), Jarrod B. Martin, Kristofor Nelson, Eric Rudenberg and Jonathan Squires, *Freefalling With A Parachute That May Not Open: Debtor-In-Possession Financing in the Wake of the Great Recession* (2010) (ssrn id:130566[1]; copy on file with the author), and Sandeep Dahiya, Kose John, Manju Puri and Gabriel Ramirez, *The Dynamics of Debtor-in-Possession Financing: Bankruptcy Resolution and the Role of Prior Lenders* (draft of June 13, 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430566, Thomas G. Kelch, *The Phantom Fiduciary: The Debtor in Possession in Chapter 11*, 38 WAYNE LAW REVIEW 1323 (1991-1992).

The structure and terms of the DIP Financing are also used to exert influence over the debtor and achieve results desired by the DIP Lenders. The DIP Financing may be structured as a revolver of some type in order to force the debtor to borrow smaller amounts on a continuing periodic basis. This not only limits the exposure of the DIP Lenders, it also allows covenant testing of the debtor on a frequent periodic basis. The financial and operational covenants of the DIP Financing will also be used to exert control over the debtor, with increasing stringency rigor over time. Thus, the various financial covenants may become more restrictive over time. Other financial covenants may impose minimum income requirements and reserve requirements that are difficult for the debtor entity to meet. Violation of the covenants will result in defaults, acceleration of the indebtedness, and foreclosure upon the assets and business of the debtor. That is, violations will result in a change in ownership of the debtor. The covenants may also allow the DIP Lenders to exercise remedies even during the automatic stay periods. The covenants may also provide for hands-on involvement of the DIP Lenders through the actions of a "chief restructuring officer", who is required by the DIP Financing covenants. The DIP Lenders may also take seats on the board of directors of the debtor, thereby having direct involvement in the policies and operations of the debtor. Among the many management rights that may be afforded the DIP Lenders by way of the loan documentation are veto rights over operational changes, asset or business acquisitions, asset or business dispositions, and different types of transactions. The DIP Lenders may also use the loan documentation to provide themselves with a broad range of rights, such as rights to bid the debt for company assets. In short, the DIP Financing documentation is an exceptionally powerful vehicle in the hands of sophisticated creditors.

SECTION 363 SALES

Section 363 of the United States Bankruptcy Code[46] permits the use, sale or lease of property of the bankruptcy estate, both inside and outside the ordinary course of the debtor's business.[47] It authorizes

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[46] 11 U.S.C. § 363 (2006).

[47] James J. White, *Bankruptcy Noir*, 106 MICHIGAN LAW REVIEW 691 (2007-2008), Barry E. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 305 (2010), Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL LAW REVIEW 439 (1992), Barry E. Adler and Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE LAW JOURNAL 83 (2001), Philippe Aghion, Oliver Hart and John Moore, *Improving Bankruptcy Procedure*, 72 WASHINGTON UNIVERSITY LAW QUARTERLY 849 (1994), Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 JOURNAL OF LEGAL STUDIES 127 (1985), Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 JOURNAL OF LAW AND ECONOMICS 633 (1993), Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precision Industries v. Qualitech Steel*, 59 BUSINESS LAWYER 475 (2003-2004), Lee R. Bogdanoff, *The Purchase and Sale of Assets in Reorganization Cases – Of Interest and Principal, of Principles and Interests*, 47 BUSINESS LAWYER 1367 (1991-1992), Jason Brege, *An Efficiency Model of Section 363(b) Sales*, 92 VIRGINIA LAW REVIEW 1639 (2006), Stephen I. Glover, *Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies*, 47 BUSINESS LAWYER 611 (1991-1992), Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 JOURNAL OF APPLIED CORPORATE FINANCE, SUMMER 1991, at 13, George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AMERICAN BANKRUPTCY LAW JOURNAL 235 (2002), LoPucki & Doherty: Fire Sales, *supra* note 25; Lynn M. LoPucki and Joseph W. Doherty, *Bankruptcy Vérité*, 106 MICHIGAN LAW REVIEW 721 (2007-2008), Basil H. Mattingly, *Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy*, 4 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 431 (1996), Dror Parnes, *Bankruptcy Section 363 Sales: Choices and Consequences* (draft of June 8, 2010), available at http://papers.ssrin.com/sol3/papers.cfm?abstract_id=1622282, Branko LJ. Radulovic, *The Effect of §36 Sales on Recovery Rates: Allowing for Self-Selection Bias* (draft of September 14, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstact_id=1360383, Michael H. Reed, *Successor Liability and Bankruptcy Sales Revisited – A New Paradigm*, 61 THE BUSINESS LAWYER 179 (2005-2006), Spencer C. Robinson,

a debtor to sell assets outside of the ordinary course of business upon obtaining the approval of the bankruptcy court upon a hearing. These sales may be of discrete assets of the debtor or may entail a sale of the debtor as a going concern. Section 363 sales and actions are permitted in order to maximize the assets of the estate for the benefit of the unsecured creditors. The property constituting the bankruptcy estate can be sold "free and clear of any interest in such property of an entity other than the estate". If the bankruptcy court determines that adequate grounds exist, the assets of the debtor can be sold free and clear of the debts, including secured debts.[48] Section 363(h) permits a sale of the estate's interest (and any co-owner's interest) in the property of the estate. Section 363(f) sets out five criteria: if any one of these criteria is met, the sale is permissible (subject to the "adequate protection" requirements, which frequently means having the interests attach to the sale proceeds): (i) applicable non-bankruptcy law permits the sale of the property free and clear of the non-estate interest; (ii) such entity consents; (iii) such interest is a lien and the sale price is greater than the value of all liens on such property; (iv) such interest is in a bona fide dispute; and (v) such entity could be compelled, in a legal or equitable proceeding, to accept money in satisfaction of such interest.[49]

DIP Financings are post-petition financings to the debtor in the bankruptcy proceeding. They are sometimes described as being of two types: (a) "loan oriented", where the DIP Lenders, through strong financial and operational covenants, have significant leverage over and control of the debtor and its operations; and (b) "loan and control" or "loan to own", where the DIP Financing is used to effect a transfer of control to the DIP Lender itself, either through a sale to the DIP Financing provider or as the intended outcome of the Chapter 11 proceeding.

Commentators have identified a number of risks that are associated with the provision of DIP Financings. The DIP Lender may have too great an incentive to force the debtor to liquidate assets. The DIP Lender may use the DIP Financing to improve the status of the pre-petition loans made by that provider by consolidating pre-petition loans and post-petition DIP Financings into a single facility, with consolidated loan having the benefit of the "super-priority" afforded DIP Financings (thereby bootstrapping the pre-petition loan to a higher priority of payment). The DIP Financing may include particularly restrictive covenants that are designed to allow the DIP Lender to foreclose on the debtor's business and take ownership of that business. The DIP Financing frequently diverts value from the general creditors to a very limited and select group of creditors that provide the DIP Financing. And the covenant and control provisions of the DIP Financing may stymie competing bids for control of a troubled company.

Keeping Secured Lending Secure: The Limited Legacy of Chrysler's § 363 Bankruptcy, 14 North Carolina Banking Institute 515 (2010), Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 Columbia Law Review 527 (1983), and Alan S. Trust, *From Airwaves to Airplanes: A Practical Synthesis for Chapter 11 Sales Outside the Ordinary Course of Business*, 91 Commercial Law Journal 267 (1986).

[48] 11 U.S.C. § 363(b)(a), (f) (2006).

[49] 11 U.S.C. 1129, requires that a court determine that a plan of reorganization complies with the usual priorities of the Bankruptcy Code before that plan is approved, unless creditors consent to a plan deviating from those priorities. There are circumstances in which a § 363 sale might determine core aspects that would normally be addressed under § 1129 with disclosure, voting under § 1129(a)(8, and, if voting fails, judicial cram-down under § 1129(b). In such a case, there is a tension between § 363 and § 1129. Various bankruptcy scholars emphasize that this tension was particularly acute in the recent chapter 11 proceeding involving Chrysler Corporation. See, e.g., Mark Roe and David Skeel, *Assessing the Chrysler Bankruptcy*, 108 Michigan Law Review 727 (2009-2010), which is critical of the proceeding on various grounds.

EAST CAMERON REORGANIZATION PROCEEDINGS

The East Cameron oil and gas *sukūk* is (to the author's knowledge) the only *Sharīʿah*-compliant instrument to be considered by a bankruptcy court in a formal bankruptcy or insolvency proceeding. It is a particularly useful example of the operation of a debtor-friendly bankruptcy and insolvency regime as the bankruptcy proceeding was initiated under Chapter 11 in the United Sates Federal bankruptcy court in Louisiana.

This case study allows us to raise a wide range of *Sharīʿah*-related issues for consideration. Let us consider an example of only one category of issues, albeit a category of fundamental issues. Is it permissible, under the *Sharīʿah*, to allow the occurrence of certain transactions that are not *Sharīʿah* compliant in circumstances where those transactions are a transitory expedient that will be reversed or unwound within very short periods and where those non-compliant transactions are necessary in order to comply with secular bankruptcy and insolvency law and where it is virtually certain that those transactions will have no lasting effect? Consider, for example, the use of an interest-bearing DIP Financing by the *Sukūk* Holders in the East Cameron reorganization where the DIP Financing will be converted to equity in a short period. As we will see, this is one of many such issues that will need to be considered as we move to the introduction of *Sharīʿah* principles in the secular bankruptcy and insolvency context. This paper considers only a very few such issues. The objective is to focus the reader on the necessity of careful consideration of all issues before precipitous action is taken.

The East Cameron oil and gas *sukūk* was issued in 2006.[50] East Cameron Gas Company ("*ECGC*"), a Cayman Islands limited liability company, issued US$ 175 million of *sukūk* due July 2016 that were expected to have quarterly redemptions that depended upon hydrocarbon production from the relevant natural gas properties. ECGS is the "*Trustee*" of the *Sukūk* Trust pursuant to the Declaration of Trust, dated July 5, 2006. ECGC is also the "*Issuer SPV*" that issued the *sukūk* certificates.

ECGC and Louisiana Offshore Holding LLC ("*LOH*"), a Delaware limited liability company, as "*Purchaser SPV*", entered into a Funding Agreement, dated as of July 5, 2006 (the "*Funding Agreement*"). The Funding Agreement was the primary payment and cash allocation document in the transaction. Pursuant to the Funding Agreement, (a) proceeds from the *sukūk* issuance were used to purchase various overriding royalty interests in the natural gas properties from the Originator, East Cameron Partners, LP (the bankrupt debtor), and (b) quarterly repayments would be made periodically to ECGC and paid to *Sukūk* Holders. ECGC, LOH and Deutsche Bank Trust Company Americas, as Collateral Agent, entered into various other documents pertaining to the *sukūk* transaction, including the "*Security Documents*".

The structure of the *sukūk* transaction prior to the reorganization in the bankruptcy proceeding is depicted graphically in Figure 1. Cash flow arrangements are highlighted in that Figure.

[50] The author was a partner at the law firm that represented most of the *Sukūk* Holders in the East Cameron bankruptcy proceedings and was directly involved in those proceedings. As a result of confidentiality and ethics considerations, this paper draws upon only publicly available information pertaining to that proceeding and omits discussion of other relevant information and considerations.

Figure 1: Inception of *Sukūk* Transaction – Highlighting Cash Flows

Open Choke Energy Advisors
Open Choke Energy Partners
OCIEI Minerals
BT Operating Company (Operator)
Open Choke Energy LLC
33%
36%
LP
28%
1%
1%
GP
East Cameron Partners, LP (“Debtor” and “Originator”)
Bankruptcy: Note that the cash flow is through LOH
Independent Member 0%
Managing Member 100%
100% Working Interest 8% NRI
Louisiana Offshore Holding, LLC (“LOH” and “Purchaser SPV”)
72% ORRI
Leases EC71/EC72
20% RI
MMS Other Royalty Holders
Funding Agreement
Production Proceeds
East Cameron Gas Company (“Trustee”, “ECGC” and “Issuer SPV”)
East Cameron Gas Co. *Sukūk* Trust
Sukūk Certificates
Sukūk issuance and related cash flows
Collateral Agency and Intercreditor Agreement
Letter of Credit Provider
Sukūk Holders
Deutsche Bank Trust Company Americas (“Collateral Agent”)

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In brief summary, the progression of events pertaining to the default and initiation of the bankruptcy proceeding involving the East Cameron oil and gas *sukūk* was as follows:

- On September 17, 2008, a Notice that an Exogenous Enforcement Event, namely a Hydrocarbon Mix Shortfall Exogenous Enforcement Event, was served on the Purchaser SPV (LOH) and East Cameron Partners, LP, a Texas limited partnership (the “*Originator*” and, subsequently, the “*Debtor*”).

- On October 9, 2008, the *Sukūk* Holders, at a meeting, adopted certain resolutions with respect to, among other things: (x) declaring the funding under the Funding Agreement immediately due and payable in full and applying the Accelerated Payment Schedule (in lieu of the Payment Schedule); (y) requiring the Purchaser SPV (LOH) to withdraw all amounts in the Earnout Account and deposit those amounts in the Collection Account; and (z) the exercise by ECGC and the Collateral Agent of the rights and remedies under the Funding Agreement and the Security Documents.

- On October 16, 2008, the Originator/Debtor, East Cameron Partners, LP, filed a voluntary petition for relief under Chapter 11 of Title 11 of the United States Code in the United States

Bankruptcy Court for the Western District of Louisiana, Lafayette/Opelousas Division (No. 08-512-07).

- Also on October 16, 2008, the Originator/Debtor filed a complaint requesting injunctive relief against the Purchaser SPV (LOH), ECGC and the Collateral Agent – the "*Adversary Proceeding*" – to (i) prevent the sale, conveyance, transfer and liquidation of the overriding royalty interest ("*ORRI*") that secured the obligations of the Purchaser SPV to ECGC under the Funding Agreement, and (ii) recharacterize the *sukūk* as a secured loan transaction.

- On November 18, 2008, the Bankruptcy Court entered the requested preliminary injunction.

- On August 7, 2009, to fund Originator/Debtor operations during the pendency of the Chapter 11 proceeding, various *Sukūk* Holders entered into a Debtor-in-Possession Credit Agreement and related documents to provide up to US$ 4,490,000 in loans to the Originator, which loans were secured by a first priority lien and security interest in essentially all of the assets of the Originator/Debtor.

- And at various times thereafter, the other events discussed in this paper occurred. Of particular import are the "363 asset sale" transaction and the conversion of the DIP Financing into equity, each as discussed below.

The East Cameron bankruptcy proceeding was a Chapter 11 reorganization proceeding. The theory of Chapter 11 is as follows: Chapter 11 proceedings are relatively pro-debtor proceedings that provide for a reorganization of the business and affairs of the debtor so as to provide the debtor with a "fresh start" and so as to preserve the debtor's business. The management of the debtor stays in control of operations. Procedurally, the debtor has the exclusive right to propose the reorganization plan in the first 120 days after the bankruptcy filing. Burdensome contracts and leases can be terminated. The debtor often reduces its debt by repaying some debt and discharging other debt. There is usually a consolidation of debtor obligations, and the debtor reemerges from the bankruptcy proceeding as an operating business with a reconfigured capital structure. Existing equity holders may be removed or diluted. The reorganization plan is the critical focus, but other factors may intervene (363 sales of assets, for example). In contrast to the theory, and in common with many Chapter 11 proceedings in more recent years, the debtor (here East Cameron Partners, LP) did not emerge as the operating business: a change of control was effected through a conversion of the DIP Financing to equity.

In devising a resolution to the issues that arose in the bankruptcy proceeding, the *Sukūk* Holders had to address a broad range of operational issues. The *Sukūk* Holders had to address issues pertaining to payment of unsecured creditors. They also had to provide for payments to the owner of the lease concessions, the Bureau of Ocean Energy Management, Regulation and Enforcement (formerly known as the Minerals Management Service), an agency of the United States Department of the Interior that manages natural gas, oil and other mineral resources on the outer continental shelf of the United States, which would have to subsequently consent to the reorganization (to the extent of any change in the parties to the oil and gas leases). The *Sukūk* Holders had to arrange for a new operator and negotiate all matters with the new operator. And the *Sukūk* Holders had to determine how to keep the properties operational so that the working interests and related rights to the oil and gas would not be lost, which they accomplished when some of the *Sukūk* Holders (but not all) made a DIP Financing to the Debtor (East Cameron Partners, LP), as depicted in Figure 2.

Figure 2: Debtor-in-Possession Financing

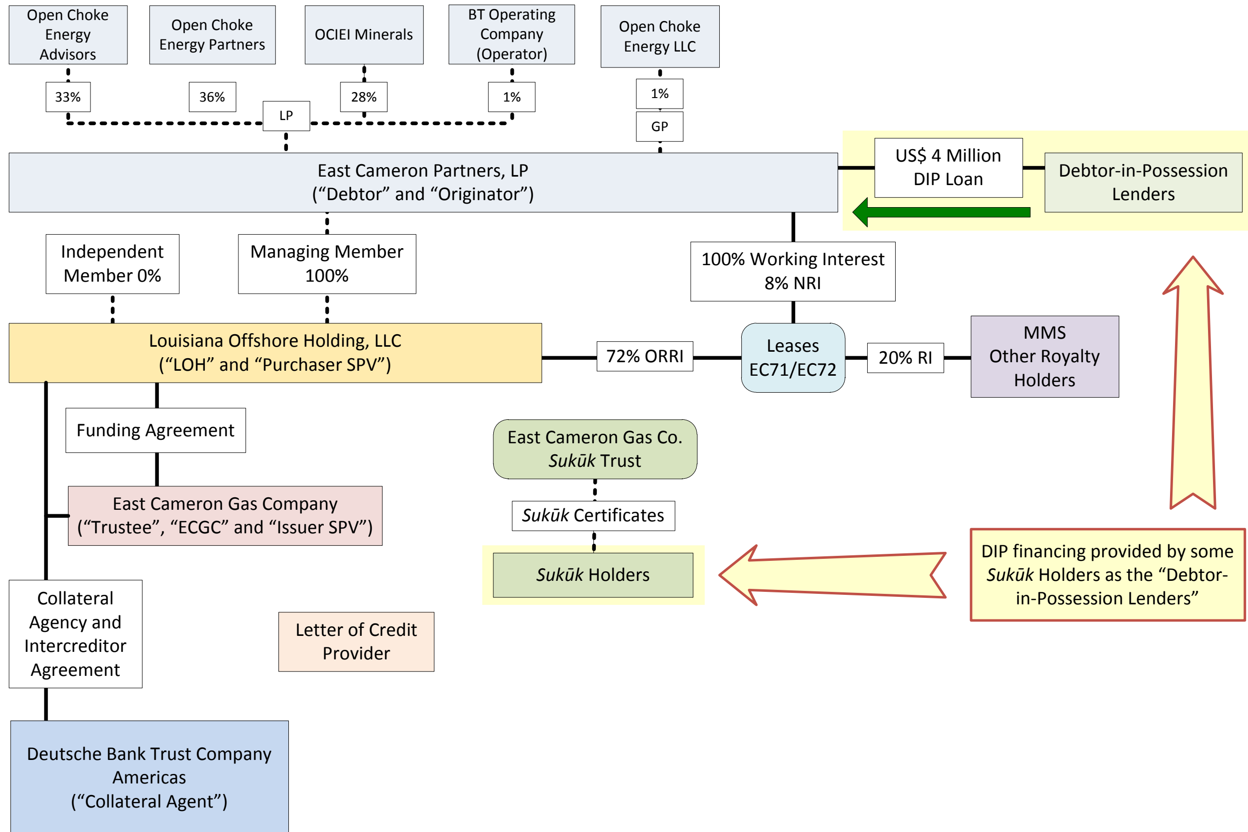

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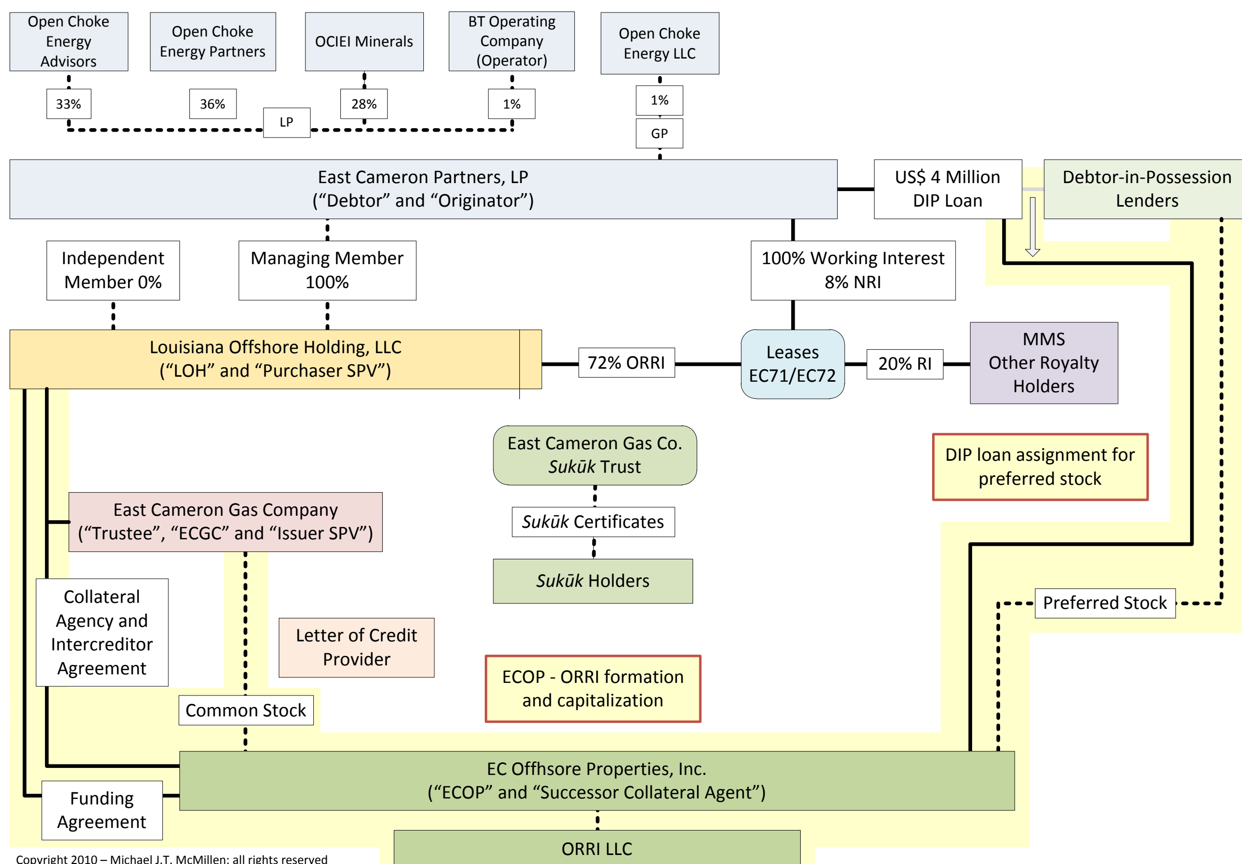
Figure 3 illustrates some of the early steps in the conversion of the DIP Financing to equity in the East Cameron reorganization. The existing trustee was replaced by a new trustee. The new trustee was a newly-formed entity, EC Offshore Properties, Inc. or ECOP. ORRI LLC was formed as a subsidiary of ECOP (for use in a later step of the reorganization). Two assignments were effected, one of the Funding Agreement and one of lender's rights in respect of the DIP Financing in exchange for preferred stock in ECOP (which is held by some of the *Sukūk* Holders after the consummation of this step).

Figure 3: Step 1 – ECOP Formation and Capitalization and DIP Loan Assignment



For future consideration, consider a *Sharīʿah* issue that arises in connection with the conversion of the DIP Financing position to a preferred stock equity position. Preferred stock is generally defined as being "preferred" in two regards: there is a preference as to periodic payments; and there is a payment preference in liquidation, most notably liquidation in bankruptcy. The periodic payment preference is largely a matter of the timing of the payment (assuming, for the moment (and contrary to customary practice), that the common or non-preferred stock is structured such that the obligation to make the payment on that stock survives on a cumulative basis). This element of a preferred stock can be addressed from a *Sharīʿah* perspective. The second element of preference, in the liquidation context, is more interesting in a situation such as the East Cameron bankruptcy because the transaction is already in a bankruptcy proceeding that focuses on reorganization (rather than liquidation). Suffice it to say, for the moment, that the structuring of the preferred stock for to address *Sharīʿah* issues is a delicate undertaking in this type of scenario.

Figure 4 depicts the asset sales and transfers in the East Cameron reorganization. A cash payment was made by the LOC Provider and certain *Sukūk* Holders (the "*Contributing Holders*") to LOH and the rights of ECOP under the Funding Agreement were extinguished. The ECOP assets, specifically the 72% ORRI and other assets of the Debtor, were transferred to ORRI and the DIP Financing obligations were extinguished.

Figure 4: Step 2 - LOH Asset Transfer, Contributor's Preferred Stock, and 363 Asset Sale

Open Choke Energy Advisors
Open Choke Energy Partners
OCIEI Minerals
BT Operating Company (Operator)
Open Choke Energy LLC
33%
36%
28%
1%
1%
LP
GP
East Cameron Partners, LP ("Debtor" and "Originator")
US$ 4 Million DIP Loan
Former Debtor-in-Possession Lenders
Independent Member 0%
Managing Member 100%
Other Specified Assets of Debtor
100% Working Interest 8% NRI
Louisiana Offshore Holding, LLC ("LOH" and "Purchaser SPV")
Leases EC71/EC72
20% RI
MMS Other Royalty Holders
US$ 500,000
East Cameron Gas Co. *Sukūk* Trust
East Cameron Gas Company ("Trustee", "ECGC" and "Issuer SPV")
Sukūk Certificates
72% ORRI
Sukūk Holders
Preferred Stock
Collateral Agency and Intercreditor Agreement
Letter of Credit Provider
Contributing Holders
100% Working Interest 8% NRI
Common Stock
Preferred Stock
EC Offhsore Properties, Inc. ("ECOP" and "Successor Collateral Agent")
Funding Agreement
ORRI LLC

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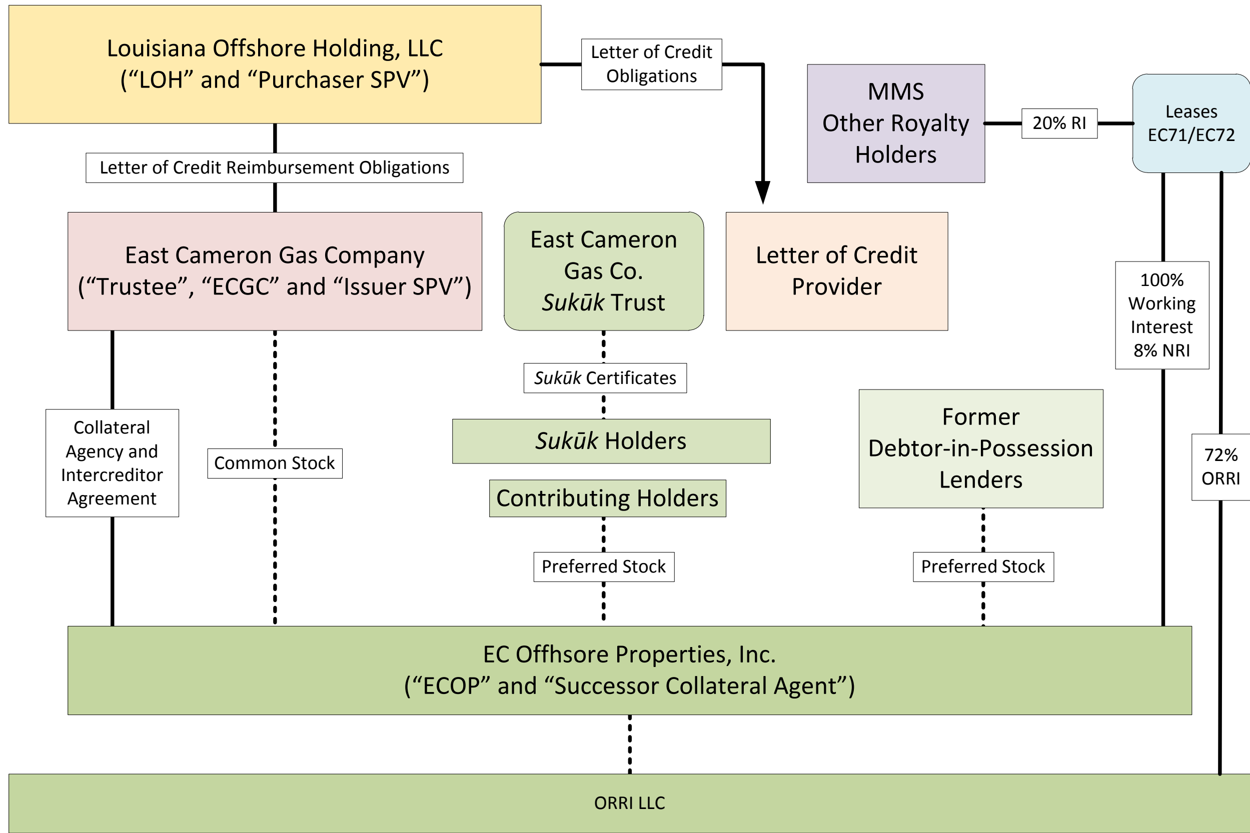
Figure 5 summarizes the state of the reorganization after step 2.

Figure 5: Restructured Transaction – After Step 2



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The next step in the reorganization involved the exchange of the *Sukūk* Certificates and certain LOC obligations for common stock of newly-formed companies (that will acquire assets), as illustrated in Figure 6. Note that, like the original providers of the DIP Financing (which were *Sukūk* Holders), the LOC Provider obtained preferred stock. Note also that the *Sukūk* Certificates are retired, and the *Sukūk* Trust is dissolved, after the exchange of the *Sukūk* Certificates for common stock.

Figure 6: Step 3 – Exchange of Common Stock for *Sukūk* and LOC Obligations

Louisiana Offshore Holding, LLC (“LOH” and “Purchaser SPV”)

Letter of Credit Obligations

MMS Other Royalty Holders

20% RI

Leases EC71/EC72

East Cameron Gas Co. *Sukūk* Trust

Letter of Credit Reimbursement Obligations

Former Letter of Credit Provider

Sukūk Certificates

East Cameron Gas Company (“Trustee”, “ECGC” and “Issuer SPV”)

100% Working Interest 8% NRI

Common Stock

Former *Sukūk* Holders

Collateral Agency and Intercreditor Agreement

Common Stock

Contributing Holders

Former Debtor-in-Possession Lenders

72% ORRI

Common Stock

Preferred Stock

Preferred Stock

EC Offhsore Properties, Inc. (“ECOP” and “Successor Collateral Agent”)

ORRI LLC

ECGC exchanges its Common Stock in ECOP to the *Sukūk* Holders for the *Sukūk* Certificates (which are then retired, disssolving the *Sukūk* Trust) and the LOC Provider (against the existing Letter of Credit Obligations) and for forgiveness of certain of the Letter of Credit Obligations of LOH. The Collateral Agency and Intercreditor Agreement is terminated.

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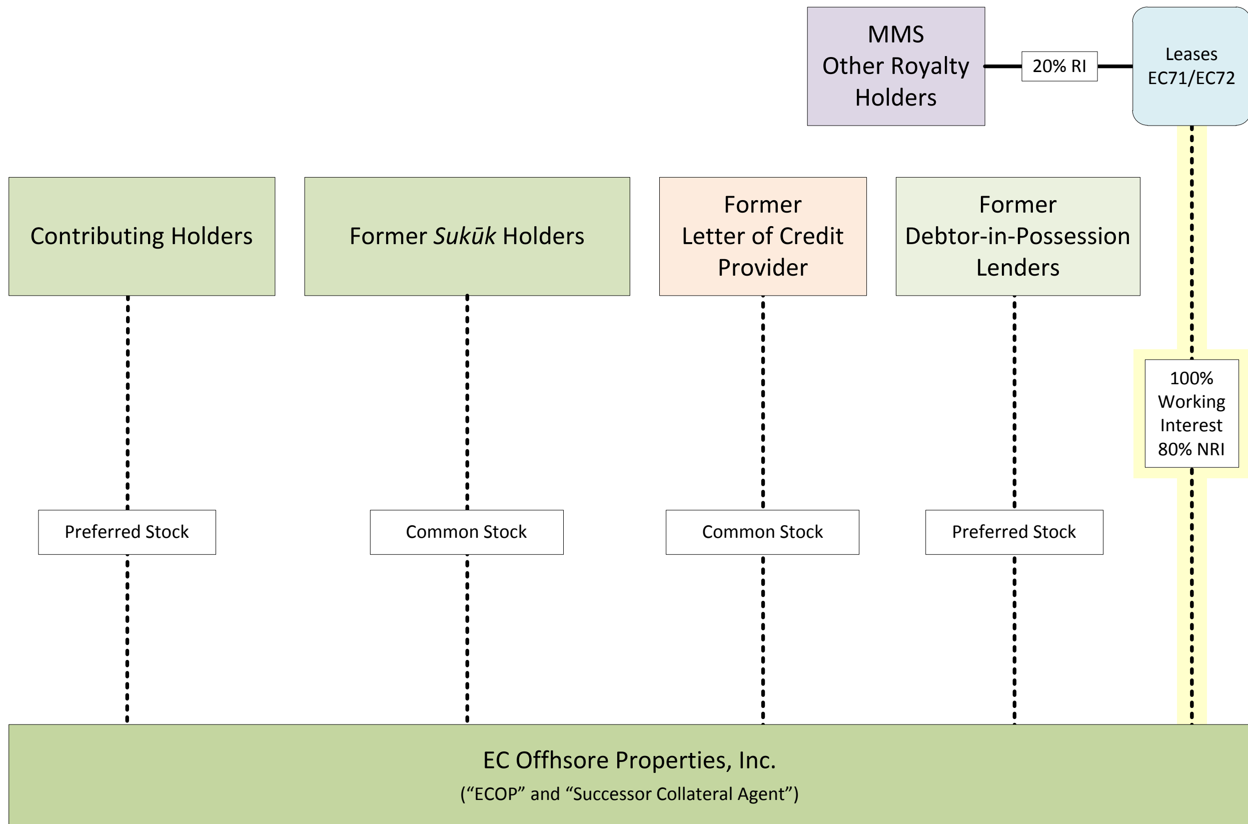
Immediately after the common stock exchange, ORRI LLC is consolidated into ECOP, as the final step in the reorganization. The final capital structure is depicted in Figure 7. As can be seen from Figure 7, the *Sukūk* Certificates have been completely retired, the *Sukūk* Trust has been liquidated, and the *Sukūk* Holders are now equity holders in ECOP, which holds all of the interests in the oil and gas leases that were originally held by the Debtor. The equity interests in ECOP are both preferred stock and common stock, which presents some of the *Sharīʿah* issues previously noted.

Figure 7: Final – After Step 4 (Consolidation of ORRI into ECOP)



CONCLUSION

The growth of the Islamic finance and investment industry, increasing comfort with the principles and operation of Islamic finance and investment structures and transactions, greater sophistication of Islamic finance an investment structures, and the unfortunate collapse of global financial markets are operating collectively to focus attention on the *Sharīʿah* principles pertaining to bankruptcy and insolvency and issues that will arise in connection with efforts to introduce those principles into secular bankruptcy and insolvency regimes throughout the world. This essay has provided an introductory survey of some of the types of issues that will need to be addressed as those efforts progress.

It seems clear that a great deal of basic and fundamental research first needs to be conducted with respect to the nature and nuance of the relevant *Sharīʿah* principles. This research will have to commence with first principles and advance, painstakingly, to the point where secular bankruptcy and insolvency practitioners, as well as those conversant with *Sharīʿah* concepts, can achieve a sound understanding of the *Sharīʿah* principles and considerations. This will be no small task. Materials are lacking in every language, and are essentially non-existent in English. What does exist was formulated in commercial and financial markets that are quite different than those now existing.

The issues to be considered are legion. Starting at the level of fundamental principle, will the contemplated regime provide for reorganization along the lines of Chapter 11 systems, or will liquidation be the essential thrust of the system? If, in line with international trends, the system will incorporate reorganization concepts and principles, what is the *Sharīʿah* basis for this regime? Even the fundamental questions are daunting. For example, consideration will need to be given to debt rescheduling concepts, debt forgiveness concepts, delayed debt payment concepts, equity conversion concepts, asset sale concepts, and differential equity conceptions. There will have to be consideration of whether voluntary bankruptcies can and will be permissible. And after agreement is reached on the basic nature and parameters of the system, the long road of discovery and elucidation of specific *Sharīʿah* principles will have to be addressed. That undertaking will wind through a great deal of new territory, from the *Sharīʿah* perspective, and will entail a comparative laws analyses, and a systemic comparison, unlike any in history.

It seems safe to say that not even the most preliminary formulations for implementation can be fathomed at the present time. But it also seems safe to say that successful implementation can be envisioned with a relatively high degree of confidence if the resources are brought to bear and the spirit of constructive enterprise is maintained.