

Trading in Distress: Clearing an Imperfect Market?

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I. Introduction

Creditors and non-creditors of a distressed entity may seek to trade in claims against an entity for a variety of reasons. The economics of claims trading can be a lure to risk capital depending on the specific case situation. Trading in claims has become a significant investment business unto itself. The trading of claims has its proponents and opponents. Proponents generally cite the need for efficiently functioning markets and the need for liquidity. Opponents generally hold an aversion to the notion of profit making in claims and influencing a bankruptcy reorganization via the positions acquired in the claims trading process. This article takes no sides on any particular claims trading practice or strategy. Experience and market activity do suggest however that even the most imperfect markets have the need for orderly market making in order to facilitate liquidity based on particular supply and demand requirements. That being said, there are potential pitfalls and complexities when trading in distressed claims which should be evaluated by market participants.

II. Claims Trading Issues

From the standpoint of those engaging in claims trading, primary risks associated with claims purchasing include equitable subordination, recharacterization of loans to equity interests, and vote designation.

A. Bankruptcy Court Regulation of Claims Assignments and Purchases

There are currently no provisions in the Bankruptcy Code that generally govern the purchase or sale and assignment of claims against a debtor. Under the Federal Rules of Bankruptcy Procedure (the "Rules"), Rule 3001(e) specifies certain procedural rules regarding the postpetition assignment of claims, but does not substantively govern the process. In fact, Rule 3001 was amended in 1991 in response to what Congress perceived to be excessive judicial intervention into the terms of claims assignment.¹ Since Rule 3001 only deals with "claims," it does not apply to trading in equity securities, which are called "interests" under the Code and are addressed in Rule 3002. Transfers of claims based on publicly traded bonds or debentures are also specifically exempt from Rule 3001(e)(2)-(4) and no other bankruptcy Rule regulates any such postpetition trading, at least if the transaction is an outright purchase. The intent behind such exclusions is to avoid interference with existing markets for publicly traded bonds and debentures.² As discussed below, in certain situations full disclosure of the claim purchase may nonetheless be advisable.

B. Claims Trading Risks for Insiders/Fiduciaries

Any risk analysis of claims trading in bankruptcy must begin with the determination of the status of the purchasing entity, specifically, whether such entity is deemed an insider. The outcome of this determination plays a key role in the scrutiny applied to the transaction and the burden of proof to be shouldered by the purchaser. Insiders owe fiduciary duties to the debtor and are required to deal in good faith with its creditors and equity holders, while noninsiders have no fiduciary obligation to the debtor or its creditors. Additionally, absent some exercise of control, non-management creditors do not owe the debtor and its creditors a duty of fair dealing. Because of these differences, courts closely scrutinize conduct by insiders and hold them to a higher standard of conduct. Insiders are held to a "rigorous scrutiny" standard requiring that, once the movant has shown evidence of a breach of fiduciary duty or that the creditor engaged in conduct that was somehow unfair, the burden shifts to the claimant to show the fairness of the transaction. For noninsider claimants, the burden of proof does not shift and proponents of subordination must show with particularity "egregious conduct", such as fraud, spoliation or overreaching.³ The determination of insider status is a question of fact that must be determined on a case-by-case basis through

¹ Ellen R. Werther, *et al.*, *Trading in the Claims of Chapter 11 Debtors*, 682 PLI/Comm 317, 321 (1994) (citing Advisory Committee Note to New Rule 3001(e)).

² Randolph J. Haines, *Trading Claims in Bankruptcy*, 680 PLI/Comm 99, 103-04 (January 1994) (citing C. Fortgang & T.M. Mayer, *Trading Claims and Taking Control of Corporations under Chapter 11*, 12 Cardozo L. Rev. 1 (1990)).

³ *In re Holywell Corp.*, 913 F.2d 873 (11th Cir. 1990); *In re Fabricators, Inc.*, 926 F.2d 1458 (5th Cir. 1991).

examination of the totality of the circumstances.⁴ Although not determinative, the purchaser's control over the debtor is a persuasive factor.

i. Control Over the Enterprise and Closer Scrutiny

Additional factors considered by courts in analyzing claims trading are issues of control and usurpation of corporate opportunity. When discerning control, courts generally consider whether the creditor and debtor have a sufficiently close relationship with each other that their "conduct is made subject to closer scrutiny than those dealing at arms length."⁵ The two factors often considered are (i) the closeness of the parties and (ii) the relative degree of control each has over the other.⁶ Although the above standard appears ambiguous, courts generally require "evidence of extensive control" before finding insider status under Bankruptcy Code Section 101(31)(B)(iii).⁷ Even if a purchaser is not in "control" of the debtor, however, receipt of nonpublic information, such as through the performance of due diligence or with debtor cooperation, may be sufficient to fall under the ambit of section 101(31), although none of the listed requirements are technically met.⁸

ii. Purchase by Fiduciaries - Corporate Opportunity

It is well settled that officers, directors and dominant or controlling stockholders of corporations are fiduciaries of those corporations.⁹ Upon insolvency, a fiduciary relationship is also created between such individuals and the corporation's creditors.¹⁰ As such, any dealings that the officer, director, or dominant stockholder has with the corporations for which they are fiduciaries are subjected to "rigorous scrutiny,"¹¹ and the test for determining the fairness of such transactions is whether "the transaction carries the earmarks of an arm's-length bargain."¹² In order to avoid inequitable conduct through the usurpation of corporate opportunity, a claims purchasing fiduciary has the duty to share "everything it [knows]", including its identity,¹³ with the company's board and creditors' committee before commencing its purchase. Such notification should be an affirmative act on the part of the purchaser, as informal knowledge on the part of the board or committee may not be a defense.¹⁴

⁴ *In re Allegheny Int'l Inc.*, 118 B.R. 282, 298 (Bankr. W.D. Pa. 1990), *In re Hillside Park Apts., L.P.*, 205 B.R. 177, 184 (Bankr. W.D. Mo. 1997) (finding a creditor to be an insider where the creditor's current officers and directors were general partners of the debtor until shortly before the debtor filed for bankruptcy protection, and were limited partners postpetition).

⁵ H.R. No. 95-595 (1977); see also *Herbert Construction Co. v. The Greater N.Y. Sav. Bank (In re 455 CPW Assocs.)*, No. 99-5068, 2000 U.S. App. LEXIS 23470, at *16-17 (2d Cir. Sept. 14, 2000) (unpublished opinion) (citing *In re ABC Elec. Svs., Inc.*, 190 B.R. 672, 675 (Bankr. M.D. Fla. 1995) (considering "whether or not the facts indicated an opportunity to self-deal or exert more control over the Debtor's affairs than was available to other creditors")); *In re Gilbert*, 104 B.R. 206, 209 (Bankr. W.D. Mo. 1989).

⁶ *Gilbert*, 104 B.R. at 210.

⁷ *CPW*, 2000 U.S. App. LEXIS 23470, at *17-18; *ABC*, 190 B.R. at 675 (stating that actual management over debtor's affairs that affords "an opportunity to self-deal" is an indication of insider status).

⁸ *Allegheny*, 118 B.R. at 297-99 ("[I]t is clear that Japonica exploited its special access to information, personnel and the premises of the debtor to attempt to assert its influence and control . . . Japonica sought and received inside information as proponent of the plan [and the] court finds as a matter of fact that Japonica is an insider and fiduciary . . .").

⁹ *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (usurpation of corporate opportunities case); *In re Main, Inc.*, Nos. 98-5947, 1999 U.S. Dist. LEXIS 9312, at *41 (E.D. Penn. June 23, 1999) (citing *Doemling*, 127 B.R. 945, 951 (Bankr. W.D. Pa. 1991) (case concerning usurpation of corporate opportunity by a director); *In re Logue Mech. Contracting Corp.*, 106 B.R. 436, 439 (Bankr. W.D. Pa. 1989)).

¹⁰ *Main*, 1999 U.S. Dist LEXIS 9312, at *41 (citing *In re Martin*, 154 B.R. 490, 494 (Bankr. C.D. Ill. 1993)).

¹¹ *Id.* (citing *Pepper*, 308 U.S. at 306).

¹² *Pepper*, 308 U.S. at 306-07 (finding that when an insider's dealings with his corporation are challenged, "the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.").

¹³ *Citicorp Venture Capital Ltd. v. Committee of Creditors Holding Unsecured Claims*, 160 F.3d 982, 988 (3d Cir. 1998).

¹⁴ *Id.* (finding that the committee briefly discussed the potential purchase at a meeting, but because similar rumors were prevalent and generally unfounded, the committee was not sufficiently notified of the purchase).

C. Remedies Against Improper Claims Trading

Potential remedies that a court may impose on a claims trading transaction deemed inappropriate include disgorgement of profits, equitable subordination and vote designation.

i. Disgorgement of Profits, Damages

The minimum remedy for improper purchase of claims at a discount by a fiduciary is to subordinate or disallow the fiduciary's claim to the extent its face amount exceeds the amount paid.¹⁵ If this remedy is inapplicable, *e.g.*, the insider has no pending claim against the estate, a measure of damages for breach of fiduciary duty is the profits lost by the corporation as a consequence of the breach.¹⁶ If circumstances warrant, it is conceivable that other damages could be assessed against the breaching party.

ii. Equitable Subordination of Claims

Equitable subordination is a doctrine that allows a bankruptcy court, as a court of equity, to subordinate the claim of one creditor to those of other creditors in circumstances where the creditor has engaged in some type of inequitable conduct that has resulted in injury to other creditors.¹⁷ The fundamental aim of equitable subordination is to undo or offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of bankruptcy results.¹⁸ The doctrine is remedial, not penal, and should only be applied to the extent necessary to offset the specific harm creditors suffered on account of the inequitable conduct.¹⁹ Pursuant to Bankruptcy Code Section 510, courts have held that to establish that equitable subordination is appropriate with regard to a creditor's claim against the debtor's estate, the debtor or trustee must show that the creditor engaged in inequitable conduct (fraud, illegality, breach of fiduciary duty, undercapitalization of the debtor, or use of the debtor as an alter ego or mere instrumentality); the inequitable conduct must have resulted in injury to creditors; and subordination of the creditor's claim must not be inconsistent with other bankruptcy laws.²⁰ The inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination of a claim irrespective of whether it was related to the actual acquisition or assertion of that claim.²¹ Further, inequitable conduct by a claim transferor has also been held sufficient to justify subordination of the transferred claim in the hands of an innocent purchaser.²² A claim arising from dealings between a debtor and an insider will be more "rigorously scrutinized" by the courts.²³ Moreover, in circumstances where the plaintiff seeks equitable subordination with regard to a claim of

¹⁵ *Papercraft*, 211 B.R. at 825; *Toy King*, 256 B.R. at 175.

¹⁶ *Toy King*, 256 B.R. at 175; *Insulfoams v. Donaldson*, 184 B.R. 694, 708 (W.D. Pa. 1995).

¹⁷ *Stratton v. Equitable Bank*, 104 B.R. 713, 729-30 (D. Md. 1989) (citing *Pepper v. Litton*, 308 U.S. 295 (1939); *L&M Realty Corp. v. Leo*, 249 F.2d 668 (4th Cir. 1957)). Equitable subordination is an unusual remedy that should be applied only in narrow circumstances. See *In re Fabricators, Inc.*, 926 F.2d 1458 (5th Cir. 1991) (equitable subordination should be applied only in limited circumstances and only to the extent necessary to offset the harm the creditor causes); *In re Dan Ver Enterprises, Inc.*, 86 B.R. 443 (Bankr. W.D. Pa. 1988) (equitable subordination is not to be invoked lightly); *In re Omni Graphics, Inc.*, 119 B.R. 641 (Bankr. E.D. Wis. 1990) (equitable subordination is to be applied sparingly).

¹⁸ *Id.* at 206 (citing *In re McFarlin's, Inc.*, 49 B.R. 550, 554 (Bankr. W.D.N.Y. 1985)).

¹⁹ *Id.* (citing cases).

²⁰ For example, in *U.S. v. Noland*, 517 U.S. 535, 536 (1996), the Supreme Court held that a court may not equitably subordinate an entire category of tax penalty claims in derogation of Congress' ordering of priorities under Bankruptcy Code §§ 503, 507 and 726; see also *In re ASI Reactivation, Inc.*, 934 F.2d 1315, 1321 (4th Cir. 1991); *Wilson v. Huffman*, 712 F.2d 206, 212 (5th Cir. 1983) (bankruptcy court must make explicit findings on each of the three elements when granting equitable subordination); *In re Mobile Steel Co.*, 563 F.2d 692, 699-700 (5th Cir. 1977) (as a court of equity, bankruptcy court may subordinate claim if three conditions are met).

²¹ *Mobile Steel*, 563 F.2d at 700.

²² *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 333 B.R. 205, 223 (Bankr. S.D.N.Y. 2005), leave to appeal granted sub nom., *Enron Corp. v. Springfield Assoc., LLC (In re Enron Corp.)*, 2006 WL 2548592 (S.D.N.Y. Sept. 5, 2006).

²³ *Id.*; *In re N & D Prop., Inc.*, 799 F.2d 726, 731 (11th Cir. 1986); see also *Wilson v. Huffman (In re Missionary Baptist Found. of Am., Inc.)*, 818 F.2d 1135, 1144 n.8 (5th Cir. 1987) ("The reason that transactions of insiders will be closely studied is because

a fiduciary or insider of the debtor who is also a creditor, the line between the insider-creditor and the debtor is often blurred, as the insider-creditor is typically in a position to exert control over the debtor. Consequently, it can become more difficult to establish with particularity that the insider-creditor has engaged in inequitable conduct.²⁴ In response, courts have shifted the burden from the plaintiff to the insider defendant to show the fairness of transactions.²⁵

iii. Plan Vote Designation – Section 1126(e)

The bankruptcy court has the power to designate any vote as “not cast in good faith” and to disqualify it for purposes of determining plan acceptance. This standard applies to any claim regardless of insider classification.²⁶ “Good faith” is not defined in the Code, so the determination of what constitutes good faith has been left to be developed by the courts. The general rule is that bad faith will not be found where a creditor’s purpose is to further its interests as a creditor. Where a creditor believes a plan does not provide for the best interests of its class, as a whole, rejection of the plan is not bad faith. Where a creditor votes against a plan in order to extort terms favorable only to itself²⁷ or to propose a plan designed solely to facilitate a competitor’s acquisition of the debtor,²⁸ the court may disqualify the vote as being cast in bad faith. Section 1126(e) has also been invoked to designate votes resulting from claims purchases made to advance non-creditor interests, such as attempts to gain control of the company.²⁹ Further, Section 1126(e) has been interpreted to preclude votes motivated by “pure malice, strikes and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business.”³⁰

D. Other Claims Trading Issues

i. Recovery vs. Control – Improper Purpose

The purpose of reorganization is to offer an opportunity to maximize value for all creditors and interests holders. Against this backdrop, some courts have differentiated between recovery and control (or control profit).³¹ Control profit is not shared through a reorganization plan with all creditors and all interest holders. A control profit will be shared only by the acquirer and its affiliates, when the acquirer intends to use its newly acquired control to extract economic profits for itself, not to maximize the results for all creditors.³² One court has held that acquiring claims with the clear purpose of achieving control of the debtor and earning a control profit deprives other creditors of this value by “manipulation of the bankruptcy process through the strategic purchase of claims.”³³ Accordingly, the *Allegheny* Court stated, under a “competitor takeover” fact pattern, that trading in claims to achieve profits on a specific claim may be destructive of the reorganization process unless: (i) both buyer and seller are informed; (ii) the

such parties usually have greater opportunities for such inequitable conduct, not because the relationship itself is somehow a ground for subordination. If the alter ego or insider has fiduciary responsibilities to other creditors, then claims that might otherwise be allowable as proved may perhaps be subordinated.”)

²⁴ *Toy King*, 256 B.R. at 198-99 (citing cases).

²⁵ *Fabricators*, 926 F.2d at 1367-70; *Toy King*, 256 B.R. at 198.

²⁶ *Allegheny*, 118 B.R. at 293.

²⁷ *In re Featherworks*, 25 B.R. 634 (Bankr. E.D.N.Y. 1982).

²⁸ *Allegheny*, 118 B.R. at 289.

²⁹ “[W]hen the voting process is being used as a device with which to accomplish some ulterior purpose, out of keeping with the purpose of the reorganization process itself, and only incidentally related to the creditor’s status *quo* creditor, § 1126(e) is rightly invoked. Thus, voting to block a plan in order to acquire the company one’s self justifiably results in disqualification.” *In re Landing Assoc., Ltd.*, 157 B.R. 791, 807-08 (Bankr. W.D. Tex. 1993)

³⁰ *Haines*, *supra* note 2, at 113-14, 117 (citing *In re Federal Support Co.*, 859 F.2d 17, 19 (4th Cir. 1988) quoting *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942)); *In re MacLeod Co. Inc.*, 63 B.R. 654, 655-56 (Bankr. S.D. Oh. 1986) (disqualifying votes of creditors voting on plan for the purpose of putting a competitor out of business); *In re Beugen*, 99 B.R. 961, 965 (B.A.P. 9th Cir. 1989) (denying standing to object to discharge on basis of purchased claim, where purchaser attempted “to use the court as a whipping post to inflict punishment” on the debtor).

³¹ See e.g. *In re Allegheny Int’l, Inc.* 118 B.R. 282 (Bankr. W.D. Pa. 1990).

³² *Allegheny*, 118 B.R. at 299.

³³ *Id.* at 300.

purchaser is willing to hold the claim until distribution; and (ii) the original claimant does not wish to hold the claim or needs immediate cash.³⁴

ii. Trading Orders and Trading Restrictions

In larger Chapter 11 cases, the entry of trading orders designed to protect net operating losses and other tax attributes of debtors is increasingly becoming commonplace.³⁵ Such trading orders typically restrict trading of claims against, or securities of, the debtor, absent compliance with certain notification and objection procedures.³⁶ Such trading orders are necessary in many cases because NOLs are often very valuable assets of the estate and unregulated trading in a debtor's claims and equity interests may result in limitations on the use of NOLs.³⁷ Because the sale of claims against or securities of a debtor in violation of trading orders can result in a bankruptcy declaring such transactions null and void, purchasers and sellers of claims or securities should familiarize themselves with the provisions of any trading orders prior to entering into any such transactions.

iii. Plan Confirmation - Section 1145 Securities Issues

Claims trading can trigger application of the securities laws upon confirmation of a plan of reorganization. Generally, Bankruptcy Code Section 1145(a) exempts creditors from the registration requirements of the Securities Act of 1933 when they resell securities that they received pursuant to a Chapter 11 plan because the plan issuance is deemed to be a public offering.³⁸ However, purchasers of claims must be aware of potential limitations on this safe harbor with respect to securities received on account of purchased claims.³⁹ This is because the Section 1145 exemption is unavailable to "underwriters."⁴⁰ Section 1145(b)(1)(A) defines an underwriter to include any entity which purchases claims "with a view to distribution of any security received or to be received in exchange for such a claim." Thus, a purchaser who purchases claims after the filing of a chapter 11 case, who believes that it will receive securities on account of such claim and anticipates selling such securities in the after market, "may well have purchased the claim with a view to distribution of the security to be received in exchange for the claim."⁴¹ In such event, the Securities and Exchange Commission has indicated that such a purchaser may still dispose of its securities in "ordinary trading transactions" – those not involving concerted action, special informational documents or special compensation to brokers or dealers.⁴² Given these issues, a purchaser of claims who has received securities pursuant to a Chapter 11 plan should consult with counsel prior to reselling such securities.

iv. Bankruptcy Rule 2019 Disclosure Issues

Rule 2019 provides that, in a case under Chapter 9 or 11 of the Bankruptcy Code, any entity or committee representing more than one creditor or security holder of the debtor must file a verified statement with the court making certain enumerated disclosures.⁴³ In the case of committees, these disclosures include information of each

³⁴ *Id.* at 299.

³⁵ See, e.g., *In re Northwest Airlines Corp.*, No. 05-17930 (Bankr. S.D.N.Y.); *In re U.S. Airways Group, Inc.*, No. 02-83984 (Bankr. E.D.Va.); *In re Mirant Corp.*, No. 03-46590 (Bankr. N.D.Tex).

³⁶ Mark A. Speiser, et al., *NOLs: The Policy Conflicts Created by Trading Orders*, Commercial Lending Review (May-June 2005).

³⁷ See Speiser *supra*.

³⁸ See 11 U.S.C. § 1145 (West 2007).

³⁹ Sally S. Neely, *Investing in Troubled Companies and Trading in Claims and Interests in Chapter 11 Cases – A Brave New World*, 836 ALI-ABA 109, 206 (1993).

⁴⁰ 11 U.S.C. § 1145(a).

⁴¹ *Collier on Bankruptcy*, ¶1145.03[3][a] (15th ed. rev.).

⁴² See *Manville Corp.*, SEC No-Action Letter, 1986 WL 68341, at *3 (Aug. 28, 1986); Such holders may also be able to avail themselves of the exemptions from the registration requirements pursuant to Rules 144 and 144A of the Securities Act of 1933 if certain conditions are met.

⁴³ Fed. R. Bankr. P. 2019.

committee member which is commonly regarded by claims traders as highly confidential and proprietary – the time at which each committee member’s claims were acquired, the amount paid therefor, and any subsequent sales or dispositions thereof.⁴⁴ In a recent decision, *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007), the United States Bankruptcy Court for the Southern District of New York held that a group of hedge funds acting as an unofficial committee was required to make the above-described disclosures.⁴⁵ However, on the heels of the *Northwest* ruling, the Bankruptcy Court for the Southern District of Texas refused to compel an unofficial committee of noteholders to make such disclosures under similar facts.⁴⁶ To date, the *Northwest* and *Scotia Development* courts appear to be the only two that have ruled on this issue. Given these inconsistent interpretations of the disclosure requirements of Rule 2019, claim holders should be mindful of Rule 2019.

III. Conclusion

Trading in claims has evolved into a sophisticated means by which buyers seek to obtain special situations returns and sellers seek to obtain recovery and liquidity without having to take on the risk of a restructuring or the process of a Chapter 11 bankruptcy case. The dynamics of claims trading will vary from case to case. Given the potential complexities and downside risks in the claims trading arena, having a clear understanding of the facts and potential issues surrounding a trade is key to managing risk when trading claims. Whether a proponent or an opponent of claims trading, it is something that has in the larger matters become a material dynamic and must be factored into any restructuring and reorganization practice and strategy.

⁴⁴ Fed. R. Bankr. P. 2019(a)(4).

⁴⁵ *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

⁴⁶ *In re Scotia Dev., LLC*, Case No. 07-20027, Docket No. 659 (Bankr. S.D.Tex 2007).

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