THE SHADOW BANKRUPTCY SYSTEM

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This Article exposes and explores the shadow bankruptcy system. "Shadow bankruptcy" describes the influence that private investors (e.g., hedge funds, private equity funds, and investment banks) increasingly exert over the reorganization of troubled firms, within and outside of Chapter 11 of the United States Bankruptcy Code, the principal legal system for salvaging distressed companies.

Like the "shadow banking" system for which it is named, shadow bankruptcy thrives on and promotes opacity and undisclosed, possibly perverse, incentives. Shadow bankruptcy exploits regulatory gaps to conceal the identity and motives of private investors, increasing the uncertainty and complexity – and thus the cost – of negotiations to restructure troubled firms; it burdens judicial resources through internecine fights of little benefit to reorganizing debtors; it relies on complex, multi-faceted hedging strategies that may effectively short-sell a debtor's reorganization effort and result in depressed asset values and the premature liquidation of otherwise viable firms. Shadow bankruptcy thus threatens Congress's basic aspiration in creating Chapter 11: preserving going concerns and jobs through negotiated reorganizations.

This Article proposes a novel, market-based solution that addresses many shadow bankruptcy problems through "positional disclosure." Positional disclosure would require private investors in distressed firms to reveal material rights against or affecting troubled firms (including debt, equity, and derivatives) in real-time via online platforms. The Article also suggests other remedies and guidelines for further study.

INTRODUCTION

"We were all afraid of bankruptcy."[1]

The conduct of bankruptcy proceedings not only should be *right but must* seem *right.*[2]

Alas, for man's dealings: while they prosper, one might compare them to a shadow . . . .[3]

Who knows what evil lurks in the hearts of men? The Shadow knows . . . .[4]

Who's afraid of Chapter 11?

If responses to the current economic crisis are any indication, the answer is: lots of people. But this is puzzling. Despite the fact that the country has recently endured its most significant financial trauma since the Great Depression, Chapter 11 of the Bankruptcy Code,[5] the principal legal system for addressing business failure in the United States, has been surprisingly under-used, increasingly misused, or both.

Thus, in the most egregious examples – Bear Stearns, AIG, and the auto industry – the federal government provided billion-dollar taxpayer subsidies to keep these companies out of Chapter 11.[6] Even after it finally capitulated to

[1] Micheline Maynard & Michael J. de la Merced, *Will G.M.'s Story Have a Hero?*, N.Y. TIMES, July 26, 2009, at BU1 (quoting Steven Rattner, former head of the President's automotive task force at the U.S. Department of the Treasury).

[2] Knapp v. Seligson (*In re* Ira Haupt & Co.), 361 F.2d 164, 168 (2d Cir. 1966) (emphasis added).

[3] AESCHYLUS, AGAMEMNON 191, lines 1327-30 (John Dewar Denniston & Denys Page eds., 1957).

[4] Wikiquote, *The Shadow*, http://en.wikiquote.org/wiki/The_Shadow (quoting the introduction to radio episodes of *The Shadow*, a program featuring a fictional detective character by the same name created by Walter B. Gibson) (last visited Mar. 9, 2009).

[5] Congress enacted the first version of the current Bankruptcy Code in 1978, Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended primarily at 11 U.S.C. §§ 101-1532 (2006) and in scattered sections of 28 U.S.C.), and has amended it several times, most recently in 2005. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, 28 U.S.C.). Chapter 11 of the Bankruptcy Code appears in 11 U.S.C. §§ 1101-1174.

[6] For discussions of how and why these firms were kept out of Chapter 11, see, for example, Jonathan C. Lipson, Auto Immune: The Detroit Bailout and the Shadow Bankruptcy System (Dec. 19, 2008), http://www.concurringopinions.com/archives/2008/12/jonathan_lipson.html (discussing auto industry bailouts); Jonathan C. Lipson, The

bankruptcies for Chrysler and General Motors, the Obama administration exercised extraordinary control over their cases, speeding the companies through the process in record time.[7] In other cases, Chapter 11 has provided cover for what is, in reality, the liquidation of firms that might otherwise be viable going concerns.[8]

Congress enacted Chapter 11 in 1978 to promote the renegotiation of a troubled firm's debts, rather than liquidation or litigation.[9] Although the

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Loophole that Became a Wormhole: Why the Fed Had to Bail Out AIG (Sept. 19, 2008), http://www.concurringopinions.com/archives/2008/09/the_loophole_th.html; Jonathan C. Lipson, The BS that Didn't Bark: Why Bear Stearns Didn't (Doesn't) Go into Bankruptcy (Mar. 24, 2008), http://www.concurringopinions.com/archives/2008/03/lipson_on_the_b_1.html.

This is not to suggest that bankruptcy is unused. Far from it. According to the American Bankruptcy Institute, "Chapter 11 business reorganizations increased 113 percent to 7,396 during the first half of 2009 from 3,470 during the same period of 2008." Press Release, Am. Bankr. Inst., Total U.S. Bankruptcies in First Half of 2009 Up 36 Percent over First Half of 2008; Chapter 11 Business Filings Increase 113 Percent (Aug. 13, 2009), http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/Content Display.cfm&CONTENTID=58407.

[7] *See In re* General Motors Corp., 407 B.R. 463, 479, 520 (Bankr. S.D.N.Y 2009) (approving an expedited sale of assets approximately one month after commencement of case and quoting President Obama as saying "I'm *not talking about . . . a company that's stuck in court for years, unable to get out.*"); *In re* Chrysler LLC, 405 B.R. 84, 89-92 (Bankr. S.D.N.Y. 2009) (discussing the financing provided by the U.S. Treasury that facilitated the acquisition of Chrysler's assets), *and In re* Chrysler LLC, 405 B.R. 79, 81-82 (Bankr. S.D.N.Y. 2009), *aff'd*, No. 09-2311-bk 2009, WL 2382766 (2d Cir. Jun. 5, 2009), *temporary stay granted sub nom.* Ind. State Police Pension Trust v. Chrysler LLC, 129 S. Ct. 2275 (2009), *and temporary stay vacated and further stay denied*, 129 S. Ct. 2275 (2009).

[8] As discussed later, an especially troubling example of this involves the remarkable collapse of Steve & Barry's, a formerly thriving discount retailer taken over by private investors. *See infra* notes 227-41 and accompanying text.

[9] *See, e.g.*, Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457 n.28 (1999) ("'[T]he Chapter 11 process relies on creditors and equity holders to engage in negotiations toward resolution of their interests.'" (quoting G. Eric Brunstad, Jr. et al., *Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One*, 53 BUS. LAW. 1381, 1405 n.136 (1998))); Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 441 (1984) ("[C]hapter 11 is biased toward settlement by the parties in interest in the case."); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 229-44 (1990) (examining how the fair and equitable rule limits a court's ability to impose a reorganization plan on a dissenting class in a bankruptcy proceeding); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 126 (1990) ("Current law provides a complex legal environment in which representatives of thousands of creditors and shareholders bargain over the disposition of billions of dollars in assets. Adjudication of cases within that environment is thought to be virtually impossible.").

system certainly has its critics,[10] its overarching policy goal is to preserve going concerns and jobs, thus maximizing recoveries and preventing the collapse of otherwise viable businesses.[11] In theory – and perhaps in reality[12] – the Chapter 11 system can create value in ways that market actors, left to their own devices, could not. So, the question is simple: why, in the face of such serious financial distress, do we fear the very mechanism Congress created to prevent or remedy these sorts of problems?

One answer is the rise of the shadow bankruptcy system. "Shadow bankruptcy" describes the influence that largely unregulated private investors – such as hedge funds, private equity funds, and investment banks – exert over distressed companies. "Shadow bankruptcy" adopts and adapts the term "shadow *banking*," which has been used to characterize the same sorts of investors and their questionable activities in the larger financial system.[13]

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[10] *See* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 2-3 ("[T]he debate over Chapter 11 reflects a division over which policies bankruptcy law should embrace."). *Compare, e.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078-79 (1992) ("Chapter 11 should be repealed, abolishing court-supervised corporate reorganizations and, in effect, precluding residual claimants from participating in any reorganization of the firm."), *with* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 355 (1993) ("[T]he [Bankruptcy] Code carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt. The choice to make bankruptcy 'rehabilitative' represents a desire to protect these parties along with the debtor and creditors who are more directly affected.").

[11] *See* H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap."); 123 CONG. REC. 35,444 (1977) (statement of Rep. Rodino) ("For businesses, the bill facilitates reorganizations, protecting investments, and jobs.").

[12] *See* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 612-40 (2009) (describing the value-creating aspects of Chapter 11).

[13] The term "shadow banking" is generally attributed to PIMCO managing director Paul McCulley. Paul McCulley, *Teton Reflections*, GLOBAL CENT. BANK FOCUS (PIMCO), Aug./Sept. 2007, at 2, *available at* http://media.pimco-global.com/pdfs/pdf/GCB%20Focus%20Sept%2007%20WEB.pdf?WT.cg_n=PIMCO-US&WT.ti=GCB%20Focus%20Sept%2007%20WEB.pdf ("I've dubbed [it] the 'shadow banking system' – the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures."). For a brief explanation of the shadow banking system, see William H. Gross, *Pyramids Crumbling*, INVESTMENT OUTLOOK (PIMCO), Jan. 2008, http://media.pimco-global.com/pdfs/pdf/IO%20Jan_08%20WEB.pdf?WT.cg_n=PIMCO-US&WT.ti=IO%20Jan_08%20WEB.pdf; Nouriel Roubini, *NYU Professor Predicting a Whale of a Bear Market*, FIN. WK., Feb. 28, 2008, http://www.financialweek.com/ apps/pbcs.dll/article?AID=/20080228/REG/346385380/1036. The "shadow banking system" has become a common target of political outrage. Senator Hillary Clinton, for example, blamed the credit crisis of 2008-2009 in part on "the rapid evolution of the securities and banking industry

As with shadow banking, shadow bankruptcy thrives in regulatory gaps and ambiguities. Sophisticated and aggressive private investors exploit interstices in Chapter 11, and between Chapter 11 and other laws – in particular federal securities laws – that might check their behavior. Thus, shadow bankruptcy promises to do for the corporate reorganization system what shadow banking did for the larger financial system: privatize gains and socialize losses, in three related ways.[14]

First, private investors are just that – private. Unlike traditional commercial banks and other regulated financial actors, hedge funds and private equity funds are subject to little regulatory or public scrutiny.[15] Despite the fact that Chapter 11 is a highly public process, private investors fight aggressively to conceal their identities[16] and their investment strategies[17] in the Chapter 11 cases in which they are involved. Complicating matters is the rise of a robust, largely unregulated – that is, private – secondary market for claims against troubled firms.[18] These claims can trade quickly among investors, potentially

[which] overwhelmed our regulatory framework, resulting in an entire shadow banking system that operated outside of oversight and without accountability." 154 CONG. REC. S8979 (daily ed. Sept. 18, 2008) (statement of Sen. Clinton).

[14] This phrase – "privatize gains and socialize losses" – was made famous in a September 22, 2008 speech by Representative Marcy Kaptur from Ohio:

> Rule five: Always keep in mind the goal is to privatize gains to a few and socialize loss to the many. For 30 years in one financial scandal after another, Wall Street game masters have kept billions of dollars of their gain and shifted their losses to American taxpayers. Once this bailout is in place, the greed game will begin again.

154 CONG. REC. H8547 (daily ed. Sept. 22, 2008) (statement of Rep. Kaptur).

[15] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1047-57, 1062-70 (2007) (comparing mutual funds to the "largely unregulated" hedge funds).

[16] *See* Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1375 n.193 (2007) (reporting a "roaring controversy over [the] disclosure obligations" of hedge funds involved in bankruptcy cases); Kevin J. Coco, Note, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 618; James M. Shea, Jr., Note, *Who Is at the Table?: Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors Under Federal Rule of Bankruptcy Procedure 2019*, 76 FORDHAM L. REV. 2561, 2602 (2008); D. Tyler Nurnberg & Heath D. Rosenblat, *Disclosure Rules Alter Chapter 11 Hedge Fund Strategies*?, N.Y. L.J., Apr. 30, 2007, at 4.

[17] Federal securities laws that might require disclosure of attempts to take control of voting equity generally do not apply to attempts to take control of debt, which will likely exert control of a distressed firm before or during a Chapter 11 case. *See infra* notes 69-74 and accompanying text.

[18] For discussions of the development of this market see, for example, Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 576 (2002) (describing the market for distressed debt, particularly trade debt, but observing the liquidity of debentures and bonds); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in*

changing the composition of a debtor's controlling stakeholders – secretly – overnight.

Second, complex investment strategies may create value-destroying incentives. Hedge funds, for example, may take multiple positions in a company, for a variety of reasons.[19] Sometimes, these positions literally

Chapter 11, 12 CARDOZO L. REV. 1 (1990); Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69 *passim* (2008); Adam J. Levitin, *Finding* Nemo*: Rediscovering the Virtues of Negotiability in the Wake of* Enron, 2007 COLUM. BUS. L. REV. 83; Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 181 (2004) ("[D]istressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act."); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 101-04 (1995); Glenn E. Siegel, ABI Committee on Public Companies and Trading Claims, *Introduction: ABI Guide to Trading Claims in Bankruptcy Part 2*, 11 AM. BANKR. INST. L. REV. 177, 177 (2003) ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims. . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader . . . ."); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684 (1996); Paul M. Goldschmid, Note, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 193 n.6 (noting that the term "'distressed-debt investors' . . . refers to a class of investors who purchase the assets or claims of firms once their debt or operations become 'distressed'").

[19] "'Hedge fund' has no uniformly accepted meaning, but commonly refers to a professionally managed pool of assets used to invest and trade in equity securities, fixed-income securities, derivatives, futures and other financial instruments." DOUGLAS L. HAMMER ET AL., SHARTSIS FRIESE LLP, U.S. REGULATION OF HEDGE FUNDS 1 (2005). Discussions of the role of hedge funds in bankruptcy appear in, for example, Mark Berman & Jo Ann J. Brighton, *Will the Sunlight of Disclosure Chill Hedge Funds? The Tale of Northwest Airlines*, AM. BANKR. INST. J., May 2007, at 24, 24 ("[H]edge funds are not confined to a single type of investment and might acquire an interest at any one or more places in a company's capital structure."); Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. L. REV. 281, 282 (2009) ("What distinguishes hedge funds from other investors is that hedge funds tend to pursue active and aggressive investment strategies. Thus, hedge funds use leverage, sell short, and invest in derivatives. They trade much more frequently than other investors."); Shea, *supra* note 16, at 2589 ("Distressed investors participate in Chapter 11 reorganizations in several ways, in both debt and equity positions. Hedge funds, in particular, often invest in first- or second-lien secured debt and join lender groups; frequently they invest in unsecured subordinated notes, bonds and other debentures, and equity securities."); Mark S. Lichtenstein & Matthew W. Cheney, *Riding the Fulcrum Seesaw: How Hedge Funds Will Change the Dynamics of Future Bankruptcies*, 191 N.J. L.J., Jan. 14, 2008, at 102; *The Vultures Take Wing*, ECONOMIST, Mar. 31, 2007, at 77, 77-80 (discussing the role that banks and hedge funds plan to play in the distressed and bankruptcy market).

"hedge" risk. An investor may hold both senior debt and preferred stock in the same troubled company in order to mitigate the effects of a fall in a debtor's value. If the debtor is worth more, both investments pay off. If the debtor is worth less, then at least the senior debt will still pay off. Other times, investors may hold multiple positions for more strategic reasons. Holding certain claims or interests might, for example, create the power to block an out-of-court restructuring of a firm's debt, or confirmation of a reorganization plan, neither of which can occur without the support of a certain number and amount of claims and interests.[20] This leverage might, in turn, enable the investor to extract rents from other stakeholders of the debtor who are committed to supporting the plan.

More ominously, in the very largest cases, investors may hold derivatives that pay off only if the debtor fails disastrously. For example, those who hold credit default swaps against certain large corporate debtors – Lehman Brothers, for example – might make more on the swap if the debtor goes into bankruptcy than they would on the debt they hold if the debtor continued as a going concern. The investor then has an incentive to force the debtor into bankruptcy even if the debtor might be better off outside bankruptcy.[21] As with the

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There is some evidence that some hedge funds are reducing their investments in distressed firms. *See* HEDGEWORLD & DYKEMA, 2009 INSOLVENCY OUTLOOK SURVEY 1 (2009), http://www.dykema.com/bankruptcy/2009InsolvencySurvey.pdf ("[T]he majority of today's hedge fund managers have adopted a more conservative approach toward investment opportunities in financially troubled companies as insolvency concerns continue to mount."). Nevertheless, "hoping to capitalize on bargains created by the financial crisis, a small number of hedge funds are actively investing in securities of distressed companies either to profit via an increase in the value of securities, or to acquire equity stakes during bankruptcy proceedings." *Id.* Given the inherently unreliable nature of data about hedge funds, it is difficult to know what this really means. *See* Alex Grecu et al., *Why Do Hedge Funds Stop Reporting Their Performance?* 4-12 (CEPS Working Paper No. 124, 2006), *available at* http://www.princeton.edu/~ceps/workingpapers/124malkiel.pdf (examining hedge funds that chose to stop reporting their performance and discussing the problem of "survivorship bias" in hedge fund performance estimates). In any event, the Dykema Survey also notes that a majority of hedge fund managers have at least some investments in troubled companies. HEDGEWORLD & DYKEMA, *supra*, at 1 ("53 percent of hedge fund managers have invested a portion of their portfolios in financially troubled companies but the majority of these respondents have only a small percentage – between 1-10 percent – of their portfolios in those securities.").

[20] The mechanics of plan confirmation and voting are summarized briefly *infra* Parts I.A and III.B.1.a.

[21] *See, e.g.*, Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 427-30 (2007). A credit default swap is essentially a form of insurance that a creditor may purchase against the risk that a debtor defaults; if the debtor fails to pay, the insurer will. *Id.* at 411 ("[A credit default] swap is a contract covering the risk that a specified debtor defaults. One party (the 'protection seller') acquires the credit risk associated with a debt or class of debts in exchange for an annual fee from the counterparty (the 'protection buyer')."); *see also* Henry T.C. Hu & Bernard Black, *Debt, Equity and*

shadow banking system, shadow bankruptcy players may profit from short sale strategies. Here, however, those on the losing end of the short will be the debtor, its estate and its many other constituents, including employees, creditors, and individual investors.

Third, private investors' time horizons are opaque, and thus potentially problematic. Under the model Congress envisioned in the Bankruptcy Code, lenders could be cajoled into long-term investing through a reorganization plan that would satisfy claims with, among other things, new securities in the debtor (e.g., more debt, more equity, or both). Today's private investors, however, may feel far greater pressure to cash out sooner, even if this destroys long-term value. To that end, they may acquire control (through claims trading) before bankruptcy and use that control to strip – and then flip – assets, rendering an otherwise viable firm incapable of reorganizing.

Shadow bankruptcy thrives at the expense of one of the basic mechanisms of the reorganization system: transparency. Transparency has long been a vital feature of reorganization under Chapter 11, which has often been characterized as a "fishbowl."[22] "The key" to successful reorganization under Chapter 11, the Second Circuit famously observed in the *Lionel* case, "is disclosure."[23] But the transparency Congress envisioned for Chapter 11 was largely a one-way mirror: it forces debtors and certain statutorily created entities such as official creditors' committees to disclose certain information. But it also leaves opaque the identities and intentions of the debtors' many other stakeholders, regardless of their guile or sophistication.

Because modern transaction technologies – the hedge fund and the claims trading market, for example – now permit the most sophisticated and aggressive of these stakeholders to manipulate the outcomes of reorganization, there is a fundamental mismatch between transaction technology and regulation. Just as the regulatory architecture meant to manage the larger financial system – i.e., the federal securities and banking regimes – failed to

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Hybrid Decoupling: Governance and Systemic Risk Implications, 14 EUR. FIN. MGMT. 663, 680-89 (2008) (discussing the use of credit default swaps and the implications for individual and systemic risks); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1034-35 (2007) (explaining that credit derivatives may create perverse incentives for an investor to force the debtor into default and affirmatively destroy value); John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention – A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1384 (2008).

[22] *E.g.*, James P.S. Leshaw, *Acquisitions of Troubled Businesses: A Comparison of the Bankruptcy and Nonbankruptcy Alternatives*, 69 FLA. BAR J., Dec. 1995, at 75, 75. As discussed below, much of the informational groundwork for Chapter 11 was laid in the bankruptcy reforms that grew out of the New Deal. *See infra* Part I.D.

[23] Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983) (citing H.R. REP. NO. 95-595, at 226 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6185).

prevent the rise and abuses of the shadow banking system, Chapter 11 cannot interdict or manage the shadow bankruptcy system.

This Article exposes and explores the contours and consequences of this regulatory lapse. To be sure, it does not argue that private investment in distressed firms is inherently or necessarily problematic. There is, in fact, evidence that such investment can be productive, at least for investors.[24] But if, as Douglas Baird has argued, Chapter 11 reorganization "has morphed into a branch of the law governing mergers and acquisitions,"[25] then the important questions from that context will be the important questions here, including most basically: how do we create a fair and efficient market for control of distressed firms consistent with Congress' remedial goals under Chapter 11?

This Article argues that, as in other contexts, systemic transparency is central to any solution. Although there have already been dozens of proposals to fix the larger financial system – many of which call generally for more transparency – none address the unique challenges of shadow bankruptcy.[26] This Article fills that gap by proposing a model of "positional disclosure." Positional disclosure would require private investors to disclose material rights against or affecting distressed firms, whether direct or derivative, and whether held singly or collectively, in real time, using online market portals or similar information systems. Positional disclosure would bring shadow bankruptcy out of the dark.

This Article, based in part on confidential interviews with system participants[27] and recent case studies, proceeds in three parts. Part I briefly describes how and why Congress meant Chapter 11 to be a transparent system and illustrates current limitations on transparency in that system. Part II describes how shadow bankruptcy exploits these limitations, and some of the costs created by that exploitation. Part III suggests remedies for shadow bankruptcy, in particular a regime of positional disclosure organized around emerging information technologies.

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[24] *See* Greg Nini et al., Creditor Control Rights, Corporate Governance, and Firm Value 22-29 (June 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344302 (discussing the positive returns to equity following financial restructurings precipitated by covenant defaults).

[25] Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 75 (2004).

[26] *See infra* Part III.

[27] The interview subjects include judges, lawyers, private investors, and other system participants, who are all actively involved in restructuring distressed firms. They were selected based on their prominence in this field. They are neither a random sample nor (necessarily) representative of bankruptcy system participants generally. They are, however, actively engaged in, and likely well informed about, the practices and problems addressed in this Article. All spoke on the condition of anonymity. For further notes on methodology, see *infra* Appendix.

I. STANDING IN THE SHADOWS – THE TRANSPARENT SYSTEM CONGRESS THOUGHT IT CREATED

Like many legal structures, Chapter 11 is, in effect, an information system.[28] When it enacted Chapter 11 of the Bankruptcy Code in 1978, Congress created a system that it believed would maximize transparency.[29] Transparency would, in turn, increase recoveries and confidence in the system through informed stakeholder control.

Chapter 11 is thought to be transparent largely because it occurs in and around a courthouse. Although reorganization is designed to produce negotiated settlements rather than litigated judgments, no important matters, including the ultimate settlement device – the debtor's plan of reorganization – can be effectuated unless blessed by a bankruptcy court. Since matters that require court approval are presumptively open to public scrutiny,[30] much (but not all) of the important information about a reorganizing firm should be

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[28] Other legally-created information systems include the securities law system, *see infra* Part III, and the notice-filing system contemplated by Article 9 of the Uniform Commercial Code. Lynn LoPucki was one of the first to recognize and develop the insight that the U.C.C. created an information system. Lynn M. LoPucki, *Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway*, LAW & CONTEMP. PROBS., Summer 1992, at 5, 7-9.

[29] In the early 1990s – before the rise of the shadow bankruptcy system – David Skeel observed that:

> [T]he Bankruptcy Code and rules require the debtor to file various forms of disclosure and provide dramatically liberalized access to the debtor's officers, employees, and files. . . . [T]he existence of a collectivized insolvency proceeding acts as an information forcing device which enables the parties to detect misbehavior that otherwise might have gone unnoticed . . . . The process also gives every constituency an opportunity to watch the firm during its transition period, and thus to reassess their relationship with the debtor . . . .

David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 507. This remains the prevailing, albeit naïve, view. *See, e.g.*, Mark D. Plevin, Leslie A. Epley & Clifton S. Elgarten, *The Future Claims Representative in Prepackaged Asbestos Bankruptcies: Conflicts of Interest, Strange Alliances, and Unfamiliar Duties for Burdened Bankruptcy Courts*, 62 N.Y.U. ANN. SURV. AM. L. 271, 287 (2006) ("The Chapter 11 framework contemplates a largely transparent process in which all constituencies resolve their conflicting interests through negotiations held under rules established in the Bankruptcy Code.").

[30] The Bankruptcy Code provides that, subject to important exceptions, "a paper filed in a case under this title and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge." 11 U.S.C. § 107(a) (2006); *see also* Gitto v. Worcester Telegram & Gazette Corp. (*In re* Gitto Global Corp.), 422 F.3d 1, 8-9 (1st Cir. 2005) ("[T]he plain language of § 107(a) evinces a clear congressional intent that papers filed in bankruptcy cases be available to the public. Many, if not the vast majority, of these papers will include material that is likely to affect an individual's reputation in the community. Allegations of mismanagement or fraud, for example, might well cause a reasonable person to alter his opinion of the individual against whom the allegations are made.").

available to "the world." In order to understand the shadow bankruptcy system, it is first necessary to understand the contours of the transparent system Congress believed it was creating – the system that increasingly stands in the shadows. This Part describes the informational features of that system, and their limitations.

A. *Transparency Events*

Reorganization under Chapter 11 was meant to be transparent by virtue of certain events that must occur in every case. For example, a Chapter 11 case may be commenced only by filing a public document known as a bankruptcy petition that sets forth the debtor's name, address, authorized agents, etc.[31] A schedule of assets and liabilities should accompany the petition or be filed early in the case, revealing financial and economic information that might not otherwise be publicly available.[32] The schedules should contain a wealth of information about the debtor, including its assets and liabilities, current income and expenditures, executory contracts and unexpired leases, and a statement of financial affairs, among other things.[33]

A second important information-generating event will often involve financing for the debtor's case, either because a pre-bankruptcy lender permits the debtor to use "cash collateral,"[34] or because the debtor obtains new financing under a "debtor-in-possession financing" ("DIP") facility.[35] But a debtor cannot obtain major financing without court approval, and no court would approve financing without significant amounts of financial and related information about the debtor – information that is generally considered valuable. Large sums of money hinge on its accuracy. Objections to the financing (e.g., from other creditors, who think the terms too rich) may result in an early valuation of the debtor. This information may, in turn, be

[31] *See* 11 U.S.C. § 301(a). This sub-Part and the next provide background for readers who may not be acquainted with basic attributes of the Chapter 11 process. Experts may wish to skip ahead.

[32] *See* Tung, *supra* note 18, at 1733 & n.242 (citing 11 U.S.C. § 521 (1994), 11 U.S.C. app. at 988-1006 Official Bankruptcy Form 6 (Schedules) (1994), and 11 U.S.C. app. at 1007-16 Official Bankruptcy Form 7 (Statement of Financial Affairs) (1994)); *see also* FED. R. BANKR. P. 1007. These schedules are to be filed in a voluntary case within fifteen days of commencement of the case, unless extended for "cause." FED. R. BANKR. P. 1007(c).

[33] FED. R. BANKR. P. 1007(b). Certain private investors use these schedules to solicit claims from original creditors of a debtor. Telephone Interview with Other System Participant No. 2 (Aug. 5, 2009) ("You have guys who get lists of creditors, Schedule F information, and send a letter to everybody and their mother offering to buy trade claims at some discount."). As discussed further below, claims trading has become a central and problematic feature of shadow bankruptcy. *See infra* Part II.A.2.

[34] 11 U.S.C. §§ 361, 363.

[35] *Id.* § 364.

extremely useful to stakeholders trying to develop a strategy toward the debtor, and much of it may not otherwise be publicly available.[36]

More important still will be requests to sell assets during the case. At least until recently, there was reason to believe that non-ordinary course asset sales under section 363 were becoming more common events.[37] These transactions may involve the sale of a division or other property of the debtor, or even the entire debtor as a going concern, subject to the requirement that the sale not circumvent the reorganization plan process.[38] These sales may only occur after notice and a hearing, which will often require disclosure of information about the assets sold, the price paid, competing bids (if any), and so forth. While there are serious questions about the value generated by such sales, at least in

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[36] Valuation information in DIP financing is sought, and received, in many different forms. As one practice article explains:

> Valuation analysts . . . are often called upon to value special-purpose industrial and commercial properties within a bankruptcy context. These valuations are performed to determine a secured creditor's collateral position, to identify asset spin-off opportunities, to arrange sale/leaseback or other debtor-in-possession (DIP) financing, to assess the fairness of the purchase/sale of bankruptcy estate assets, to analyze the financial feasibility of a proposed reorganization plan and for many other reasons.

Robert F. Reilly, *Measuring Economic Obsolescence in the Valuation of Special-Purpose Properties*, AM. BANKR. INST. J., Sept. 2007, at 36, 36.

[37] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751 (2002) [hereinafter Baird & Rasmussen, *End of Bankruptcy*] ("Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure."); *see also* Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 679 (2003) [hereinafter Baird & Rasmussen, *Twilight*] ("The large Chapter 11s of 2002 confirm our claim in *The End of Bankruptcy* that going-concern sales and implementation of pre-negotiated deals now dominate the scene."). *But see* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 43 n.189 (2007) ("The numbers of section 363 sales of large public companies fell from seventeen in 2003 to five in 2004, and one in 2005. In 2006 there were two."). At least some of the cases cited by Professors LoPucki & Doherty were then pending, so it is possible some may have had subsequent § 363 sales.

[38] *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1070-72 (2d Cir. 1983). The recent bankruptcies of Chrysler and General Motors have arguably stretched courts' power to approve these sales. *See* Mark J. Roe & David A. Skeel, Assessing the Chrysler Bankruptcy (Sept. 7, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1426530.

As discussed below, the recent case involving the Steve & Barry's discount store – in which the debtor sold all of its assets before a plan was confirmed – suggests that courts are increasingly willing to tolerate sales that effectively circumvent the plan process. *See In re* Stone Barn Manhattan LLC, 405 B.R. 68, 74-79 (Bankr. S.D.N.Y. 2009); Emily Chasan, *Steve & Barry's US Store Closings Can Begin: Court*, REUTERS, Nov. 24, 2008, http://www.reuters.com/article/ousiv/idUSTRE4AN8F920081124; *infra* notes 227-41 (discussing the Steve & Barry's bankruptcy).

theory they are supposed to take place in a transparent environment that promotes bidding and confidence in the sale process.

Perhaps the most informationally significant event of all will be the promulgation and confirmation (approval) of a plan of reorganization. A plan of reorganization is, in simple terms, a new contract between a debtor and its many stakeholders. It may be confirmed only after a vote by a sufficient number of informed stakeholders (creditors and shareholders).[39] Stakeholders will, in turn, be informed only if the plan comes with a court-approved disclosure statement.

A bankruptcy court may only approve a disclosure statement if it contains "adequate information."[40] This is

> information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records . . . that would enable . . . a hypothetical investor of the relevant class to make an informed judgment about the plan.[41]

For most plans, the disclosure statement need not reflect the kind of information or detail that would be found in securities law disclosures,[42] although federal securities laws may provide an apt analogy in certain circumstances.[43]

Federal securities laws will, however, matter (more) in the case of so-called "prepackaged" plans. These plans involve the solicitation of votes on a proposed plan before a bankruptcy case actually begins. If the proponents (e.g., management and certain investors) get enough votes for the plan, they will then commence a case, filing the plan with the bankruptcy petition and requesting expedited confirmation.

Under sections 1125(g) and 1126(b), prebankruptcy solicitations may be effective in bankruptcy, provided that they comply with "applicable

[39] 11 U.S.C. §§ 1126, 1129(a).

[40] *Id.* § 1125(b).

[41] *Id.* § 1125(a); *see also In re* Ferretti, 128 B.R. 16, 19 (Bankr. D. N.H. 1991); *In re* Monroe Well Serv., Inc., 80 B.R. 324, 330-332 (Bankr. E.D. Pa. 1987); *In re* Jeppson, 66 B.R. 269, 291-93 (Bankr. D. Utah 1986); *In re* Stanley Hotel, Inc., 13 B.R. 926, 933 (Bankr. D. Colo. 1981) (stressing the importance of including in the disclosure statement information useful to typical investors rather than lawyers); H.R. REP. NO. 95-595, at 408-09 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6365 ("[T]he adequacy of disclosure is measured against the typical investor, not an extraordinary one."). *See generally* Nicholas S. Gatto, Note, *Disclosure in Chapter 11 Reorganizations: The Pursuit of Consistency and Clarity*, 70 CORNELL L. REV. 733 (1985) (discussing the standards and judicial interpretations of the adequacy of disclosure).

[42] *See In re* Applegate Prop. Ltd., 133 B.R. 827, 830 (Bankr. W.D. Tex. 1991).

[43] *See In re* Crowthers McCall Patterns, Inc., 120 B.R. 279, 300 (Bankr. S.D.N.Y. 1990) (stating that courts may analogize to reporting requirements of securities laws when considering whether to approve a disclosure statement).

nonbankruptcy law."[44] In general, complying with federal securities laws seems to satisfy these sections, at least where the debtor was a publicly traded company.[45] This is, however, a murky area. As discussed below, there are important gaps between the informational architecture of the Bankruptcy Code and the federal securities laws. Shadow bankruptcy exploits these gaps.

B. *Structural Transparency*

Congress also intended to build transparency into the system through the structures and entities common to Chapter 11 reorganizations. For example, official (or "statutory") committees that represent creditors are ubiquitous in larger Chapter 11 reorganizations.[46] These committees – which, as discussed further below, stand in contrast to the more shadowy "unofficial" committees that private investors may create[47] – perform a variety of functions, all of which depend on access to information about the debtor. They are expected to review and comment on the major events discussed above, such as obtaining financing or selling assets. They are expected to object to these proposals if they believe the debtor could get better terms. Such objections are expected to produce greater recoveries for the committees' constituents.

A creditors' committee can do none of these things without information. Thus, Chapter 11 expressly gives them the power to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business."[48] Statutory committees usually retain professionals to conduct a wide range of investigations, most of which will tend to focus on the failures that led to bankruptcy, the debtor's value, and/or its ability to reorganize.[49]

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[44] 11 U.S.C. §§ 1125(g), 1126(b).

[45] *See* Kurt A. Mayr, *Unlocking the Lockup: The Revival of Plan Support Agreements Under New § 1125(g) of the Bankruptcy Code*, 15 NORTON J. BANKR. L. & PRAC. 729, 735 (2006).

[46] The creditors' committee is ordinarily composed of holders of the seven largest unsecured claims. 11 U.S.C. § 1102(b)(1). The United States trustee may appoint more than one committee. *Id.* § 1102(a)(1). The court may also direct the United States trustee to create additional official committees. *Id.* § 1102(a)(2). If the court orders that a committee of equity security holders be created, this committee would generally be composed of the seven largest equity holders. *Id.* § 1102(b)(2).

[47] *See infra* Part II (describing these "unofficial" committees, their resistance to disclosure, and the ways in which they affect the bankruptcy system).

[48] 11 U.S.C. § 1103(c)(2); *see, e.g.*, *In re* Cumberland Farms, Inc., 154 B.R. 9, 12 (Bankr. D. Mass. 1993) (stating that one of three basic functions of a creditors' committee is to monitor the debtor's operations closely).

[49] *See* 11 U.S.C. § 1103(a), (c)(2) (authorizing the committee to employ attorneys, accountants, or other agents); *In re* Moseley, 149 B.R. 458, 460 (Bankr. W.D. Ky. 1993) (allowing payment of attorneys' fees for professional services performed on behalf of the committee because the committee was fulfilling its duty to thoroughly investigate the financial affairs and activities of the debtor).

Committees do not typically produce public reports about a debtor, and often the information they receive may be highly sensitive.[50]

Perhaps the greatest challenge to the informational functions of statutory committees is a product not of secrecy per se, but of timing. These committees are not typically formed at the commencement of a case. Rather, the United States Trustee appoints them shortly after the case is commenced. Yet, a debtor may seek approval of financings and sales – two important events – when it files its petition, and before a committee is even appointed.

This was a concern in both the Chrysler and General Motors reorganizations, in which these approvals were sought before committees were formed. In both cases, the debtors filed with their petitions motions to approve government-backed financing and asset sale procedures even though an official creditors' committee had not been appointed.[51] Although the committees in

[50] Because official committees will often have access to confidential information about a debtor, another informational challenge in reorganization involves a kind of insider trading. *See* Robert P. Enayati, *Undermining the Trading Wall: The BAPCPA's Affront on the Creditors' Committee's Duty of Confidentiality in Chapter 11 Bankruptcies*, 21 GEO. J LEGAL ETHICS 703, 706 (2008) ("A creditor can sit on a committee and secure proprietary information and then use that information to gain an unfair advantage over the party from whom it is purchasing and over other creditors who are purchasing claims."). The solution proposed by the court in the *Federated* case, and generally adopted elsewhere, has been "trading walls" – informational screens between those who might sit on a committee (and thus obtain confidential information) and affiliates or employees of that creditor who might be engaged in claims trading. *In re* Federated Dep't Stores, Inc., No. 1-90-00130, 1991 Bankr. LEXIS 288, at *2-4 (Bankr. S.D. Ohio Mar. 7, 1991). Trading walls were also an issue in the more recent, and controversial, *FiberMark* case, discussed *infra* Part II.A.4. Order Approving Specified Information Blocking Procedures and Permitting Trading in Securities of the Debtors upon Establishment of a Screening Wall, *In re* Fibermark, Inc., No. 04-10463 (Bankr. D. Vt. Aug. 16, 2005), *available at* http://online.wsj.com/public/resources/documents/WSJ-HarveMiller_report.pdf.

[51] The *In re Chrysler, LLC* debtors filed motions on May 1 and May 3, 2009, but the creditors' committee was not appointed until May 6. Motion of Debtors and Debtors in Possession for Interim and Final Orders (A) Authorizing Them to Obtain Postpetition Financing; and (B) Granting Adequate Protection to Certain Prepetition Secured Parties at 27, *In re* Chrysler, LLC, No. 09-50002 (AJG) (Bank. S.D.N.Y. May 1, 2009), *available at* http://chap11.epiqsystems.com/ViewDocument.aspx?DocumentPk=B3A9BD89-5DA0-444 7-8CFB-A27D5AC0F294; Motion of Debtors and Debtors in Possession Pursuant to Sections 105, 363, 364 and 503 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004 and 6006, for (I) an Order (A) Approving Bidding Procedures and Bidder Protections for the Sale of Substantially All of the Debtors' Assets and (B) Scheduling a Final Sale Hearing and Approving the Form and Manner of Notice Thereof; and (II) an Order (A) Authorizing the Sale of Substantially All of the Debtors' Assets, Free and Clear of Liens, Claims, Interest, and Encumbrances, (B) Authorizing the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases in Connection Therewith and Related Procedures, and (C) Granting Certain Related Relief at 52, *In re* Chrysler, LLC, No. 09-50002 (AJG) (Bank. S.D.N.Y. May 3, 2009), *available at* http://chap11.epiqsystems.com/ViewDocument.aspx?DocumentPk=BAABBC23-97E8-409

both cases ultimately supported these requests, the fact that they had fewer than nine days to review and respond must have restricted the committees from raising significant objections. Even if they had the information, there was little time to act on it.[52]

Statutory committees are not the only structural components that could contribute to transparency if properly used. More specialized participants – in particular Chapter 11 trustees and examiners – could play important (albeit often indirect) roles to ensure that information flows in reorganization cases. For example, if a Chapter 11 case runs into serious problems, the court may appoint a Chapter 11 trustee, who will effectively displace management. Although not necessarily their principal function, Chapter 11 trustees will conduct an investigation into the "acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business."[53]

E-A31C-9A5801C68FAC; Appointment of Official Committee of Unsecured Creditors, *In re* Chrysler, LLC, No. 09-50002 (AJG) (Bankr. S.D.N.Y. May 6, 2009), *available at* http://chap11.epiqsystems.com/viewdocument.aspx?DocumentPk=cde65303-1cf8-49b7-bfbb-35f6601ca0a5 [hereinafter Committee Appointment] (appointing a creditors' committee after the filing of the motions). The General Motors bankruptcy proceeded similarly. *Compare* Ken Bensinger & Martin Zimmerman, *GM in Chapter 11: The Nation's Opinions; Details of the Plan; GM Seizes Chance for a Fresh Start; Its Bankruptcy Filing Will Free the Automaker from Crushing Financial Burdens. But Can It Return to Profitability?*, L.A. TIMES, June 2, 2009, at A1 (reporting that on the first day of the case, the judge overseeing the GM bankruptcy "approved motions to allow GM to continue operations while restructuring"), *with* Tim Higgins, *Salaried GM Retirees Seek Court Input*, DETROIT FREE PRESS, June 4, 2009, at 2B (reporting that the official creditors' committee was not appointed until two days later).

[52] *Compare* Committee Appointment, *supra* note 51, at 1 (establishing the creditors' committee on May 5, 2009), *with* Order, Pursuant to Sections 105, 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004 and 6006, (A) Approving Bidding Procedures for the Sale of Substantially All of the Debtors' Assets, (B) Authorizing the Debtors to Provide Certain Bid Protections, (C) Scheduling a Final Hearing Approving the Sale of Substantially All of the Debtors' Assets and (D) Approving the Form and Manner of Notice Thereof at 9, *In re* Chrysler, LLC, No. 09-50002 (AJG) (Bankr. S.D.N.Y. May 7, 2009), *available at* http://chap11.epiqsystems.com/viewdocument.aspx?DocumentPk=21257e1e-4935-49ae-9d8b-49447753aa50 (permitting objections to the order until May 19, 2009, only 14 days after the appointment of the committee), *and* Interim Order Pursuant to Bankruptcy Code Sections 105(a), 361, 362, 363, 364 and 507 and Bankruptcy Rules 2002, 4001 and 6004 (A) Approving a Dip Credit Facility and Authorizing the Debtors to Obtain Post-Petition Financing Pursuant Thereto, (B) Granting Related Liens and Super-Priority Status, (C) Granting Adequate Protection to Certain Pre-Petition Secured Parties, and (D) Scheduling a Final Hearing at 9, *In re* Chrysler LLC, No. 09-50002 (AJG) (Bankr. S.D.N.Y. May 4, 2009), *available at* http://chap11.epiqsystems.com/viewdocument.aspx?DocumentPk=843b8208-58cb-4912-a69c-ef2d2c809e16 (permitting objections to the order until May 15, 2009, only ten days after the appointment of the committee).

[53] 11 U.S.C. § 1106(a)(3); *see also* GEOFFREY C. HAZARD, JR. ET AL., THE LAW AND ETHICS OF LAWYERING 304-08 (3d ed. 1999) (discussing Report of the Trustee Concerning

If a trustee is not appointed, the parties may ask the court to appoint an examiner under section 1104(c) "to conduct such an investigation of the debtor as is appropriate."[54] Among other things, an examiner may be appointed to investigate "any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management."[55] Congress created this position with transparency in mind: the examiner was, in part, to be a proxy for the investigative functions played by the Securities and Exchange Commission and mandatory trustee under prior law.[56]

Yet, as with many aspects of the current system, its transparency mechanisms have been underappreciated or improperly used. Thus, while examiners have played important, often controversial, roles in some of our most recent, high-profile bankruptcy reorganizations,[57] they remain extremely rare.[58] When they are sought and appointed, it would often appear to be due to

Fraud and Other Misconduct in the Management of the Affairs of the Debtor, *In re* O.P.M. Leasing Servs., Inc., No. 81-B-10553 (BRL) (Bankr. S.D.N.Y. Apr. 25, 1983)).

[54] 11 U.S.C. § 1104(c). *See generally* Jonathan C. Lipson, Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies (draft of Oct. 9, 2009) (unpublished manuscript, on file with author) (conducting an empirical analysis of the use of examiners in bankruptcy cases).

[55] 11 U.S.C. § 1104(c).

[56] At the same time that Congress reduced the role of the Securities and Exchange Commission in reorganizations, Congress created the examiner to provide "special protection for the large cases having great public interest" and "to determine fraud or wrong-doing on the part of present management." 124 CONG. REC. 33,990, 34,003 (1978) (statement of Sen. DeConcini).

[57] *See* Response of the United States Trustee to the Motion of the Walt Disney Company for Appointment of Examiner Pursuant to Section 1104(c)(2) of the Bankruptcy Code at 2-5, *In re* Lehman Bros. Holdings, Inc., 404 B.R. 752 (Bankr. S.D.N.Y. 2009) (No. 08-13555), 2008 WL 4932252 (arguing that an examiner was statutorily required); *see also In re* New Century TRS Holdings, Inc., 390 B.R. 140, 147 (Bankr. D. Del. 2008); *In re* Refco, Inc., No. 05-60006 (RDD) (Bankr. S.D.N.Y Aug. 16, 2007); *In re* Mirant Corp., No. 03-46590, 2004 WL 2983945, at *1-5 (Bankr. N.D. Tex. Sept. 1, 2004); *In re* Worldcom, No. 02-13533 (AJG), 2003 Bankr. LEXIS 2192, at *7-8 (Bankr. S.D.N.Y. May 16, 2003); *In re* Enron Corp., 279 B.R. 671, 676 n.5 (Bankr. S.D.N.Y. 2002).

[58] A recent empirical study of large Chapter 11 cases found that trustees and examiners were sought in around fifteen percent of cases, and appointed in less than half of those. Lipson, *supra* note 54, at 7. The following table summarizes these findings:

breakdowns in negotiations among stakeholders, and not to promote transparency per se.[59]

Another transparency-promoting entity in bankruptcy might be the Office of the United States Trustee ("UST"). Congress created the UST program in the 1978 Bankruptcy Code as a modest administrative adjunct to the largely judicial processes in bankruptcy.[60] Unlike the Securities and Exchange Commission – which once played a more direct role in the oversight of disclosure in reorganization – the UST generally has existed to police the bankruptcy system for conflicts of interest by professionals (lawyers), "cronyism," or debtor misconduct.[61] Transparency might be a byproduct of the UST's work, but it is not likely to be its principal focus.

Taken together, the important events and entities in a Chapter 11 case show that Congress meant the process to be highly transparent. Yet, these transparency mechanisms have three limitations.

First, they are often under-used, poorly used, or misused. Debtors' schedules are notoriously unreliable, and bankruptcy examinations rarely occur. As discussed in Part II below, asset sales often result in purchases at far less than book (and perhaps market) value,[62] and official creditors' committees may simply be tools of private investors.[63]

Second, they create a one-way mirror. They demand disclosure by and about the debtor and, to a much lesser extent, professionals and official entities involved in the process. But, subject to a few controversial exceptions discussed in Part II below,[64] Chapter 11 requires little reciprocal transparency of debtors' stakeholders. Although a major creditor may be able to control a

		All Cases	
		Cases	% All
All Cases		576	100
Examiner	Requested	87	15.1
	Granted	42	7.29
Trustee	Requested	81	14.06
	Granted	24	4.17

Id. at 24 fig.2.3.2 (portion).

[59] *See id.* at 31-34 (discussing the practice of using examiner requests for purely strategic reasons).

[60] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, ch. 15, 92 Stat. 2549, 2651-57 (codified as amended at 28 U.S.C. §§ 581-589 (2006)).

[61] *See* Donna S. Tamanaha & Roberta A. DeAngelis, *General Overview of the United States Trustees Program*, *in* UNDERSTANDING THE BASICS OF BANKRUPTCY & REORGANIZATION 2006, at 257, 263-64 (PLI Comm. L. & Practice, Course Handbook Series No. A-890, 2006).

[62] *See infra* notes 220-26 and accompanying text.

[63] *See infra* notes 185-94 and accompanying text.

[64] *See infra* notes 121-34 and accompanying text.

debtor's fate – and thus affect all of the debtor's other stakeholders – Chapter 11 has largely permitted such stakeholders to remain in the shadows.

Third, and perhaps most basic, whatever transparency Chapter 11 may create is possible only if a reorganization case has actually been commenced. Unless and until that occurs, the Bankruptcy Code has little direct force. As discussed in the next subsection, even though Chapter 11 filings may be on the rise, troubled companies frequently do not go into bankruptcy. Instead, their debts are restructured out of court, where the informational rules are even less certain.

C. *Nonbankruptcy Restructurings*

Just because a firm is failing does not mean it will go into bankruptcy. Data recently released by Nini et al. indicate that few firms that breach covenants in financial contracts – loan agreements or bond indentures – actually go into bankruptcy. They looked at a sample of 8666 firms (and 203,733 firm-quarter observations) from 1997 to 2007.[65] It appears that only seven percent of the firms in their sample actually entered bankruptcy or were liquidated.[66] This finding is consistent with the observation of one private investor who told me that "[t]he real problem isn't that [private investors] manipulate the bankruptcy process. Hell, that's gone on for years. It's that they're keeping companies out of bankruptcy when they should go in."[67]

There is certainly room to debate whether any given firm would be better off restructuring in or out of Chapter 11.[68] It is, however, clear that the informational rules that apply absent bankruptcy are problematic. Unlike Chapter 11, there is no attempt to create a coherent disclosure regime that produces transparency in the non-bankruptcy restructuring process.

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[65] Nini et al., *supra* note 24, at 10. For each firm-quarter observation, the authors' primary variable was "an indicator of whether or not a firm [was] in violation of a financial covenant." *Id.* They used covenant violations as the measuring event because it is "a point where . . . negotiations are taking place between the lenders and the borrower. Immediate changes in management that follow these negotiations can provide large sample evidence of creditor influence on corporate governance." *Id.*

[66] *Id.* at 14. I say "appears" because their report indicates that "7.1% of violators exit the sample for a distress-related reason," but those reasons are not defined. *Id.* Nevertheless, the authors claim that "[c]learly, liquidation or bankruptcy is not the primary outcome for firms that violate covenants." *Id.* Their work does not describe the procedural differences between bankruptcy and liquidation (e.g., whether bankruptcy includes liquidating reorganization plans under Chapter 11, whether all liquidations occur only outside bankruptcy, etc.).

[67] Telephone Interview with Private Investor No. 2 (Jan. 14, 2009).

[68] An inference from the work of Nini et al. is that distressed firms should not enter bankruptcy, as non-bankrupt firms with covenant defaults often end up performing quite well. *See* Nini et al., *supra* note 24, at 4-5 ("The[] returns [for the sample], measured via traditional event study methods, are about 5% per year higher than their risk-adjusted benchmarks.").

The securities exchange system regulated by the Securities Exchange Act of 1934 ("1934 Act"),[69] is the only system that comes close to a transparent disclosure regime. The 1934 Act usually requires a firm subject to its rules to report large amounts of information, including if it has violated a financial covenant, thus indicating that the firm has been in financial distress.[70] The federal securities system mirrors the bankruptcy system, though, in the sense that it does not require private investors to disclose the acquisition of debt, even if that debt may effectively control the fate of the distressed firm.

Two sets of rules under the securities laws might help, if they applied. The first, section 13(d) of the 1934 Act, requires any person or group that becomes the owner of more than five percent of any class of publicly traded equity securities to file (within ten days) with the issuer and the SEC a statement setting forth the person's background, the source of funds used for the acquisition, the purpose of the acquisition, the number of shares owned, and any relevant contracts, arrangements or understandings.[71] The purpose of Rule 13d-1 is fairly clear: it enables an equity issuer and its other shareholders to know whether someone is acquiring enough shares to influence the issuer's governance.[72] The problem is that this rule does not apply to "straight" debt securities.[73] Its application to derivative and short positions is uncertain.[74]

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[69] Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78nn (2006)).

[70] *See* Nini et al., *supra* note 24, at 10-11 (explaining that firms registered with the SEC would include such information in their mandatory electronic 10-K and 10-Q SEC filings).

[71] *See* 17 C.F.R. § 240.13d-1 (2008). The rule provides, in part, as follows:

> (a) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D (§ 240.13d-101).

Id.

[72] GAF Corp. v. Milstein, 453 F.2d 709, 717, 720 (2d Cir. 1971) ("[T]he purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control.").

[73] *See* Anne Marrs Huber & Thomas H. Young, *The Trading of Bank Debt In and Out of Chapter 11*, 15 J. BANKR. L. & PRAC. 15, 33 n.21 (2006) ("It is noteworthy that there is no need to file a 13D with the Securities and Exchange Commission when acquiring large amounts of claims against a debtor in bankruptcy, making acquiring control of a corporation in bankruptcy somewhat easier than acquiring a large block of shares in the open market, prepetition."). It might apply to convertible debt.

[74] *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 867-71 (2006).

In *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, the court held that acquisition of security-based derivatives may trigger the reporting requirement of Rule 13d-1. 562 F. Supp. 2d 511, 548-52, 568 (S.D.N.Y 2008). The main issue in *CSX* was whether an investment fund's ownership of CSX security-based derivatives conferred beneficial

Similarly, rules that require disclosure of tender offers are likely to have little force here. The Williams Act regulates tender offers at the federal level prescribing, among other things, filing, disclosure, and dissemination requirements, and is incorporated in sections 14(d) and (e) of the 1934 Act.[75] While section 14(d) applies only to tender offers for equity securities registered under section 12 of the 1934 Act, section 14(e) applies to any tender offer, including those for debt securities. The net effect is that a tender offer for debt securities need only comply with the anti-fraud rules of section 14(e) and not with the more fulsome registration and disclosure rules of section 14(d).[76]

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ownership of the shares themselves on an acquiring investment fund, therefore making the fund a beneficial owner of more than five percent of CSX shares and subject to the disclosure requirements of Rule 13d. *Id.* at 539-52. Referring to the language of Rule 13d-3(a) and the SEC's intention that the rule provide a broad definition of "beneficial ownership" so as to ensure disclosure "from all persons who have the ability to change or influence control," *id.* at 540-41 (quoting Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 33-5925, 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978)), the court determined that a holder of a security-based derivative may be held to beneficially own the shares referenced by the derivative and therefore be subject to the disclosure rules of Rule 13d. *Id.* at 547-48.

The *CSX* court, however, did not apply Rule 13d-3(a) in *CSX*. *Id.* at 548. Instead, the court applied Rule 13d-3(b), which provides that the holder of a security-based derivative formed for the purpose of thwarting beneficial ownership under Rule 13d-3(a) still beneficially owns the securities. *Id.* The investment fund was deemed to beneficially own the shares referenced by its equity swap for the purpose of the disclosure requirement of Rule 13d, because of its purpose to evade the reporting requirements. *Id.* at 548-49.

[75] 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2006); *see also* Gas Natural v. E.ON AG, 468 F. Supp. 2d 595, 603-04 (S.D.N.Y. 2006).

[76] Section 14(d) of the Securities Exchange Act, as codified, provides, in part, as follows:

> It shall be unlawful for any person, directly or indirectly, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, to make a tender offer for, or a request or invitation for tenders of, any class of any equity security which is registered pursuant to section 12, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 78*l*(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.], if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than 5 per centum of such class, unless at the time copies of the offer or request or invitation are first published or sent or given to security holders such person has filed with the Commission a statement containing such of the information specified in section 78m(d), and such additional information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78n(d); *see also* DIV. OF CORP. FIN., SEC, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS: TENDER OFFER RULES AND SCHEDULES 3 (1997), http://www.sec.gov/interps/telephone/cftelinterps_tender.pdf ("Regulation 14E applies to tender offers for any securities other than exempt securities as defined by Section 3(a)(12) of the Exchange Act. Rules 14e-1 to -3, therefore, apply to tender offers for debt and/or

Thus, there is a gap: prior to bankruptcy, we require disclosure for those who seek to control a firm by obtaining its shares, but not if they seek to control a firm by obtaining its debt. When a firm is solvent, this gap does not matter, since creditors will not exercise the sort of control that concerns the securities laws: they are unlikely to affect the composition of a firm's board or management, make basic investment and strategic decisions for the firm, and so on.

All of this changes, however, once a firm is in distress. As practitioners have long known – and as theoretical and empirical literature now confirm – once a firm is in financial trouble, creditors take control and equity holders take a back seat.[77] This transfer of power tends to follow a conventional understanding of the priority that creditors generally have over shareholders in the repayment of firm obligations.[78] Thus, the "most surprising result" found by Nini et al. was a "statistically and economically significant increase in forced CEO turnovers following the announcement of a covenant violation, rising from 1.5% in the year before violation to 8% by one year after the violation."[79] When a firm is in distress, creditors – not shareholders – call the shots.

As discussed further below, shadow bankruptcy capitalizes on this.[80] Private investors may acquire the debt of troubled firms before bankruptcy and force changes in management, company direction, and so on. Investors who acquire the same sort of control through the purchase of equity would have to disclose this. If they do so by acquiring debt, they do not.

D. *Past as Prologue – William O. Douglas and the Roots of Transparency*

That there is a gap in disclosure between the federal securities and bankruptcy laws is, in some sense, ironic because the informational features of

equity securities, and the securities of non-reporting companies."); Brett A. Carron & Steven M. Davidoff, *Getting U.S. Security Holders to the Party: The SEC's Cross-Border Release Five Years On*, 26 U. PA. J. INT'L ECON. L. 455, 456 n.3 (2005) ("Section 14(d) . . . appl[ies] only to third party tender offers for equity securities registered under Section 12 of the Exchange Act, whereas the requirements of Section 14(c) . . . apply to all tender offers extended into the United States.").

[77] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1248 (2006); Harner, *supra* note 18, at 72 (reporting that 65.5% of eighty-two respondents to a survey indicated that they used distressed investing to influence board or management decisions); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 178-79 (2009); Nini et al., *supra* note 24, at 6.

[78] *See* Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224, 231-45 (2007) (explaining the development of the modern priority-duty doctrine).

[79] Nini et al., *supra* note 24, at 3.

[80] *See infra* Part II (discussing the lack of transparency in the shadow bankruptcy system and how private investors exploit this to manipulate the bankruptcy system).

both were significantly influenced by one important architect, William O. Douglas. Before succeeding to the Supreme Court seat of Louis Brandeis – also a strong advocate of shedding light on shady financial practices[81] – Douglas wanted to fix the reorganization system. Although we chiefly think of him as a left-liberal member of the Supreme Court – most notoriously the "penumbras" of his majority opinion in *Griswold v. Connecticut*[82] – he was also among the most prominent bankruptcy scholars of his generation.[83] In 1934, he joined the newly formed SEC,[84] where he authored a massive, eight-volume report on failures in the reorganization system.[85] This report, which was ordered in connection with adoption of the Securities Exchange Act of 1934,[86] was heavily influential in laying the foundation for the current reorganization system, including much of its informational architecture. Its findings are eerily pertinent today.

The reorganization system Douglas found in the 1930s was really two distinct systems rather than one. On the one hand, there was the formal bankruptcy law in place at the time, the Bankruptcy Act of 1898,[87] which governed individual bankruptcies and generally goaded business debtors toward liquidation rather than reorganization. It was not hospitable to the reorganization of the nation's largest corporations, in particular the railroads, almost all of which encountered major financial distress at one time or another.

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[81] "Publicity is justly commended as a remedy for social and industrial diseases," Justice Brandeis famously observed. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914). "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." *Id.*

[82] 381 U.S. 479, 484 (1965).

[83] *See* David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1079 (2000) ("It is no exaggeration to say that, during the decade from roughly 1928 to 1938, Douglas figured prominently in every significant development affecting bankruptcy law and bankruptcy theory."). The articles that emerged from Douglas's work include William Clark, William O. Douglas & Dorothy S. Thomas, *The Business Failures Project – A Problem in Methodology*, 39 YALE L.J. 1013 (1930); William O. Douglas & Dorothy S. Thomas, *The Business Failures Project – II. An Analysis of Methods of Investigation*, 40 YALE L.J. 1034 (1931); William O. Douglas & J. Howard Marshall, *A Factual Study of Bankruptcy Administration and Some Suggestions*, 32 COLUM. L. REV. 25 (1932); William O. Douglas, *Some Functional Aspects of Bankruptcy*, 41 YALE L.J. 329 (1932); and William O. Douglas, *Wage Earner Bankruptcies – State vs. Federal Control*, 42 YALE L.J. 591 (1933).

[84] *See* JAMES F. SIMON, INDEPENDENT JOURNEY: THE LIFE OF WILLIAM O. DOUGLAS 139 (1980).

[85] SEC. AND EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936-1940) [hereinafter DOUGLAS REPORT].

[86] *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, §§ 4, 211, 48 Stat. 881, 885, 909 (1934) (codified as amended at 11 U.S.C. §§ 78a-78nn (2006)).

[87] Ch. 541, 30 Stat. 544 (1898), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

On the other hand, there was a second system that large corporate debtors (e.g., railroads) used, the equity receivership.[88] This was a process wholly outside the scope of the bankruptcy law at the time[89] and largely a creation of the managers, lawyers, and bankers involved with the company – the "reorganizers," in Douglas's somewhat derisive terms.

Douglas believed that this system hurt individual investors. Through reorganization, he argued, investors sought "an expeditious, economical, fair, and *honest* readjustment of their company's affairs."[90] The reorganizers' goals, however, were often in conflict with the interests of investors, and it was the needs of the reorganizers that the reorganization system had evolved to meet. Douglas wrote:

> Reorganizers at times have not been interested in fair reorganization, since fairness might seriously intrude into their own plans and affairs. Reorganizers at times have not desired honest reorganizations, in the investors' sense of the word, because such reorganizations would be costly to them. They have been motivated by other factors. And they

[88] Arthur Dean explained the mechanics of the process as follows:

> The pattern, generally speaking, following the appointment of the receiver or receivers, was for one or more of the various mortgage trustees to petition the receivership court for leave to foreclose the mortgage. The foreclosure action or actions were consolidated with the original general creditor's bill, and the receivers for the latter were then usually appointed receivers for the mortgage bondholders. . . .
>
> Following the formulation of a plan by the committees, the court on motion fixed an upset price for the sale of the mortgaged properties. Generally the creditors or reorganization managers bid in the properties, using the [bondholders'] deposited mortgage securities as part payment for the foreclosure price, and borrowed or raised enough cash to pay non-assenting or dissenting creditors. An agreement was then entered into with a new corporation created for the purpose, whereby, in consideration for the transfer to it of (1) the properties foreclosed at the foreclosure sale and (2) cash or securities to the extent provided for in the plan, the new corporation would issue its securities in accordance with the reorganization plan.

Arthur H. Dean, *Corporate Reorganization*, 26 CORNELL L. Q. 537, 538-39 (1941). Perhaps the leading work on the equity receivership was Paul D. Cravath, *The Reorganization of Corporations; Bondholders' and Stockholders' Protective Committees; Reorganization Committees; and the Voluntary Recapitalization of Corporations*, *in* SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153 (MacMillan Co. 1917).

[89] Certain aspects of the equity receivership were ultimately codified in what came to be known as § 77, *see* Act of Mar. 3, 1933, ch. 204 § 77, 47 Stat. 1474 (1933) (codified prior to repeal at 11 U.S.C. § 205 (1976)), pertaining to railroad reorganizations, and § 77B, *see* Act of June 7, 1934, ch. 424 § 77B, 48 Stat. 912 (1934) (codified prior to repeal in scattered sections of 11 U.S.C.), pertaining to other corporations.

[90] 1 DOUGLAS REPORT, *supra* note 85, at 2 (emphasis added). Douglas observed that "[f]rom the investors' point of view no reorganization could be thoroughgoing unless the reorganizers adhered to these objectives of expedition, economy, fairness, and *honesty*." *Id.* at 3 (emphasis added).

have endeavored – in large measure with success – to mould the reorganization process so as to serve their own objectives.[91]

The tension between reorganizers' and investors' interests was exacerbated by the opacity of the reorganization system. "Outwardly . . . [r]eorganizers will merely have dressed the procedure in familiar and respectable garb. In fact, these reorganization conventions will often conceal the real motives and objectives. Behind the scenes will appear a fight for control of the reorganization and of the new company."[92]

These fights for control often involved conflicts between investors' interest in an efficient and fair reorganization and management's desire to retain control of the company.[93] Yet lack of transparency was a problem for investors even in the absence of management impropriety.[94] In cases where management failed directly or indirectly to control the reorganization, outside speculators would swoop in, often rallying shareholders under the banner of a "better" reorganization, in an effort to dominate the reorganization process and gain control of the company.[95]

Reorganizers were able to manipulate the process chiefly through the device ironically known as the "protective committee."[96] Protective committees were generally informal committees of bondholders organized by investment bankers for the debtors, which would try to persuade bondholders to deposit their securities with the committee.[97] The committee would then exercise the bondholders' rights, usually agreeing to the terms of the reorganization proposed by the reorganizers.[98]

Although these reorganizations had the trappings of creditor democracy, Douglas complained that "not infrequently these devices have been abused in such a way as to cause their functions to be perverted to serve the interests of reorganizers as distinguished from the interests of investors."[99] Intended to unify security holders and enable effective representation, protective

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[91] *Id.* at 4.

[92] *Id.* at 5.

[93] One common scenario was collusion between management and investment banks. Management would exert control over the reorganization process, adopting a plan by which the colluding investment bank would acquire the company at a deep discount. In return, management would retain control.

[94] *See* 1 DOUGLAS REPORT, *supra* note 85, at 99 (indicating that the "absence of effective control by management or [pro-management] bankers" contributed to problems).

[95] *Id.* at 880 ("At times powerful outside interests, who have had no previous connection with the company, seize upon the chaos of reorganization for the purpose of entering and taking possession of the company. . . . They are seeking control of the corporation and the possibilities of the great power and profits which control entails.").

[96] *Id.* at 1.

[97] *See* Cravath, *supra* note 88, at 162-63.

[98] *See id.*

[99] 1 DOUGLAS REPORT, *supra* note 85, at 1.

committees were often hijacked by reorganizers and used for their own purposes, to investors' detriment.[100]

Another problem plaguing equity receiverships involved outsiders wishing only to disrupt the reorganization process in order to extort payment.[101] Both individual plaintiffs and protective committees employed this strategy.[102] In the context of protective committees, such practices clearly implicated the same transparency problems and solutions discussed above.

Whether brought by protective committees or individuals, reorganizers often settled such claims secretly, regardless of their legitimacy.[103] Predictably, Douglas preferred transparency: "[S]ecret settlement . . . is inimical to the interests of investors and creditors as a whole. . . . If a settlement is advisable to save expenses, it should be open and not covert . . . ."[104] In addition to the mere fact that a settlement occurred, settlement disclosure served to provide parties with information material to the reorganization.[105] Moreover, by making public the identities of parties to settlements, the practice of extortion by disruption would be deterred, thereby increasing efficiency of the reorganization process.[106]

Douglas came to three basic conclusions about the equity receivership system. First, the interests of investors – not reorganizers – had to be paramount in reorganization.[107] "It is," his report observed, "their investment which is at stake in any reorganization."[108] Second, those who represent investors in reorganization had to recognize and act on their fiduciary duties to

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[100] *Id.* at 1-2.

[101] *See id.* at 706 ("Sometimes a protective committee without any financial stake or other connection with the company is organized . . . [and] motivated principally by the desire to create a strategic or nuisance value which it will use . . . to force payment and settlement."). Of course, it was difficult to distinguish between claims brought solely in pursuit of ransom and strategic blocking as leverage for legitimate claims. *Id.* at 693 ("[I]t is exceedingly difficult to distinguish between good and bad faith; between an honest claim, sincerely pursued, and an allegation of injury devised in order to create a nuisance value for a worthless position.").

[102] *See id.* at 691 (discussing individual "strikers" and their questionable tactics); *id.* at 706 (discussing the harms of self-seeking, independent committees).

[103] *Id.* at 693.

[104] *Id.* at 693-94.

[105] *Id.* at 694 ("[I]f the banker or dealer has in fact been guilty of fraud or misrepresentation, the secret settlement will suppress facts germane to the reorganization and to the qualifications of those in control of it.").

[106] *Id.* ("[S]ecret settlement may encourage the growth of a sort of racketeering which, not being predicated upon genuine misdoing, is not in the public interest, and which is, in fact, merely a form of capital waste.").

[107] *Id.* at 897 ("It is essential that measures should be taken to place the control of reorganizations with *bona fide* security holders and their direct representatives.").

[108] *Id.*

the investors they represented.[109] "It is," he asserted, "intolerable that [reorganizers] should possess dual or multiple interests."[110] Third, those strategies he considered most abusive had to be curtailed.[111] Thus, the agency abuses of the protective committee as well as "[h]igh pressure salesmanship, misrepresentation and non-disclosure in solicitation methods must be controlled, so that security holders may be assured of an honest and complete portrayal of all material facts affecting their investment."[112]

Douglas's conclusions led to a series of reforms, some involving substantive control of the reorganization process, others involving improved disclosure. As discussed further in Part III, those involving substantive control – the mandatory appointment of a trustee to replace management, for example – withered over time.[113] Those involving disclosure have tended to survive, although they appear to be increasingly outmoded.

Thus, votes on reorganization plans should not be solicited "until the plan has been carefully scrutinized by the court and its submission to the creditors and stockholders authorized."[114] This would be the forerunner of the disclosure statement, which must contain "adequate information" for a stakeholder vote.[115] Similarly, the Douglas Report led directly to the adoption of Chapter X and Rule 10-211 thereunder, which required disclosure of the "personnel and activities of those acting in a representative capacity" in order to help foster fair and equitable plans free from deception and overreaching.[116] As discussed in Part II, this was the forerunner to Bankruptcy Rule 2019, which requires certain disclosures by informal (non-statutory) committees. These committees are often the organizational device of choice for private investors. They are not happy with its disclosure requirements, and so resist its force and seek its repeal.

Recognizing Douglas's contribution is important because he understood both the securities and reorganization systems better than any scholar did in his era – and perhaps even now. He saw that these were integrated systems. Shrewd market actors should not be permitted to create or exploit gaps

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[109] *Id.* ("It is essential that renewed emphasis be given to the fact that representatives of security holders in reorganization occupy a fiduciary position.").

[110] *Id.*

[111] *Id.*

[112] *Id.* at 897-98.

[113] Two central recommendations from the Douglas Report have not survived. One – the Report's first – was that "[i]n every case a qualified and disinterested trustee should be appointed." *Id.* at 899. Another was that an administrative body – in particular, the SEC – "be made available to the court as an aid in the administration of the estates." *Id.* at 900-01. As discussed below, both became features of the Chandler Act of 1938, and both were abandoned in the current Bankruptcy Code. *See infra* note 117.

[114] 1 DOUGLAS REPORT, *supra* note 85, at 900.

[115] *See supra* notes 40-43 and accompanying text.

[116] *In re* Nw. Airlines Corp. (*Nw. Airlines I*), 363 B.R. 701, 704 (Bankr. S.D.N.Y. 2007) (citing 13A LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 10-211.04 (1976)).

between them. Thus, holistic reform – the various federal securities laws of the 1930s as well as the several bankruptcy reforms leading up to the Chandler Act of 1938 – can be seen as a series of attempts to regulate and channel capital market activity in good times and in bad.

Yet, this system has become dated and fragmented, to the point where securities law and bankruptcy law hardly speak to one another. The 1978 Bankruptcy Code significantly reduced the role of the SEC in Chapter 11,[117] and recent amendments have largely exempted certain "system-critical" securities from the operation of the bankruptcy process, including credit default swaps and other financial derivatives.[118] As explained above, while the Bankruptcy Code was meant to create a transparent process, its disclosure mechanisms are at best half-measures, leaving creditors and other stakeholders largely in the shadows.[119] In the absence of bankruptcy, neither the federal securities laws nor the Bankruptcy Code have any real power to affect control transactions involving debt of a distressed firm, even though those transactions can have enormous consequences for all of a firm's stakeholders.

In short, and as explored in greater detail in the next Part, the informational architecture of the 1930s no longer assures transparency in the process of restructuring troubled firms. Absent transparency, the shadow bankruptcy system thrives.

II. CASTING THE SHADOWS: THREE CHALLENGES TO SYSTEM TRANSPARENCY

The foregoing Part shows how and why Congress designed a reorganization system that was meant to be transparent. This Part describes three ways that shadow bankruptcy subverts transparency and explains some of the costs created by that subversion.

A. *Who Goes There? – Claims Trading*

Identifying the real stakeholders in a restructuring or reorganization has long been an informational challenge. The statutory committees described above, and rules forcing disclosure of circumstances where one party represents

[117] Under Chapter X of the Bankruptcy Act, the SEC had standing to act as a party in interest during the entire bankruptcy proceeding. *See* Chandler Act, ch. 575, §§ 156-80, 52 Stat. 840, 888-92 (1938), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549. Any plan of reorganization for a debtor with more than three million dollars in debt had to be submitted to the SEC for comment prior to confirmation. *Id.* § 172, 52 Stat. at 890-91. The Bankruptcy Code provides a much more modest role for the SEC. *See* 11 U.S.C. § 1109(a) (2006) ("The Securities and Exchange Commission may raise and may appear and be heard on any issue in a case under this chapter, but the Securities and Exchange Commission may not appeal from any judgment, order, or decree entered in the case.").

[118] *See, e.g.*, 11 U.S.C. § 561(a) (exempting certain securities from bankruptcy stay).

[119] *See supra* notes 28-64 and accompanying text.

multiple claimants, all arose in response to the problems with protective committees identified by Douglas in the 1930s.[120] Shadow bankruptcy works against these reforms. Similarly, recent developments in transaction technology – including a robust secondary market in claims against reorganizing debtors – have made it increasingly difficult to know with certainty who has important claims against a debtor at any given point in time. There is also the possibility that this system permits sophisticated players to obtain transitory control, and to exercise that control, in ways that may benefit the holder at the expense of the debtor and its other stakeholders. This sub-Part describes how and why participant identity is a growing problem in the reorganization system.

1. Non-Statutory Committees – The Return of the Protective Committee?

Fights about transparency in the bankruptcy system often involve the simplest questions of identity: who are you, and whom do you represent? In recent years, this fight has taken place over the application of Bankruptcy Rule 2019. This rule requires any "entity"[121] that represents "more than one creditor or equity security holder" to file a statement setting forth, among other things,

> the name and address of the creditor or equity security holder . . . the nature and amount of the claim or interest and the time of acquisition . . . the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged . . . [and] the amounts of claims or interests . . . the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.[122]

This seemingly obscure, technical rule has been the basis for some serious fights because private investors often do not want to comply with it. Two recent, controversial opinions from the Northwest Airlines reorganization highlight the problem.[123] In *Northwest Airlines I*, a group of hedge funds representing about twenty-seven percent of the debtor's equity retained the law firm of Kasowitz, Benson, Torres & Friedman to represent them.[124] The hedge funds (through the firm) objected to the disclosures required by Rule 2019 on the rather improbable grounds that they did not in fact represent other

[120] *See supra* Part I.D.

[121] For the purpose of the Bankruptcy Code and Federal Rules of Bankruptcy Procedure, an "entity" is any "person, estate, trust, governmental unit, [or] United States trustee." 11 U.S.C. § 101(15).

[122] FED. R. BANKR. P. 2019.

[123] In the first of the two cases, Judge Gropper required the Northwest Airlines ad hoc shareholders' committee to comply with disclosure requirements of Federal Rule of Bankruptcy Procedure 2019. *In re* Nw. Airlines Corp. (*Nw. Airlines I*), 363 B.R. 701, 702-04 (Bankr. S.D.N.Y. 2007). In the second case, Judge Gropper denied the ad hoc committee's request to file the Rule 2019 disclosures under seal. *In re* Nw. Airlines Corp. (*Nw. Airlines II*), 363 B.R. 704, 705-09 (Bankr. S.D.N.Y. 2007).

[124] *Nw. Airlines I*, 363 B.R. at 701.

shareholders – only themselves – and that the law firm was not an equity holder itself.[125] Judge Gropper dismissed their position out of hand. Citing Douglas's major study of protective committees,[126] he concluded that Rule 2019 "cannot be so blithely avoided."[127]

Undaunted, the hedge funds then sought in *Northwest Airlines II* to disclose their positions only under seal, not publicly.[128] Public disclosure, they argued, would reveal their "bargaining position" by giving "counterparties an unfair advantage if they were to know [the funds'] basis or acquisition cost of the assets [the funds] were trying to sell."[129] Here, too, Judge Gropper was unmoved:

> It bears recalling that this Committee purports to control 27 percent of the outstanding stock of the Debtors . . . . By acting as a group, the members of this shareholders' Committee subordinated to the requirements of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the Debtors' securities. This is not unfair because their negotiating decisions as a Committee should be based on the interests of the entire shareholders' group, not their individual financial advantage. [130]

Judge Gropper reasoned that any burden imposed by disclosure was "overridden by the interests that Rule 2019 seeks to protect."[131] These interests would have been the rights of similarly situated stakeholders: "Rule 2019 protects other members of the group – here, the shareholders – and informs them where a committee is coming from by requiring full disclosure of the securities held by members of the committee and the respective purchases and sales."[132] This would, in turn, give "other shareholders . . . information as to Committee member purchases and sales so that they [may] make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own."[133]

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[125] *Id.* at 703.

[126] *Id.* at 704 (citing DOUGLAS REPORT, *supra* note 85).

[127] *Id.* at 703.

[128] *Nw. Airlines II*, 363 B.R. at 705. Bankruptcy Code § 107(b) provides in pertinent part that "the bankruptcy court shall . . . protect an entity with respect to a trade secret or confidential research, development, or commercial information." 11 U.S.C. § 107(b) (2006). Rule 9018 similarly provides that "the court may make an order which justice requires (1) to protect the estate or any entity in respect of a trade secret or other confidential research, development, or commercial information." FED. R. BANKR. P. 9018.

[129] *Nw. Airlines II*, 363 B.R. at 708 (quoting Decl. of Daniel Krueger at 3).

[130] *Id.* at 708.

[131] *Id.* at 709.

[132] *Id.*

[133] *Id.* Judge Gropper added: "It also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy case and play a major role." *Id.*

The *Northwest Airlines* rulings have been controversial precisely because private investors do not want to reveal this sort of information.[134] In response to the *Northwest Airlines* rulings, their trade associations, the Securities Industry and Financial Markets Association ("SIFMA") and the Loan Syndications and Trading Association ("LSTA"), asked the Judicial Conference, which oversees the Rules of Bankruptcy Procedure, to repeal Rule 2019 for "important public policy reasons."[135]

Perhaps it would have been more accurate to say they wanted the rule repealed for important *private* policy reasons: their real concern, as explained in their letter, is that such disclosures may give others "knowledge of a particular long or short position" that would allow these other investors to "move the market in a direction adverse to the fund that was forced to disclose."[136] This would, in turn, result in "an exodus of distressed investors from the market" which would "likely lead to a decrease in liquidity for the debt and equity of bankrupt companies."[137] What they are really saying is that coming out of the shadows may produce competition that they fear: it might limit their ability to exploit the system.

Bankruptcy Judges Drain[138] and Gerber[139] have publicly opposed the SIFMA/LSTA request. Both judges have presided over some of the nation's

The limitation in this analysis is that it assumes that investors hold one – and only one – type of claim (or interest) against a debtor and thus that one particular committee could represent them. As we shall see, a new complexity here is the distinct possibility of hedging strategies whereby investors hold multiple positions against a debtor. This makes their goals much more complex and difficult to determine in the debtor's reorganization. It is true that other shareholders might benefit from knowing about the activities of the Northwest Airlines ad hoc shareholders' committee. But should there also be an ad hoc (or statutory) committee of Northwest shareholders who simultaneously hold Northwest bonds *and* senior debt?

[134] *See* Letter from Loan Syndications & Trading Ass'n and the Sec. Indus. & Fin. Mkts. Ass'n to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conference of the U.S. 7 (Nov. 30, 2007), *available at* http://www.uscourts.gov/rules/BK%20Suggestions%202007/07-BK-G-.pdf [hereinafter SIFMA/LSTA Proposal] (arguing that "information about when a claim was purchased, or for how much" does not need to be disclosed, because it "has no legal relevance to the claim holder's rights under the Code or non-bankruptcy law, or to the amount the claim holder may recover in the case").

[135] *Id.* at 6.

[136] *Id.* at 24.

[137] *Id.*

[138] *See* Letter from Hon. Robert D. Drain to Advisory Comm. on Bankr. Rules 1 (Jan. 13, 2009), *available at* http://www.uscourts.gov/rules/BK%20Suggestions%202008/08-BK-N-Suggestion-Drain.pdf [hereinafter Drain Letter] (responding to the SIFMA/LSTA Proposal by urging, instead, that the Advisory Committee "broaden [the] scope" of FED. R. BANKR. P. 2019).

[139] *See* Letter from Hon. Robert E. Gerber to Advisory Comm. on Bankr. Rules (Jan. 9, 2009), *available at* http://www.uscourts.gov/rules/BK%20Suggestions%202008/08-BK-M-

largest and most complex recent Chapter 11 cases.[140] As public actors with no particular constituency to protect,[141] their concerns are worth taking seriously. They see repeal of Rule 2019 as highly problematic because it would threaten system transparency. In the words of Judge Drain, "the repeal of Rule 2019 would make it much more difficult to know literally who the other side is."[142] According to Judge Gerber, the goal of private investors is "less transparency."[143] But, he explained, "Transparency must be maintained to permit parties in interest to participate meaningfully in cases . . . and to permit judges to continue to act to maximize value and to achieve the best outcome for all."[144]

To get a feel for how costly and vitriolic fights over this seemingly innocuous rule can be, consider recent fireworks in the Lehman Brothers reorganization.[145] There, the debtors sought to extend the exclusive period to file a plan of reorganization.[146] Certain private investors, including hedge funds, objected.[147] In essence, the private investors argued that extending the exclusive period would merely increase costs and impair transparency –

Suggestion-Gerber.pdf [hereinafter Gerber Letter] (asking the Committee to "update," rather than repeal, Rule 2019).

[140] Judge Drain has presided over, among others, the *Refco* and *Delphi* cases. *In re* Refco, Inc., 336 B.R. 187 (Bankr. S.D.N.Y. 2006); *In re* Delphi Corp., No. 05-44481, 2009 Bankr. LEXIS 574 (Bankr. S.D.N.Y. Mar. 11, 2009). Judge Gerber has presided over, among others, the *General Motors*, *Adelphia*, and *Lyondell Chemical* cases. *In re* Gen. Motors Corp., No. 09-50026, 2009 Bankr. LEXIS 1800 (Bankr. S.D.N.Y. July 7, 2009); Adelphia Commc'ns Corp., v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 365 B.R. 24 (Bankr. S.D.N.Y. June 11, 2007); *In re* Lyondell Chem. Co., No. 09-10023, 2009 Bankr. LEXIS 2603 (Bankr. S.D.N.Y. Sept. 9, 2009).

[141] Whether bankruptcy judges in the Southern District of New York, such as Judges Drain and Gerber, have a constituency to protect is a contested claim. Some, in particular Professor LoPucki, would argue that judges there are captured by the local bankruptcy bar, and thus unwilling to scrutinize questionable practices. LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 140-81 (2005). These letters suggest a more complex story, at least when it comes to the practices of private investors.

[142] Drain Letter, *supra* note 138, at 1.

[143] Gerber Letter, *supra* note 139, at 6.

[144] *Id.* at 6-7.

[145] The United States Bankruptcy Court for the Southern District of New York conducted an omnibus hearing on July 15, 2009. Transcript of Omnibus Hearing, *In re* Lehman Bros. Holdings, Inc., Nos. 08-13555(JMP) and 08-01420 (JMP) SIPA (Bankr. S.D.N.Y. July 15, 2009) [hereinafter Lehman Transcript]. The transcript of the hearing was "embargoed" until October 2009. One attorney I interviewed indicated that he believed the embargo was intended to cool the market for Lehman Brothers claims. Telephone Interview with Lawyer No. 5 (Aug. 5, 2009).

[146] Lehman Transcript, *supra* note 145, at 68-137.

[147] *See id.* at 69-70.

meaning information about the debtor, not its creditors – by delaying the filing of a disclosure statement.[148]

For what were likely strategic reasons, the private investors did not file their 2019 statement until shortly before the exclusivity hearing, and then, according to counsel for the debtors, it was defective.[149] Although Judge Peck did not address the issue in that context, he as well as counsel to the private investors, the debtors and the official creditors' committees all appeared to view this as a "big issue."[150]

Along the way, tempers flared. At the close of argument, counsel to the official creditors' committee had this to say about counsel to the private investors:

> And I really rise to address one of [investors' counsel's] broadsides against the committee and its professionals. Whether he got carried away in a flight of rhetorical fancy or not doesn't really matter. His comments with respect to the [official] committee [of unsecured creditors] were inexcusable. He argued that the position of the official creditors' committee should be discounted because we are paid by the estate. The insinuation that we represent our pocketbooks and he represents the creditors generally is absurd and deplorable. I expected better from my esteemed colleague.[151]

We do not know whether such fulmination was the product of frustration over the 2019 issue, the high stakes of the case, or merely personal animosity. Nor do we know the frequency or severity of problems in compliance with Rule 2019 generally. According to those I spoke with, failing to make these disclosures may not, in fact, create quite the "battle ground" feared by some

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[148] Rather incredibly, counsel to the private investors assured the court that he was acting not solely in the interests of these investors but also of all of the creditors of Lehman Brothers:

> I ask Your Honor not to interpret that we're some group looking for a special advantage. We are a group that bought up enough debt to have a stake, and it's worthwhile to try to increase the returns that will come out of this case. That's why we are here, and we realize that we do that for everybody, not just for us.

Id. at 106. Continuing along the same vein, he added:

> [W]e came here to get permission to file a plan that would be supported and trumpeted and benefit all creditors. Nothing we did would only redound to our benefit, because we don't think for one second the Court would allow that to happen. Why waste our time proposing a plan that only helps us or gives us an unfair advantage compared to everyone else? It was never in our minds. We don't think it would be a total waste of time and money. We came here to do something that would benefit us and all other creditors equally.

Id. at 123.

[149] *Id.* at 77.

[150] *Id.* at 87 ("In respect of 2019, Your Honor, given all the remarks, I'll simply say there is a big issue. We agree with the committee.").

[151] *Id.* at 130.

observers.[152] In confidential interviews, system participants indicated that some hedge funds are willing to go along with the *Northwest* decisions in letter if not in spirit. As one hedge fund manager explained to me, "They're big boys, and they've swallowed the *Northwest* ruling. They have moved on."[153]

Moreover, other participants noted that in many cases, private investors will want their presence known. "They file notices of appearance" – which, by definition, require them to reveal their identity – "because they want to receive notice of what's going on," one lawyer explained.[154] There is often simply no strategic advantage to concealing one's identity. Many distressed investors are activists,[155] and activists cannot be wallflowers. As another hedge fund manager explained, "Most entities that buy large positions want to be active, so they have no problem coming out and revealing themselves."[156]

Yet, *Northwest Airlines* and *Lehman Brothers* are not the only cases presenting this problem,[157] doubtless because not all investors are activists all the time. Many participants interviewed for this paper acknowledged that they had participated in, or heard about, cases where a stakeholder with an undisclosed position surfaced late in the plan process, objecting to proposed treatment in ways that upset delicate negotiations. As one seasoned Chapter 11 lawyer explained, "Today, I don't know who's sitting across the table from me. When somebody is in district court, I know what they want. But now, in

[152] *See, e.g.*, Hu & Westbrook, *supra* note 16, at 1375 n.193 (reporting a "roaring controversy over [the] disclosure obligations" of hedge funds involved in bankruptcy cases); Coco, *supra* note 16, at 611 ("Debtors, creditors, and equity holders in Chapter 11 proceedings are waging war with one another . . . .").

[153] Telephone Interview with Private Investor No. 1 (Jan. 9, 2009).

[154] Interview with Lawyer No. 2 in Phila., PA (Jan. 18, 2009).

[155] *See* Harner, *supra* note 18, at 72; Kahan & Rock, *supra* note 19, at 283 ("Unlike traditional investors, activist hedge funds look for bonds where companies have violated, have arguably violated, or are about to violate some contractual provisions; buy up a large quantity of the issue; and then aggressively enforce their rights.") .

[156] Interview with Private Investor No. 2, *supra* note 67.

[157] At least one court has ruled in favor of hedge funds seeking secrecy, although the ruling lacks precedential value. In *In re Scotia Development, LLC*, the court held that a group of noteholders did not have to disclose the details of its members' trading positions, ruling that an informal creditor group jointly represented by a single law firm was not the sort of "committee" that Rule 2019 was intended to address. *See* Order Denying Scotia Pacific Co. LLC's Motion for an Order Compelling the Ad Hoc Noteholder Group to Fully Comply with Bankruptcy Rule 2019 By Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 1-2, *In re* Scotia Dev., LLC, No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007), *available at* http://www.akingump.com/docs/publication/972.pdf. The issue was also litigated, but ultimately settled, in *In re Mirant*. *See* Notice of Hearing on the Motion of New Mirant Entities to Compel Certain Holders of Class 3 Claims to Comply with Rule 2109 of the Federal Rules of Bankruptcy Procedure at 1, *In re* Mirant Corp., No. 03-46590 (Bankr. N.D. Tex. May 16, 2007); Press Release, Mirant Corp., Mirant to Complete Settlement with Pepco (Aug. 7, 2007), *available at* http://investors.mirant.com/releasedetail.cfm?ReleaseID=351384.

bankruptcy, I may not know all the right players and, even if I do, I may not know their real incentives."[158]

2. Claims Trading

Problems of identity are significantly magnified by the development of a robust secondary market for claims against, and interests in, distressed firms. This market exists to a significant extent as an unregulated securities market.[159] The lack of regulation permits private investors to move in and out of positions covertly. Indeed, but for the secondary market for distressed debt, shadow bankruptcy would not exist.

Claims trading is the buying and selling of claims against a debtor. This trading can occur before or during bankruptcy. While there is no single exchange for these claims, several sources interviewed for this paper explained that some investment banks maintain trading desks in claims against distressed firms,[160] and that agent banks in syndicated loans may manage the purchase and sale of loan participations.[161] Usually, the theory is that purchasers will acquire claims for a discount from the face amount of the claim, either directly or through an investment bank.[162] Claims purchasers make money in a variety of ways. They may capture the spread between the price paid and distributions by the company, which may be cash, new debt, or stock. Alternatively, they may resell the claim for a higher price.[163]

Being largely unregulated, it is difficult to estimate the size of this secondary market, but it is said to be in the hundreds of billions of dollars, if not more. According to SecondMarket, an online firm that acts as a broker/dealer in "illiquid assets" such as bankruptcy claims:

> The bankruptcy claims market is estimated to be a $500+ billion marketplace ($1+ trillion including Lehman Brothers), of which nearly $300 billion consists of general unsecured claims. However, only a

[158] Telephone Interview with Lawyer No. 3 (Feb. 6, 2009).

[159] *See* Drain & Schwartz, *supra* note 18, at 622 ("If bankruptcy claims were treated as securities, the SEC at least would be able to develop means to track claim trades and discern potential insider trading situations.").

[160] Interview with Other System Participant No. 2, *supra* note 33 ("The hedge funds and investment banks tend to source their deals themselves. They may have their own trading desks, and they may buy for their own book for a client."); Interview with Private Investor No. 1, *supra* note 153.

[161] Telephone Interview with Lawyer No. 4 (Aug. 4, 2009).

[162] *See* Harner, *supra* note 18, at 75.

[163] Interview with Other System Participant No. 2, *supra* note 33 ("Usually, these guys are just doing price arbitrage, they want to buy low and cash out high."); *see also* Harner, *supra* note 18, at 75 ("The amount of the discount [in a claims purchase] varies by situation, but can range from a low discount of 20% to a high discount of 60% or perhaps even 80%.").

fraction of that market has traded historically, which is usually concentrated in the largest bankruptcy cases.[164]

The transparency of this secondary market is determined by two sets of factors: the type of claim traded and the timing of the trade. Generally speaking, three types of claims may trade: (1) bank loans or portions thereof, known as "participations"; (2) public bonds; and (3) "trade claims," which can include unpaid debts for goods, services, etc. The distinctions matter because only public bonds are recognized as "securities" for these purposes and regulated as such. Thus, the federal securities laws appear to require no pre-bankruptcy disclosure of any sort involving loan participations[165] or trade claims.[166]

To some extent, the market for information itself has facilitated disclosure, although it is difficult to characterize the result as "transparency." Thus, because publicly traded bonds are traded on an exchange, it is relatively easy to obtain price quotes on them.[167] Services such as Debtwire "publish[] real-time news and data for financial professionals in fixed income markets across the world."[168] Moreover, LSTA, with Standard & Poor's, has created a proprietary leveraged loan index containing pricing information about certain leveraged loans.[169] Websites such as Creditex[170] and Markit[171] also provide trading and settlement information about certain bankruptcy claims and credit default swaps. Similarly, as one hedge fund manager explained, private providers like Standard & Poor's have subscription services that perform some of these functions, but on a limited and proprietary basis.[172]

These private information providers lubricate the secondary market in distressed debt in important ways. They provide some price data and, in some cases, trading and settlement platforms. LSTA is working to create

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[164] SecondMarket.com, Secondary Market for Buying and Selling Chapter 11 and Chapter 7 Bankruptcy Claims, http://www.secondmarket.com/market-detail/bankruptcy-claims.html (last visited Sept. 28, 2009); *see also* Levitin, *supra* note 18, at 86 ("[The claims trading market] was estimated to be in the hundreds of billions of dollars about a decade ago and has seen a prodigious growth in recent years.").

[165] Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51, 54-56 (2d Cir. 1992). Although not a party to the litigation, the SEC apparently argued, unsuccessfully, that loan participations were securities. *Id.* at 56.

[166] *See* Drain & Schwartz, *supra* note 18, at 576.

[167] Interview with Other System Participant No. 2, *supra* note 33 ("Bonds still trade over the wire.").

[168] Debtwire, http://www.debtwire.com (last visited Sept. 28, 2009).

[169] LSTA, http://www.lsta.org/marketdatasub.aspx?id=36 (last visited Sept. 18, 2009).

[170] Creditex, http://www.creditex.com (last visited Sept. 18, 2009).

[171] Markit, http://www.markit.com (last visited Sept. 18, 2009).

[172] Interview with Private Investor No. 1, *supra* note 153; *see also* Standard & Poor's Leveraged Commentary & Data, http://www.lcdcomps.com (last visited Sept. 18, 2009).

standardized documentation for trading loan participations.[173] Depending on what that documentation provides – and who gets to see it – these efforts could enhance transparency as well.

But nothing here requires public disclosure of the identities of purchasers or the various positions they hold. Furthermore, as private systems, their data are available only at a price. While private investors themselves can likely afford the subscription fees, many other stakeholders of a debtor, and even the debtor itself, might not. Information about the pre-bankruptcy secondary market for distressed debt is thus fragmented, partial, and opaque.

During bankruptcy, some disclosure of purchaser identity is required, but not much. At least in theory, those who purchase claims against a debtor in bankruptcy will disclose this publicly under Bankruptcy Rule 3001(e). This rule provides that "[i]f a claim other than one based on a publicly traded note, bond, or debenture has been transferred . . . after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee."[174] Before the provision was added in 1991, bankruptcy courts had to approve such transfers and thus had far greater control over claims trading.[175] Now, claims trade without notice, disclosure of the purchase price, or any judicial oversight at all, except when there is a challenge to the authenticity of the transfer.[176]

The problem is that Rule 3001(e) is largely designed to aid a debtor in determining who should receive distributions under a plan (or otherwise). It is not designed to tell the debtor or its other stakeholders information that would

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[173] LSTA, http://www.lsta.org/hub_stddoc.aspx?id=110 (last visited Sept. 18, 2009).

[174] FED. R. BANKR. P. 3001(e)(2).

[175] The pre-1991 amendment version of Bankruptcy Rule 3001(e) provided, in relevant part:

> (1) *Unconditional Transfer Before Proof Filed*. If a claim other than one based on a bond or debenture has been unconditionally transferred before a proof of the claim has been filed, the proof of claim may be filed only by the transferee. If the claim has been transferred after the filing of the petition, the proof of claim shall be supported by (A) a statement of the transferor acknowledging the transfer and stating the consideration therefor or (B) a statement of the tranferee setting forth the consideration for the transfer and why the transferee is unable to obtain the statement from the transferor.
>
> (2) *Unconditional Transfer After Proof Filed.* If a claim other than one based on a bond or debenture has been unconditionally transferred after the proof of claim has been filed, evidence of the terms of the transfer shall be filed by the transferee. The clerk shall immediately notify the original claimant by mail of the filing of the evidence of transfer and that objections thereto, if any, must be filed with the clerk within 20 days of the mailing of the notice or within any additional time allowed by the court. If the court finds, after a hearing on notice, that the claim has been unconditionally transferred, it shall enter an order substituting the transferee for the original claimant, otherwise the court shall enter such order as may be appropriate.

FED. R. BANKR. P. 3001, 11 U.S.C. app. at 917 (1988).

[176] *See* Drain & Schwartz, *supra* note 18, at 579 ("[A]mended Rule 3001(e) dispenses with notice (other than notice to the transferor), and the court should not become involved unless the transferor objects to its own purported trade. Moreover, the parties to the trade are not required by the amended rule to disclose any terms of transfer.").

aid negotiations or prevent misconduct. It does not apply at all to trading that may occur prior to commencement of a bankruptcy case. Nor does it apply before proofs of claims have been filed in respect of claims against the debtor, which may well not happen until late in the case. Nor does it require filings by those who purchase loan participations where represented by an agent bank.[177] Nor is there any requirement that notice be filed at the time of the transfer. Nor would compliance with the rule tell other stakeholders much about the claim purchaser. Nor does it require the purchaser to disclose the amount of consideration paid for the claim.[178] Nor is there any obligation to disclose other positions the purchaser might hold, such as credit-derivative or short positions.[179]

Thus, we have two sets of gaps: (1) gaps within the federal securities laws, which essentially exempt debt purchasers from revealing their identities; and (2) gaps within federal bankruptcy law that make it difficult, if not impossible, to know the identity of debt purchasers in a timely way during a bankruptcy case.

3. Empty Creditor Voting

An extreme version of the problems created by claims trading involves the possibility of "empty voting." In a recent series of articles, Bernard Black and Henry Hu have articulated some of the problems that arise when control rights can be decoupled from economic rights for very brief periods.[180] "Voting rights," they argue, "can be decoupled from economic interests quickly, at low cost, and on a large scale. Investors can have greater voting than economic

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[177] *See, e.g.*, *In re* Okura & Co., 249 B.R. 596, 599-601, 615 (Bankr. S.D.N.Y. 2000) (holding that a loan participant could not directly assert a claim against a debtor in bankruptcy because there is no privity between the participant and the debtor).

[178] *In re* Burnett, 306 B.R. 313, 314 (B.A.P. 9th Cir. 2004).

[179] As Judge Gerber explained in his opposition to the repeal of Rule 2019:

> Many distressed debt investors continue to buy and sell debtors' debt during the pendency of the chapter 11 case (as compared and contrasted to simply buying the debt and then awaiting the case outcome), and some *ad hoc* committees try to influence proceedings in the case even while their members are buying and selling debt whose prices or value might be affected by the rulings on the matters as to which they have sought to influence the court. These trading activities are normally not disclosed . . . .

Gerber Letter, *supra* note 139, at 6.

[180] *See* Hu & Black, *supra* note 21, at 665 ("[Decoupling] impedes what one might call 'debt governance' – the interactions between creditors and firms (or other debtors), such as negotiations to address loan terms and conditions. Financial restructurings are often made harder and sometimes infeasible, both in and out of formal bankruptcy."). Hu and Black have made a cottage industry of developing this insight. *See, e.g.*, Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 628 n.1 (2008) (collecting citations to their writing on empty voting).

ownership, a pattern we termed 'empty voting.'"[181] The problem here, they explain, is informational. Being "hidden," these control rights "can permit stealth takeover bids . . . . Conversely, target companies can defend against bids by using decoupling to place votes in friendly hands."[182]

They have argued that this problem infects not only equity, but debt. Investors can purchase bonds and vote, or threaten to vote, to waive covenants.[183] Loan participations may give the lead bank voting rights far in excess of its economic stake in the debtor. The ability to traffic in claims may also create the ability to traffic in voting control of those claims. While Bankruptcy Rule 3001(e) requires a creditor to file notice of the transfer of a proof of claim, it does not appear to require those who file these forms to indicate who actually has the right to vote them. As noted above, Rule 13d-1 appears to play no role here.[184] Thus, in its strongest form, claims trading may permit private investors to exercise remote and undetected control of the reorganization process.

4. Committee Manipulation and Information Arbitrage

While we do not know how pervasive empty voting is, we do know that private investors are sometimes lured out of the dark and onto official committees by the promise of access to confidential information about a debtor. Nothing prevents private investors from joining official committees, and in some cases their presence has proved highly contentious.

In the FiberMark bankruptcy, for example, Silver Point L.P., a hedge fund that traded in distressed debt, was invited to join the official creditors' committee after it acquired a large position in FiberMark's public notes.[185] The committee was, according to the report of examiner Harvey R. Miller, dominated by another creditor, AIG Global Investment Corp., and its workout specialist, Mark Musante.[186] Conflicts between Silver Point and AIG resulted in significant and costly disruptions, including allegations (unsubstantiated) that Silver Point engaged in illegal trading in FiberMark claims. According to Miller, committee members "resort[ed] to strategic litigation based upon doubtful claims . . . [which] further inflamed an already counterproductive environment to the detriment and prejudice of the reorganization process and the interest of creditors other than AIG . . . and Silver Point."[187] The

[181] Hu & Black, *supra* note 21, at 664.

[182] *Id.*

[183] *See id.* at 679-80.

[184] *See supra* notes 71-74 and accompanying text.

[185] *See* Report of Harvey R. Miller, as Examiner, at 4, *In re* FiberMark, Inc., No. 04-10463 (Bankr. D. Vt. Aug. 16, 2005) [hereinafter *FiberMark* Report].

[186] *Id.* at 2, 4 ("Mr. Musante, on behalf of AIG, dominated the activities of the Committee. Indeed, to a large measure, Mr. Musante . . . in effect, was the Committee.").

[187] *Id.* at 11-12.

FiberMark examiner estimated that the delay caused by these fights reduced the value of distributions to creditors by almost sixty million dollars.[188]

More egregious still was the behavior of one private investor in the WorldCom bankruptcy. There, Blue River Capital, a hedge fund, essentially lied about its positions in order to obtain a seat on the creditors' committee.[189] According to an SEC administrative order, Van D. Greenfield, the manager and compliance officer of Blue River, caused Blue River to enter into simultaneous backdated purchases and short sales of WorldCom unsecured notes.[190] Greenfield then wrote to the United States Trustee, claiming to hold $400 million of WorldCom bonds, and asking to be appointed to WorldCom's creditors' committee.[191] Greenfield did not, however, disclose that Blue River "had no net economic interest in the notes because it also held a $400 million short position in the Notes."[192] Greenfield thereafter had the purchase cancelled, leaving it holding only a much smaller net claim against the debtor – one that would not likely have resulted in its appointment to the creditors' committee.[193] Ultimately, Blue River's duplicity was discovered. Greenfield and Blue River paid a $150,000 settlement to the U.S. Treasury, neither admitting nor denying wrongdoing.[194]

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[188] *Id.* at 12.

[189] *See In re* Van D. Greenfield, Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Exchange Act Release No. 34-52,744, 86 SEC Docket 1623, 1625 (Nov. 7, 2005) [hereinafter Greenfield Order].

[190] According to the Greenfield Order:

> On July 25, 2002, Greenfield directed [Blue River trader] Reybold to execute a short sale of $400,000 in face value of the Notes in one Blue River proprietary account and a purchase of $400,000 in face value of the Notes in another Blue River proprietary account and to book both trades as having been made "as of" July 19, 2002, the last business day before the Petition Date. In fact, Blue River had not traded any WorldCom securities on July 19, 2002.

Id.

[191] *Id.*

[192] *Id.* Greenfield failed to disclose additional pertinent information:

> The [Greenfield] letter did not disclose that . . . the transaction in the Notes had not yet settled, or that the purchase had occurred after the Petition Date but was backdated to a date prior to the Petition Date. A $400 million unsecured claim would have put Blue River among the top 20 unsecured creditors of WorldCom as disclosed in WorldCom's schedule of the 50 largest unsecured claims against it that was filed on the Petition Date.

Id.

[193] *Id.* at 1627 ("By obtaining membership on WorldCom's creditors' committee . . . Greenfield's actions also could have had the effect of depriving another legitimate creditor from obtaining a seat on WorldCom's creditors' committee.").

[194] *Id.* at 1628.

5. The Costs of Shadow Identity

The ability to cloak identity creates three related types of costs affecting distressed firms.

First, and perhaps most prosaic, fights about identity can be expensive. The debtor and other official entities – all of whom are paid by the debtor's estate – may become involved in fights like those in the Lehman Brothers, Northwest Airlines, or FiberMark bankruptcies. These fights may be worthwhile to the particular private investor, but it is far from clear that they benefit the estate. They take judicial time and resources from a system that is already heavily taxed. "[Rule] 2019 is being used as a litigation weapon," one private investor told me.[195] As one judge stated: "The problem with the hedge funds is that they use the bankruptcy court as a battleground without paying any rent."[196]

Second, and perhaps more important, shadow bankruptcy affects the dynamics of negotiations. Negotiation has a special role in business restructurings whether inside or outside Chapter 11. In the eyes of many system participants, the whole point of the process is to come to a new agreement about the debtor's capital structure. Firms will usually choose bankruptcy only if they cannot come to a consensual restructuring outside bankruptcy. Thus, General Motors commenced its Chapter 11 case, in part, because it was unable to come to terms with certain investors and the United States government.[197]

If a company goes into bankruptcy, negotiations are expected to continue. A court will typically impose a resolution – the "cramdown" of a non-consensual plan or a liquidation – only if it is clear that negotiations are failing. Chapter 11 negotiations are thus premised on the complex proposition that value can be maximized for all stakeholders in a debtor if the debtor is given a reasonable opportunity to restructure its affairs.[198] Steven Schwarcz has observed that "[t]he genius of bankruptcy reorganization law is that it provides incentives for debtors and their creditors, notwithstanding their disparate interests, to reach a voluntary agreement on the terms of the restructuring."[199]

Shadow bankruptcy obscures these incentives, and thus makes negotiation more uncertain and expensive. One attorney who has represented debtors and creditors in large Chapter 11 cases (and who had previously worked as in

[195] Telephone Interview with Private Investor No. 3 (July 14, 2009).

[196] Telephone Interview with Judge No. 1 (Jan. 8, 2009). He elaborated: "They impose enormous costs on the system, but they pay nothing for it. The airlines have to pay for fuel, for gate charges, and so forth. But hedge funds and private equity funds get to use the bankruptcy courts for all sorts of strategic purposes without paying a nickel." *Id.*

[197] *In re* Gen. Motors Corp., 407 B.R. 463, 479-80 & n.9 (Bankr. S.D.N.Y 2009).

[198] *See In re* Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985) ("The purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state.").

[199] Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 959 (2000).

investment banker) explained: "Trading in and out of credits definitely can be a problem. If you're negotiating a term sheet and suddenly eighteen percent of your group is gone, it's a problem. You don't necessarily have to start from scratch, but it creates problems."[200] Similarly, as Judge Drain's letter to the Rules Committee opposing repeal of Rule 2019 noted, it is hard to negotiate anything, much less a plan of reorganization, it you don't "know literally who the other side is."[201] He elaborated:

> Thus, one may negotiate a settlement that results in the withdrawal of a pleading only to have another pleading spring up by someone who purports not to have been in the group that settled. Or one may negotiate a settlement with someone only to learn later that they were still helping to fund the law firm that was prosecuting a group pleading – or that the law firm is continuing to prosecute the pleading, ostensibly on behalf of the group, when, in fact, the group has shrunk because many of its members have settled. These are not hypothetical concerns. Each has occurred in cases before me, and reference to Rule 2019 helped to straighten out the situation and keep the parties' positions clear.[202]

Third, and perhaps more disturbing, cloaking identity may conceal the real sources of control in a reorganization. To the extent that voting rights under a bond indenture or a reorganization plan can be separated from beneficial ownership of the claim, we have the possibility that those really in control of the reorganization will be unknown to most participants. Concealing control creates opportunities for arbitrage that would benefit aggressive investors at the expense of reorganizing debtors and their other stakeholders.

Ultimately, the identity problem presented by shadow bankruptcy is that it is not clear how often parties ignore or subvert rules designed to promote transparency, such as Rules 2019 and 3001(e). According to Judge Gerber, "failures to provide the information actually required by Rule 2019 . . . are widespread, and failures to make all of the required disclosures are the rule, not the exception."[203] As former Secretary of Defense Donald Rumsfeld might

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[200] Interview with Lawyer No. 4, *supra* note 161.

[201] Drain Letter, *supra* note 138, at 1.

[202] *Id.*

[203] Gerber Letter, *supra* note 139, at 5 (footnote omitted). As he further explained:

> Much of the time, a submission purporting to be made in accordance with Rule 2019 is filed. In fact, the better law firms file them religiously. But while my colleagues may have had better fortune than I have had, I have never seen a purported Rule 2019 submission in a case before me where all of the information Rule 2019 requires was actually provided. Rather, in all of the Rule 2019 submissions I have seen, an *ad hoc* committee or other investor group has described the ownership of the bonds or other debt of its members in the aggregate, without disclosure of the individual ownership by members of the committee or group. Nor have I ever seen any disclosure on behalf of a distressed debt investor or investor group of the dates of acquisition of the bonds or other debt acquired (other than saying that it was acquired at "various times," or "on a number of dates"), nor the prices paid for it. Nor has any Rule 2019 filing I have ever

say, "we don't know what we don't know."[204] We know, in other words, that there is good reason to believe that important players in the system withhold their identities when it suits their purposes – e.g., while other parties are negotiating a reorganization plan – only to surface and, in so doing, disrupt whatever balance was struck. In destabilizing negotiations, private investors at minimum create uncertainty, cost, and delay. At worst, they can, as in the *FiberMark* case, cost other creditors millions of dollars.

B. *What Do They Want?*

Why do private investors want to conceal their identities? It may be because, as their trade associations claim, disclosure would reveal proprietary trading strategies, depriving them of a competitive edge. But in some cases, secrecy will be essential because they hold complex, multi-faceted – "hedged" – positions that are actually antithetical to the debtor's success. According to their trade associations (SIFMA and LSTA), transparency "can have a potentially counterproductive effect" because "distressed investors such as hedge funds employ aggressive and complex investment strategies."[205] Private investors may gain more from the debtor's failure than its success by "shorting" the reorganization process. If that is the motive, then concealment obviously makes sense. Even when they do not remain in the shadows, their tactics – like those of all rational self-maximizers – are to buy low and sell high. There is evidence that shadow bankruptcy permits and perhaps promotes this – to the harm of debtors and their larger constituencies.

1. Hedging Strategies

Part of the problem here derives from the complex hedging strategies that private investors might use. Private investors may acquire any number of positions against a debtor in bankruptcy. One hedge fund may, for example, acquire secured and unsecured claims, as well as preferred stock, or even

> seen included information on *sales* of the bonds, claims, or other debt – a matter significant not only in its own right, but also because it would reveal short positions in bonds, resulting in an interest in the failure of the chapter 11 case, or in lower distributions to other creditors long in those bonds.

Id. at 5-6.

As if to confirm Judge Gerber's dark views, private investors in the Lehman Brothers bankruptcy allegedly filed their 2019 statements late and with defects. *See supra* notes 145-51 and accompanying text.

[204] As Rumsfeld famously observed, "[T]here are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unkown unknowns – the ones we don't know we don't know." Donald Rumsfeld, U.S. Sec'y of Defense, Dep't of Defense News Briefing (Feb. 12, 2002) (transcript available at http://www.defenselink.mil/transcripts/transcript.aspx?transcriptid=2636).

[205] SIFMA/LSTA Proposal, *supra* note 134, at 22-23.

common stock.[206] The economic goal may be to reach the "fulcrum" position, the point in the capital structure that achieves maximum control for minimum investment.[207] According to interviews with participants, hedging in reorganization itself is not especially new.[208] But, it is not the same today as it was when Congress enacted the current Bankruptcy Code in 1978.

Nothing in the legislative history to the current law directly addresses what sort of capital structure Congress envisioned when it enacted Chapter 11. Most likely, Congress had no particular structure in mind, since it designed a system that was meant to be highly flexible, to permit the reorganization of small, local firms as well as very large public companies. But, as one seasoned Chapter 11 lawyer explained, "The assumption was that [it] was a simpler capital structure at the time. The . . . premise was that the parties would sit at the table and negotiate and know what one another wanted. Today, you have no idea what someone's real incentives are."[209]

The reason one may not understand other investors' incentives is that, in addition to the ability to trade in and out,[210] investors can hold multiple positions against or affecting a debtor in Chapter 11. For example, an investor may acquire both the senior debt of a company and a short position against that company's stock. If the reorganization plan severely dilutes or eliminates the stock, the debt and the short may pay. If the plan does not do this, the holder may use the senior debt to block confirmation of the plan. The mere fact that the holder *might* hold a short position – which is disclosed nowhere – will distort negotiations. The possibility that private investors might hold multiple positions has, at minimum, an *in terrorem* effect that likely gives private investors the capacity to influence reorganizations disproportionate to their actual holdings.

Neither the court nor other participants have any certain way to discover a holder's multiple positions until it is too late. A notorious example occurred in the Adelphia reorganization. According to a statement by Bankruptcy Judge Robert Gerber, who presided over the case:

> [I]nvestors long in bonds of Adelphia Parent admitted to other investors that they had a short position in bonds of Arahova Communications, one of the Parent's subsidiaries. The investors' short position gave them an economic stake in a lower recovery for Arahova creditors – and, as some argued, an economic stake from which the investors would profit from the failure or delay of the entire chapter 11 case.[211]

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[206] *See, e.g.*, sources cited *supra* note 19.

[207] *See, e.g.*, Lichtenstein & Cheney, *supra* note 19, at 102 ("The 'fulcrum' is the point of a company's capital structure at which its liabilities exceed its assents.").

[208] Interview with Private Investor No. 2, *supra* note 67.

[209] Interview with Lawyer No. 3, *supra* note 158.

[210] *See supra* Part II.A.2 (discussing claims trading).

[211] Gerber Letter, *supra* note 139, at 6 n.11.

In Judge Gerber's view, expressed in opposition to the proposal to repeal Rule 2019, the cure here would have been disclosure of the short position: "[D]isclosure of the short positions would seem to be essential to make that which was said about the long positions not misleading."[212] As one participant interviewed for this paper explained, "The really important thing is to disclose the full position, including shorts and derivatives."[213]

Consider also the more recent experience in *Lehman Brothers*, where private investors objected to the debtors' request to extend the exclusive period in which to file a reorganization plan, but failed to file a plan of their own. That they did not file their own plan, or even an outline of one, suggested to the court that perhaps they had other motives, including forcing the debtors to divulge information that might enable the investors to gain an advantage in the secondary market.[214] Reading between the lines, it would appear Judge Peck, in overruling their objection, had concerns about this strategy.

> Mr. Bienenstock [counsel to the private investors], you are representing, however we deem it, a rump group of self-selected creditors that has chosen sophisticated counsel to try to achieve an objective. Now, if that objective is [in] today's record, so be it. If the objective is to say we need more [debtor] transparency, that may be a different motion. If the objective is to say we should minimize administrative expenses in this case, I wholeheartedly agree. But I'm not sure an exclusivity objection is the means to those ends.[215]

An extreme example of hedging strategies that might harm debtors involves credit default swaps ("CDSs"). As many have already observed, these instruments create a classic problem of moral hazard. In a CDS, a creditor of the debtor purchases what is effectively insurance from a third party (a "protection seller") in the form of a swap. The insurance is that the protection seller will pay the creditor (the "protection buyer") if the debtor encounters any number of forms of financial distress, including, most importantly, bankruptcy. CDS is, in many respects, a fancy term for a third-party guarantee.

As with guarantees, the creditor who benefits from the guarantee may decide that collecting on the guarantee is a more profitable option than trying to collect from the debtor. But the creditor can only do that if the swap has

[212] *Id.* I suspect disclosure will not address problems created by equity short sales in this context. *See infra* Part III.B.2.

[213] Interview with Lawyer No. 3, *supra* note 158. He went on: "Everybody says 'we can't reveal our trading strategies.' Bullshit. This is about knowing who you are dealing with and what they want." *Id.*

[214] This was the view of counsel to the debtors. *See* Lehman Transcript, *supra* note 145, at 125 ("[T]he poor creditor, who is not involved in the inner circles of these cases, he doesn't know, or she doesn't know, what's happening. . . . I would submit to Your Honor that there was an attempt here to take advantage of people who don't know what the claims are going to be worth.").

[215] *Id.* at 105.

been triggered. If bankruptcy triggers the swap, the creditor may then seek to commence an involuntary bankruptcy proceeding against the debtor, not to collect from the debtor, but instead to collect from the swap protection seller.[216]

2. Buy Low, Sell High

It is not clear how common or destructive hedging strategies are. Indeed, as discussed in greater detail in Part III, the lack of information here is part of the problem. But private investors are sometimes happy to reveal their identities, and even their strategies, if doing so will enable them to obtain a quick profit at the expense of the estate.

One famous method here is the so-called "loan-to-own." In a loan-to-own strategy, a private investor will acquire debt of a distressed firm before or during bankruptcy. It may then provide financing to the debtor in the form of cash collateral or a new debtor-in-possession facility, as discussed in Part I. But the real goal of the loan is not the repayment of principal plus interest, as one might expect from a conventional lender, but instead the conversion of that loan into a controlling equity position in the debtor.

A recent survey of hedge funds reports that a large number of respondents invest in secured debt of troubled companies with a view to acquiring a controlling equity interest.[217] According to this study, "78 percent of respondents said secured loans have become their primary investment vehicle for investing in distressed debt, up sharply from 43 percent in 2007."[218] Such loan-to-own strategies "provide the greatest opportunity to acquire an equity stake at a bargain basement price should the borrowers deleverage by swapping debt for equity in or outside of bankruptcy court."[219]

Consider also asset sale strategies. On a conventional view, non-ordinary course asset sales should be a good thing because, in a transparent system, bidding will be high, creating maximum value for stakeholders. According to some scholars – most notably Douglas Baird – this is a good thing. "Today," Professor Baird wrote, "creditors of insolvent businesses . . . no longer need a substitute for a market sale. Instead of providing a substitute for a market sale, chapter 11 [bankruptcy reorganization] now serves as the forum where such sales are conducted."[220] Reorganization under Chapter 11 of the Bankruptcy

[216] *See* Lubben, *supra* note 21, at 427 ("Creditors will have every incentive to trigger the swap by filing an involuntary bankruptcy petition against the debtor, illustrating the important point that 'bankruptcy' is the one credit event that can be controlled by credit buyers.").

[217] *See* HEDGEWORLD & DYKEMA, *supra* note 19, at 1.

[218] *Id.*

[219] *Id.*

[220] Baird, *supra* note 25, at 71. Indeed, Professor Baird and Dean Rasmussen claim that the success of market forces has resulted in the death of traditional forms of reorganization. *See* Baird & Rasmussen, *Twilight*, *supra* note 37, at 699; Baird & Rasmussen, *End of*

Code, according to Baird, "has morphed into a branch of the law governing mergers and acquisitions."[221] This is said to be good because it is assumed that transparency will produce the highest and best price for an asset. As Baird (with Morrison) has explained:

> A regime of mandatory auctions is strongly information forcing. It gives managers (and everyone else with an incentive to preserve the firm as a going concern) an incentive to make information available and verifiable to potential buyers. Such a rule destroys the option value associated with keeping the firm running for a short time (assuming no buyer is willing to purchase the firm *in toto* at the outset), but it gives the managers an incentive to ensure that a market for the firm's assets always exists.[222]

The predicate here is that sales will inevitably produce more and better information, which will, in turn, produce higher and better valuations for the assets of reorganizing debtors that may be sold in a Chapter 11 case. In theory, of course, this should be right. If managers are acting on their fiduciary duties to maximize asset values, they would do this because information will (at least in theory) tend to improve asset prices. Knowledgeable market actors are more likely to compete amongst one another for a debtor's assets. The better informed they are, the more vigorous the bidding is likely to be.

But, of course, theory does not always comport with reality, and the assumption that managers will want to maximize assets values (and produce information to do so) assumes away all the conflicts of interest they might experience. Consider the following situation: management has found a stalking horse to set a floor for bidding on certain assets – for example, a particular division of the company. The arrangement with the stalking horse would certainly give it access to confidential information about the company, and the auction procedures approved by the court would almost certainly require that the same information be provided to other bona fide bidders, in an effort to drive up the sale price.

But we would also expect that managers will have an abiding interest in their own welfare. Thus, if one bidder quietly promises them, individually, some better deal – say, attractive new employment agreements – we might expect that management would prefer that bidder. Management might, under

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Bankruptcy, *supra* note 37, at 751. The Supreme Court would appear to concur with the aspiration, if not the empirical claim. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457 (1999) ("[T]he best way to determine [a reorganizing debtor's] value is exposure to a market.").

[221] Baird, *New Face*, *supra* note 25, at 75; *see also* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918 (2003) ("The endless negotiations and mind-numbingly bureaucratic process that seemed to characterize bankruptcy in the 1980s have been replaced by transactions that look more like the market for corporate control.").

[222] Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356, 369 (2001).

those circumstances, manipulate the flow of information to other bidders or stakeholders (such as the creditors' committee), provide more (or better) information to the bidder that has offered the sweetheart deal, and so on. The debtor's managers might feel an especially strong impulse to do this if they had been appointed before bankruptcy by private investors who support a favored bidder – or actually are the bidders themselves.

Thus, some observers are not so sanguine about the virtues of the sale process, in particular because valuations often appear depressed. Professors LoPucki and Doherty, for example, have marshaled evidence to show that asset sales involving large, publicly-traded corporate debtors produce much less value than reorganizations.[223] They have argued that conflicts of interest among investment bankers and the absence of competition among courts for large cases may explain this effect.[224] This may well be true. But another possibility is informational: the parties – in particular, creditors or other potential bidders – lack the information to generate greater value.[225] Consider, for example, LoPucki and Doherty's explanation of the sale of Polaroid's assets:

> Polaroid's CEO resigned early in the bankruptcy case and was replaced by two lower-level employees as co-CEOs. One had a base salary as CEO of $375,000, the other $390,000. After they took the job, Polaroid adopted a retention bonus plan that resulted in their being paid $844,000 and $878,000 respectively in their final year of work. They sold Polaroid to the sole bidder, One Equity Partners Imaging Corp. ("OEP"), for a price that was widely condemned by the financial press as too low. Immediately upon closing the sale, OEP hired them to continue running the company as co-CEOs. The two swore under oath that they had no contract to work for OEP before they closed the sale. But they may not have needed one. The custom appears to be that if the buyer hires the selling managers, the selling managers get a share of the buyer's equity in the company. Indeed*, a year after the sale closing, Polaroid disclosed that each of the two employees in question owned stock in OEP valued at $3 million to $4 million*.[226]

[223] *See* LoPucki & Doherty, *supra* note 37, at 24 ("Controlling for the company's earnings, reorganized companies recover about 75% of their book value, compared to a 29% recovery ratio for those that sell."); *id.* at 44 ("[O]n average, reorganizations yielded 80% or 91% of book value, while sales yielded only 35% of book value.").

[224] *Id.* at 40 ("We think court competition explains the bankruptcy courts' passivity [in challenging low sales valuations]."); *id.* at 44-45 ("The managers who decided to sell these companies rather than reorganize them frequently had conflicts of interest. So did the investment bankers who advised the managers and solicited bids.").

[225] *See id.* at 38 ("[T]o know that the sale price is inadequate, a party may need to spend millions of dollars for an independent valuation.").

[226] *Id.* at 33-34 (emphasis added) (citations omitted). On April 16, 2009, Polaroid was sold for eighty-eight million dollars to the joint venture Hilco Consumer Capital, LP and

An even more disturbing example involves the recent debacle in the Steve & Barry's bankruptcy. On July 9, 2008, Steve & Barry's, a discount retail chain started by entrepreneurial University of Pennsylvania students, filed for bankruptcy.[227] Before bankruptcy, it had been one of the nation's fastest growing retailers, opening hundreds of stores selling clothing under the names of celebrities such as Sarah Jessica Parker, Venus Williams, and Stephon Marbury.[228]

On July 16, 2008 – a week after commencing its case – it sought authority to sell the entire business as a going concern.[229] Despite the fact that no creditors' committee had been appointed, the bankruptcy court approved bid procedures which ultimately led to a sale of Steve & Barry's to the stalking horse,[230] investment firms Bay Harbour Management and York Capital Management, which purchased the retailer for $168 million.[231] This, despite the fact that the debtor's own motion to create these procedures claimed that the debtor's assets and annual revenues were worth nearly five times that amount on a book basis.[232]

Despite buying the debtor for this fire sale price, the purchasers could not make a go of it. "With a plan to liquidate the chain's remaining 173 stores by early 2009," the new owners filed for bankruptcy protection a second time, less than four months later, in November 2008.[233] Steve & Barry's previous

Gordon Brothers Brands, LLC, two private equity firms from Toronto and Boston respectively. Lithograph Legends, LLC v. U.S. Trustee, No. 09-CV-943(JMR), 2009 WL 1209469, at *1 (D. Minn. Apr. 30, 2009). Although Patriarch, a New York-based private equity firm, challenged the sale, a district judge refused Patriarch's appeal, allowing the sale to move forward. *Id.* at *5.

[227] *In re* Steve & Barry's, Inc., 405 B.R. 68, 71 (Bankr. S.D.N.Y. 2009).

[228] *See* James Covert, *Star Lines Dodging Steve & Barry Hit*, N.Y. POST, July 10, 2008, at 33.

[229] *See* Debtors' Amended Motion Pursuant to Sections 105(a), 363, and 365 of the Bankruptcy Code and Bankruptcy Rules 6004 and 6006 for (i) Approval of Procedures in Connection with the Sale of all or Substantially all of the Debtors' Assets, (ii) Authorization to Enter into Stalking Horse Agreements in Connection Therewith, (iii) Approval of the Payment of Stalking Horse Protections, and (iv) the Setting of Related Auction and Hearing Dates at 3, *In re* Stone Barn Manhattan LLC, 405 B.R. 68 (Bankr. S.D.N.Y. 2008) (No. 08-12579) [hereinafter Steve & Barry's Sale Motion].

[230] *See* Declaration of Scott Sozio in Connection with BH S&B Holdings, LLC's Offer to Purchase Substantially all Assets of the Debtors at Exhibit 1 ¶¶ 1-2, *In re* Stone Barn Manhattan LLC, 405 B.R. 68 (Bankr. S.D.N.Y. 2008) (No. 08-12579) (stating that BH S&B Holdings, formed by Bay Harbour Management, and Steve & Barry's entered into an asset purchase agreement with the intention of operating Steve & Barry's as a going concern).

[231] *See* Chasan, *supra* note 38.

[232] *See* Steve & Barry's Sale Motion, *supra* note 229, at 4 ("As of May 31, 2008, Steve & Barry's . . . consolidated assets totaled approximately $732.7 million . . . . Consolidated revenues for the twelve months ended May 31, 2008, were approximately $656.6 million.").

[233] Chasan, *supra* note 38; *see also In re* BH S&B Holdings LLC, 401 B.R. 96, 99-100 (Bankr. S.D.N.Y. 2009).

owners objected, claiming that "they still owned the inventory and other assets in about 65 of the remaining shops."[234] The former owners also said "that Bay Harbour and York Capital had failed to fulfill some terms of the original asset purchase agreement."[235] The new and former owners of the company entered into a stipulation, "allowing the former owners access to about $7.4 million in cash and $11 million in various escrow accounts."[236]

The net result? A business estimated to be worth over half a billion dollars was liquidated for a tiny fraction of its value. Creditors of Steve & Barry's can expect to receive virtually nothing from their claims. As important, Steve & Barry's 8600 domestic employees lost their jobs.[237]

At this point, it is difficult to know what to make of the *Steve & Barry's* case. Part of the blame must be laid at the feet of the current credit crisis. According to the debtor, it was compelled to seek the immediate sale in the first case because its principal creditor, General Electric Capital Corporation ("GECC"), conditioned the debtor's use of cash collateral on a sale of the debtor no later than August 15, 2008.[238] Without the consent of GECC, the debtors claimed that they had no cash, and were thus unable to replenish inventory and remain in business.[239] Why GECC withdrew credit is not currently known. Certainly, Judge Gropper's statement about the case appears to have some merit: "It is a terrible economic situation that we all face."[240]

Yet, Judge Gropper – who presided over the *Northwest Airlines* cases discussed above, and who is surely sensitive to the machinations of the shadow system – was also quick to absolve everyone involved: "I don't think anyone can blame themselves," he said after commencement of the second case.[241]

This may be true, but it leaves many questions. What efforts had been made to obtain alternative financing or to use the powers given to debtors to obtain permission to use GECC's cash collateral? Under Bankruptcy Code section 363(c)(2), the Bankruptcy Court may permit the debtor to use cash collateral over the creditor's objection.[242] From the public pleadings, it would appear that no effort was made to use this cash collateral. Similarly, what sort of fees did Bay Harbour and York Capital take out of the company when they purchased it in the first case? What relationship, if any, existed between these investors and GECC? How vigorous could the bidding have been given the extremely short period allotted – less than a month?

[234] Chasan, *supra* note 38.

[235] *Id.*

[236] *Id.*.

[237] Steve & Barry's Sale Motion, *supra* note 229, at 4.

[238] *Id.* at 2.

[239] *Id.*

[240] *See* Chasan, *supra* note 38 (quoting Judge Gropper).

[241] *Id.* (quoting Judge Gropper).

[242] 11 U.S.C. § 363(c)(2) (2006).

There is, in short, likely more to the Steve & Barry's story than just the credit crisis. The behavior of the participants creates grounds for serious concern. Would a more transparent system have produced a better result? We do not know. We do know, however, that private investors (GECC, Bay Harbour, York Capital) caused (and perhaps suffered) serious losses.

Private investors, like everyone else, want to make the most for the least. Today, however, gaps in the reorganization system permit them to act not only for their own benefit, but also to the detriment of the debtor and its other stakeholders, in two ways.

First, in many cases, it will simply not be possible to know the stakeholder's real incentives. If a creditor or shareholder held only one position, it would be fairly easy to imagine how a given result in reorganization would affect that holder, and thus whether the holder would support or oppose a proposal. Multiple positions tend to undercut one of reorganization's chief mechanisms – the negotiated settlement. As one participant said to me, "It's very hard to shoot a moving target. I can't negotiate with you if I don't have some idea what you really want."[243]

Second, these positions may well lead to behavior that destroys value for the debtor's other stakeholders.[244] As one bankruptcy lawyer (who had previously been an investment banker) explained, a bankruptcy sale "may not be the best result for creditors, but it's very good for the buyers."[245] If a stakeholder's short or derivative position pays only if the debtor's reorganization plan fails, or assets are sold for a fire sale price, then the stakeholder will act accordingly. While this may maximize value for that stakeholder, it may reduce recoveries for other stakeholders, destroy going concern value, and needlessly eliminate jobs.

C. *When Do They Want It?*

The *Steve & Barry's* case discussed above is an example not only of devastatingly low valuations, but also of a more specific and troubling feature of the shadow system: short, or at least unpredictable, time horizons. The model on which the current system is predicated assumes that investors would likely hold for long periods of time. Being heavily regulated, commercial banks – who were important creditors in the 1970s – were only permitted to make "safe and sound" loans which would amortize over a fairly lengthy and predictable term. Public investors – whether bondholders or stockholders – were also generally assumed to be investing for the long term. While bankruptcy reorganization would be a speed bump in that investment path, it did not necessarily alter the underlying time horizon. Thus, reorganization

[243] Interview with Lawyer No. 3, *supra* note 158.

[244] *See* Hu & Black, *supra* note 21, at 682 ("[O]ne [bankruptcy] judge described a case in which a junior creditor complained that that firm's value was too *high*, even though a lower value would hurt the class of debt the creditor ostensibly held.").

[245] Interview with Lawyer No. 4, *supra* note 161.

under Chapter 11 was seen as a way of preserving and maximizing this long-term value by saving companies that had at least the apparent possibility of a viable future.

Private investors, however, may have much shorter time horizons. As one hedge fund manager explained, "Creditors want cash, so the market is affecting going concern values."[246] Another put it more bluntly: "In the old days, people wanted to see two things: to get paid and to see the company survive. Today, people only want one thing: to get paid."[247] In the Lehman Brothers bankruptcy, Judge Peck overruled private investors' objection to an extension of the exclusive period because, he indicated, they lacked patience:

> [The private investors'] argument is not based upon anything that feels like reality to me. It seems to be predicated on impatience, impatience with a process that, done professionally, necessarily will take time. How on earth could anybody develop a confirmable plan before the examiner's report is done? How could anybody develop a confirmable plan before the bar date? How can anybody develop a confirmable plan without fully understanding the value of the assets that underlie what you've described as a forty plus billion dollar business? Well, okay, that's the basket, that's a broad valuation we could apply to the basket, but what's in it? And without being able to disclose what's in it, how can anybody make an informed judgment with respect to whatever this liquidation plan looks like?[248]

Private investors may look for a quick return because they are greedy. But they may also be subject to the capital calls of their own investors who, increasingly nervous and illiquid, need to exit an investment in the hedge fund, even if doing so today may produce a lower return than a long term buy and hold strategy. This, in turn, may place private investors at odds with the debtor's other stakeholders (including other private investors), who might want to reorganize the company and realize a return over a much longer period.[249]

Shadow bankruptcy presents other timing issues. Perhaps the most important, as explained above, is that private investors can influence distressed

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[246] Interview with Private Investor No. 2, *supra* note 67.

[247] Interview with Private Investor No. 3, *supra* note 195. Similarly, as Robert Rosenberg and Michael Riela explain, "hedge funds are more likely than more traditional investors to seek short-term returns that are not necessarily tied to the debtor's successful reorganization." Robert J. Rosenberg & Michael J. Riela, *Hedge Funds: The New Masters of the Bankruptcy Universe*, 17 NORTON J. BANKR. L. & PRACT. 701, 703 (2008).

[248] Lehman Transcript, *supra* note 145, at 95.

[249] Rosenberg & Riela, *supra* note 247, at 709 ("Partly as a result of hedge funds' short-term investment horizon and investments in multiple segments of a company's capital structure, hedge funds' interests are not always aligned with those of debtors and other parties. The focus by a number of hedge funds on the maximization of short-term returns often has caused tensions among the parties to a restructuring and may conflict with the Bankruptcy Code's emphasis on the rehabilitation of debtors.").

firms before bankruptcy. This may be for laudable purposes, such as to help finance an out-of-court restructuring. But it may also reflect a loan-to-own strategy that ultimately reduces value for the debtor's other stakeholders. In some cases, private investors would rather keep the company out of bankruptcy so that they can foreclose on assets acquired for less than their fair market value.[250]

In either case, Chapter 11 has little regulatory reach here. True, sections 1125(g) and 1126(b) of the Bankruptcy Code deal with pre-bankruptcy solicitations in connection with a reorganization. And, of course, many of the avoidance powers in bankruptcy can cover significant pre-bankruptcy periods.[251] But applicable fraudulent transfer law would not avoid (undo) a "regularly" conducted – meaning procedurally sufficient – foreclosure sale, no matter how low the selling price might be.[252] As discussed above, the federal securities laws do little useful work here.[253] Nor can the Bankruptcy Code, if no bankruptcy case has been commenced. In short, as with regulating issues of identity and motive, the current system prevents us from responding to the real time horizons of private investors, which creates costs and reduces recoveries.

To be sure, private investors can bring liquidity and expertise to the system – both of which might otherwise be in short supply.[254] Thus, as discussed in the next Part, we should be wary of substantive re-regulation that discourages active participation of private investors. There is nothing inherently problematic about private investors who exploit regulatory gaps to make money. That is a basic feature of our system. But the gaps are now too big, and some re-regulation is in order. The important questions will involve the nature and extent of that regulation.

III. SHEDDING LIGHT

Describing the contours and costs of shadow bankruptcy is easier than developing a cure. There have already been scores of proposals to address the larger economic crisis, as well as certain aspects of the shadow bankruptcy problem more specifically. Yet, all suffer from problems of scale. The large systemic proposals are just that: their focus is too wide to capture something as

[250] *See* Erika Lovley, *How Troubled Firms Skip Bankruptcy Court*, WALL ST. J., Feb. 7, 2007, at B5B.

[251] Depending on which fraudulent transfer regime is used, the look-back period can be as little as one year and as long as six. *See* Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. BANKR. L. & PRAC. 101, 109-13 (2002).

[252] *See* BFP v. Resolution Trust Corp., 511 U.S. 531, 544 (1994); Jonathan C. Lipson, *First Principles and Fair Consideration: The Developing Clash Between the First Amendment and the Constructive Fraudulent Conveyance Laws*, 52 U. MIAMI L. REV. 247, 257-60 (1997).

[253] *See supra* notes 69-76 and accompanying text.

[254] *See, e.g.*, Goldschmid, *supra* note 18, at 259 ("The arrival of distressed debt investors can add new, positive energy to the reorganization process.").

seemingly specialized as shadow bankruptcy. Conversely, proposals that focus exclusively on shadow bankruptcy tend not to view its problems in a larger context, and so would permit gaps to persist.

This Part first summarizes certain existing sets of proposals and explains why they are unlikely to solve shadow bankruptcy problems. Second, it sets forth two specific types of solutions. The more important and novel solution would use emerging information technologies to create a system of "positional disclosure" that would require private investors in distressed firms to reveal all of their material rights against (or affecting) those firms in real time. It also argues that certain combinations of holdings found to be especially destructive should be forbidden entirely when a firm becomes distressed. Finally, it recommends further study.

A. *Regulatory Reform: A Growth Industry*

Since the credit market collapse of late 2008, there have been dozens of proposals to re-regulate the financial system.[255] A review of the major

[255] Even before the full magnitude of the crisis became apparent, the U.S. Department of Treasury was busy developing a regulatory overhaul scheme. *See generally* U.S. DEP'T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf [hereinafter TREASURY BLUEPRINT] (presenting "a series of 'short-term' and 'intermediate-term' recommendations that could immediately improve and reform the U.S. regulatory structure"). Since then, scores of proposals have come forth, most focusing on improved risk management, increased transparency generally, or structural reforms to the existing regulatory framework. *See, e.g.*, CONG. OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY (2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf [hereinafter COP REPORT]; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009), *available at* http://www.gao.gov/new.items/d09216.pdf (discussing the influential role of less-regulated market participants, including hedge funds and other private equity funds, and proposing reforms that would identify those institutions and products that introduce high levels of systemic risk); THE GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), *available at* http://www.group30.org/pubs/reformreport.pdf (discussing regulation of private investors generally); THE GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008), *available at* http://www.deloitte.com/dtt/cda/doc/content/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf; Press Release, Comm. on Capital Mkt. Regulation, Recommendations for Reorganizing the U.S. Financial Regulatory Structure (Jan. 14, 2009), http://www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf (arguing for reduced regulatory fragmentation); INV. CO. INST., FINANCIAL SERVICES REGULATORY REFORM: DISCUSSION AND RECOMMENDATIONS (2009), *available at* http://www.ici.org/pdf/ppr_09_reg_reform.pdf.

proposals makes apparent, however, that while some would regulate private investors, none would attempt to address directly the problems of shadow bankruptcy described above. Others may propose remedies to certain shadow bankruptcy problems, but they tend to be incomplete.

1. Systemic Proposals

Consider first the United States Treasury's March 2008 "Blueprint" to overhaul the financial system. As the product of the prior administration, it is unlikely in itself to be adopted today. Yet, its focus on regulatory restructuring has been influential in many recent reports. For purposes of this Article, what is interesting about the blueprint is that it says almost nothing about business reorganization. Thus, while former Treasury Secretary Paulson devoted 212 pages to describing an "optimal" regulatory scheme,[256] the word "bankruptcy" appears only three times, and never with the thought that it would be part of the "major" overhaul envisioned.[257]

Similarly, more recent proposals from the Treasury Department might tangentially influence shadow bankruptcy, but would not regulate it directly.[258] For example, Treasury Secretary Tim Geithner's March 2009 proposal would, among other things, require the registration of all private investors "whose assets under management exceed a certain threshold."[259] They would then be subject to "disclosure requirements and regulatory reporting requirements."[260] As with many other proposals, the principal concern here is with systemic threats. Thus, private investors would be required to report "on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability."[261]

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[256] TREASURY BLUEPRINT, *supra* note 255, at 13-14, 137-82 (concluding that an objectives-based regulatory structure would be optimal for the future).

[257] *See id.* It does mention "business reorganization" – once and rather oddly – in the context of discussing general attributes of bank regulation:

> For instance, some of the most important regulatory principles serving the goal of an efficient and competitive banking system include limitations on banks' insider lending practices, oversight of business reorganizations and changes in control of banks, restrictions on banks' ability to "tie" their services to non-banking products, and nationwide deposit caps. These provisions aim at ensuring wide availability of credit by preventing banks from abusing their substantial economic power.

Id. at 42.

[258] *See* Press Release, U.S. Dep't of the Treasury, Treasury Outlines Framework for Regulatory Reform: Provides New Rules of the Road, Focuses First on Containing Systemic Risk (Mar. 26, 2009), *available at* http://www.treasury.gov/press/releases/tg72.htm (resolving to minimize a failing financial institution's impact on the financial system, rather than addressing the creditors' rights in bankruptcy).

[259] *Id.*

[260] *Id.*

[261] *Id.*

Secretary Geithner also hopes to rein in the over-the-counter derivatives market. Under this proposal, "the government will regulate the markets for credit default swaps and over-the-counter derivatives for the first time."[262] Among other things, this reform would "force all standardized OTC derivative contracts to be cleared through appropriately designed central counterparties" which would be subject to "comprehensive settlement systems supervision and oversight."[263]

Of the major reports that consider new financial regulation, the one that appears to be most attuned to problems of shadow bankruptcy was that produced by the Congressional Oversight Panel ("COP"). COP was created in connection with the 2008 Emergency Economic Stabilization Act, which, among other things, created a $700 billion fund to purchase troubled assets or invest in financial services (or other) firms.[264] The COP report focuses heavily on problems of transparency created by private investors, and argues that greater disclosure is a key to regulatory reform.[265] Although the COP Report does not directly address the problems of shadow bankruptcy described in this Article, it does contain an extended discussion of, and appreciation for, the role that reorganization processes can and should play in the financial system, arguing in particular that receivership and liquidation mechanisms that currently apply to banks should also apply to nonbank financial institutions.[266]

That these proposals do not effectively address shadow bankruptcy is not entirely surprising. While restructuring troubled businesses is obviously an important piece of the current economic puzzle, the many reports published thus far recognize that today's crisis is the product of much broader and deeper regulatory failings. Bankruptcy, by contrast, is just one piece of the puzzle, and perhaps not a comparatively large one.[267] Moreover, as described in the next sub-Part, solutions are possible, but prove challenging.

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[262] *Id.*

[263] *Id.*

[264] *See* Emergency Economic Stabilization Act, 12 U.S.C.A. §§ 5201, 5233 (West 2008) (creating COP); *id.* § 5211 (establishing the Troubled Asset Relief Program); COP REPORT, *supra* note 255, at 55.

[265] COP REPORT, s*upra* note 255, at 29 (recommending "new measures to improve transparency in the shadow financial system" because lack of transparency "contributed to failures of risk management and difficulty in pricing assets and assessing the health of financial institutions").

[266] *Id.* at 24.

[267] As one system participant said to me: "I think it would be great if the [government created] a public place with bids and asks for these sorts of things. But I think the government has other things on its plate. I am not sure it has the attention span for this." Interview with Other System Participant No. 2, *supra* note 33.

2. Bankruptcy-Specific Proposals

The various problems identified in this Article have not, of course, gone unnoticed. Rather, proposals that do respond to shadow bankruptcy are piecemeal and partial. They would tinker with certain existing mechanisms, such as amending Bankruptcy Rules 2019 or 3001(e) or Securities Exchange Act Rule 13d-1. But none consider the system more broadly, and so none can fully shed light on the shadow system.

Judge Gerber, for example, would expand Bankruptcy Rule 2019 in substance, but would eliminate the requirement that the purchase price be disclosed.[268] He would require disclosure of short or economically similar positions, as well as "any position or interest that would result in a financial gain upon the failure or delay of the chapter 11 case, or upon decreased recoveries by any other constituency."[269] Similarly, others have advocated amending Rule 3001(e) to require disclosure of the purchase and sale price of claims[270] or to impose an ownership disclosure rule akin to Rule 13d-1 in bankruptcy that would try to reach the real motives of the players, rather than their simple, stated claims.[271]

These are all laudable proposals. At least as currently articulated, however, they each have their limitations. In the case of Judge Gerber's proposal, the stopping point is not clear. Almost every position in a case could – and likely would – enjoy "financial gain . . . upon decreased recoveries by any other constituency."[272] Bankruptcy is a zero-sum game – indeed, sometimes a negative-sum game – and so it will also be intensely distributive. If the bankruptcy pie is not big enough to feed all creditors, it will be very tempting to eat off someone else's plate. Proposals to expand Rules 2019 or 3001 will matter only if a bankruptcy case is commenced, which is hardly guaranteed. Changes to Rule 13d-1, which could apply prior to bankruptcy are likely to be equally ineffective: the rule does not (and perhaps cannot) require disclosure of derivative rights (short sale positions) and, in any case, would only address reporting companies under the 1934 Act.

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[268] *See* Gerber Letter, *supra* note 139, at 10.

[269] *Id.* Judge Gerber offers seven proposals in all. *Id.* at 10-11.

[270] W. Andrew P. Logan III, Note, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 500-03 (1994) (arguing that requiring disclosure would promote market efficiency by providing more information to buyers and sellers of claims).

[271] *See* Coco, *supra* note 16, at 651 ("The proposed rule mandating ownership disclosure when a party acquires one half in number or one third in amount of claims or interests would occur toward the end of the Chapter 11 case, when the confirmation [process] separates the parties into classes.").

[272] Gerber Letter, *supra* note 139, at 10 (recommending that Rule 2019 require, in addition, "disclosure of any position or interest that would result in a financial gain upon the failure or delay of the chapter 11 case"). Nor is it clear whether these changes would apply to all stakeholders, or only to those who, as under current law, represent other stakeholders.

The problem is not that these proposals ignore shadow bankruptcy per se, but that they are unlikely to result in solutions that address its unique problems. None would alter private investors' incentives to litigate in ways that are wasteful and costly to bankruptcy estates; none would require real-time disclosure of positions (single or multiple) affecting distressed firms; none would forbid especially destructive combinations of holdings, such as senior debt coupled with equity shorts; none would create transparency before and during bankruptcy. All would, in short, leave gaps in which shadow bankruptcy would continue to thrive.

B. *Solutions*

Broadly speaking, we can regulate private ordering in three ways: through forced disclosure, substantive controls, or both. Much (but not all) of the logic of the federal securities law system is premised on the first. Other systems – in particular commercial banking – are premised largely on the second. As described in Part I, to a significant extent, Congress has preferred disclosure over substantive control of the private parties negotiating the restructuring of troubled firms. While the information-forcing aspects of reorganization built into Chapter 11 have their roots in the work of William O. Douglas, it is important to remember that he had a strong appetite for government interference in this process, including the mandatory removal of management of large firms.[273] Thus, although there have been experiments with substantive control of reorganization, they have generally not endured.

1. Positional Disclosure

To call the problem "shadow bankruptcy" is to imply that disclosure is a cure. This Part describes a new kind of disclosure system, one that would address many problems of shadow bankruptcy while leaving market actors free to maximize value for themselves and – one hopes – the other stakeholders of troubled firms. It develops a system of "positional disclosure." Positional disclosure would be real-time disclosure (via online platforms) of the material positions an investor holds, individually or in concert with other private investors, against or affecting a distressed firm, whether the positions are direct or derivative rights. This sub-Part describes how positional disclosure would

[273] *See* 1 DOUGLAS REPORT, *supra* note 85, at 897 ("[C]ontrol of reorganizations should be denied to persons whose sole claim is derived from a position in the management of the corporation or from banking associations with it."). He appears to have tempered this view considerably by the mid-1950s. Douglas's opinion in *General Stores Corp. v. Shlensky*, 350 U.S. 462 (1956), stunned many by holding that even publicly held companies could file for relief under Chapter XI, thereby leaving management in possession. *Id.* at 466 ("A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company. And there is no reason we can see why c. XI may not serve that end. The essential difference is not between the small company and the large company but between the needs to be served.").

work, and why it is superior to any likely alternatives for most shadow bankruptcy problems.

a. *Triggering Events and Scope*

The basic, and difficult, questions facing anyone who wants to require greater disclosure in the reorganization system include: who must make disclosure, when, and what must they disclose? To answer simply: disclosure here should be triggered by, and reflect, the confluence of two sets of events: one involving a target firm's financial condition and the other involving the materiality of the positions against (or affecting) it.

Firm Distress. Positional disclosure would be required only as to investments in, or affecting, distressed firms. But what is a "distressed" firm? As noted above, it cannot simply be a firm in Chapter 11, because many troubled firms never file and, in any event, important trading may well occur before a case is commenced.[274] It may also be tempting to say a firm is distressed only if it were "insolvent" in some way. This, however, is a notoriously manipulable term.[275] Insolvency can thus be extremely difficult to determine ex ante.

A more certain way to determine distress is the presence of a default under a bank loan or bond indenture exceeding some reasonable notional amount, say five million dollars. Thus, a firm would be distressed if it had violated a covenant under a material lending agreement to which it was a party, but not if it simply breached a photocopier lease. This method of defining distress has precedent in the finance literature for many of the reasons it would be useful here: it is taken to be evidence that a firm's creditors are likely to be taking over and, in any event, negotiating with management and perhaps amongst themselves over a resolution of the firm's troubles.[276] These defaults are usually important enough that they are reported under the Securities Exchange Act of 1934; for private companies, services such as Standard & Poor's may provide information of this sort.

Materiality – Control. In addition to defining distress, we need a way to decide whether a position is "material." Not every holder of every claim against a troubled firm should have to make disclosure. Rather, a holder must acquire a "material" investment in or affecting the distressed firm.

Under the federal securities regulation framework, "materiality" is central to any claim of fraud. Plaintiffs seeking to recover for fraud must prove by a

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[274] *See supra* Part I.C; *supra* Part II.A.2.

[275] *See generally* Lipson, *supra* note 78 (discussing the difficulty of determining fiduciary duties of corporate directors of distressed companies to creditors and shareholders where insolvency is itself hard to define).

[276] As noted above, Nini et al. observe covenant violations because they are "a point where we know that negotiations are taking place between the lenders and the borrower. Immediate changes in management that follow these negotiations can provide large sample evidence of creditor influence on corporate governance." Nini et al., *supra* note 24, at 10.

substantial likelihood that a questionable statement or omission involves "material" facts.[277] A statement or omission is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[278] Materiality "depends on the significance the reasonable investor would place on the withheld or misrepresented information."[279] This definition of materiality exists as a check on securities fraud suits.

In the case of shadow bankruptcy, materiality would address a more basic factual question: what positions held by an investor have the ability to influence materially the outcome of a restructuring? Materiality in this context simply means control. Determining control, in turn, requires a three-step analysis.

As a first step, materiality for direct claims – meaning bonds, loans, equity interests, and so forth – could be determined by reference to either the voting rules under the governing instruments or the voting rules under Chapter 11. As discussed above, a private investor may have the ability under a loan agreement or bond indenture to withhold a vote to restructure a company before bankruptcy, and thus extract rents from other investors. Having this amount of debt would be "material" because it would enable the investor to prevent a restructuring, and so should be disclosed. Of course, a private investor may also hold enough of a loan or tranche of debt that it can commence enforcement proceedings or amend the governing contract by itself. These, too, would be material positions.

In the absence of contract provisions that delineate a material (control) position, Chapter 11's voting rules may provide guidance. A Chapter 11 plan cannot be confirmed unless supported by a sufficient amount and number of creditors and equityholders.[280] While a fair amount of gamesmanship can occur in this electoral process, the basic idea is that stakeholders vote by class and only holders of substantially similar claims (or interests) can be classified together.[281] Thus, at least in theory, holders of unsecured claims should be in a

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[277] *See* LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, 4 SECURITIES REGULATION 617-18 (4th ed. 2006); Yvonne Ching Ling Lee, *The Elusive Concept of "Materiality" Under U.S. Federal Securities Laws*, 40 WILLAMETTE L. REV. 661, 663 (2004) (describing close relationship between SEC materiality standard and Supreme Court case law).

[278] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (adopting rule for 14a-9 proxy actions); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (extending *TSC Industries* by "expressly adopt[ing] the *TSC Industries* standard of materiality for the 10(b) and Rule 10b-5 context").

[279] *Basic Inc.*, 485 U.S. at 240. *See generally* David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 540-41 (2006) (summarizing the law of materiality).

[280] *See supra* notes 46-50 (discussing statutory committees).

[281] 11 U.S.C. § 1122 (2006). The only limitation on the creation of classes is that a plan proponent may not do so to gerrymander a vote. *In re* Save Our Springs Alliance, Inc., 388 B.R. 202, 234 (Bankr. W.D. Tex. 2008) ("In examining the parameters of that general rule

single class together, holders of common shares should be in their own class, and so forth.

A class of claims is deemed to have approved a plan if at least two-thirds in amount and greater than one-half in number have approved the plan (only the former metric applies to shares).[282] If a sufficient number of classes approve a plan, it can be confirmed. Classes of claims that are not "impaired" – meaning, the legal rights of the holder are unaffected by bankruptcy[283] – are conclusively presumed to have supported the plan,[284] and classes that receive nothing are deemed to have rejected it.[285]

For our purposes, the important determination will necessarily be hypothetical, but would treat as material the acquisition of more than one-third in amount or one-half in number of any class of claims or interests. The challenge here, of course, will be that an investor could not know ex ante how claims or interests will be classified under a plan, and so cannot fully know the denominator.

Nevertheless, in many cases involving private investors, the calculation should be fairly clear. A single bank loan that has a first-priority lien on all of a debtor's assets will be a single class no matter how many parts of it have been sold. Debt or equity securities issued under a single indenture should be presumed to be a single class for this purpose (and so holding more than one-third in amount or one-half in number would presumptively create the power to block a class vote on a Chapter 11 plan). Trade claims would be more complicated, but the pre-bankruptcy activity involving these claims appears (at least anecdotally) to be less influential than trading in loans and bonds.

A second step of the analysis would require investors to determine whether they were acting in concert with other private investors. As explained above, ad hoc committees have created problems in Chapter 11 cases such as *Lehman*

[of § 1122], the Court articulated 'the one clear rule that emerges from otherwise muddied caselaw on § 1122 claims classifications: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.'" (quoting Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1279 (5th Cir. 1991))); *see also In re* Woodbrook Assocs., 19 F.3d 312, 318 (7th Cir. 1994) (recognizing the "one clear rule" as articulated in *Greystone* and applying this rule to the facts in *Woodbrook*); Lumber Exch. Bldg. Ltd. P'ship v. Mut. Life Ins. Co. of N.Y. (*In re* Lumber Exch. Bldg. Ltd. P'ship), 968 F.2d 647, 649 (8th Cir. 1992); Steelcase, Inc. v. Johnston (*In re* Johnston), 140 B.R. 526, 529 (B.A.P. 9th Cir. 1992).

[282] 11 U.S.C. § 1126(c)-(d) (indicating under (c) that a class of *claims* must have "at least two-thirds in amount and more than one-half in number of the allowed claims of such class" to accept a plan, yet under (d) a class of *interests* "has accepted a plan if such plan has been accepted by holders of . . . at least two-thirds in amount of the allowed interests of such class").

[283] *Id.* § 1124.

[284] *Id.* § 1126(f).

[285] *Id.* § 1126(g).

Brothers, and we can expect such groups to form before bankruptcy.[286] An investor may, individually, hold an amount of debt insufficient to influence a reorganization under applicable voting rules. But, if that investor acts in concert with other investors, they could collectively affect the outcome. Materiality should be determined by reference to the real control that a private investor (or group of investors) could exert in the restructuring process. This will be a difficult determination in some cases, but federal securities law already requires equity investors to disclose aggregate positions in change of control transactions, so it is certainly possible to make this determination in most cases.

A third step would require investors to determine whether they hold positions *affecting* the debtor. The goal here is to require disclosure of indirect interests, in particular rights under derivative instruments.[287] There is, as discussed above, anecdotal evidence that combinations of direct and derivative claims can create perverse incentives.[288] But, up to a certain point, many combinations may well be legitimate trading strategies. A blanket prohibition on holding multiple positions would be unwise and probably unenforceable.

Rather, an investor would simply have to disclose all material positions affecting a distressed firm. Unlike direct claims, however, where materiality would be triggered by exceeding some threshold amount, all derivative rights should be presumed material. This is because they appear to have the ability to distort incentives in ways that increase transaction costs for other investors and may even invite perverse, value-destroying behavior. Thus, any credit derivative affecting a distressed firm should be disclosed, regardless of the notional amount of the reference credit.

b. *Logistics – Real-Time Online Disclosure*

Any positional disclosure system involving distressed firms should maximize the use of existing and emerging information technologies. Real-time online disclosure would require private investors to disclose all of their material positions against or affecting a distressed firm in an electronic registry. As discussed above, services such as SecondMarket, Markit, Creditex

[286] *See supra* notes 123-53, 179 and accompanying text.

[287] The definition of a "derivative" for this purpose would build on that created by the SEC: "[A]ny option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security." General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.16a-1(c) (2009). It would have to be modified to account for, among other things, credit derivatives. While disclosure would be appropriate with respect to credit derivatives, it would not, as discussed below, address the destructive effect of equity derivatives (short sales). In certain cases, those should be prohibited outright as against a distressed firm. *See infra* Part III.B.2.a (proposing substantive limit on enforceability of equity derivatives).

[288] *See supra* Part II.B.

and LSTA all provide somewhat limited examples of how this might look.[289] Another approach might involve the SEC's electronic document filing system[290] (EDGAR) – soon to be replaced by the more user-friendly IDEA system[291] – and its many private conduits.[292]

At least part of the problem of shadow bankruptcy derives from the fact that the information system that exists is outmoded.[293] To the extent private investors must disclose anything, it will usually be in the event of a Chapter 11 filing, and then only as required by Bankruptcy Rules 2019 and 3001. These are both problematic rules, however. Private investors fight over their application and effect. Moreover, these disclosures are via dockets, which can be enormous, cumbersome, and difficult to search.[294] Dockets do not exist to facilitate fair and efficient trading; they are (supposed to be) logs of activity in or affecting a judicial proceeding.

Disclosure through online portals should fix much of this. It should reduce or eliminate fights about the application of Rules 2019 and 3001 and streamline case management, because disclosure would be required before a case (if distress occurs) and would continue during a case (if commenced). One would expect these portals to have a variety of data functions, as current data portals such as SecondMarket, Creditex, and Markit currently offer on a more limited basis. This could reduce both litigation and transaction costs and improve transparency.

A more difficult logistical question will involve cost. Firms like Creditex, Markit, and Standard & Poor's offer proprietary and limited coverage of certain aspects of the shadow system.[295] But these are not charities. Who will pay to expand these systems, and how should their services be metered? In the case of a securities issuance, the issuer generally bears the costs of registration or becoming a reporting company. But companies in financial distress are, by definition, not likely to be in a position to pay to participate in the sort of information system described here. Moreover, it would not necessarily benefit

[289] *See supra* notes 168-73 and accompanying text.

[290] *See* SEC. & EXCH. COMM'N, EDGAR FILER MANUAL (VOL. II) (2009), http://www.sec.gov/info/edgar/edgarfm-vol2-v12.pdf.

[291] According to the Securities and Exchange Commission: "IDEA, short for Interactive Data Electronic Applications . . . [will give investors] better and more up-to-date financial disclosure in a form they can readily use." Press Release No. 2008-179, Sec. & Exch. Comm'n, SEC Announces Successor to EDGAR Database: "IDEA" Will Make Company and Fund Information Interactive (Aug. 19, 2008), *available at* http://www.sec.gov/news/press/2008/2008-179.htm.

[292] *See, e.g.*, Morningstar Document Research (formerly 10-K Wizard), http://www.10kwizard.com (last visited Sep. 7, 2009).

[293] *See supra* notes 28-80 and accompanying text.

[294] A study of the dockets of 576 of the largest Chapter 11 cases filed from 1991 through June 2007 showed an average of 4336 docket entries. *See* Lipson, *Understanding Failure*, *supra* note 54, at 38.

[295] *See supra* notes 168-73 and accompanying text.

the debtor directly: such a system would exist chiefly to level the playing field among the debtor's stakeholders, in order to prevent the costly, value-destroying gamesmanship that has become increasingly common.

The principal beneficiaries of the existing system are private investors. They have already begun to create and subscribe to information systems to facilitate some distress trading. It would seem likely that they are in the best position to bear the costs of compliance with a real-time disclosure regime, although they may object to doing so on the expanded basis proposed here. Broader participation in the system, as contemplated here, may reduce costs for any given private investor.

c. *Enforcement*

Yet another question will involve enforcement. We can take both positive and negative approaches to enforcement. Positive enforcement would include affirmative causes of action that regulators or private individuals might assert against a private investor who failed to disclose a material position. Negative enforcement would render unenforceable material positions that should have been disclosed, but were not.

Both might be appropriate, but positive enforcement creates more problems. Regulatory enforcement is only as good as the regulators. As we have seen, the SEC has not been the most effective force in the financial system, although that office would be the logical regulator here. Private enforcement (i.e., civil suit by individuals) may not be an especially popular approach, politically speaking. The Sarbanes-Oxley Act, for example, appears to create no private cause of action.[296] Fears about excessive litigation costs and strike suits may discourage Congress from creating private civil liability here.

Negative enforcement mechanisms may thus be superior: failure to make required disclosure would create an affirmative defense that a debtor, or its bankruptcy trustee, could assert against a private investor. So, for example, if a private equity fund acquired a material position in a distressed firm's debt or made a material loan to a distressed firm, it would have to disclose this as described above. If it failed to do so, and the debtor defaulted, the debtor would defend by pleading that the private investor was required, but failed, to make positional disclosure and so failed to satisfy a condition to making the rights enforceable. The private investor that fails to make positional disclosure would, on this model, risk rendering the investment valueless.

If this sounds far-fetched, it is not. It is similar in effect to Article 9 of the Uniform Commercial Code, which generally requires a lender to make a notice filing in order to "perfect" its security interest in a debtor's property. Strictly

[296] *See, e.g.*, Diaz v. Davis (*In re* Digimark Corp. Derivative Litig.), 549 F.3d 1223, 1232 (9th Cir. 2008) ("Section 304 [of the Sarbanes Oxley Act] focuses on the 'person regulated' rather than the 'individual[] who will ultimately benefit from [the statute's] protection,' and thus does not provide a private right of action." (quoting Alexander v. Sandoval, 532 U.S. 275, 289 (2001)).

speaking, of course, Article 9 does not require notice-filing to make a security interest *enforceable*; enforceability and perfection are separate determinations.[297] Given the priority structure of Article 9 and the way the Bankruptcy Code actually treats unperfected security interests, however, an unperfected security interest is of little value.[298] Thus, compliance with an expanded notice filing system could easily become a condition to the enforceability of positions acquired against or affecting distressed firms.

d. *The Policy Goal*

Questions of scope and enforcement raise questions about the ultimate policy goal of disclosure. To the extent that federal securities law supplies the model, the question is whether disclosure is an end in itself, or is instead a means to some other end. While there are legitimate debates about the extent to which securities law should force market participants to disclose information, the "primary policy" of U.S. securities law has been "the remediation of information asymmetries"[299] through a mandatory disclosure system that "compels business corporations and other securities issuers to disseminate detailed, generally issuer-specific information when selling new

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[297] A security interest is enforceable under the U.C.C. when it has "attached" meaning, among other things, that the debtor has rights in the property, has executed a security agreement describing the property, and has received value (e.g., a loan). U.C.C. § 9-203 (2005). "Perfection" can be accomplished in a variety of ways, usually by notice filing. *See id.* §§ 9-308, 9-310.

[298] As a practical matter, an unperfected security interest has little value because most other claimants – including a bankruptcy trustee – will have priority greater than or equal to a creditor holding such an interest. *See id.* §§ 9-317, 9-322. In bankruptcy, the trustee (which includes the debtor in possession) has the "strong arm" power to avoid unperfected security interests for the benefit of the estate. 11 U.S.C. § 544 (2006).

One might ask why the Article 9 system does not already solve the problems I have identified. The answer, of course, is that it applies only to a single type of transaction – a loan secured by personal property – and fails to include the richer sorts of information discussed above, in particular about other positions the secured creditor might hold. Moreover, recent amendments to Article 9 have, in my opinion, eroded the effectiveness of this notice filing system. *See generally* Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421 (2005). That, however, is a different problem.

[299] Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH U. L.Q. 449, 450 (2002); *see also* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 422 (2003) ("[B]y mandating disclosure[, federal securities law] enables informed investor decision making, boosts investor confidence, and reduces agency costs."). *See generally* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 226-77 (3d ed. 1989) (providing a "Telescopic Preview of the SEC Statutes" beginning with the Securities Exchange Act of 1934).

securities to the public and requires specified issuers to file annual and other periodic reports containing similar information."[300]

Some – including Justice Douglas – believed that disclosure was an end in itself, meant to deter market misconduct.[301] The information was, in his eyes, less important than the fact that it had to be disclosed. Others offer a more nuanced view, focusing on the demand-side for information. For example, former law professor and current SEC Commissioner Troy Paredes has stated:

> Investors, analysts, and others need to use the disclosed information effectively for the disclosures to be useful. In other words, for our mandatory disclosure system to work, securities market participants must not only have access to information, but must be able to search and process in an effective manner the information that is disclosed.[302]

Given the sophistication of private investors, it seems more appropriate to focus on the real ways in which they are likely to use information, rather than bluntly require them to make massive, but potentially meaningless, disclosures.[303] Positional disclosure advances this policy. It provides information that matters to system participants – positions likely to affect outcomes – in a comparatively efficient manner. It would not require disclosure of the price paid, or proprietary trading strategies. It would simply require those with material rights against the company to reveal those rights in a way that was meaningful to those likely thereby affected.

e. *Other Issues*

Positional disclosure sounds simple, but obviously creates many questions, more than can be answered in this Article. This sub-Part has addressed some of the basic questions. Others include the following:

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[300] Seligman, *supra* note 299, at 450. The federal securities laws include the Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (2006) (regulating the registration of securities); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (regulating secondary markets in securities); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (regulating debt securities); the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78*lll* (requiring securities brokers and dealers to contribute to a fund which protects investors against a brokers inability to meet its financial obligations to its customers); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (regulating mutual funds and similar investments); and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (regulating certain investment advisors).

[301] *See, e.g.*, 1 DOUGLAS REPORT, *supra* note 85, at 693-94 (finding secrecy "inimical to the interests of investors and creditors as a whole").

[302] Paredes, *supra* note 299, at 432.

[303] *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 283 (2000) (proposing to "shift the focus of regulation directly onto investors and away from other securities market participants" in order to "allow regulators to provide protections tailored to the informational needs of specific segments of investors").

Legacy holders. Should those who held material positions against or affecting a debtor before distress have to disclose those holdings once the debtor is in financial trouble? Or should this form of disclosure apply only to those who acquire a position during distress?

Post-violation trading. What if a private investor fails to make disclosure but then trades away its position to another investor who does disclose? Should the purchaser acquire its position subject to whatever defects were created by virtue of the first investor's failure? Or should there be something like a "holder in due course" doctrine here?

Aggregation rules. It is easy enough to say that a materiality determination should reflect the real control that private investors have, whether they act individually or in concert with others. But deciding how to aggregate positions can be tricky. What if different divisions of a single investment bank individually hold immaterial amounts of a company's debt, but on a collective basis would be deemed to hold a material position? Would it matter whether the divisions actually acted in concert? Would a firewall make a difference?

The role of agents. Loan participations are typically managed by agent banks. The agent may effectively have significant influence in the reorganization process because the debtor will deal directly with the agent, who acts on behalf of all lenders under the facility. What sort of disclosure, if any, should agents make? Does it matter if the agent holds less than a material amount of debt?

These are only a few of the questions a fully developed system of positional disclosure would raise. Thus, as discussed in the next sub-Part, further study (as well as certain substantive controls) will also be important in addressing shadow bankruptcy.

2. Control and Further Study

Disclosure may not cure all ills caused by shadow bankruptcy. While it appears to be a promising first step, we also know from studies like Douglas's that disclosure alone may be necessary but not sufficient to correct systemic abuses. New substantive controls may also be required. This was Douglas's view in the 1930s. Disclosure alone would be inadequate, he reasoned, because disorganized investors faced what was essentially a coercive tender offer.[304] Thus, Douglas proposed two sets of modifications to the reorganization system:

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[304] *See* 1 DOUGLAS REPORT, *supra* note 85, at 905 ("[They] are faced with a 'Hobson's choice' of not depositing . . . – with the result that they get little or nothing – or going along with the committee and paying the committee such toll as the committee may dictate.").

As Douglas explained:

> Mere disclosure in these situations is hardly sufficient for the protection of investors. On default, investors, unorganized and largely helpless to help themselves, have little freedom of choice but to go along with those who, self-constituted and self-appointed, announce themselves as their protectors. Disclosure of the facts regarding these protectors is of little practical utility to investors. Prospective purchasers of securities

> In the first place, methods must be designed to bring within a system of regulation and control committees presently exempt and immune from any supervision. In the second place, the basis for regulation must be broadened so as to require not only the disclosure of relevant facts but also to eliminate material conflicts of interest and unconscionable practices which may persist in spite of full disclosure.[305]

Today, while one observer noted that bankruptcy sales "have become a means by which you can have bankruptcy-type hostile takeovers,"[306] it is less obvious that individual investors are gulled by shadow bankruptcy. To be sure, it may create social costs in the form of lost jobs, depressed asset values, and needless litigation. But shadow bankruptcy does not appear to prey on individual investors. So, why might any substantive control be in order?

a. *Equity Short Sales – A "Downtick Rule"?*

As noted above, perhaps the most destructive tactic in shadow bankruptcy is coupling an over-collateralized senior position with an equity short. This (or a similar) combination should give the holder an incentive to see the debtor liquidated, since it will collect the most on both positions: fully collateralized, it will be paid 100% on its secured claim, and, by virtue of a liquidation, the equity will be cancelled and the short should pay.

Short-selling is a complicated business, and is generally thought to perform important signaling functions. If investors short the stock of a solvent firm, they are telling other investors that they bet the stock will decline in value. But its destructive capacities have also long been understood. Thus, from 1938 until 2007, the SEC imposed the so-called "uptick" rule, which permitted the selling of borrowed shares only after an increase (or "uptick") in the share price.[307] This placed an important limit on the destructive capacity of a short, and generally reduced market volatility – until its repeal. Today, there is evidence that "the repeal of the uptick rule makes markets highly vulnerable to manipulation resulting in severe under valuations and market instability."[308]

> have, by and large, a real choice – to buy or not as their judgment dictates. To them disclosure of the pertinent facts surrounding the offering is of great value. But in case of these default situations the case is quite different. An investor with an investment in an insolvent company holds the securities; his investment has already been made; his choice is drastically limited. It will be of small comfort to know that those who control his destiny are incompetent or faithless fiduciaries.

Id. at 904.

[305] *Id.* at 905. Douglas went on to recommend "[t]hat standards of full disclosure, such as those set forth in the Securities Act of 1933 in regard to the issuance of securities, be imposed upon the solicitation of all deposits and proxies in connection with reorganizations and that present exemptions from such control be restricted." *Id.* at 907.

[306] Interview with Lawyer No. 4, *supra* note 161.

[307] Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348-59 (July 3, 2007).

[308] Yaneer Bar-Yam, New England Complex Systems Institute, Market Instability and the Uptick Rule (Oct. 17, 2008), http://www.necsi.edu/headlines/uptick.html; *see also* DION

While it is not clear whether the SEC will reinstate the uptick rule, it would appear that the value-destroying power of short sales may be as great, or greater, in the case of shadow bankruptcy. If equity short sales signal a lack of confidence, that would be especially destructive when involving a distressed firm, where investors already have good reason to doubt the company's future. Disclosure of equity short positions purchased during the reference firm's distress might actually do more harm than good.

Thus, it may be appropriate to limit outright short sales transactions of equity once a firm has become distressed, as defined above (i.e., a financial covenant has been breached). Any such transaction entered into while a firm was in distress would be void and unenforceable. This "downtick" rule would deter private investors from taking multiple positions that create strong incentives to see the debtor's complete failure. So long as the debtor (the reference entity) is in distress, short sales of equity should not be permitted or enforceable.

This may be a controversial proposal. Yet, system participants interviewed for this Article claimed that they believed this sort of activity to be rare. "Who would sell a[n equity] short against Circuit City within three weeks of its bankruptcy?" one asked rhetorically.[309] "No one. And if it's much before that, who's to say it's not a legitimate investment?"[310]

If this person is correct – and these shorts are rare – then there should be no objections. At most, this would be a prophylactic protection against a theoretical problem that may exist, but can be neither proved nor denied.

b. *Further Study*

That we suspect, but do not know, how much short selling occurs in this context is one of several reasons why further study is appropriate. Today's financial and securities regulatory scheme grew out of a series of landmark reports from the late 1920s through the 1930s on the banking, securities, and bankruptcy systems.[311] That architecture served the needs of the United States

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HARMON & YANEER BAR-YAM, TECHNICAL REPORT ON SEC UPTICK REPEAL PILOT, NECSI Technical Report 2008-11 (Nov. 2008), http://www.necsi.edu/research/UptickTechReport.pdf (analyzing effects of the repeal of the uptick rule on the "rapid decline of value of individual corporations and the stock market as a whole in 2008").

[309] Interview with Lawyer No. 4, *supra* note 161.

[310] *Id.*

[311] For bankruptcy-related reports, see sources cited *infra* note 312. For reports relating to the Banking Act of 1933, see, for example, HENRY STEAGALL, HOUSE COMM. ON BANKING & CURRENCY, BANKING ACT, 1933, H.R. REP. NO. 73-254 (1933) (Conf. Rep.), *reprinted in* 2 BANKING ACTS 1913-1956 LEGISLATIVE HISTORY (COVINGTON & BURLINGTON comp. 1956) [hereinafter BANKING HISTORY]; HENRY STEAGALL, HOUSE COMM. ON BANKING & CURRENCY, BANKING ACT OF 1933, H.R. REP. NO. 73-150 (1933), *reprinted in* 2 BANKING HISTORY, *supra*; CARTER GLASS, SENATE COMM. ON BANKING & CURRENCY, OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS, S. REP. No. 73-77 (1933), *reprinted in* 2 BANKING HISTORY, *supra*; CARTER GLASS, SENATE COMM. ON

capital markets remarkably well for several generations. Yet, part of the larger point of this paper is that transactional technologies have now outrun that system. In order to determine how to restructure the regulatory framework as it applies to distressed firms, we would first do well to know what that framework is supposed to be regulating.

In the case of corporate reorganization, there have been a half-dozen major system studies over the years, the most recent of which was published by the National Bankruptcy Review Commission in 1997.[312] While these reports made significant contributions to our understanding of the system at their respective times, they could not have anticipated the profound changes that have occurred since. It is thus no surprise that these reports did not address the threats to transparency created by the shadow bankruptcy system.

To learn how to study the system effectively, we should look to Douglas's report on the reorganization system in the 1930s, which has two important

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BANKING & CURRENCY, OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS, S. REP. NO. 72-584 (1932), *reprinted in* 2 BANKING HISTORY, *supra*.

For reports related to the Securities Act of 1933, see, for example, FEDERAL SECURITIES ACT, HEARING ON H.R. 4314 BEFORE THE H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 73d Cong. (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar comps., 2001) [hereinafter SECURITIES HISTORY]; DUNCAN FLETCHER, SENATE COMM. ON BANKING & CURRENCY, REGULATION OF SECURITIES, S. REP. NO. 73-47 (1933), *reprinted in* 2 SECURITIES HISTORY, *supra*; FRANKLIN D. ROOSEVELT, A RECOMMENDATION TO THE CONGRESS FOR FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. DOC. NO. 73-12 (1933), *reprinted in* 2 SECURITIES HISTORY, *supra*.

For reports regarding the Securities Exchange Act of 1934, see DUNCAN FLETCHER, SENATE COMM. ON BANKING & CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 73-1455 (1934), *reprinted in* 5 SECURITIES HISTORY, *supra*; Letter from Franklin D. Roosevelt, President of the U.S., to the Chairman of the Banking and Currency Comm. of the Senate (Jan. 25, 1934), *reprinted in* 5 SECURITIES HISTORY, *supra*; Letter from William A. Gray, Counsel for the Senate Comm. on Banking and Currency to the Comm. on Banking and Currency (Feb. 18, 1933), *reprinted in* 5 SECURITIES HISTORY, *supra*.

[312] *See* 1 NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 589-95 (1997), *available at* http://govinfo.library.unt.edu/nbrc/report/12chapt1.pdf. Prior studies include: WILLIAM J. DONOVAN, IN THE MATTER OF AN INQUIRY INTO THE ADMINISTRATION OF BANKRUPTS' ESTATES CONDUCTED BEFORE HON. THOMAS D. THACHER, JUDGE OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, PURSUANT TO THE PETITION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, THE NEW YORK COUNTY LAWYER'S ASSOCIATION, AND THE ORDERS OF SAID COURT MADE THEREON, *in* ASS'N OF BAR, CITY OF N.Y. ET AL., *IN RE* ADMINISTRATION OF BANKRUPT ESTATES (1930); THOMAS D. THACHER, SOLICITOR GENERAL, REPORT TO THE PRESIDENT ON THE BANKRUPTCY ACT AND ITS ADMINISTRATION IN THE COURTS OF THE UNITED STATES (1931), *in* S. DOC. NO. 72-65 (1932); DOUGLAS REPORT, *supra* note 85; DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 1, 196-218 (1971); and REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, H.R. DOC. NO. 93-137 (1973).

lessons for anyone studying the shadow system today. First, his analysis was empirical. Being a legal realist, Douglas believed that the best way to make policy was to understand what was going on in the real world.[313] Thus, he developed questionnaires and interviewed system participants about the dynamics of the reorganization process.[314] The data Douglas gathered led him to conclude that the reorganization system was deeply flawed, existing chiefly for the benefit of managers, bankers and lawyers, most of whom were feckless, faithless, or both.[315]

Bankruptcy scholarship since Douglas's time has become a fountainhead of empiricism, producing an enormous body of high quality research.[316] In the famous words of Professors Warren and Westbrook, "a debate without data is a useless excursion, a trip from nowhere to nowhere."[317] Although there have been many articles assessing the merits of various pieces of the shadow

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[313] LAURA KALMAN, LEGAL REALISM AT YALE: 1927-1960, at 9 (1986) (describing William O. Douglas as "devoted to the integration of jurisprudence with a heretofore unstudied fact situation" and whose articles "were replete with condemnations of conceptualism and celebrations of functionalism").

[314] Skeel, *supra* note 83, at 1088 ("Douglas and his principal assistant [and protégé], Abe Fortas . . . developed an extensive questionnaire to give to the bankers and lawyers involved in every significant restructuring case in the country. Fortas and other members of the SEC staff, and occasionally Douglas himself, then crisscrossed the country conducting interviews.").

[315] Concerning bankers and managers, the Douglas Report complained:

> Managements and bankers seek perpetuation of [their] control for the business patronage it commands, which they may take for themselves or allot to others, as they will. They seek, also, to perpetuate that control in order to stifle careful scrutiny of the past history of the corporation. Thereby, claims based on fraud or mismanagement are stilled . . . .

1 DOUGLAS REPORT, *supra* note 85, at 863. Concerning lawyers, Douglas had this to say: "[C]ounsel fees frequently constitute the largest single item on the list of reorganization fees . . . . [T]he bar has been charging all that the traffic will bear. It has forsaken the tradition that its members are officers of the court and should request and expect only modest fees." *Id.* at 867.

[316] Much of this work comes from Professors Lynn LoPucki and Elizabeth Warren and Jay Westbrook. *See, e.g.*, LOPUCKI, *supra* note 141; LoPucki & Doherty, *supra* note 37, at 3 (presenting empirical evidence that "reorganization remains essential for dealing with distressed large public companies"); LoPucki & Whitford, *supra* note 9, at 126; and Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 499 (1999) (surveying "more than 3,000 cases drawn from 23 judicial districts across the nation"). Other recent contributions in this vein include Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2310 (2005); Stephen J. Lubben, *Corporate Reorganization & Professional Fees*, 82 AM. BANKR. L.J. 77, 79 (2008) (studying "the professional fees and expenses awarded by U.S. bankruptcy courts in the reorganizations of American businesses").

[317] Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1258 (1994).

bankruptcy system, none have recognized its larger contours, and few have dug deeply into real practices.[318] To the extent it is quantitative, the existing literature can largely address only revealed preferences by, for example, surveying system participants, or counting certain types of entries on court dockets. This methodology makes inferences about the world based on observed behaviors.[319] This is, of course, useful – when there is behavior to observe.

The problem with shadow bankruptcy is that the whole point is to remain out of sight, unobserved. Thus, conventional quantitative empirical analysis – counting cases or pleadings in dockets – may not be useful. Dockets do not show the instances where private investors have failed to file adequate notice under Rules 2019 or 3001, even though they should have done so. Regressing against price data may tell us that creditors have the capacity to improve share performance, but it cannot tell us the social costs or durability of the improvement. There is no source from which we can observe and tabulate short or derivative positions affecting debtors. There is no registry of motives or incentives, although we know they are both important and increasingly difficult to predict.

Thus, something closer to Douglas's methodology may be appropriate. Questionnaires are likely to be helpful, but more important still will be interviews and perhaps testimony of system participants. It is possible many of these participants may demand anonymity – to remain in the shadows, so to speak. Asking shadow system players to reveal their preferences is a bit like asking for defection: they are more likely to do so if assured of anonymity.[320] Thus, any study of the shadow system should be sensitive to the reality that learning about real practices will be especially challenging where practitioners appear to go to great lengths to conceal their identities and activities.[321]

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[318] One exception, which addresses one part of the problem (claims trading) is Harner, *supra* note 18, at 97-110 (analyzing how self-seeking distressed debt investors "thwart the debtor's attempts to reorganize its business or to maximize returns to all creditors").

[319] *See generally* Lee Epstein & Gary King, *The Rules of Inference*, 69 U. CHI. L. REV. 1 (2002) (applying "the rules of inference used in the natural and social sciences to the special needs, theories, and data in legal scholarship").

[320] As one participant explained to me: "The only way you can get anything on this is by way of deep background. No one will want to talk to you otherwise." Interview with Judge No. 1, *supra* note 196.

[321] We should also remember that Douglas did not exactly approach his work in a scientific manner. Having practiced in the corporate reorganization field, he believed he knew what was wrong, and set out to prove it. His investigations may have been in the real world, but he was looking for something that he already believed existed. Thus, even he acknowledged that the SEC reports that arose from these investigations were more advocacy pieces than impartial discussions. *See* David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1369, n.166 (1998) ("Douglas himself noted that the report was as much a brief supporting the SEC proposals as an objective report." (citing *Hearing Before the Comm. on the Judiciary, House of*

Second, and perhaps more important, Douglas had a uniquely broad understanding of how reorganizations fit into the larger financial system of his time. It is thus not surprising that he believed the SEC should be the administrator of choice for bankruptcy reorganization, and that disclosure rules should mimic those of the federal securities laws. This is doubtless because even before joining the SEC, Douglas had written extensively about the securities system.[322] He understood how the parts fit together, and approached the problems presented by corporate reorganization with that holistic sensibility in mind.[323] His concern for protecting small investors crossed regulatory boundaries – he knew that investors needed protection from sharp practices at underwriting, just as they needed protection from the self-serving antics found in equity receiverships.

The actors and transactions that comprise today's shadow bankruptcy system, like shadow banking, have thrived in the interstices of several regulatory systems. Hedge funds are not mutual funds, and so escape meaningful SEC oversight. Claims trading is clearly a kind of securities market, but one largely outside the regular scrutiny of the SEC or any regulatory body. Credit default swaps are neither securities nor insurance, and so have not been regulated by the SEC, the CFTC, or state insurance regulators.[324]

Fragmentation has long been a key feature of the U.S. regulatory structure, both vertically and horizontally. Thus, since the New Deal, an alphabet soup of agencies has overseen distinct features of the financial system, in part, no doubt, to maintain a diffusion of market and regulatory power. The SEC, the CFTC, the OCC, and the FDIC may all have important roles to play in the

Representatives, on H.R. 6439, 75th Cong. 164 (1937) (statement of William O. Douglas, SEC Chairman))).

[322] *See generally, e.g.*, William O. Douglas & George E. Bates, *Some Effects of the Securities Act upon Investment Banking*, 1 U. CHI. L. REV. 283 (1933); William O. Douglas, *A Functional Approach to the Law of Business Associations*, 23 ILL. L. REV. 673 (1929).

[323] For example, Douglas was part of a group of Yale law professors who introduced a "functional" approach to studying business law, replacing traditional doctrinal categories with "units" that looked holistically at the way firms operate. *See* Joseph V. Kline, Book Review, 41 YALE. L.J. 1255, 1255 (1932) (reviewing WILLIAM O. DOUGLAS & CARROL M. SHANKS, CASES AND MATERIALS ON THE LAW OF CORPORATE REORGANIZATION (1931) and praising it for its breadth).

[324] Indeed, the Commodities Futures Modernization Act of 2000 assured that credit default swaps could not be federally regulated. Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-365 (codified in scattered sections of 7, 11, 12, and 15 U.S.C. (2006)). Among other things, this assured that CDSs would not be treated as "securities" under federal law. 15 U.S.C. § 77b-1. The State of New York – home of many issuers of CDSs – has since announced that it will attempt to regulate the CDS market. *See* State of New York Insurance Department Circular Letter No. 19 (Sept. 22, 2008), *available at* http://www.ins.state.ny.us/circltr/2008/cl08_19.pdf.

regulation of a large Wall Street financial firm.[325] A number of theories attempt to explain this fragmentation, including that it may be in the interests of those subject to regulation to keep the regulators divided, that federalism is a deeply held value, and that it prevents concentrations of excessive power.[326] The Treasury Department's 2008 "Blueprint" to remake the regulatory system is intended in part to address and rationalize this atomized approach to managing the financial system.[327]

While fragmentation of regulation may make sense, fragmentation of understanding does not. To study the causes of the credit crisis without understanding the role that the reorganization system plays in it is to look only at one side of the issue. Yet, so far, that has been the approach.

CONCLUSION – A LIGHTER SHADE OF GRAY

The problems of shadow bankruptcy are, at one level, simply problems of inefficient markets. As one former attorney, who now manages a claims-trading platform, put it:

> I think the world would be infinitely better with greater transparency. But it's a difficult balance. Right now, you have lots of guys who make money because the market is inefficient, there isn't a lot of information out there. Their margins are really high. But what they don't realize is that if there were greater transparency, their margins would go down, but their volume would go up astronomically. But this is the way they do it, it's what they know, and they don't want to change.[328]

Yet, if we embrace transparency as a solution to the larger credit crisis, it is difficult to understand why the reorganization system should be different. Transparency has long been a central aspiration of the system(s) used to

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[325] Consider, for example, traditional commercial banks. Their activities were initially segregated and constrained from those of other financial actors in the National Bank Act of 1863, ch. 58, 12 Stat. 665 (1863), *repealed by* National Bank Act of 1864, and the National Bank Act of 1864, ch. 106, 13 Stat. 99 (1864) (codified as amended in scattered sections of 12 U.S.C.). Congress expanded these constraints through the McFadden Act of 1927, ch. 191, 44 Stat. 1224 (1927), which gave states the authority to limit branching within the state; the Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (1933), which separated commercial and investment banking; and the Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. §§ 1841-50), which limited bank holding companies to activities related to banking and prohibited them from holding more than five percent of the voting stock of a non-banking firm. The Gramm-Leach-Bliley Act, which significantly deregulated banking, was a notable change of direction. *See* Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, and 18 U.S.C.).

[326] *See generally* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (tracing the origin of modern American corporations to technology, economics, and politics to "explain the corporate patterns we observe").

[327] *See* TREASURY BLUEPRINT, *supra* note 255, at 1.

[328] Interview with Other System Participant No. 2, *supra* note 33.

reorganize troubled firms. The infrastructure of the current system, however, is over seventy years old. Transaction technologies and regulatory gaps enable sophisticated and aggressive private investors to outrun that system. While private investment may well bring capital and expertise to troubled firms, it may also result in needless failures at great social cost. Until we shed light on shadow bankruptcy, we will not know which is which.

APPENDIX – METHODOLOGY

I conducted the interviews used in this Article in two phases under an exemption from an institutional review board granted by Temple University. The first phase involved interviews in connection with a related project, a study of the use of examiners in large Chapter 11 cases.[329] In this phase, I conducted structured interviews with bankruptcy lawyers (five), current or former judges (five), former examiners (three), and current or former bankruptcy system administrators (e.g., employees of the United States Trustee program) (six).

The second phase focused specifically on the shadow bankruptcy system, and used rolling interviews with bankruptcy lawyers (five), current bankruptcy judges (two), private investors (three), and other system participants (two). I conducted the interviews on a rolling basis, organized around the following questions:

1. Can you describe changes in the role that private investors play in the reorganization process in the last fifteen years?
2. Describe how the claims trading process works, and its effect on reorganization.
3. Do private investors often take multiple positions against the same debtor?
4. Have you observed short-selling strategies by private investors as against companies in distress or in Chapter 11?
5. What effect, if any, have private investors had on transparency in the Chapter 11 system?

I took contemporaneous notes. They are available on a redacted basis to preserve confidentiality.

[329] *See* Lipson, *supra* note 54.