THE YALE LAW JOURNAL

DOUGLAS G. BAIRD & ROBERT K. RASMUSSEN

Antibankruptcy

ABSTRACT. In large Chapter 11 cases, the prototypical creditor is no longer a small player holding a claim much like everyone else's, but rather a distressed debt professional advancing her own agenda. Secured creditors are more pervasive and enjoy much more control than they had even a decade ago. Moreover, financial innovation has dramatically increased the complexity of each investor's position. As a result of these and other changes, the legal system now faces a challenge that is much like assembling a city block that has been broken up into many parcels. There exists an anticommons problem, a world in which ownership interests are fragmented and conflicting. This is quite at odds with the standard account of Chapter 11—that it solves a tragedy of the commons, the collective action problem that exists when general creditors share numerous dispersed, but otherwise similar, interests. This Article draws on the lessons of cooperative game theory to show how, in combination, these recent changes are toxic. They undermine the coalition formation process that is a foundational assumption of Chapter 11.

AUTHOR. Douglas G. Baird is Harry A. Bigelow Distinguished Service Professor of Law, University of Chicago Law School. Robert K. Rasmussen is Dean and Carl Mason Franklin Chair in Law, Gould School of Law, University of Southern California. We thank John Armour, Donald Bernstein, Joe McCahery, Michael McMahon, and Matthew Stoker for their help, as well as participants at the Penn Institute for Law and Economics Corporate Roundtable, the Annual Meeting of the American Law and Economics Association, and the Vanderbilt Law and Business Conference. The Sarah Scaife Foundation, the Lynde and Harry Bradley Fund, and the John M. Olin Foundation provided research support.



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INTRODUCTION

Chapter 11 is now the last firewall protecting many of the country's largest corporations. It may hold. Over the last decade, and especially during the dot-com meltdown, Chapter 11 has been singularly successful. Long gone is the time when the managers of Eastern Airlines could allow it to wither away in bankruptcy with the creditors standing by helplessly.[1] A new breed of bankruptcy judges, lawyers, and turnaround specialists have come on the scene. They do not get caught up in emotion. They can cast a cold eye, harness markets, and make tough decisions. Billion-dollar corporations (United Airlines, Kmart, Budget Rent A Car) overcame financial distress in Chapter 11 and continued to operate.[2] Even in such fraud-ridden cases as Enron, assets were sensibly redeployed, general creditors received substantial recoveries, and wrongdoers and their fellow travelers were held to account.[3]

There is, however, considerable reason to doubt that reorganization law is up to the challenge it is about to face, at least in the largest cases.[4] The successes of recent years do not readily translate to the current economic

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1. *See* Seth Lubove, *A Bankrupt's Best Friend*, FORBES, Apr. 1, 1991, at 99.

2. For a discussion of United's Chapter 11, see David Armstrong, *United Plan Approved: Reorganization Will Let Airline Emerge from Bankruptcy*, S.F. CHRON., Jan. 21, 2006, at C1. For a discussion of Kmart's, see Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 725-27 (2008). Budget used Chapter 11 to effect a sale. *See* Terry Brennan, *Judge OKs Budget Sale to Cendant*, DAILY DEAL, Nov. 9, 2002, *available at* 2002 WLNR 3561147.

3. *See Recovery Rate Hits 50 Percent as Enron Creditors Receive More Than $6 Billion in Special Distributions*, INVESTMENT BUS. WKLY., June 16, 2008, at 164 ("Today's distribution pushes the total amount returned to creditors past $20 billion, almost triple the amount originally anticipated. With this distribution, Enron creditors now are receiving 50.3 cents on the dollar and Enron North America Corp. . . . creditors are receiving 50 cents on the dollar, both excluding gains, interest and dividends."). Financial institutions that participated in the off-balance sheet vehicles that masked Enron's financial condition were forced to make substantial settlements. *See id.* (reporting a $1.866 billion settlement by Citigroup to resolve the claims of Enron's general creditors against it). For the fate of Enron's executives, see Kristen Hays, *A Sordid Chapter on Enron Ending: Kenneth Rice Is the Final Figure To Be Punished After Pleading Guilty to Crimes in the Scandal*, HOUSTON CHRON., June 18, 2007, at A1 (reporting that eight Enron former executives are serving prison terms of up to twenty-four years after reaching plea agreements).

4. In this paper, our focus is on the largest cases, those involving hundreds of millions or billions of dollars. The dynamic of small cases is utterly different and one cannot extrapolate from one to the other. *See* Douglas G. Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* (Yale Int'l Ctr. for Fin., Working Paper No. 05-29, 2007), *available at* http://ssrn.com/abstract=866865 (showing that capital structures of small and large cases are dramatically different).

environment. The players today are different from those in past downturns.[5] For a long time, the capital structure of a firm in reorganization consisted of a senior bank with a security interest in all the firm's assets and a group of dispersed, but homogenous, unsecured creditors that an active creditors' committee could represent.[6] The bank, the committee, and the debtor's managers bargained with each other against a backdrop of well-developed norms.

Today, we no longer have a single bank and dispersed general creditors. Dozens of constantly changing stakeholders occupy every tranche, each pursuing its own agenda.[7] Some seek long-term control of the business, while others are passive, short-term investors. Others may hold a basket of both long and short positions in multiple tranches and complicated hedges involving other businesses. Their concerns—such as whether a particular action will be a "credit event" in a credit default swap—often have nothing to do with preserving the business or maximizing the value of its assets. Indeed, failure of the business can mean large returns to some creditors.[8] The recent credit

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5. Some of these changes have been underway for a time, but remained largely invisible during a period of enormous liquidity. In the early part of this decade, selling even the largest businesses on the market was usually an option. *See* Douglas G. Baird & Robert K. Rasmussen, *Reply: Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 679 (2003) (reporting that, apart from the instances in which Chapter 11 was used to implement a deal arranged outside of bankruptcy, there were sixty-seven large reorganization cases in 2002 and fifty-two were sales of one kind or another).

6. *See* Marshall S. Huebner & Benjamin A. Tisdell, *As the Wheel Turns: New Dynamics in the Coming Restructuring Cycle*, *in* THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE 2008/2009, at 77, 78 (2008) ("Twenty-five years ago . . . [t]he major creditor participants in corporate reorganisations were usually large commercial banks and other institutional creditors (e.g., insurance companies), indenture trustees representing bondholders and the debtors' vendors.").

7. *See generally* Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 93 (2008) ("Distressed debt investors with different investment strategies but the same investment target may lead to potential conflicts among creditors."); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 407 (2007) ("The operation of chapter 11 is premised on a perception of ownership that may no longer exist or is at the very least threatened by the expansion of credit derivatives."); Harvey R. Miller, *Chapter 11 in Transition—from Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 390 (2007) ("Distressed debt traders have different motivations and objectives than the old line relationship banks and trade creditors. . . . The explosion of distressed debt trading marked the end of the relationships that had been a major support structure of the reorganization paradigm of 1978.").

8. Karl Denninger, *GM: Bankrupt, UNLESS . . . .*, The Market Ticker, Apr. 1, 2009, http://market-ticker.denninger.net/archives/921-GM-Bankrupt,-UNLESS.....html (speculating that GM bondholders were refusing to renegotiate because their bonds are backed by AIG credit default swaps that will pay in full if GM files for bankruptcy).

contraction has meant that the sale of the company sometimes must be done too quickly and sometimes cannot be done at all. In short, the new world of corporate reorganizations has more heterogeneous creditors whose rights against the business are deeply fragmented.

In the past, the bargains that parties reached among themselves followed a few familiar patterns. While there were many possible deals, the players naturally gravitated toward only a few.[9] In the new environment, with different players holding different stakes, the old patterns no longer apply and new ones have yet to take shape. There are no longer organized groups (like agented lenders or even creditors' committees), but instead investors have "one-off" relationships with the debtor entity (for example, counterparties with individual repos or swaps). The types of institutions vary—from banks and broker-dealers to hedge funds and private equity firms. The current environment is one in which there are no natural leaders (or followers) among the creditors to perform the shuttle diplomacy required to build a consensus. Without familiar benchmarks, there is no shared understanding of what form a plan should take. Coalition formation is harder.[10] Worse yet, in some cases there may be no stable equilibrium at all. To use the language of cooperative game theory, the core may be empty.[11]

In this Article, we review the changes in finance over the last decade and show how each is at odds with basic assumptions of Chapter 11. Our conclusion can be stated simply. The challenge the legal system faces is much like assembling a city block that has been broken up into many parcels. In this scenario, we face an anticommons problem, a world in which ownership interests are fragmented and conflicting.[12] This is quite at odds with the

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9. To cast things in the language of game theory, there were many possible equilibrium agreements, but comparatively few were focal points. For the classic discussion of focal points, see THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 57-58 (1960).

10. In the recent Adelphia reorganization, for example, infighting among at least twelve unofficial groups of creditors resulted in seven proposed reorganization plans, and professional fees and expenses initially sought by these twelve groups alone totaled over $100 million. *See* Huebner & Tisdell, *supra* note 6, at 80.

11. For a discussion of the "empty core" and how it relates to corporate reorganizations, see *infra* Part IV.

12. For a discussion of the anticommons problem, see Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998). *See also* MICHAEL HELLER, THE GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES (2008) (identifying anticommons problems in a variety of settings); Lee Anne Fennell, *Commons, Anticommons, Semicommons* (Univ. of Chi. Law & Econ., Olin Working Paper No. 457, 2009), *available at* http://ssrn.com/abstract=1348267 (exploring the relationship among commons, anticommons, and semicommons).

standard account of corporate reorganizations – that it solves a tragedy of the commons, the collective action problem that exists when general creditors share numerous dispersed, but otherwise similar, interests.[13] Bankruptcy has become antibankruptcy.

Part I examines how the prototypical general creditor has changed. It is no longer a small player holding a claim much like everyone else's. Moreover, this group changes constantly throughout the course of the case. Part II examines the changed nature of the secured creditor and, especially, the way in which it now enjoys much more control than it had even a decade ago. In Part III, we focus on financial innovation and the way that derivatives and the ability to hedge alter the dynamics of Chapter 11. Part IV draws on the lessons of cooperative game theory to show how in combination these changes are toxic. They undermine the coalition formation process that is central to Chapter 11.

I. THE CHANGING FACE OF UNSECURED DEBT

A. The Bargaining Dynamic in Chapter 11

Bankruptcy law developed in a world of limited financial instruments. Secured debt (generally held by banks), unsecured debt (comprised of private debt, bonds, and trade credit), and publicly traded stock largely exhausted the types of investments that comprised the capital structure of large businesses.[14] The action lay at the level of the general creditors. The bankruptcy was for the benefit of the general creditors. Hence, the drafters of the Bankruptcy Code provided that administrative expenses be paid after the secured creditors, but before the general creditors.[15]

The creditors of the typical financially distressed business, whether bondholder or supplier, enjoyed at bottom the same legal right: the ability to

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13. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10-11 (1986) (noting that the role of bankruptcy to solve "a common pool problem" is "largely unquestioned").

14. Tort claimants are comparatively rare. *See* Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1227-30 (2005) (excluding mass product liability cases, tort claims are present in as few as one percent of bankruptcy cases). Other types of claimants (most notably tax claimants) loom large in smaller cases, but this Article focuses exclusively on the largest cases. While small Chapter 11s make up the vast majority in number, the total assets are overwhelmingly concentrated in a small handful of large cases. For a discussion of the empirical differences and the different dynamics between large and small cases, see Baird et al., *supra* note 4.

15. *See* 11 U.S.C. § 506 (2006) (determining secured status); *id.* § 507 (giving administrative expenses priority over most unsecured claims).

sue and reduce their claim to judgment. If each were left to her own devices, they might tear the business apart. The Bankruptcy Code worked its magic by forcing the group to work together as one. The Code turned every variety of right against the debtor into a "claim."[16] A loan at ten percent due in five years was treated the same as a loan at five percent due in ten years.[17] Someone who had a breach of contract action had a claim for the damages she would have received under nonbankruptcy law.

Because they held the same kind of legal right subject to the same treatment, all had the same incentive to maximize the value of the estate. Every claim entitled the stakeholder to exactly the same thing—a pro rata share of the bankruptcy estate.[18] A small committee of the largest creditors could thus look after everyone's interest.[19] The general creditors as a group bore the expenses of the committee.[20] Dispersed general creditors with small claims were spared the expense of vindicating their rights on their own. Because everyone had the same legal rights and received identical pro rata treatment, we could safely allow the decisions of the group as a whole to bind the dissenters.[21] There was no need to fear a tyranny of the majority. The plan had to treat those similarly situated in the same way.[22]

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16. *See id.* § 101(5) (defining "claim" for purposes of the Bankruptcy Code as generally any "right to payment").

17. *See id.* § 502(b)(2) (disallowing claims for unmatured interest).

18. *See id.* § 726(b) (providing for pro rata distributions in Chapter 7 liquidations). Chapter 11 accomplishes this through requirements placed on the plan of reorganization. *See infra* note 21.

19. *See* 11 U.S.C. § 1102.

20. *See id.* § 503(b)(3)(F) (including as administrative expenses of the estate the expenses incurred by members of the creditors' committee).

21. Only substantially similar claims can be placed in the same class for purposes of voting on the plan, everyone in a class must be treated identically, and the plan cannot provide different treatment to classes at the same priority level. *See id.* § 1122(a) (requiring that claims in the same class must be "substantially similar"); *id.* § 1123(a)(4) (requiring that the plan provide for the same treatment for each claim of a particular class "unless the holder of a particular claim or interest agrees to a less favorable treatment"); *id.* § 1129(b)(1) (mandating that, unless a class consents, it cannot be unfairly discriminated against). For a discussion of classification and related issues, see *In re Dow Corning Corp.*, 244 B.R. 634, 644 (Bankr. E.D. Mich. 1999), which stated that "[c]laims may be classified together only if they are 'substantially similar' to one another" and "substantially similar claims may not be classified separately when it is done for an illegitimate reason."

22. There are a few exceptions, of course. Some claims (such as those of the tax collector, 11 U.S.C. § 507(a)(8), and those of workers for unpaid wages, *id.* § 507(a)(4)(A)), are given priority. But these are the exception and they do not figure significantly in large cases. *See* Baird et al., *supra* note 4, at 20-23.

By the standard account, general creditors were dispersed.[23] Whereas the secured debt was primarily concentrated in the hands of a single institution, various parties held unsecured debt. The problem was one of collective action. As a group, the unsecured creditors would have been better off by taking concerted action, but no one creditor was willing to take the laboring oar. The costs of participation fell on those who participated, but the benefits were distributed to all creditors. While for creditors as a group the best course of action was to participate in the reorganization discussions, for each individual creditor the rational thing to do was stay passive. The nonbankruptcy rights were insufficiently tailored to allow them to act in a way that was mutually beneficial. Just as the agency issuing fishing licenses or regulating drilling in an oil field attempts to maximize value, those charged with overseeing the reorganization took steps to preserve the value of the estate on behalf of general creditors, who were presumptively similarly situated and entitled to equal treatment.

In addition to the incentive towards passivity, unsecured creditors also lacked the information necessary to participate in the reorganization.[24] A central issue in most reorganization cases was valuation—the amount the company would be worth if liquidated and the amount if kept together. While creditors might have been able to piece together information on liquidation values from publicly available sources, putting a price on the company as a going concern was a more difficult endeavor. One had to know the future plans for the company and what the plausible projections were for the future revenue stream. These both required information that the company had but that outsiders did not. Indeed, the creditors had no legal entitlement to such information.[25]

The answer to these problems was to give a central role to a committee to represent the interests of the unsecured creditors.[26] The committee would be staffed with creditors, presumptively those holding the seven largest claims

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23. *See* JACKSON, *supra* note 13, at 11-19.

24. Burke Gappmayer, *Protecting the Insolvent: How a Creditor's Committee Can Prevent Its Constituents from Misusing a Debtor's Nonpublic Information and Preserve Chapter 11 Reorganizations*, 2006 UTAH L. REV. 439, 440 ("The balance between the creditors' need for disclosure and the debtor's need for confidentiality is struck in Chapter 11 proceedings by the appointment of a creditors' committee that is made up of specific creditors and is given access to all of the debtor's information, including nonpublic information.").

25. One of the authors discussed the central role valuation plays in Chapter 11 at length in Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006).

26. *See* David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 523, 525-26 (1992).

against the debtor.[27] The existence of the committee provided a mechanism by which private information could be shared with the creditors. The committee would negotiate on behalf of the unsecured creditors as a group. Moreover, the committee would be able to collect the information that it needed in order to make an informed judgment. It could hire accountants to investigate the books of the company. It could hire investment bankers to assess what options the company had. It enjoyed the broad 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, and any other matter relevant to the case."[28] It could engage attorneys to help guide it through the bankruptcy proceeding.[29] Moreover, the debtor would pay for all of the committee professionals, such as investment bankers and accountants.[30] Because the Code assumed that the secured creditors would be paid in full and the general creditors would receive the residual, the effect of having the debtor pay was to spread the expenses among all of the general, unsecured creditors.

The creditors on the committee had both a fiduciary duty and an economic interest to represent the group of unsecured creditors as a whole. The case law established that those on the committee had to represent the interests of the unsecured creditors as a group.[31] By and large, this duty corresponded with the economic interest of the creditors. In theory, a creditor would maximize the value of its own claim by maximizing the value distributed to the unsecured creditors as a group.

The creditors' committee is a portal into the bankruptcy process. While any individual creditor has to pay its own costs should it seek to participate in the reorganization proceeding, the creditors' committee can hire counsel and advisors and have these fees reimbursed by the estate as an administrative expense.[32] Also, the creditors' committee can extract concessions from the debtor. The debtor would be hard-pressed to confirm a plan of reorganization

27. 11 U.S.C. § 1102(b)(1).

28. *Id.* § 1103(c)(2).

29. *Id.* § 1103(a) (giving the committee, subject to court approval, the power to employ "attorneys, accountants, or other agents").

30. *Id.* § 330(a)(1).

31. *See, e.g.*, *In re* Drexel Burnham Lambert Group, Inc., 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992) (noting that the fiduciary duty "extends to the class as a whole, not to its individual members").

32. 11 U.S.C. § 330(a)(1)(A) (providing for "reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney"); *id.* § 1103(a) (authorizing the committee to hire professionals).

over the active opposition of the creditors' committee. As such, the debtor has reason to listen to its concerns.

This approach—one that assumes common interests among dispersed creditors—fits awkwardly with what we find today. By the time of the bankruptcy, unsecured claims are in the hands of distressed debt professionals.[33] They often hold complicated positions, combining ordinary claims with derivative instruments. They pursue their own agendas. Rather than dispersed and homogenous, they are close at hand, well informed, and radically different from one another. As a result, the idea of a committee as the principal vehicle for mediating the interests of the general creditors as a group may no longer work. Having a seat on the creditors' committee can provide an investor with a good deal of input into the way in which a bankruptcy case proceeds. At the same time, however, someone on the creditors' committee is supposed to attend to the interests of the general creditors as a whole. Reconciling the traditional committee structure with the new type of player requires forcing disclosures from the investor and limiting her range of action, especially with respect to the trading of claims.[34] Whether this can be done in a way that keeps the largest players at the bargaining table has proved hard to determine.[35] In an environment in which sitting at the bargaining table exposes participants to inside information, the most important players often want to stay in the shadows.[36] This is an inversion of the traditional process, one in which those with the most at stake wanted to be on the creditors' committee, rather than stay away from it.

The paradigm of the disparate but homogenous general creditor is complicated for a further reason. Large corporations are typically not a single entity, but rather a corporate group. A single group of managers runs the business as a whole and cash from all operations flows into a single account, but many creditors have rights only against a particular subsidiary. In theory, each subsidiary files its own separate bankruptcy petition and should have its

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33. *See supra* note 7.

34. For a discussion of disclosure obligations in bankruptcy and, in particular, the way they contrast with disclosure obligations outside of bankruptcy, see Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569 (2002).

35. For a discussion of how so-called "Chinese Walls" may be used to mitigate this problem, see *infra* note 86.

36. *See* Huebner & Tisdell, *supra* note 6, at 82 ("[M]embers of senior lender groups now frequently decline to receive company information so they can remain unrestricted and capable of purchasing and selling public subordinated debt. In some recent cases, only a handful of senior lenders have been willing to receive non-public information, making it impossible to include the vast majority of lenders in reorganisation plan negotiations.").

own creditors' committee. Its assets should be segregated from those of the other entities. In practice, this is hard. Sorting out the relative rights of the different creditors requires both connecting creditors with specific entities and unscrambling the transactions among the different subsidiaries. Especially when there is widespread fraud, determining exactly how much each related entity owes the other is enormously expensive. In *WorldCom*, for example, there was approximately a trillion dollars in intercorporate transfers,[37] and, with a CFO facing years in prison,[38] hundreds were hired merely to create consolidated financial statements.[39]

For a long time, bankruptcy lawyers have navigated this problem by using the device of "substantive consolidation," in which the different corporate groups are treated as one for purposes of the plan of reorganization. When enough of the affected groups are willing to consent to such a plan, bankruptcy judges tend to approve such plans, notwithstanding appellate opinions that make the practice suspect.[40] Hence, we have an odd world in which substantive consolidation takes place in more than half of the largest cases,[41] even though black letter law unequivocally states that the practice is to be imposed only in the rarest of circumstances.[42]

Precisely because of the difficulty of valuing different claims against different corporate entities, it is often hard to assess exactly where one claim stands vis-à-vis another. When a business has hundreds or thousands of subsidiaries, there is no easy way to sort out the rights of the creditors, even though they are all nominally general creditors. Even if the general creditors of each of the entities can coordinate their actions (and for reasons that we shall discuss in the next section, they often can), it is hard for them to reach agreement with each other, as each is able to contest the value of their claims and there is not an easy way to resolve their dispute.

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37. *In re* WorldCom, Inc., No. 02-13533, 2003 WL 23861928, at *11 (Bankr. S.D.N.Y. Oct. 31, 2003).

38. *See Sullivan Plans To Plead Not Guilty to Fraud*, TORONTO STAR, Sept. 17, 2003, at C12; *see also In re WorldCom*, 2003 WL 23861928, at *13 (noting the "loss of individuals with institutional knowledge").

39. *In re WorldCom*, 2003 WL 23861928, at *13.

40. *See* Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 15 (2005) ("Substantive consolidation lacks the solid foundation one usually expects of doctrines so firmly embedded in day-to-day practice.").

41. *See* William H. Widen, *Prevalence of Substantive Consolidation in Large Bankruptcies from 2000 to 2004: Preliminary Results*, 14 AM. BANKR. INST. L. REV. 47, 53 (2006).

42. *In re* Owens Corning, 419 F.3d 195, 208-09 (3d Cir. 2005) (noting that there is nearly unanimous consensus among appellate courts that substantive consolidation is a remedy to be used "sparingly").

B. Claims Trading

The changing composition of creditors in Chapter 11 is due more than any other reason to the rise in claims trading. The ability to trade in claims against a Chapter 11 debtor began to take hold in the 1980s.[43] At that time, however, some courts interpreted the Bankruptcy Rules to allow them to review claim trades and ensure that those selling them received full disclosure.[44] In 1991, however, the Rules Committee decided to deregulate claims trading, as existing judicial oversight was perceived to impair the liquidity of claims.[45] This newly deregulated market for claims provided opportunities that the highly regulated market for acquiring control through equity did not.[46] The increased presence and financial wherewithal of hedge funds heightened the importance of this aspect of reorganization practice.[47] This last decade saw the rise of hedge funds across the financial landscape.[48] It is not surprising that

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43. *See* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 1-3 (1990) (describing claims trading in various bankruptcies dating back to 1986); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 101 n.71 (1995) (citing statistics on the growth of the claims trading market from the mid-1980s into the mid-1990s).

44. *See, e.g.*, *In re* Allegheny Int'l, Inc., 100 B.R. 241, 243-44 (Bankr. W.D. Pa. 1988).

45. W. Andrew P. Logan III, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 501-02 (1994) (describing the decision of the Rules Committee to remove claims trading from judicial oversight to promote a liquid market in claims).

46. There is, for example, nothing comparable to the Williams Act. *See* Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f)) (requiring, among other things, disclosure of holding more than five percent of the equity of a publicly traded company).

47. *See* 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) (noting that "distressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act"); Glenn E. Siegel, *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 . . . ."); *see also* 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 (discussing the growing importance of the role that distressed debt investors play in Chapter 11).

48. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) (noting that hedge funds engage in new forms of active investment in corporations); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and*

their influence extends to companies *in extremis*. Several funds exist whose sole purpose is to find value in the distressed end of the market. When a company is insolvent, investing in equity is not the safest route toward exercising influence. For those seeking outsized returns, debt is the instrument of choice. Claims trading, in essence, creates a market in all of the company's debt.

The basic rationale for claims trading is simple. It allows easy exit from a reorganization proceeding for those who are ill equipped to navigate it. Chapter 11 cases can be drawn-out affairs.[49] When a debtor files for Chapter 11, the debtor is prohibited from paying prepetition debt.[50] Payments on such obligations await the end of the case, absent a showing that immediate payment makes creditors as a group better off.[51] But the holders of some claims, such as suppliers of goods and services, never expected to be long-term investors in the enterprise and do not want to wait until the end of the proceeding for payment. They are not set up to participate in the Chapter 11 proceeding. They have little knowledge of the ins and outs of bankruptcy practice. Perhaps even more importantly, their business model is not built around tying up capital in bankruptcy proceedings. Even if a trade creditor still wants an ongoing relationship with the debtor, it is eager to monetize its claim for prepetition goods and services. Similarly, small holders of long-term debts of a corporation may care primarily about regular payments to provide ongoing income. Claims trading allows the small, distant creditor an easy way out of the bankruptcy process. Undiversified small stakeholders can easily opt out of the bankruptcy process and receive fair value for their claims provided the market for claims is sufficiently liquid.[52]

Corporate Control, 155 U. PA. L. REV. 1021 (2007) (noting the recent emergence of hedge funds taking an active part in acquiring and managing corporations).

49. For example, of the fifty-seven companies that were public at the time they filed for bankruptcy and confirmed reorganization plans in 2005, twenty-six were in bankruptcy for over a year, and one was in bankruptcy for almost seven years. *See* NEW GENERATION RESEARCH, THE 2006 BANKRUPTCY YEARBOOK AND ALMANAC 46-47 (Kerry A. Mastroianni ed., 2006).

50. 11 U.S.C. § 362(a) (2006). Over time, some exceptions have emerged, most notably for suppliers of goods within twenty days before the filing of the bankruptcy petition. *Id.* § 503(b)(9).

51. *See, e.g.*, *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (disallowing immediate payment of "critical vendors" in the absence of a showing that the payment benefited unsecured creditors as a group).

52. As one of us has discussed elsewhere, whether the market for claims is in fact sufficiently liquid, however, is itself subject to doubt. *See* Douglas G. Baird, *The Bankruptcy Exchange*, 3 BROOK. J. CORP. FIN. & COM. L. (forthcoming Jan. 2010).

Claims trading flourishes because it is attractive to buyers as well as sellers.[53] Those with money to invest can make a profit. An investor with more knowledge about the likely outcome of the case and a longer time horizon can make a positive return. One way is by providing liquidity.[54] Investors can earn premiums from impatient creditors looking to turn their claims into cash. Creditors seeking liquidity are willing to forgo more in the future for a little less today.

Distressed debt players, however, rely on more than providing liquidity to justify their operations. The new investors may also profit from their ability to navigate the bankruptcy process.[55] They may be better able to assess how much the debtor will ultimately be able to pay on its claims. A hedge fund that examines a company in full is more likely to have a good sense of the entire value of the enterprise than is a trade creditor or small bondholder.[56] Moreover, the investor may be able to find overlooked value in the instruments that the debtor has issued. Either way, the new investor may be able to use its knowledge of the reorganization process to generate a higher return than could the party that owned the claim when the debtor filed for bankruptcy.[57]

In addition, in some instances the ability to buy claims allows strategic investors to gain control of the business. Here it might seem that claims trading plays the same role as a conventional takeover contest outside of bankruptcy, differing only in that the outsider buys debt rather than equity. Indeed, it is easy to identify bankruptcy cases where the fight for control was front and center. The most notable example of buying claims to obtain control of a company in bankruptcy is the Kmart reorganization. ESL Investments, a well-heeled hedge fund, acquired control by buying up Kmart's debt.[58] The reorganization plan gave ESL the right to appoint four directors. Edward

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53. For a discussion of the benefits of claims trading, see Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1701-03 (1996).

54. *Id.* at 1701.

55. *Id.* at 1702.

56. *See* Baird & Bernstein, *supra* note 25, at 1949 (showing how large creditors acquire private information about the debtor).

57. For example, just days after essentially buying Kmart out of Chapter 11 bankruptcy for nearly $1 billion, hedge fund ESL Investments sold some of Kmart's undervalued real estate assets for $900 million. ESL ultimately profited over $3 billion from selling off Kmart properties. *See* Marty Bernstein, *Hey, What's This Guy Up To?*, WARD'S DEALER BUS., Dec. 1, 2008, at 33, *available at* http://www.wardsdealer.com/ar/auto_hey_whats_guy/index.html.

58. *See* Harner, *supra* note 2, at 725-27. Other recent examples of investors acquiring debt to exercise control include Loews Cineplex Entertainment Corp., Maidenform Brands, Inc., McLeodUSA Inc., National Equipment Services, Inc., New World Pasta Company, Rand McNally & Co., Regal Entertainment Group, and XO Communications, Inc. *See id.* at 707.

Lampert, the head of ESL, appointed himself, two of his employees, and a major investor in ESL.[59]

This market for corporate control, however, is different in a crucial respect from the one that exists outside of bankruptcy and comes with its own distinct risks. The Code's committee structure, by giving all large creditors a seat at the table, creates a situation where all parties battling for control of corporations in Chapter 11 are also given a large role in crafting the reorganization plan at the same time.

The case of FiberMark illustrates some of the problems.[60] FiberMark was a specialty producer of paper products based in Vermont.[61] The company had been formed in 1989 by a management-led buyout of a division of Boise Cascade.[62] The capital structure of the company was relatively simple. It had a secured credit facility of $85 million.[63] Throughout the events surrounding FiberMark's financial distress, the company had more than sufficient assets to pay off the facility in full, and the secured lender, GE Capital, did not play a role in the fight that ultimately erupted.[64] Public bonds formed the bulk of the rest of FiberMark's financing. These bonds had a face amount of $346 million. The remaining unsecured debt was roughly $12 million.[65] In light of this capital structure, whoever controlled the bond debt would control the outcome of the case. It might seem that things should have gone smoothly, but they did not. The reorganization proceeding eventually became a brutal fight among

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59. *Id.* at 726; *see also* PR Newswire, *Edward S. Lampert Appointed Chairman of the Board, Kmart*, HIGHBEAM RES., May 6, 2003, http://www.highbeam.com/doc/1G1-131714851.html (announcing the appointment of Lampert); Steven T. Mnuchin, http://people.forbes.com/profile/steven-t-mnuchin/70724 (last visited Dec. 13, 2009) (stating his position as Vice Chairman of ESL at the time); *The Next Warren Buffett?*, BUSINESSWEEK, Nov. 22, 2004, http://www.businessweek.com/magazine/content/04_47/b3909001_mz001.htm (describing Thomas Tisch as a member of the Tisch family, which was a large investor in ESL); William C. Crowley, http://people.forbes.com/profile/william-c-crowley/8783 (last visited Dec. 13, 2009) (describing his position as President and Chief Operating Officer of ESL).

60. The fight in *FiberMark* is set out in detail in Report of Harvey R. Miller as Examiner, *In re* FiberMark, Inc., 349 B.R. 385 (Bankr. D. Vt. 2006) [hereinafter Miller Report].

61. *Id.* at 27.

62. *Id.*

63. *Id.*

64. General Electric's secured claim was left unimpaired, and it stipulated to an adequate protection order early in the case. *See* Disclosure Statement With Respect to Amended Joint Plan of Reorganization Under Chapter 11, Title 11, United States Code of FiberMark, Inc., et al. as Debtors at 7-8, *In re* FiberMark, Inc., No. 04-10463 (Bankr. D. Vt. Nov. 1, 2005).

65. For a brief account of the history and prepetition debt structure of FiberMark, see Miller Report, *supra* note 60, at 27.

three hedge funds that was only settled after the bankruptcy court intervened and appointed an examiner to investigate them.[66]

Two of the hedge funds, AIG Global Investment Corporation and Post Advisory Group, acquired FiberMark bonds before it filed for bankruptcy. At the time of the bankruptcy petition, AIG had about nineteen percent of the outstanding notes, and Post held another fifteen percent of the notes.[67] Neither was able to acquire any more notes during the case.[68] They thus had over a third of the outstanding notes at the time the case began (which meant that there would not be a consensual reorganization plan without their approval), and both were appointed to serve on the creditors' committee.[69] The indenture trustee for the notes and a trade creditor holding a $50,000 claim were also appointed to the committee.[70]

Because the other creditors were not actively involved, Post and especially AIG believed that they could control the committee, which would allow them to control FiberMark's reorganization.[71] Moreover, because their holdings were so large, their interests no longer corresponded with those of other claimholders. They were like a large controlling shareholder while the other bondholders were more like minority shareholders. Outside of bankruptcy, minority shareholders protect themselves through contract, and they may have some ability to enjoy the control premium.[72] By contrast, once in bankruptcy, a creditor holds only a generic "claim." Any contractual protections that she obtained outside of bankruptcy disappear. The Bankruptcy Code homogenizes

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66. *See In re* FiberMark, Inc., 330 B.R. 480, 489-93 (Bankr. D. Vt. 2005).

67. *See* Miller Report, *supra* note 60, at 2, 4.

68. *Id.* at 22.

69. *Id.* at 28.

70. *See id.* at 4. The trade creditor eventually sold its claim to Silver Point. As part of the sale, the trade creditor agreed to remain on the creditors' committee as an agent of Silver Point. *Id.* at 10, 21.

71. *Id.* at 4.

72. The extent to which minority shareholders must rely on contract varies by state. *Compare* Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993) (en banc) (noting that minority investors must protect themselves through contract as the "tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration"), *with* Brodie v. Jordan, 857 N.E.2d 1076 (Mass. 2006) (noting that under Massachusetts law shareholders of closely held corporations owe fiduciary duties to one another and the majority cannot frustrate the "minority's reasonable expectations of benefit" from their ownership of shares). *See generally* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003) (exploring the limited ways in which legal doctrine constrains the actions of controlling shareholders).

all claims, as it assumes that creditors at the same priority level share a common cause. Dissenting claimholders in a particular class have no ability to protect themselves through contract. As against the creditor holding a controlling position, they have the right only to insist that they be paid as much as they would receive in a liquidation.[73]

The representative of AIG dominated the creditors' committee. He took an active role in the case, worried about the amount of money being spent, and tried to direct the actions of the managers on the theory that the public debt holders were the residual claimants of the company.[74] At the beginning of the proceeding, he favored a quick reorganization plan that basically wiped out the existing equity and converted the debt to equity.[75] Such a course of action would have left AIG as the largest shareholder and firmly in control of the business. He made it clear that he had no confidence in the CEO.[76]

AIG and Post were surprised to learn in the summer of 2004 that Silver Point, a fund noted for its expertise in investing in distressed companies, had begun acquiring large quantities of notes shortly before the case began and continued to do so while the case proceeded.[77] Silver Point was asked to join the creditors' committee, and, by the time it was appointed in October, it held thirty-five percent of the public notes.[78]

The drama of the case—one that lasted many months—consisted largely of the negotiations among the three hedge funds on a corporate governance agreement as to how the company was to be run after bankruptcy. Silver Point's arrival drastically altered the expectations of AIG and Post. Before they knew of Silver Point's investments in FiberMark, they believed that they would end up with de facto control of the reorganized company.[79] Silver Point's large stake and its intent to continue purchasing bonds made it clear that Silver Point would be the controlling shareholder of any reorganized company. Indeed, it appears that Silver Point eventually acquired more than fifty percent of the outstanding bonds, resulting in the three hedge funds holding well over

73. 11 U.S.C. § 1129(a)(7) (2006).

74. Miller Report, *supra* note 60, at 2-3.

75. *Id.* at 98-99.

76. *Id.* at 69-70.

77. *Id.* at 4.

78. *Id.* at 4-5. This ability to acquire such a significant stake in the company without attracting the attention of other major investors illustrates how opaque the claims trading market can be, even to those who participate in it on a regular basis.

79. *Id.* at 302.

eighty percent of the unsecured debt.[80] Once AIG and Post saw the changed landscape, they focused on minimizing the power that Silver Point would have as the controlling shareholder of the reorganized FiberMark.[81]

When Silver Point came into the picture, the prospects for a quick reorganization evaporated. Basically, the three hedge funds could never reach agreement among themselves as to what rights each would have in running the company post reorganization. What had been a corporate reorganization transformed itself into an ugly take-over battle in which AIG and Post, like entrenched board members, used their position on the creditors' committee to further their own interests rather than to advance the interest of the creditors as a group.[82]

In *FiberMark*, the parties reached agreement only after a blistering report issued by the court-appointed examiner.[83] To be sure, the parties involved took issue with many of the findings of the report,[84] but the highly public report did refocus the parties' negotiations. It resulted in an agreement under which Silver Point bought out the interests of the other hedge funds as well as the notes held by other investors.[85] *FiberMark* illustrates the potential and perils of a world in which the liquidity of claims itself makes coalition building difficult. In addition, it underscores how one of the basic mechanisms of the Bankruptcy Code may no longer function effectively. Large creditors are active and pursuing their own agendas (such as gaining control of the corporation), and they cannot be trusted to represent everyone's interests when serving on the committee. Moreover, because committee members receive confidential information which could prevent them from continued trading, some large players no longer even want to serve.[86] The days of a harmonious creditors'

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80. *Id.* at 4 (stating that AIG and Post own thirty-five percent of debt); *id.* at 8 (stating that Silver Point owns more than fifty percent of debt).

81. *Id.* at 5-8.

82. *See* Peter Lattman, *Bankrupt*, FORBES, Oct. 31, 2005, at 60 (calling FiberMark "a controversial, 'ugly' Chapter 11 proceeding" and summarizing much of Miller's report), *available at* http://www.forbes.com/forbes/2005/1031/060.html.

83. *Id.*

84. *See id.* at 62.

85. *See* Terry Brennan, *Turmoil Over, FiberMark Exits*, DAILY DEAL, Jan. 5, 2006, *available at* 2006 WLNR 222106.

86. Sometimes a hedge fund will be allowed to participate on the committee and be allowed to trade provided it erects a "Chinese Wall" that blocks information acquired while sitting on the committee from being used. In practice, however, these walls have proved porous. *See* Daniel Sullivan, Comment, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533, 557 (2008) (noting that "trading walls are not a panacea and there are certain harms they cannot prevent"). Such a screening wall was used in the FiberMark bankruptcy. Silver Point agreed

committee comfortably speaking on behalf of the interests of all creditors large and small have vanished.

II. THE TRANSFORMATION OF SECURED DEBT

A. The Decline of the Traditional Bank

Twenty-five years ago the large bank was one of a handful of players on the scene.[87] The bank would make a large loan to the company and would have a security interest in most, if not all, of the company's assets. The financial interest of the bank, as a fully secured creditor, was relatively straightforward.[88] If it could realize the value of its collateral, it would be paid in full. As such, the lender had an incentive to turn its collateral into cash via some form of sale. Left to its own devices, the senior lender would sell the discrete asset in which it had a security interest, and this would lead to the closure of the business. The lender was biased toward liquidation.[89] Because it did not share in the upside should the debtor's fortunes improve, it did not take such possibilities into account. Rather, if the lender could force a liquidation immediately, it could be paid in full. It saw no need to risk continuation that could only reduce its return. Even if the company was to be sold, the bank could not be trusted if it was owed less than the company was worth. In this situation, the bank may not have sought top dollar. It would only look for a sale that would pay it in full. Given these incentives, the bank should not have had its hand on the levers of control.[90]

Changes in bank lending practice render this account obsolete. Central to the new dynamic is the rise of the syndicated loan.[91] Single banks no longer

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to join the committee only on the condition that it be allowed to continue trading in debtor's notes, so the court entered an order establishing the wall. *See* Miller Report, *supra* note 60, at 5.

87. *See* Huebner & Tisdell, *supra* note 6, at 78.

88. *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 106-07 (1984).

89. *See* Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. REV. 581, 599 (1993); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 844-45 (2004).

90. *See* JACKSON, *supra* note 13, at 181-89 (asserting that secured creditors should receive the value of their rights, but the decision as to the fate of the corporation should be left to the general creditors).

91. Syndicated loans grew from $137 billion in 1987 to more than $1 trillion dollars in 1997. *See* Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 J. FIN. INTERMEDIATION 404,

make loans to large businesses. Given the amount of these loans, any bank that funded the loan itself would be tying up a hefty portion of its capital with a single borrower. To take a simple example, assume that we have ten banks and ten borrowers. Each borrower wants to borrow $200 million, and there is a ten percent chance that any given borrower will default during the term of the loan. In a world where loans were funded by a single bank, any bank loaning $200 million would have a ten percent risk that a large portion of its capital would end up in default.

Syndication allows the banks to reduce this risk. By parceling out each loan among a consortium of banks, each bank can lessen its default risk. In our example, if each bank signed up to fund ten percent of each borrower, each would have mitigated its risk. To be sure, by participating in more loans it is more likely that some debtor in each bank's portfolio will default. Each bank expects to have to deal with a default on a $20 million commitment. It is much easier, however, for each bank to handle a $20 million default rather than a $200 million default. In exchange for taking on a greater risk that it will have to deal with some default, each bank has greatly reduced the risk that it will have a default that would threaten the viability of the bank.

For each loan, one of the banks takes the lead role.[92] It is charged with monitoring the debtor and overseeing the interests of the creditors as a group. Befitting the lead bank's status as the leader of the syndicate, the expectation developed that the lead bank would hold a portion of the loan that was larger than any other member.[93] By holding a share that was disproportionate to that of the other members of the syndicate, the lead bank would take a bigger economic hit should it fail to maximize the value of the loan.[94] Making such a commitment made the loan easier to sell to other lenders.[95]

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407 (2000). For a general discussion of syndicated lending, see ANDREW FIGHT, SYNDICATED LENDING (2004); and AGASHA MUGASHA, THE LAW OF MULTI-BANK FINANCING: SYNDICATED LOANS AND THE SECONDARY LOAN MARKET (2007).

92. For a discussion of loan syndication and typical structures, see Katerina Simons, *Why Do Banks Syndicate Loans?*, NEW ENG. ECON. REV., Jan.-Feb. 1993, at 45, 46, *available at* http://www.bos.frb.org/economic/neer/neer1993/neer193c.pdf.

93. *See* Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans*, 62 J. FIN. 629, 633 (2007) ("[T]he lead arranger typically holds a larger share of the loan than any of the participants.").

94. *See* Simons, *supra* note 92, at 47-48.

95. *See* Sufi, *supra* note 93, at 663-65 (concluding that lead arrangers retain a larger portion of the loan when information asymmetry concerns are greatest, such as when the borrower is opaque). A number of factors, including the legal rights available to creditors in a particular jurisdiction, affect the composition of the lending syndicate. *See* Benjamin C. Esty & William L. Megginson, *Creditor Rights, Enforcement, and Debt Ownership Structure: Evidence*

The lending agreement contained various covenants.[96] The documents provided the lender with access to information generally unavailable to other investors.[97] The lead bank could use this information to monitor the borrower. If the borrower tripped up a covenant, it would have to procure a waiver.[98] The contract governing the syndicate did not grant the lead bank the unilateral right to grant a waiver; rather, the waiver had to be approved by a requisite majority of the syndicate members.[99] For the most part, however, syndicate members would follow the recommendation of the lead bank as they had less knowledge about the borrower, but the same economic interests and instincts as the lead bank.[100]

Syndication is a long-standing practice that underwent enormous growth in the 1990s.[101] Initially, it had little effect on bankruptcy practice. Many syndicate members were banks, and while at some level they were competitors, they also were repeat players. Any bank that reached an agreement with a borrower to fund a new loan would have to shop the loan to its brethren.[102] Other frequent participants in these syndicates were pension funds looking for a safe return on their assets who were more than content to follow the recommendation of the lead bank.[103]

The composition of lending syndicates, however, has changed recently. Membership is no longer limited to banks and pension funds. Hedge funds can

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from the Global Syndicated Loan Market, 38 J. FIN. & QUANTITATIVE ANALYSIS 37 (2003) (suggesting a relation between syndicate structure and legal risk).

96. For a discussion of how loan covenants empower banks, see Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1227-36 (2006).

97. *See* Sufi, *supra* note 93, at 632-33.

98. Baird & Rasmussen, *supra* note 96, at 1211-12.

99. *See* Sufi, *supra* note 93, at 633.

100. *See id.* ("[T]he lead arranger typically also acts as the 'agent' bank that monitors the firm, governs the terms of the loan, administers the drawdown of funds, calculates interest payments, and enforces financial covenants.").

101. *See* Dennis & Mullineaux, *supra* note 91, at 407-10.

102. *See* Simons, *supra* note 92, at 49 ("[T]he lead banks' concern with maintaining their reputations in the marketplace may lead them not only to avoid abuses but to promote risky loans even less aggressively than safe loans.").

103. *See* Agasha Mugasha, *The Secondary Market for Syndicated Loans: Loan Trading, Credit Derivatives, and Collateralized Debt Obligations*, 19 BANKING & FIN. L. REV. 199, 199 (2004) (noting that regular participants in the secondary loan market include banks and other financial institutions such as insurance companies, pension funds, and mutual funds).

participate in the syndication stage.[104] Moreover, there is a rapidly developing secondary market in syndicated loans.[105] The advantage of this market to those lenders participating in the syndicate is readily apparent. Unless restricted by the terms of the credit agreement, a member of the syndicate has an exit option. It can sell its portion of the loan to a willing buyer.[106] Trading of these loans has increased dramatically in recent times.[107] Thus, when a borrower trips up covenants in its loan or files for bankruptcy, it will not necessarily have to come to an understanding with the bank that has funded its senior debt. Today, hedge funds can purchase enough of a tranche in the secondary market so that they have the power to block any waiver of default, proposed amendment to the credit facility, or plan of reorganization that does not meet with their approval.[108]

Unlike the staid bank of an earlier era, a hedge fund that holds a position identical to the one held by a bank in an earlier time may view bad states of the world in a radically different way.[109] It might seem that it would make no

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104. *See* Barry Bobrow, Mercedes Tech & Linda Redding, *An Introduction to the Primary Market*, *in* THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING 157, 168 (Allison Taylor & Alicia Sansone eds., 2006) ("Hedge funds represented 29 percent of the primary market for institutional loans with spreads of LIBOR + 400 basis points or higher in 2005.").

105. *See* Meredith Coffey et al., *The Secondary Loan Market*, *in* THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING, *supra* note 104, at 393, 415-16 (noting that from 2000 to 2005 hedge fund trading in the syndicated loan market has risen from ten percent of JP Morgan's trading volume to nearly thirty percent of the total trading volume).

106. *See* A. Burak Güner, *Loan Sales and the Cost of Corporate Borrowing*, 19 REV. FIN. STUD. 687, 689-90 (2006) (explaining why borrowers may dislike loan sales and suggesting that borrowers receive lower interest rates when they allow banks to sell participations in the loans); Sang Whi Lee & Donald J. Mullineaux, *Monitoring, Financial Distress, and the Structure of Commercial Lending Syndicates*, 33 FIN. MGMT. 107, 118 (2004) (indicating consent on reselling the loan is required in fewer than half of the syndications). The options provided to banks by the secondary loan market are in many ways similar to the options that claims trading in bankruptcy provides to the holders of claims.

107. *See* Mugasha, *supra* note 103, at 201 ("Secondary loan trading has increased tenfold in the last five years.").

108. *See, e.g.*, Jonathan Keehner, Caroline Salas & Jason Kelly, *Harrah's Owners Said To Hedge Against Bankruptcy (Update 1)*, BLOOMBERG, Mar. 13, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJzJ_THa9Pck (noting that private equity firms that held equity in Harrah's bought debt to gain control over the potential bankruptcy should Harrah's fail).

109. *See Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 10-24 (2009) [hereinafter *Miller Testimony*] (statement of Harvey R. Miller, Senior Partner, Weil, Gotshal & Manges LLP) (observing, in the context of retailer bankruptcies, that

difference whether a hedge fund or a bank was the lender. Both ought to be interested in maximizing the value of their investments and hence it would seem that both would, in expectation, pursue the same path. Especially when a business finds itself in economic distress, however, this may not be so. Banks and hedge funds, though owning the same instrument, often have drastically different business models. Banks are repeat players. A bank can have a relationship with a business that lasts for decades. The bank provides a large suite of services beyond simply making the loan. In addition, commercial norms and its reputation constrain its conduct in any particular relationship. While it might, for example, have the legal right to call a loan in default, commercial norms and its concern about its reputation with other borrowers may lead it to waive the covenant. A hedge fund, by contrast, has a limited life, provides no services, and acts under no reputational constraints.

In addition, those who work for banks and those who work for hedge funds bring different skill sets. Those who work for banks excel at monitoring the debtor and ensuring their collateral is safe.[110] Hedge funds hire entrepreneurs with industry expertise who have the skills needed to take a much more active role in the affairs of the company. When a loan covenant is violated, a bank might insist on additional collateral, while a hedge fund might insist on a new CEO. Finally, there are regulatory differences. A hedge fund can buy into a troubled debtor with a view to holding equity in the business for a number of years in the event it is reorganized. By contrast, a bank is limited in its ability to hold stock.[111]

Banks make their profit by lending money and having it paid back.[112] They do not seek to own and operate the business. Not so with hedge funds. A hedge fund may buy the loan with the view that in the event of default it would be left with the business, and given the amount at which it purchased the

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financial institutions and members of lender syndicates have adopted a more distant and shorter term relationship with debtors).

110. For a discussion of the kind of monitoring in which banks engage, see Christopher James, *Some Evidence on the Uniqueness of Bank Loans*, 19 J. FIN. ECON. 217 (1987); and Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009).

111. *See* 12 U.S.C. § 1843(a), (c)(2) (2006) (allowing banks to hold equity that has been converted from debt, but presumptively limiting the holding period to two years). For a discussion of the limits on banks to invest in, deal, and underwrite securities, see RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 130-34 (4th ed. 2009).

112. *See* D.K. Sarasvathy et al., *Perceiving and Managing Business Risks: Differences Between Entrepreneurs and Bankers*, 33 J. ECON. BEHAV. & ORG. 207 (1998) (noting that bankers begin by identifying the return they seek and then focus on minimizing risks).

notes, it would not be a bad price at which to acquire it even if it were in financial distress. Banks want their money back; hedge funds loan to own.[113] The same dynamic that plays out with respect to publicly traded unsecured debt now plays out with respect to traditional bank debt as well.[114]

The increasing role of hedge funds in owning the secured debt of distressed companies calls into question the long-standing assumption that senior investors are biased towards liquidation.[115] Far from having a liquidation bias, a hedge fund may affirmatively want to advance a reorganization plan in which it ends up with the equity of the business. Rather than push for a market sale, it prefers a judicial process it can control. Not only can it push for a low valuation, but the managers of the business (individuals whose options will be reset upon emergence from Chapter 11) will push for a low valuation as well.[116]

In short, the senior lender in the identical place within the capital structure is doing exactly the opposite of its traditional counterpart. Instead of fleeing from the Chapter 11 process, it embraces it. Rather than terminating its relationship with the business, the hedge fund wants to run it. Rather than fighting the managers, it takes control both through conditions imposed on debtor-in-possession financing and by installing new officers, most typically a chief restructuring officer (CRO).[117]

B. The Second Lien Loan

The first layer of secured debt often does not exhaust the borrowing capacity of the business. Borrowers in need of additional funds borrow from lenders who will take a junior position (in return for a higher interest rate). In

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113. Of course, one should not exaggerate these differences. Since the repeal of the Glass-Steagall Act, the differences between banks and hedge funds have diminished, but the process has been one in which banks have become more like hedge funds rather than the other way around. The effect is to magnify the changes that hedge funds have brought to the scene.

114. Hedge funds look for the fulcrum security—the one that gives it control of the reorganization. They are equally content with owning secured and unsecured debt.

115. *See, e.g.*, Baird & Jackson, *supra* note 88, at 106-08 (discussing the bias of secured creditors towards liquidation and the bias of junior parties for delay).

116. In Part III, we take account of the rise of credit default swaps. *See infra* Part III. These new investment vehicles can provide another reason for a party holding a part of a syndicated loan to favor a formal default rather than a workout.

117. *See Miller Testimony*, *supra* note 109, at 14 ("The chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor in possession, expansion of creditor (particularly secured creditor) control, the increasing imposition of creditor-designated chief restructuring officers (CROs), claims trading, more complex debt and organizational structures, and short-term profit motivation.").

years past, the debtor would access this additional value through mezzanine financing on an unsecured basis.[118] In the 1980s, this financing was provided by savings-and-loan associations and insurance companies.[119] These were relatively passive investors who had little ability to affect the operation of the company. To the extent that any investor was monitoring the debtor, it was the lead bank in the lending syndicate.

Today, however, we see a new trend in the capital markets. The debtor accesses the difference between the senior loan and full enterprise value through a second lien loan.[120] The lenders take a security interest in the same assets as does the first lender. Their right to payment, by and large, is not subordinated to the senior debt. Maturity schedules are set so that the borrower is required to make payments on both loans. The second lien lenders can seek to be repaid at the same time as the senior lender is being repaid. Moreover, unlike subordinated debt, they do not have to pay any monies that they collect to the senior debt. Rather, they are second only in terms of their claim on the collateral package. Only when collateral is sold for cash does the senior lender have first dibs.[121] The second lien market has exploded over the last several years.[122] As with syndicated first lien loans, there is a robust secondary market for second lien loans.[123] Hedge funds are primary purchasers of second lien debt.[124]

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118. *See* CORRY SILBERNAGEL & DAVIS VAITKUNAS, MEZZANINE FINANCE 6-7 (2006), http://pages.stern.nyu.edu/~igiddy/articles/Mezzanine_Finance_Explained.pdf.

119. *See id.* at 6.

120. *See* Marc Hanrahan & David Teh, *Second Lien Loans*, *in* THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING, *supra* note 104, at 109 (noting that second lien loan financings are now a widely used financing tool, often selected by borrowers in lieu of unsecured high-yield debt or traditional unsecured mezzanine financing).

121. *See id.*

122. In 2003, second lien issuance in the North American market totaled just under $8 billion, but the amount was over $29 billion in 2006. Gary D. Chamblee, *Reducing Battles Between First and Second Lien Holders Through Intercreditor Agreements: The Role of the New ABA Model Intercreditor Agreement Task Force*, 12 N.C. BANKING INST. 1, 1 (2008) (citing statistics from the Loan Pricing Corporation). Although the market continued to grow, reaching $15.21 billion in the second quarter of 2007 alone, the credit crunch that hit the financial markets dropped the total back to $4.56 billion for the fourth quarter of 2007. *Id.*

123. *See* Hanrahan & Teh, *supra* note 120, at 110 n.3 (noting that collateralized debt obligation and collateralized loan obligation funds have started incorporating second lien loans into their portfolios since 2003).

124. *See* Harner, *supra* note 2, at 715 n.45; *see also* Cynthia Futter & Anne E. Wells, *What To Expect from Hedge Funds Today and in the Future: An Overview and Insolvency Perspective*, 29 CAL. BANKR. J. 213, 221 (2007) (noting that hedge funds "have virtually created new financial markets, including the so-called second lien market").

The second loan benefits the first lender in that it puts more money into the business. This money can be used to generate additional revenues, some of which will be used to make payments to the senior lender. Yet the senior lender needs some assurances that the new lender—which, as with the senior loan, is usually a group of lenders—will not cause it undue hardship.[125] Granting a lien has consequences, both outside of bankruptcy and inside of bankruptcy. A second lien holder, by virtue of its lien, can grab its collateral.[126] After a bankruptcy petition has been filed, it can object to the use of its collateral and seek adequate protection of its interest.

The first and second lien holders sort out their respective rights in an intercreditor agreement.[127] This agreement specifies the relationship between the two lenders.[128] It addresses in detail their respective rights should the borrower file for bankruptcy. For example, the intercreditor agreement often grants the senior lender the right to sell the collateral without the consent of the second lien lender.[129] The intercreditor agreement also typically gives the senior lender the right to finance the debtor postpetition and provides that this financing will have priority over the loan of the second lien lender.[130]

The effect of second liens has yet to be felt. The hedge funds that own the second lien debt after a bankruptcy proceeding is filed are not shy about testing the limits of the intercreditor agreement. Indeed, the enforceability of the intercreditor agreement, to the extent that the second lien holder agrees to

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125. *See* Hanrahan & Teh, *supra* note 120, at 112 ("The concern [of first lien lenders] in times past has been that the existence of other secured creditors and their rights in collateral could result in complications for first lien lenders in the event of a workout or bankruptcy.").

126. *See* U.C.C. § 9-609 (2000).

127. *See* Chamblee, *supra* note 122 (discussing typical clauses in intercreditor agreements).

128. *See* MARK N. BERMAN & JO ANN J. BRIGHTON, HANDBOOK ON SECOND LIEN LOANS AND INTERCREDITOR AGREEMENTS (2009); C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 189 (2006) (summarizing the significant issues faced in intercreditor agreements); *see also* Chamblee, *supra* note 122 (discussing common provisions of the ABA model intercreditor agreement); George H. Singer, *The Lender's Guide to Second Lien Financing*, 125 BANKING L.J. 199 (2008) (discussing common provisions of intercreditor agreements and issues that may arise should the debtor file for bankruptcy).

129. *See* BERMAN & BRIGHTON, *supra* note 128, at 64-65 (noting that it is common for second lien lenders to agree to this provision); Chamblee, *supra* note 122, at 18 (indicating that the ABA Model Intercreditor Agreement permits sales by the senior lender under § 363 of the Bankruptcy Code without consent of the second lien lender as long as the interest of the second lien lender attaches to the proceeds); *see also* Dobbs, *supra* note 128, at 218-19 (observing that the parties will negotiate over whether the intercreditor agreement will contain a clause prohibiting the second lien holder from objecting to a § 363 sale).

130. *See* Dobbs, *supra* note 128, at 211-15.

waive statutory protections granted by the bankruptcy, is far from settled.[131] Litigation over the validity of the agreement, especially when the company is attempting to put its bankruptcy financing in place, could threaten to derail the reorganization effort at an early juncture.[132] The Code has proven sufficiently flexible (and the judges and the lawyers sufficiently creative) to overcome the problems that have arisen so far. For example, as a result of the increase in secured debt, many cases now enter bankruptcy administratively insolvent.[133] After the secured creditors are paid, there are no funds to pay for the costs of the reorganization. But a practice has emerged in which the secured creditor agrees to "carve out" a part of its lien to fund the costs of running the

131. First lien holders agreed to concessions to avoid litigation over intercreditor agreements in *In re Calpine*, No. 05-60200 (Bankr. S.D.N.Y. Dec. 20, 2005), which was discussed in *Calpine Reaches Settlement with Second Lien Debtholders*, REUTERS, Feb. 1, 2008, http://www.reuters.com/article/pressRelease/idUS227576+01-Feb-2008+PRN20080201, which noted what second lien holders extract in exchange for giving up whatever rights they have under an intercreditor agreement. *See In re* Dura Auto. Sys., No. 06-11202 (Bankr. D. Del. Oct. 30, 2006); *Legal Advisory: Intercreditor/Subordination Agreements in the Second Lien Generation*, BRACEWELL & GUILIANI, July 20, 2007, http://www.bracewellgiuliani.com/index.cfm/fa/news.advisory/item/a38118cd-0fd5-4517-b263-9b01149c40c4/IntercreditorSubordination_Agreements_in_the_Second_Lien_Generation.cfm ("Disputes under intercreditor agreements can be postponed (and avoided) through consensual resolutions, as occurred in the *Dura Automotive* case where the parties agreed to provide the second lien lenders (represented by Bracewell) with adequate protection treatment in the form of current cash payment of interest during the bankruptcy case, which the intercreditor agreement, if enforceable, did not permit."). Conflicts between first- and second-lien holders loomed large as well in *In re Meridian Automotive Sys., Inc.*, No. 65-11168 (Bankr. D. Del. Apr. 23, 2005). *See Judge OKs Meridian Financing Changes*, AFTERMARKET NEWS, Sept. 22, 2006, http://www.aftermarketnews.com/Item/29395/judge_oks_meridian_financing_changes.aspx. Similar problems arose in *In re New World Pasta*, No. 04-02817 (M.D. Pa. filed May 10, 2004), and *In re ACR Management LLC*, No. 04-27848 (W.D. Pa. filed June 14, 2004). *See* Mark Berman & Jo Ann J. Brighton, *Second-Lien Financings Part IV: Good, Bad, and Ugly*, 25 AM. BANKR. INST. J. 5 (2006), *available at* http://www.nixonpeabody.com/publications_detail3.asp?ID=1402.

132. For example, in *In re American Remanufacturers*, No. 05-20022 (Bankr. D. Del. Nov. 7, 2005), the second lien holders objected to the debtor-in-possession financing package offered by the first lien holders. The bankruptcy court preliminarily agreed with the objections, the first lien holders eventually withdrew their financing offer, and the case converted to a Chapter 7 liquidation. *See* Mark Berman & Jo Ann J. Brighton, *Second-Lien Financings Part II: Good, Bad, and Ugly*, 25 AM. BANKR. INST. J. 24, 24-25, 57 (2006).

133. Under the Code, secured creditors receive the value of their collateral first. After that, the administrative costs of bankruptcy are paid. *See supra* note 15 and accompanying text. A case is said to be "administratively insolvent" when there are insufficient funds to pay off the administrative expenses.

proceeding.[134] Now widely accepted, the debate is only over the extent of the carve-out. But doubt exists about other features of these new capital structures, especially the enforceability of provisions of the intercreditor agreement that tie the second lienholders' hands during the bankruptcy process.[135]

If parties find it in their interest to have a hierarchical capital structure with multiple tiers of secured debt, there seems to be no bankruptcy policy that justifies second-guessing them. To be sure, it does require a shifting of the way bankruptcy is paid for. If the second lien position is the fulcrum security—the security which is in the money, but not being paid in full—then the reorganization is being run for the second lien lenders' benefit and they should pay for it. The modern bankruptcy judge sees herself as charged with creating a forum in which the stakeholders, whoever they may be, come together and negotiate. As long as an agreement adequately deals with the substantive and procedural rights of all involved, it is not for her to question its details any more than it is for the New York Stock Exchange to review the price at which a given stock trades. She is indifferent to whether the agreement provides for an auction of the assets (as increasingly became the case over the past decade) or sets out a traditional plan of reorganization, spelling out in elaborate detail the capital structure of the reorganized firm (which has become increasingly rare, although it could return in today's environment).[136] What matters is that the process is cost-effective and protects the rights of all the stakeholders.

C. *The Rise of Control*

Senior creditors over the last two decades have learned how to gain more control over their debtors outside of bankruptcy.[137] The security interest covers

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134. For an excellent discussion of the issues surrounding carve-outs, see Richard B. Levin, *Almost All You Ever Wanted To Know About Carve Out*, 76 AM. BANKR. L.J. 445 (2002).

135. For example, a provision that takes away from the second lienholder its right to vote on the plan of reorganization is suspect. *See* Dobbs, *supra* note 128, at 221 n.64 (setting out the differing views of courts on whether junior creditors can give up voting rights in bankruptcy).

136. Unsecured creditors and equity holders can take little solace in the rise of hedge fund activism in bankruptcy. While these funds may not have the liquidation bias normally associated with the senior bank, they are not charitable institutions. They seek to control the fulcrum security, and ensure that all of those who hold investments with a lower priority receive no interest in the reorganized company.

137. *See* George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 24-25 (2004) ("[S]ecured creditors capitalizing upon agency problems to gain the help of insiders and insolvency professionals [have] effectively take[n] over—or 'hijack[ed]'—the chapter 11 process and essentially create[d] a federal unified foreclosure process."); Stephen J. Lubben,

more assets and the lead lender controls all the cash that passes through the business. Moreover, secured creditors have learned, largely through terms contained in debtor-in-possession (DIP) financing, how to gain control over the debtor during the bankruptcy itself.[138] The increase in control rights, combined with the hetereogeneity in the most senior tranche, increases the risk that creditors pursuing their own individual agendas will not advance the interests of creditors as a group.

When the senior creditor is the DIP lender, many of the restraints on individual creditors, such as the automatic stay, loosen considerably. Typically, if there is a default under the DIP loan (which can include such things as a failure to meet income projections or maintain sufficient cash reserves), the DIP lender can pursue its rights notwithstanding the automatic stay.[139] This creates few problems when the DIP facility is in the hands of a single lead bank. Banks, however, are no longer the sole source of DIP financing as hedge funds have entered into this market.[140] The formerly predictable situation becomes significantly more complicated when those providing the DIP financing are a group of competing hedge funds, each pursuing its own agenda.[141] In theory, an agreement can be put in place that ensures that, at least

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The "New and Improved" Chapter 11, 93 KY. L.J. 839, 841-42 (2005) ("[I]t is not clear that this development promotes social welfare. Rather, lender control may only benefit lenders."); Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1, 2 (2003) ("The exercise . . . of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower."); Westbrook, *supra* note 89, at 799 ("[W]idespread adoption of a privatized system depending upon dominant security interests is as undesirable as it is unlikely.").

138. *See Miller Testimony*, *supra* note 109, at 11-12 (detailing commonly approved provisions in DIP financing orders, including: "requiring the debtor in possession to hire a CRO . . . [c]ash-flow covenants that . . . can compel the sale of assets or downsizing[,] . . . [p]rovisions giving the lender control over disposition of the debtor's assets[,] . . . negative covenants that constrain management flexibility[, and] . . . [p]rovisions that subject the debtor's plan of reorganization to some form of lender control").

139. *See* Scott D. Cousins, *Postpetition Financing of Dot-Coms*, 27 DEL. J. CORP. L. 759, 793 (2002) ("Regardless of whether the DIP lender is also the prepetition lender, DIP orders often vacate the automatic stay upon the declaration of an event of default and after the expiration of a short period of time . . . .").

140. *See Restructuring Terms: Hedge Fund Roll-Ups Steamroll Creditors*, WESTLAW BUS., July 1, 2009, http://currents.westlawbusiness.com/Articles/2009/07/20090724_0041.aspx?cid=&src=WBSignon.

141. We see exactly this problem in the Lyondell reorganization, where various hedge funds such as Silver Point and Appaloosa competed vigorously to gain shares of the DIP loan. *See* Tiffany Kary, *Lyondell Case Shows Bankruptcy Loans Are Available for a Price*,

with respect to the terms of the DIP loan, the disparate lenders act as one. But whether they can craft such agreements remains to be seen.

III. FINANCIAL INNOVATION

The changes described above drastically alter the bankruptcy landscape. They are changes, however, that standing alone, the bankruptcy system could well assimilate. Indeed, we see many parts of the company's capital structure crafted with a potential bankruptcy in mind. Intercreditor agreements, for example, focus explicitly on the relative rights two classes of creditors will have in bankruptcy.[142] All things being equal, one would expect that today's capital structures would aid the resolution of financial distress. Yet, not all things are equal.

The Bankruptcy Code itself provides for secured claims, unsecured claims, interests, and pretty much nothing else.[143] Shareholders own shares; creditors have debt, with banks holding secured debt. When we think back to when the Code was drafted in the 1970s, these were the basic investments in a company. One could of course find some additional securities, but they were pretty much the exception. Put differently, the roots of the Bankruptcy Code predate Black-Scholes.[144]

In this world, it was relatively simple to ascertain the incentives of any investor. All wanted to maximize the return on their investment, but the nature of their investment dictated their optimal strategy. Secured creditors wanted safety; they were in the money and saw no need to take gambles. Equity

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BLOOMBERG, Feb. 4, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=azqyUe8pwuUM.

142. *See, e.g.*, Dobbs, *supra* note 128, at 202 (setting out the "remedy block" first lienholders seek and limits second lienholders try to place on them).

143. *See* 11 U.S.C. § 501(a) (allowing equity security holders to file an interest); *id.* § 506 (2006) (distinguishing between secured claims and unsecured claims); *see also id.* § 1129(b) (defining the cram down procedure for secured claims, unsecured claims, and interests). In recent years, the Bankruptcy Code has been amended so that many varieties of swap and derivative transactions entered into by the debtor are excepted from bankruptcy altogether. *See, e.g.*, *id.* §§ 362(b)(27), 555, 556.

144. *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649-53 (1973) (deriving a valuation formula for options and applying it to corporate liabilities); Robert C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141, 141-42 (1973) (extending the Black-Scholes theory of option pricing). For an accessible discussion of how financial innovation alters our perception of capital structures, see Alvin C. Warren, Jr., Commentary, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 465-70 (1993).

holders, in contrast, wanted to swing for the fences. Only a dramatic turnaround would allow them to see a return on their investments. Unsecured creditors, by and large, tended to favor value-increasing changes. While no party had incentives aligned with the fortunes of the business as a whole, all were confident that they could identify the motives attending to each investor.

In this world, many companies could restructure their operations outside of a formal Chapter 11 proceeding. Chapter 11 provided the benchmark against which negotiations took place. Indeed, in recent years, even when Chapter 11 was used, it was part of a process where the company would file either to implement a restructuring already agreed upon or to sell off the company.[145] Fewer and fewer companies entered bankruptcy in a free-fall state. Bankruptcy was not a discontinuous event, but rather a tool in an arsenal of those deciding the fate of the business.

Events of the last few years, however, have altered the terrain. Addressing financial distress before the filing for bankruptcy has become much more difficult, as has making decisions once the company has filed for Chapter 11.

A. Derivatives

Ascertaining economic interests is crucial to assessing bankruptcy policy. Investments come with both cash flow rights and control rights.[146] Shareholders can vote for the board of directors.[147] Credit agreements often give lenders the ability to affect the business in various ways. In the extreme case, the rights that a senior creditor has by virtue of its lending agreement give it the power to engineer a change in the corner office.[148] As a general matter, cash flow rights and control rights work in tandem. It is the investor's cash flow rights that give it the incentive to exercise its control rights in a certain manner.[149] We normally assume that an investor exercising a control right

145. *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751-52 (2002).

146. *See* Baird & Rasmussen, *supra* note 96, at 1217 ("The line between debt and equity is an entirely permeable one, in terms of both cash flow rights and control rights.").

147. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63-67 (1991).

148. *See* Baird & Rasmussen, *supra* note 96, at 1209 ("When a business stumbles, creditors typically enjoy powers that public shareholders never have, such as the ability to replace the managers and install those more to their liking.").

149. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 147, at 68 ("As residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions.").

granted by a financial instrument is acting so as to maximize the value of that instrument.

Credit default swaps have rendered this assumption obsolete. A credit default swap is a two-party contract under which one party (the protection seller) acquires the credit risk of a loan from a counterparty (the protection buyer) in exchange for a fee.[150] If there is a default or some other "credit event" (such as bankruptcy) on the loan, the protection buyer receives cash equal to the face value of the loan.[151] For example, a holder of a GM bond may enter into a credit default swap that provides that, if GM defaults on the bond, the holder can give the bond to its counterparty in exchange for the face amount of the bond. In essence, the parties have "swapped" the risk of default. The extent of this market is quite large. There is no requirement that one actually own the underlying credit instrument in order to purchase a credit default swap. Indeed, the nominal value of credit default swaps is nearly $39 trillion, far greater than the amount of debt outstanding.[152]

Credit default swaps are in the first instance merely another way for a lender to reduce its risk exposure, just as lenders do with the syndication process. Just as a bank faces less risk when it only has a piece of a $200 million loan than when it funds the entire loan itself, a bank that buys a credit default swap reduces its exposure.[153] Indeed, the advocates for credit default swaps once argued that they promise to bring stability to the banking system.[154]

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150. *See* Lubben, *supra* note 7, at 405 n.2.

151. *See id.* at 411 (listing bankruptcy, failure to pay, and restructuring as typical credit events). For more information on credit derivatives, see generally Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007), explaining the basics of credit derivatives and the ways in which they can be used.

152. *See* Gillian Tett & Paul J. Davies, *Unbound: How a Market Storm Has Seen Derivatives Eclipse Corporate Bonds*, FIN. TIMES (London), Aug. 8, 2007, at 11 ("[T]he CDS market is now 10 times larger than the tangible cash bonds on which they [*sic*] are supposed to be based."); International Swaps and Derivatives Association, Summaries of Market Survey Results, http://www.isda.org (follow "Surveys & Market Statistics" hyperlink; then follow "Summaries of Market Survey results" hyperlink; then follow "2008 Year-End" hyperlink) (last visited Sept. 5, 2009) ("The notional amount outstanding of credit default swaps (CDS) was $38.6 trillion at year-end, down 29 percent from $54.6 trillion at mid-year 2008. CDS notional outstanding for the whole of 2008 was down 38 percent from $62.2 trillion at year-end 2007.").

153. *See* Partnoy & Skeel, *supra* note 151, at 1023 (noting that credit default swaps give banks a method of shedding risk without the costs of negotiating the syndications and working with other banks and without sharing the benefits of the loan).

154. *See id.* at 1024 (describing the view of Alan Greenspan and others that credit default swaps serve as a "shock absorber" and provide systemic benefits).

Banks by and large remain the originators of large loans.[155] Private institutions such as hedge funds simply do not (at least yet) have the back office operations necessary to service a large loan and often rely on prime brokers and investment banks to provide support services.[156] Credit default swaps allow the banks to offload some of the risk of default outside the banking system. Removing risk from the banking system should bolster the banks' position should the economy hit a downturn, or at least so the story went.[157]

Financing that leads to investment in the business occurs as part of a negotiating dynamic in which it was in the self-interest of everyone to take account of the interests of the company itself. By contrast, credit default swaps are created without the input of the borrowing company.[158] Some are even created by investors with no current interest in the company at all. They are often side bets in which parties care only about "credit events," events that trigger settlement obligations under the swap. For example, the seller of a credit default swap will fight vigorously to prevent a bankruptcy filing from taking place (at least until the expiration of the swap) and the buyer will affirmatively encourage it, regardless of whether filing makes any sense for the company. This failure to attend to the interaction between these new investments and the bankruptcy process threatens to put unprecedented strain on the current system of addressing financial distress.

Buying a credit default swap differs from syndication in terms of control rights. When a lead bank sells part of the loan, it bundles with that loan any applicable control rights. Any waiver of an event of default needs to be agreed to by the syndicate. The agent may be able to cajole syndicate members to follow its recommendation, but it is still the case that those who own the loan have to make the decision. If a hedge fund sells its piece of the loan in the secondary market, it loses its ability to have an input on any decisions that the

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155. *See* Sufi, *supra* note 93, at 640 (showing that the largest lead syndicators are all banks).

156. For a discussion of the industry that services hedge funds, see Steve Bills, *JPM Buys Into Hedge Fund Middle Office*, AM. BANKER, Feb. 14, 2006, at 1 (discussing JP Morgan's strategy for competing in the business of servicing hedge funds).

157. Indeed, the proponents of credit default swaps have touted their ability to reduce the risk to the banking system. *See supra* note 154. *But see* Partnoy & Skeel, *supra* note 151, at 1040 (noting that credit default swaps also raise systemic concerns because a "rush to unwind a vast array of interconnected contracts could create serious liquidity problems in the financial markets"). Credit default swaps have in fact been blamed for the current financial meltdown. *See, e.g.*, Matthew Philips, *The Monster that Ate Wall Street: How 'Credit Default Swaps'—an Insurance Against Bad Loans—Turned from a Smart Bet into a Killer*, NEWSWEEK, Oct. 6, 2008, at 46.

158. *See* Lubben, *supra* note 7, at 411 ("The debtor on the referenced obligation is not a party to the swap, and in most cases is unaware of the transaction.").

syndicate has to make. The economic exposure and the attendant control rights remain bundled, even if the package changes hands multiple times.

When a lender purchases a credit default swap, however, it retains the control rights that accompany the loan. The protection seller now bears the economic risks of the loan, but rights under the credit agreement remain lodged in the protection buyer. If a waiver of an event of default is needed, the holder of the loan is free to vote as it sees fit. But now its economic interest has changed. In the extreme case, if the lender has purchased more in credit default swaps than it has at risk in terms of the loan itself, it may be the case that it will be to its financial advantage if the loan goes into default.[159] In the extreme, those who bought credit protection on loans they did not hold may subsequently buy loans in the secondary market for the sole purpose of preventing a workout and forcing a default.[160] While such a default and subsequent bankruptcy case may provide a lower return on its debt instrument than it would have received had the debtor procured a waiver, it may more than make up for this by collecting on its credit default swap contract. Blowing up the company may generate a higher return for these investors than saving it.

Such a shift in incentives is almost impossible for others in the process to observe. There is no public record of who has purchased a credit default swap. In the bankruptcy proceeding, all holders of claims and interests have to file their claims and interests with the bankruptcy court.[161] While it sometimes becomes unclear exactly who owns what, there is some information as to who holds the debtor's financial instruments. But since credit default swaps are private transactions to which the debtor is not a party, there is no way to know what the true financial incentives of anyone are.[162] A hedge fund that holds a large loan position that it has acquired in the secondary market may in fact be net short.

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159. *See* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 731 (2008) (describing how debt holders, like equity holders, may have negative economic ownership through derivative ownership that results in an incentive to act against the interest of other creditors).

160. *See* Partnoy & Skeel, *supra* note 151, at 1034-35 (describing an analogous situation in the Tower Automotive bankruptcy where it was believed that hedge funds blocked a restructuring plan because a default would benefit their short positions in Tower stock).

161. *See* 11 U.S.C. § 501 (2006); FED. R. BANKR. P. 3001-05.

162. In light of the recent financial crisis, Treasury Secretary Timothy Geithner proposed regulating the trading of derivatives, which includes credit default swaps. *See* Letter from Timothy F. Geithner, Sec'y of the Treasury, to Harry Reid, Senate Majority Leader (May 13, 2009), *available at* http://www.financialstability.gov/docs/OTCletter.pdf. This proposal, while addressing some problems with the extant market, would not require the public disclosure of the owners of credit default swaps.

Credit default swaps shift the focus of negotiations outside of bankruptcy in a fundamental way. Ideally, the parties to the negotiation want to maximize the value of the business, and then fight over each party's relative share. Chapter 11 is often used as part of the process to implement what the parties have decided is a value-maximizing course of action. Credit default swaps alter this dynamic. The holders of the swaps, who may have a seat at the table by virtue of holding the underlying asset, may care more about whether any course of action is a "credit event" than whether it increases the value of the company.[163]

Prior to credit default swaps, the filing of a bankruptcy petition was the midpoint in the process of resolving the company's financial distress. It was a step along a continuous path. Negotiations would start before bankruptcy, the outlines of a plan would be developed, a petition would be filed, and the plan would be implemented. Now, however, the stakes have changed. Credit default swaps make bankruptcy discontinuous. It is an event that fundamentally alters the payouts and identities of the investors. The day after a petition is filed, the old creditors may disappear and be replaced by those who now hold the debt in the company.

While the effects of the current economic downturn have just begun to play out in the bankruptcy process, we already can point to examples where credit default swaps have taken center stage. Lyondell, a transnational corporation with assets in both the United States and the Netherlands, put its American operations into Chapter 11.[164] The operations in the Netherlands, however, remained outside of any insolvency proceeding.[165] This situation sparked a fight over whether the American bankruptcy court would enjoin the holders of bonds issued by the Dutch entity from seeking recovery on those bonds.[166] Were the bondholders to declare an event of default, the Dutch company would be forced into Dutch bankruptcy proceedings, where the outcome would most likely be a value-destroying liquidation. What explains this seemingly irrational behavior by the part of the bondholders? The fact that

163. *See* Lubben, *supra* note 7, at 427 (indicating that creditors holding credit default swaps may try to "jump the gun" by filing an involuntary petition to trigger default).

164. *See* Complaint, *In re* Lyondell Chem. Co., 402 B.R. 57 (Bankr. S.D.N.Y. 2009) (No. 09-10023).

165. *See Lyondell Seeks To Stop Note Holders from Taking Action*, REUTERS INDIA, Feb. 10, 2009, http://in.reuters.com/article/rbssEnergyNews/idINBNG38261720090209.

166. *See id.*

they held a large amount of credit default swaps which would pay handsomely upon default by the Dutch company.[167]

Credit default swaps create a moral hazard problem only before the Chapter 11 begins and in its immediate aftermath. A Chapter 11 case is a "credit event" that terminates the swap.[168] The accounts are settled up and the control of the claim against the debtor soon is again placed in the hands of the person who holds the economic interest in it. Credit default swaps may seriously complicate (and potentially even distort) workouts that take place before a "credit event," but they are likely to matter in Chapter 11 only if crucial decisions are made at the start of the case and no one else is minding the store.

But credit default swaps still matter in bankruptcy.[169] Much of the action in a large case takes place on the first day.[170] Many issues—from the approval of the DIP financing to the composition of the creditors' committee—are resolved in the first month. In some cases, the entire case is effectively wrapped up within sixty days.[171] A case can arise in which the process of closing out positions takes place while the major controversies in the Chapter 11 proceedings are being resolved.[172] Credit derivatives may trade multiple times, but a credit derivative is only as good as the counterparty that issues it. If there are enough credit events across enough different firms, sorting out who

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167. *See Burning Down the House: Why Credit-Default Swaps Make Restructuring Harder To Pull Off*, ECONOMIST, Mar. 7, 2009, at 80.

168. *See supra* note 151 and accompanying text.

169. Of course, credit default swaps make it next to impossible for the creditors to agree to a prepackaged or prearranged bankruptcy. The bankruptcies of Chrysler and General Motors were able to be prearranged only because the federal government was able both to fund the cases and to cajole recalcitrant parties not to oppose the deals.

170. *See* DEBRA GRASSGREEN & MAXIM LITVAK, FIRST DAY MOTIONS (2d ed. 2006); A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 909-10 (2009) ("First-day orders are entered in virtually all large reorganizations on an expedited basis in order to address time-sensitive matters such as obtaining DIP financing, using cash collateral, paying certain creditor claims, and retaining key executives." (footnotes omitted)).

171. *See* Dickerson, *supra* note 170, at 911 (documenting the trend in recent years of large firms entering bankruptcy with a prenegotiated arrangement to sell the business).

172. The most conspicuous example is the Lehman Brothers bankruptcy. While major assets were sold in the first week of the case, the credit derivatives involving Lehman were settled weeks later. *Compare* Simon Bowers, *Lehman Fallout: Derivatives Worth Hundreds of Billions Start To Unwind*, GUARDIAN (London), Oct. 11, 2008, at 3 (reporting on the beginning of the unwinding of $200 billion in Lehman derivatives in mid-October), *with* Ben White & Eric Dash, *Barclays Reaches $1.75 Billion Deal for Lehman Unit*, N.Y. TIMES, Sept. 17, 2008, at C1 (reporting Barclays's purchase of the bulk of Lehman's assets only two days after Lehman filed for Chapter 11).

ultimately takes the fall when some counterparties prove insolvent may need to be done at the same time that various Chapter 11s are already in motion.[173]

Moreover, credit default swaps are not the only new investment impacting the resolution of financial distress. The total return swap allows an investor (total return receiver) to enjoy the economic rights in a loan without the associated control rights. In a total return swap, the owner of a loan (total return payer) exchanges the income from the loan and any appreciation for a guaranteed income stream plus protection against capital depreciation.[174] While the owner thus off-loads the economic risks associated with the loan, it retains the loan and all associated control rights. In these cases, the contracts are not necessarily settled in the event of default.

These are cases in which the owner of record is not the person with the economic interest and the holder of the economic interest is hidden from the rest of the world. The potential abuses of empty voting and hidden ownership are kept in check by the absence of any incentive on the part of the party that holds the control rights in the claim to exercise it in a way that runs contrary to the interests of its counterparty. Its return is fixed. Consider the dynamics when the party originating the loan is a bank. It is a repeat player that has transferred a portfolio of loans to the counterparty. It is not a strategic player who has another agenda. It faces a reputational penalty if it does something other than its counterparty's bidding. The risk here is not so much that the bank will vote contrary to its counterparty's interest, but rather that those with the economic interest are far away from the action.

Over time, this problem should prove self-correcting. Those buying the economic rights in a total return swap typically have the ability to sell the swap. The potential purchasers are likely to be the distressed debt professionals who will have both the expertise and the incentive to be active in the case. They too, of course, must rely on the willingness of the record owner to act as they wish, but in the typical case the record owner follows their wishes. To the extent that a tension exists, parties will try to recombine the control and formal ownership to overcome the agency problem that exists whenever ownership and control

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173. This current problem of sorting out who owns what after a credit event could be ameliorated were Congress to require the central clearing of derivatives as proposed by Secretary Geithner. See *supra* note 162.

174. *See* Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 655 n.93 (2005). The major difference between a total return swap and a credit default swap is that the protection payer in a credit default swap purchases only the credit risk associated with the loan, whereas the total return receiver gets all the economic exposure of the loan.

are separated.[175] Solving the problem, however, will likely take time, and winners and losers may appear while this is being sorted out.

Even if the big players could bargain among themselves and we no longer needed to worry about dispersed general creditors, there would still be a problem. You cannot negotiate with other stakeholders if you do not know who they are. The record owner, the person who files the claim, may not be the person who holds the economic stake. People who are stakeholders may not show up and when people do claim to be stakeholders, there is no way either to verify their claims or to know how large a stake they hold.[176]

The need to ensure negotiations upon which Chapter 11 depends may require disclosure, at least as to who owns what.[177] To be sure, disclosure rules as a general matter discourage individuals from gathering private information and dampen the incentives of parties with private information to trade.[178] But there is another principle at work here as well. The easier it is to find the stakeholders, the more likely that a sensible plan of reorganization can emerge. The better defined the property rights, the more valuable they are. Land becomes more valuable when its owner and its boundaries are easy to identify from public records.[179] The law narrowly limits the types of ownership interests in land for exactly this reason.[180] Quite apart from whether you want to buy or sell land, you can use your own land more effectively if it is easy for

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175. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (showing that central problems of corporate finance are the agency problems that arise when ownership and control are separated).

176. *See* Huebner & Tisdell, *supra* note 6, at 81-82 ("[N]ominal holders of claims are increasingly participating out or hedging their exposures (using outright participations or swaps). As a result, the apparent creditors of the troubled firm may not be the real parties in interest or even have the decision-making authority with respect to the claims they appear to own. This makes it increasingly difficult to communicate with the ultimate decision makers in the creditor body in order to negotiate a restructuring.").

177. *See* Hu & Black, *supra* note 159, at 732-35 (discussing the need for disclosure of hidden debt hedges by creditors in bankruptcies).

178. *See* Baird, *supra* note 52.

179. Gary D. Libecap & Dean Lueck, The Demarcation of Land and the Role of Coordinating Institutions (Nat'l Bureau of Econ. Research, Working Paper No. 14942, 2009) (reporting a study indicating that land in areas that use a centralized land demarcation system has a higher value than land in areas using the indiscriminate metes and bounds system), *available at* http://www.adislab.net/docs/SeminaireADIS0809/20090609-LibecapLueck-Demarcation.pdf.

180. Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1 (2000).

you to learn who your neighbors are. Knowing the identity of the holders of property rights is a key assumption of Coasean bargaining.

B. Wearing Multiple Hats

A change that is perhaps as large as any one of those discussed lies in the ability of individual investors to assemble together their own investment positions with the different instruments that are available. The proliferation of these various instruments allows particular investors to have conflicting positions in different tranches of the debtor and to have portfolios (perhaps with other firms in the same industry) that give them returns from different decisions that are dramatically different from those of other investors.

Hedge funds play an increasing role in this aspect of the bankruptcy process. Not only can a hedge fund buy into any part of a company's capital structure, but it can buy into multiple parts of the capital structure at the same time. Occupying multiple tranches is not inevitably a cause for concern. In theory, the hedge fund could acquire a position so that its economic interest was coextensive with the interest of the corporation. By holding slices throughout the capital structure, the hedge fund could focus on maximizing enterprise value rather than only maximizing the value of its investment. Yet such a benign outcome is by no means assured. Hedge funds can take actions which increase their returns but at the expense of other investors. For example, consider a company that files for bankruptcy. A hedge fund could, on the quiet, buy up a large portion of the unsecured debt. At the time, the equity is trading for trivial amounts. The hedge fund then buys up a large portion of the equity and makes this purchase public. Other investors, thinking that the hedge fund believes that there is value in the equity, reacts by bidding up the price of the unsecured debt. Surely, if the smart money thinks that equity is the place to be, the unsecured debt must be a relatively safe investment. But it may be that the purchase of the equity was simply a loss leader and the fund plans to recover the money spent on the equity through the increase in the prices of its bonds. Indeed, no one may ever know that the fund ever held the bonds. It can both buy and sell them in anonymity.

Requiring all who hold claims against the debtor to reveal what they own does not completely solve the problem. A hedge fund can have a big investment in a competitor of the debtor, and the competitor may benefit from the debtor's demise. The hedge fund could use its rights under the Bankruptcy Code to slow down and perhaps ultimately undermine the reorganization. But a hedge fund's position need not be so crudely at odds with those of the other investors for its interests to be skewed. It might have entered into other kinds of derivative contracts, such as hedges on commodities that are crucial to the

debtor's business, that make it look at a plan in a way that is different from a generic claim holder in the same class. The basic point is that the Code's assumption that all holders of the same type of claim have the same economic interest no longer holds. Just as credit defaults and total return swaps complicate bargaining outside of bankruptcy, the ability of a hedge fund to have multiple investments complicates bargaining inside of Chapter 11.

These complications are coming to the fore at the same time that liquidity, which often allowed for a sale of the company as a going concern,[181] is drying up. The ability by a group in interest to force a sale limits the opportunities for strategic investments in crafting a plan of reorganization. The sale settles the value of the assets, which are then divvied up roughly in accord with well-established priorities. To the extent that the current environment makes a sale of a large company difficult,[182] it increases the likelihood that the parties to the negotiation will not be able to assess each other's motivations. The inability to use the market sale as a benchmark for possible deals further complicates the task of forming a plan of reorganization.

IV. COALITION FORMATION AND THE PROBLEM OF THE EMPTY CORE

The problems of identifying those with an interest in a large enterprise and their economic interests do not exhaust the challenges facing modern reorganization practice. Assume for the moment that a large enterprise that finds itself today in Chapter 11 can identify the relevant players and their economic interests; in other words, it has somehow navigated around the challenges we discussed above. Here, one would be tempted to think, the new world of corporate reorganization may be a more hospitable environment for deciding the future for the business. Those with investments in the enterprise seem to face few of the obstacles – high transaction costs and an abundance of private information – that hindered consensual agreement in earlier times. The key players are not hapless public investors and small trade creditors, but sophisticated parties who have invested in this business because of the special

181. On the rise of sales of companies as a going concern, see Baird & Rasmussen, *supra* note 5.

182. Even in the days of abundant liquidity, it was still the case that the sale of very large companies was difficult to pull off. The market for two hundred million dollar companies is more robust than is the market for two billion dollar companies. For the largest companies, hedge funds need to pool their resources together. *See* Brent Shearer, *Leading the M&A Pack: Private Equity's Party Is in Full Swing . . . but for How Much Longer?*, MERGERS & ACQUISITIONS: THE DEALMAKER'S J., Nov. 2006, at 28 (discussing how funds form "clubs" to do larger deals).

expertise they bring. They want to be at the bargaining table. After control rights are properly defined and sensible disclosure rules are in place, it might seem that the bankruptcy judge needs to do relatively little other than provide rules that make trade reliable and transparent and a mechanism for resolving the disputes that arise. The chance of bargaining failure seems low. The players should reach agreement among themselves and the bankruptcy judge will have little more to do other than bless the agreement and adjudicate disputes among some of the players. But matters are not so simple.

Ironically, it is precisely here—a world in which everyone brings special expertise to the bargaining table and negotiates in an environment that is virtually frictionless—that a new difficulty arises. We should not assume that people will in fact strike deals somewhere along the Pareto frontier. When there is a zero-sum game, there are an infinite number of possible deals. The parties must form a coalition around one of many possible agreements. Bargaining works best when there are focal points that provide a basic understanding of the contours of an acceptable deal.[183] Someone is recognized as the person who takes the lead, and all of the parties have shared expectations about who gets what.

In the past, conventions emerged and coalitions formed along predictable lines. In the round of Chapter 11s in the early 2000s, for example, it was settled that out-of-the-money equity received nothing and played no role at the bargaining table. Plans that included equity, in the ordinary case, were no longer on the table.[184] Plans might include features that were in tension with appellate court decisions (such as the pervasive use of substantive consolidation[185]), but as long as everyone at the table followed existing norms, it caused few problems. Whether a feature of a plan was embedded in black letter law or even known to anyone else was not essential. As long as the repeat players who sat at the reorganization table knew it, that was enough.[186] The

183. For a discussion of how focal points play an important role in the context of bargaining between two parties, see H. Peyton Young, *The Economics of Convention*, 10 J. ECON. PERSP. 105, 116-21 (1996).

184. *See* Baird & Rasmussen, *supra* note 5, at 692.

185. *See* Baird, *supra* note 40, at 15 ("Substantive consolidation lacks the solid foundation one usually expects of doctrines so firmly embedded in day-to-day practice.").

186. Many practices in modern Chapter 11 are well known to insiders, but inaccessible to anyone else. For example, the fees of the indenture trustee are always paid, even though the Bankruptcy Code allows such fees only in the event of a "substantial contribution" in a case. 11 U.S.C. § 503(b)(5) (2006). Experienced lawyers know not to expend any energy fighting them. The fees are routinely, indeed invariably, included in the plan, without inquiry into whether the indenture trustee's contribution was in fact "substantial." Junior associates sometimes find out about this feature of modern bankruptcy practice in a hazing ritual akin

need to strike agreements in future cases held attempts at advantage taking in any particular case in check.

With the proliferation of new players and the introduction of new financial instruments, the old focal points may have disappeared. Reaching agreement is likely to become much harder, even though transaction costs are lower and information is complete. Consider the reorganization of Adelphia. Adelphia was the fifth largest operator of cable systems in the United States when it filed a Chapter 11 petition in 2002. As is common in large reorganizations, the debtor decided to sell its assets under § 363 as a going concern. In April 2005, it found a buyer willing to pay $17.6 billion, a substantial premium above its stand-alone value.[187] The purchase agreement required that the transaction close within fifteen months, and no creditor group raised serious objections either to the amount or the form of the sale.

By the traditional account, there would seem to be few impediments to wrapping up the case quickly. The only creditors were institutional investors owed fixed amounts of money. The only assets were either cash or stock in the buyer (Time Warner Cable). But things were not so simple. Adelphia was not a single corporation, but rather a group of 230 related entities.[188] Each creditor group could contest the valuation of its claim. Even though there were only a few large creditor groups, there was no easy way of putting a value on each one and there was no obvious focal point around which agreement might form. As a result, there was no way to "assuage the concerns of one creditor faction without further alienating another. . . . This effectively froze progress on the confirmation of a reorganization plan, with the deadlock increasingly threatening the . . . sale."[189]

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to the one in which the newest apprentice in a French restaurant is sent to retrieve soufflé weights lent to a rival. Aspiring bankruptcy lawyers are instructed to go to plan negotiations and to be unyielding on the question of allowing fees for the indenture trustee, only to be surprised when they are not taken seriously.

187. *See In re* Adelphia Commc'ns Corp., 368 B.R. 140, 146 (Bankr. S.D.N.Y. 2007).

188. *Id.*

189. *Id.* at 159.

The problem that we need to confront is that the core may be empty.[190] There is no deal that will stick. Consider the following stylized variation on the facts of *Adelphia*. There are four unsecured creditors, all of whom have claims of uncertain value. None brings any special value to the business, and each is

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190. An "empty core" exists when three or more parties cannot reach a stable agreement with each other because some other agreement always exists that at least one party prefers. In other words, at least one person will always defect from any tentative agreement that might be made and, hence, none ever is reached. Low transaction costs create a frictionless environment in which agreements cannot stick. For an accessible introduction to the problem of the empty core, see Lester G. Telser, *The Usefulness of Core Theory in Economics*, 8 J. ECON. PERSP. 151 (1994). The problem of the empty core may require some qualification of the Coase theorem, as it is premised on the idea that parties can reach agreement with one another if transaction costs are low enough and information is perfect. *See* Varouj A. Aivazian & Jeffrey L. Callen, *The Coase Theorem and the Empty Core*, 24 J.L. & ECON. 175 (1981) [hereinafter Aivazian & Callen, *The Coase Theorem*]; Varouj A. Aivazian & Jeffrey L. Callen, *The Core, Transaction Costs, and the Coase Theorem*, 14 CONST. POL. ECON. 287 (2003) (expanding upon the argument that the Coase Theorem may break down when faced with an empty core). *But see* R.H. Coase, *The Coase Theorem and the Empty Core: A Comment*, 24 J.L. & ECON. 183 (1981) (arguing that the empty core and the Coase Theorem can be reconciled through penalty clauses and time constraints).

The empty core has been applied to antitrust and other areas of the law. *See, e.g.*, George Bittlingmayer, *Decreasing Average Cost and Competition: A New Look at the* Addyston Pipe *Case*, 25 J.L. & ECON. 201 (1982) (applying the empty core to the *Addyston Pipe* antitrust case); Paul Stephen Dempsey, *The Financial Performance of the Airline Industry Post-Deregulation*, 45 HOUS. L. REV. 421, 482-84 (2008) (summarizing the empty core as other scholars have applied it to the airline industry and deregulation); Keith N. Hylton, *Efficiency and Labor Law*, 87 NW. U. L. REV. 471, 502-05 (1993) (applying the empty core concept to labor law and unions); Henry E. Smith, *Structured Settlements as Structures of Rights*, 88 VA. L. REV. 1953, 1969-70 (2002) (applying the empty core problem to structured settlements); John Shepard Wiley Jr., *Antitrust and Core Theory*, 54 U. CHI. L. REV. 556 (1987) (explaining the empty core's application to antitrust law but arguing that judges should ignore its implications).

Some discussions of bankruptcy have mentioned the problem of the empty core in passing. *See, e.g.*, Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. REV. 1547, 1605 n.219 (1996) (noting that coalitions formed in bankruptcy can experience problems similar to the empty core problem); Lewis A. Kornhauser, *Fair Division of Settlements: A Comment on Silver and Baker*, 84 VA. L. REV. 1561, 1575-79 (1998) (focusing on the empty core in the context of settlement and bankruptcy's pro rata sharing rule); Michael A. Perino, *Class Action Chaos? The Theory of the Core and an Analysis of Opt-out Rights in Mass Tort Class Actions*, 46 EMORY L.J. 85, 122-23 (1997) (comparing collective action problems in class actions to those in bankruptcy and applying core theory to the problem); Maxwell L. Stearns, *The Misguided Renaissance of Social Choice*, 103 YALE L.J. 1219, 1239 n.75 (1994) (warning that participants in bankruptcy cases may not be in the best position to determine how assets are divided due to the empty core problem). None of these analyses, however, has connected the problem to particular provisions of the Code, to the way in which bankruptcy judges can prevent an empty core, or to the way that changes in finance have greatly magnified the problem.

focused only on maximizing the value of its debt. The plan of reorganization establishes the mechanism that will determine how each claim is valued.[191] There is no efficiency loss in adopting one plan over another. Nevertheless, the plan does matter to the parties themselves, as each valuation mechanism tends to favor some at the expense of another. Section 1129 of the Bankruptcy Code allows any of the three to form a coalition in which they can cramdown a plan on the fourth.[192] Various rules in the Bankruptcy Code try to ensure that similar claims are treated alike,[193] but it is hard to bring this about in practice. For example, the plan of reorganization can provide that each receives twenty-five percent of the equity, but, as *FiberMark* suggests,[194] the three plan proponents can effectively divide governance rights among themselves in a way that leaves the fourth in the unhappy position of a powerless minority shareholder in a closely held corporation. In *Adelphia*, everything turned on how interdebtor disputes were resolved.

Let us assume that Firm is worth $14 and that any three of the creditors can form a coalition in which they divide $12 among themselves and leave $2 for the excluded creditor. The core here is empty. The creditor who is left out of the coalition can propose a deal that gives two members of the coalition more and still be better off than if he is left out of the deal entirely. We face a danger that the bankruptcy process degenerates into repeated and costly attempts at coalition building. To be sure, the Code's provisions provide some check. A plan that discriminated transparently in terms of allocating claims against the reorganized company would not pass muster, given the Bankruptcy Code's requirement that plans provide the same payout among claims in the same class without the adverse parties' consent.[195] Yet whenever valuation problems exist, even this requirement does not provide complete protection.

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191. Of course, in principle, it is possible for the court to keep the bankruptcy open and resolve each of the claims as best it can. In many cases, however, quite apart from the difficulty of determining the value of the claims, there is an efficiency loss from delay. In Adelphia's case, for example, even after the sale of the assets, the failure to get a plan of reorganization approved would require a premature IPO of stock received in the sale. ACC Bondholders Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 361 B.R. 337, 353 (S.D.N.Y. 2007).

192. A class accepts a plan when a majority in number and two-thirds in amount of the claims in a class vote in favor of it, *see* 11 U.S.C. § 1126(c) (2006), and when a class accepts a plan, the judge can confirm it without going through the "cramdown" procedure. *See id.* § 1129(a)(8).

193. For a description of the provisions in Chapter 11 that bring this about, see *supra* text accompanying notes 15-22.

194. *See supra* text accompanying notes 60-86.

195. 11 U.S.C. § 1123(a)(4).

In an earlier era, one in which the dominant issue in corporate reorganizations was the collective action problem of bringing diverse stakeholders together, this sort of problem did not loom large. The costs of putting together any coalition were sufficiently high that once a coalition formed, it was unlikely that anyone else would be sufficiently organized to break it up. Transaction costs and the frictions they caused kept the problem at bay. Indeed, the very fact that most creditors were passive allowed a stable coalition to form. The dramatic decline in transaction costs and the ability of investors to interact with each other at such low costs, however, now makes the empty core a problem worth taking seriously.[196]

The problem worsens when the competing investors each bring value to the business. Consider the following hypothetical. Firm is in financial distress and has defaulted on its loans to both HedgeFund and Supplier. HedgeFund is owed $10 and has a security interest in all Firm's assets. Supplier is owed $10, but it is unsecured. Firm could be sold, but only $13 would be realized from the sale. (HedgeFund would receive $10 and Supplier will receive the balance of $3). The old equityholders would be wiped out. As Firm is being wound down, Manager will be paid $2. HedgeFund, Supplier, and Manager negotiate and attempt to settle on a plan of reorganization.

HedgeFund, Supplier, and Manager all bring value to the business. HedgeFund knows how to reshape and modify the business plan in a way that puts Firm back on track. Supplier provides a crucial component and has expertise in designing the next generation of the product. Manager knows the customer base and the best way to operate the business. If all three agree to work together, Firm is worth $24. Any of the two, however, could also work together and bring added value to Firm. HedgeFund and Manager could work together and realize $22, less the $3 they must give Supplier if it is left out.[197] These two would then share the remaining $19. Similarly, should Supplier and Manager agree to go it alone, the business would be worth $20, $10 of which

196. For a description of how low transaction costs actually create empty core problems and how this relates to the Coase Theorem, see *supra* note 190. Barry Adler has suggested a reorganization mechanism in which junior creditors propose a plan that could include a take-it-or-leave-it offer for the senior creditor. Barry E. Adler, *Game-Theoretic Bankruptcy Valuation* (N.Y.U. Law & Econ. Research Paper Series, Working Paper No. 07-03, 2007), *available at* http://ssrn.com/abstract=954147. Such a mechanism might avoid the empty core problem, as the ability to make take-it-or-leave-it offers dramatically narrows the range of possible equilibrium agreements.

197. Note that although Supplier is due $10, a plan can be confirmed so long as Supplier receives what it would have received in a liquidation. *See* 11 U.S.C. § 1129(a)(7)(A)(ii).

they must give HedgeFund if it is left out.[198] This arrangement would allow Supplier and Manager to divide $10 between them. Finally, HedgeFund and Supplier could reach a deal with each other, realize $23, and exclude Manager. Manager would still capture $2 while the deal is being arranged, but $21 would still be left over to divide between the two other parties. All this is known to the parties, but not to the bankruptcy judge or to outsiders.[199]

Under these assumptions, the optimal outcome is for HedgeFund, Supplier, and Manager to reach a deal with each other and divide the $24 that is realized among them. No other combination generates as high a total return. This deal, however, is not possible. No matter what share each is given in Firm, it will always be possible for one party to enter into a coalition with another that leaves them better off than they would be if they accepted the deal with the third.

Assume, for example, that a plan is put forward in which HedgeFund, Supplier, and Manager join forces and HedgeFund receives $13, Supplier receives $6, and Manager receives $5. They are all receiving more than they would in the event of a liquidation of Firm, but it is not a plan that the parties will agree on. For example, Supplier, rather than accepting this deal, can propose to HedgeFund that they dump Manager and that HedgeFund take $14, leaving $7 for itself. HedgeFund and Supplier are both better off than they would be if they joined forces with Manager. Such a deal is not stable either. Manager would approach HedgeFund and suggest that it dump Supplier. Manager could offer HedgeFund a share of $16 and still leave $3 for itself. Supplier in turn could bribe either Manager or HedgeFund to abandon this coalition, and so forth. Under these assumptions, the core is empty. There is no agreement among the players that produces a stable equilibrium.[200]

This hypothetical is, of course, only that. When a relatively small group of sophisticated professionals cannot reach a deal over a long period of time, other factors are necessarily at work. The reorganization of Delphi, a former subsidiary of and still one of the principal suppliers of General Motors, provides an illustration. The declining fortunes of General Motors and the automobile industry generally over the last several years made it hard to enforce any deal that took a significant amount of time to implement, as one

198. As a secured claimholder, HedgeFund is entitled to its full claim up to the value of the underlying collateral, in this case all of Firm's assets. *See id.* § 506.

199. In this hypothetical, we have abstracted away many of the difficulties confronting modern reorganization practice. We have replaced shape-shifting creditors holding varying agendas with single actors, each of whom has a transparent economic interest.

200. For a discussion and formal proof of the conditions necessary under these assumptions, see Aivazian & Callen, *The Coase Theorem*, *supra* note 190, at 179-80.

party would have a strong incentive to back out. Nevertheless, as in *Adelphia*, we see sophisticated parties long unable to reach a deal with each other for reasons that seem unrelated to how the assets are used.[201] It is difficult for insiders—and may be impossible for outsiders—to ascertain in any given case whether the failure to reach a stable coalition stems from an empty core, radical disagreements about valuation, or strategic bargaining of various sorts. Nevertheless, paying attention to how coalitions come into being should inform our understanding of the Bankruptcy Code.

The possibility of an empty core creates a challenge for those designing bankruptcy policy. The solution to an empty core, however, raises challenges of its own. It is one thing to ensure that a plan will be formed; it is another to ensure that this plan will be the most efficient use of the debtor's assets. For example, consider a rule that gives the existing managers of the firm the exclusive right to propose a plan of reorganization at the outset of the case. This rule effectively removes one possible coalition from the table in our second hypothetical (namely, the coalition between HedgeFund and Supplier that eliminates Manager). Eliminating some coalitions may increase the chance that the core is not empty. This is the case with our example. There is an equilibrium plan in which Manager is given $10, HedgeFund $10, and Supplier $4. Neither HedgeFund nor Supplier can do a deal with Manager in which Manager receives more than $10 and either is left with more than it receives in the proposed plan.[202] HedgeFund and Supplier could, of course, do much better if they were able to propose a plan that excluded Manager, but the exclusivity rule prevents this from happening and thereby creates an equilibrium solution. Of course, while this sort of agenda control can prevent the core from being empty, this does not mean that the solution is optimal. Indeed, there is an extant literature that worries that managers can use agenda control to further their own interests at the cost of the enterprise as a whole.[203]

While some provisions of the Code may combat the empty core problem, others may exacerbate it. Most conspicuous are the rules governing solicitation

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201. *See* Michael J. de la Merced, *Delphi Is Said To Have a New Deal To Leave Bankruptcy*, N.Y. TIMES, July 17, 2009, at B2 (describing long and unsuccessful negotiations with shifting coalitions). Only when the government sought to engineer a sale of Delphi to a private equity firm at what the existing lenders thought was a bargain price did an agreement arise under which the existing lenders took control of the company.

202. If HedgeFund and Manager worked together and left Supplier out, HedgeFund and Manager would have only $19 to split between themselves. If Supplier and Manager worked together, they would be left with only $10 to split.

203. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 214-15 (2001).

of acceptances of plans. Section 1125 can be read to forbid agreements between creditors before the plan proponent writes a disclosure statement and has the judge approve it.[204] One-on-one discussions with another stakeholder rarely pose a problem, even if the communication is a draft plan. Negotiations per se are similarly unproblematic. Nor is § 1125 violated by obtaining informal assurances from a creditor to support a particular plan.[205] But in the new world of Chapter 11, such informal assurances are sometimes not enough. The holder of a particular claim may be a bank today and a vulture investor tomorrow. Ensuring that you can rely next month on the support you garner this week by obtaining a writing that binds the party is useful. Such binding agreements, however, may not be enforceable. Indeed, if made, they expose their creators to the risk that their votes will not count.[206] Such doubt is itself an impediment to coalition building.

In practice, bankruptcy judges have allowed parties to form coalitions without going through the hoops of § 1125.[207] Nevertheless, it is not certain that this will always be the case. A court interpreting § 1125 might conclude that a disclosure statement must be approved before someone can be asked to make a binding commitment to vote in favor of a plan. Such an interpretation of § 1125 may run counter to some practices that have emerged in recent years and may be inconsistent with sensible bankruptcy policy, but some courts, especially appellate courts, have little sympathy for interpretations that are out of step with what seems to be the plain language of the statute.[208]

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204. The relevant statutory text is set out in 11 U.S.C. § 1125(b) (2006). For a discussion of relevant bankruptcy practice, see Daniel J. DeFranceschi, *Delaware Bankruptcy Court Announces Bright-Line Rule for Use of Lock-up Agreements in Chapter 11 Cases*, 22 AM. BANKR. INST. J. 16 (2003).

205. For a narrow reading of § 1125(b), see *Century Glove, Inc. v. First American Bank of New York*, 860 F.2d 94, 100-03 (3d Cir. 1988), which interprets "solicitation" narrowly so as not to inhibit negotiations. *See also In re* Snyder, 51 B.R. 432, 437 (Bankr. Utah 1985) ("The terms 'solicit' and 'solicitation' . . . must be interpreted very narrowly to refer only to a specific request for an official vote either accepting or rejecting a plan of reorganization. The terms do not encompass discussions, exchanges of information, negotiations, or tentative arrangements . . . .").

206. *See* 11 U.S.C. § 1126(e).

207. *See* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 265-68 (4th ed. 2006).

208. *See, e.g., In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004) ("Answers to contemporary issues must be found within the Code (or legislative halls). Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text."); Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 754 (9th Cir. 1999) ("Policy arguments cannot displace the plain language of the statute; that the plain language . . . may be bad policy does not justify a judicial rewrite.").

Other long-standing parts of the Code deserve reexamination as well. The Code has long had a two-prong rule for class-wide approval by a class of debt holders. For the class to vote in favor of the plan, half of the debt holders holding more than two-thirds of the amount of debt in the class need to support the plan. Both parts of this voting standard are subject to question in today's new environment. The best justification for the majority of the holders rule is that it allows for the pooling of information.[209] Such a rule makes sense in a world of many creditors each of whom has differing information. This justification, however, runs aground in today's reorganization cases. The two-thirds in amount rule is equally suspect. The effect of this rule is to make it easier for any creditor to assemble a blocking position. Such a position will give that creditor a seat at the bargaining table. Multiplying the number of creditors who need to agree to a plan of reorganization may make it harder to find a stable coalition. Indeed, the current rules may lead to the situation that within each class there may be an empty core.

Other recent amendments compound the problem by increasing the fragmentation of claims. These include the expansion of priorities, such as requiring assurance of payment to utilities[210] and payment in full to vendors who ship within twenty days before the filing of the petition.[211] The proliferation of exclusions to the automatic stay has made matters worse as well. We can also take steps to improve the bankruptcy exchange. One can clarify exactly what rules govern claims trading and particularly what disclosure rules make sense. We can also figure out some way to identify stakeholders. Independent of optimal disclosure, you need to know who owns what in order to defragment capital structures.

But bolder steps may be needed to create focal points or otherwise ensure that the core is not empty. One way to prevent the bargaining breakdown is to give agenda control to a single party. A dictator can impose a solution on all of the parties. The bankruptcies of both GM and Chrysler were able to proceed at breakneck pace because one player—the United States government—was able to dictate the terms of the proceedings. Yet, giving power to one player raises concerns of its own. The bankruptcy judge in Delphi resisted the government's efforts to bring about a resolution of the case with its own plan, involving the

209. *See* Kevin A. Kordana & Eric A. Posner, *A Positive Theory of Chapter 11*, 74 N.Y.U. L. REV. 161, 168-69 (1999).

210. *See* 11 U.S.C. § 366.

211. *See id.* § 503(b)(9) (classifying such payment as an administrative expense).

participation of a private equity fund. As he put it, "As far as I'm concerned, they're just guys in suits. Why can't other guys in suits pay more?"[212]

The willingness of a bankruptcy judge to take unilateral action—such as insisting on an immediate sale of the assets—seems the most common way in which the problem of bargaining impasse is being solved. The costs of such a rule, of course, have been well-explored.[213] In an illiquid market, if the sale takes place, the price may be less than its value in its best use and hence stakeholder recoveries decrease.[214] Moreover, sales often require buyers to assume some, but not all, of the debtor's existing obligations.[215]

Ordering the sale of the firm to the highest bidder is a way of putting a gun to the parties' heads. Judge Milton Pollock did essentially this in the bankruptcy of Drexel Burnham. He told the parties that if they could not reach agreement in short order, he would sell the firm's assets and retired to his chambers for a few minutes. Parties found the judge's threat credible and feared that a sale would make them all worse off (believing that the particular junk bonds were worth far more than the market would pay for them). Notwithstanding weeks of deadlock, they reached an agreement that was scribbled on a yellow legal pad just before time expired.[216]

The use of this "nuclear" option may be a way to induce agreement, and the threat may only rarely need to be carried out. Moreover, little going-concern value may have been at risk in many cases. The social cost of carrying out the threat may be small. Again, the assets involved in Drexel were securities. Even if the market undervalued them, there is no social loss associated with selling

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212. *See* Richard Beales, *Delphic Dealings*, breakingviews.com, June 10, 2009, http://www.breakingviews.com/2009/06/10/delphi.aspx?sg=nytimes.

213. *See* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007) (providing empirical evidence suggesting sales in bankruptcy yield lower values than when firms reorganize).

214. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992) (showing that liquidation sales yield lower prices than actual value in best use as similarly situated firms are likely to be experiencing financial distress as well).

215. *See In re* Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009). The bidding procedures in *Chrysler* have been criticized because of the way in which the consideration offered by the only bidder consisted not only of cash, but also assumption of specified unsecured obligations of the business. For a critique, see Mark J. Roe & David A. Skeel, *Assessing the Chrysler Bankruptcy* (Univ. of Pa. Law Sch. Pub. Law Research Paper No. 09-17, 2009), *available at* http://ssrn.com/abstract=1426530.

216. Nancy Miller, *Judge Rules with Rod, Impish Smile*, USA TODAY, Mar. 25, 1992, at 5B (discussing how Judge Pollock threatened to dismantle the brokerage firm on his own if the parties did not reach a deal).

them quickly. But we need to consider the cases in which there are a variety of different plans and only one of them preserves going-concern value. In such cases, relying on the parties to reach agreement has its greatest value. When the parties themselves know the highest and best use of the assets, but others do not, inducing such an agreement may be the best way to maximize the value of the assets.

A judge that resists approaches that put value at risk is often left with the unpalatable alternative of approving plans that do not quite pass muster but do rough justice and are insulated from review by a court that would insist that square corners be cut. *Adelphia* may be an example of such a case. The district court stayed the confirmation of the plan as it had serious doubts about whether the letter of the law was being followed, but never heard the case, as the appellants were unwilling to post the required bond ($1.3 billion in cash; the first ten percent due in twenty-four hours and the balance in seventy-two).[217]

Neither of these approaches, both of which are evident in recent bankruptcy cases,[218] can be reconciled neatly with traditional accounts of what bankruptcy judges are supposed to do. Indeed, the standard academic critique of bankruptcy judges is that they exercise too much discretion and are too quick to depart from the strict letter of the law. We are no longer in a world, however, in which judicial discretion is merely a way of neglecting the absolute priority rule. The push towards simple rules creates the risk of an empty core. Putting frictions and artificial barriers in place can accelerate rather than hinder consensual, value-maximizing bargains.

CONCLUSION

Judges are quite likely to follow the lead of professional investors when they present a united front. Modern judges are likely to enforce intercreditor agreements as written, but in a world in which the financial instruments are new, the agreements will likely be incomplete and some recourse to gap-filling is necessary. Even if things will sort themselves out eventually, life is not going to be easy during the interim.

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217. *See* ACC Bondholders Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 361 B.R. 337, 368 (S.D.N.Y. 2007).

218. For an example of a case in which the bankruptcy judge brought an end to a case through a sale in which the judge assessed competing noncash bids, see *Contrarian Funds, LLC v. Westpoint Stevens, Inc.* (*In re* Westpoint Stevens, Inc.), 333 B.R. 30, 55 (S.D.N.Y. 2005).

The lifeblood of corporate reorganizations is and always has been negotiation. Creating the optimal environment for facilitating such negotiations is the principal business of those who shape the law. The most direct lesson of all this for the bankruptcy judge is likely one that the best have intuited long ago: she should not interpret the Bankruptcy Code in a way that creates an empty core. A simple and transparent bargaining environment in some cases may not be enough. Precisely because it is simple and transparent, there is an increased danger that parties will find it hard for stable coalitions to emerge. It also suggests that much of recent bankruptcy reform—changes that have added complexity to the Code and sought to corral the bankruptcy judge's discretion—are headed in the wrong direction. The problem of ensuring coalition formation requires giving bankruptcy judges more discretion, not less.

If past is prologue, the uncertainties that financial innovation brings with it are likely to be resolved satisfactorily, even if not immediately. We do not believe that this anticommons problem—and the associated empty core problem that may come with it—will be an enduring feature of corporate finance, only that the emerging round of Chapter 11 will revolve around these problems precisely because they are new. Our experience with large corporations competing in a market economy is only about a century and a half old. Capitalism is still very much a work in progress, and the science of corporate finance is at an early stage.