

Anti-Bankruptcy

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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 faces today a challenge that is much like assembling a city block that has been broken up into many parcels. There exists an anti-commons 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 paper 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.

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 helplessly by.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, Kmart, Budget Rent-A-Car) overcame financial distress in Chapter 11 and continued to operate.²

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¹ 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*, THE SAN

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 environment. The players today are different from those in past

FRANCISCO CHRONICLE, Jan, 21, 2006, at C1. For 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, November 9, 2002.

³ See *Enron Creditors Recovery Corp.: Recovery Rate Hits 50 Percent as Enron Creditors Receive More Than \$6 Billion in Special Distributions*, INVESTMENT BUSINESS WEEKLY, 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, e.g., *id.* (reporting \$1.866 billion settlement by Citibank to resolve the claims of Enron’s general creditors against it). For the fate of Enron’s executives, see Kristen Hays, *Kenneth Rice is the Final Figure to be Punished After Pleading Guilty to Crimes in the Scandal: A Sordid Chapter on Enron Ending*, HOUSTON CHRONICLE, June 18, 2007, at A1 (reporting that eight Enron former executives are serving prison terms of up to twenty-four years).

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 ICF, Working Paper No. 05-29; AFA 2008 New Orleans Meetings Paper; ECGI – Finance, Working Paper No. 107/2005), available at <http://ssrn.com/abstract=866865> (showing that capital structures of small and large cases are dramatically different).

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

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, *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 67 large reorganization cases in 2002 and 52 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 77, 78 (2008) ("Twenty-five years ago . . . [t]he major creditor participants in corporate reorganizations 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.").

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 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 towards 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

⁸ Karl Denninger, *GM: Bankrupt, UNLESS....*, MARKET TICKER, April 1, 2009 (speculating that GM bondholders are refusing to renegotiate because their bonds are backed by AIG credit default swaps that will pay in full if GM files for bankruptcy).

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 Adelpia reorganization, for example, infighting among at least 12 unofficial groups of creditors resulted in seven proposed reorganization plans, and professional fees and expenses initially sought by these twelve

cases there may be no stable equilibrium at all. To use the language of cooperative game theory, the core may be empty.¹¹

groups alone totaled over \$100 million. See Huebner & Tisdell, *supra* note 6, at 80.

¹¹ An “empty core” exists when three or more parties cannot reach a stable agreement with each other because some other agreement always exists that some parties prefer. In other words, one or more people will always defect from any tentative agreement that might be made and hence none ever is. 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); 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 it applies 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 to labor law and unions); 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); 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).

Some discussions of bankruptcy have mentioned the problem of the empty core in passing. See Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors’ Committees*, 43 UCLA L. REV. 1547, 1605 n.219 (1996) (noting that coa-

In this paper, 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 anti-commons problem, a world in which ownership interests are fragmented and conflicting.¹² This is quite at odds with the 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 anti-bankruptcy.

litions formed in bankruptcy can experience problems *similar* to the empty core problem); 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 empty core problem); Lewis A. Kornhauser, *Fair Division of Settlements: A Comment on Silver and Baker*, 84 VA. L. REV. 1561, 1575 (1998) (focusing on empty core in the context of settlement and bankruptcy’s pro rata sharing rule). None of these, however, has connected the problem to particular provisions of the Code, to the way in which bankruptcy judges can prevent an empty core, or the way changes in finance have greatly magnified the problem.

¹² For a discussion of the anti-commons problem, see Michael Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998). See also Lee Anne Fennell, *Commons, Anticommons, Semicommons* (Univ. of Chicago John M. Olin Law & Econ., Working Paper No. 457; Public Law & Legal Theory, Working Paper No. 261, 2009), available at <http://ssrn.com/abstract=1348267>; MICHAEL HELLER, *THE GRIDLOCK ECONOMY* (2008). 40

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”).

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), bondholders, trade creditors, 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 are paid after the secured creditors, but before the general creditors.¹⁵

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 paper 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 resulting radically different dynamics between the large and small cases, see Baird, Bris & Zhu, *supra* note 4.

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

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

¹⁶ See 11 U.S.C. § 101(5) (2006) (defining “claim” for purposes of the Bankruptcy Code as generally any “right to payment”).

¹⁷ See 11 U.S.C. § 502(b)(2) (2006) (disallowing claims for unmatured interest).

¹⁸ See 11 U.S.C. § 726(b) (2006) (providing for pro rata distributions in Chapter 7 liquidations). Chapter 11 accomplishes this through requirements placed on the plan of reorganization. See *infra* note 20.

¹⁹ See 11 U.S.C. § 1102 (2006).

²⁰ See 11 U.S.C. § 503(b)(3)(F) (2006) (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 11 U.S.C. § 1122(a) (2006) (claims in the same class must be “substantially similar”); § 1123(a)(4) (plan must provide for the same treatment for each

no need to fear a tyranny of the majority. The plan had to treat those similarly situated in the same way.²²

The drafters of the Bankruptcy Code assumed that the unsecured creditors had two hurdles to overcome. One was that they were dispersed. 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.²³ 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. A central issue 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 val-

claim of a particular class); § 1129(b) (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 (E.D. Mich. 1999) (“Claims 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) (2006), and those of workers for unpaid wages, § 507(a)(4)(A)) are given priority. But these are the exception and they do not figure significantly in large cases. See Baird, Bris & Zhu, *supra* note 4.

²³ See *supra* note 13.

ues 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.²⁴

The answer to these problems was to give a central role to a committee to represent the interests of the unsecured creditors. The committee would be staffed with creditors, presumptively those holding the seven largest claims against the debtor.²⁵ 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 enjoy 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.”²⁶ The court would approve the law firms that the committee hired.²⁷ Moreover, the debtor would pay for all of the committee professionals, such as investment bankers and accountants.²⁸ 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.

²⁴ One of us 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).

²⁵ 11 U.S.C. § 1102(b)(1) (2006).

²⁶ 11 U.S.C. § 1103(c)(2) (2006). *See also* § 1103(a) (giving the committee the power to employ “attorneys, accountants, or other agents”).

²⁷ 11 U.S.C. § 328(a)(1) (2006).

²⁸ *Id.*

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.²⁹ 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.³⁰ Also, the creditors' committee can extract concessions from the debtor. The debtor would be hard-pressed to confirm a plan of reorganization 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.³¹ 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

²⁹ 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”).

³⁰ 11 U.S.C. § 1103(a) (2006) (authorizing the committee to hire professionals); § 328(a)(1) (providing for payment of fees).

³¹ See note 7 *supra*.

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 trading.³² Whether this can be done in a way that keeps the largest players at the bargaining table has proved hard.³³ 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.³⁴ 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.

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 has existed for over twenty years.³⁵ The increased presence and financial wherewithal of hedge funds, however, has increased the importance of this aspect of reorganization prac-

³² 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. BANK. INST. L. REV. 569 (2002).

³³ For a discussion of how so-called "Chinese Walls" may be used to mitigate this problem, see *infra* note 58.

³⁴ 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.").

³⁵ See Chaim J. Fortgang & Thomas M. 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).

tice.³⁶ The basic rationale for claims trading is simple. It allows easy exit for those who are ill-equipped to navigate it.

Chapter 11 cases can be drawn-out affairs.³⁷ When a debtor files for Chapter 11, the debtor is prohibited from paying pre-petition debt.³⁸ Payments on such obligations await the end of the case, absent a showing that immediate payment makes creditors as a group better off.³⁹ But the holders of some claims, such as suppliers of goods and services, never expected to be a long-term investor 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

³⁶ 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*, 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 (2005) (discussing the growing importance of the role distressed debt investors play in Chapter 11).

³⁷ For example, of the 57 companies that were public at the time they filed for bankruptcy and confirmed reorganization plans in 2005, 26 were in bankruptcy for over a year, and one was in bankruptcy for almost seven years. See NEW GENERATIONS RESEARCH, *THE 2006 BANKRUPTCY YEARBOOK AND ALMANAC* 46–47.

³⁸ 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. 11 U.S.C. § 503(b)(9) (2006).

³⁹ 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).

capital in bankruptcy proceedings. Even if the trade creditor still wants an on-going relationship with the debtor, it is eager to monetize its claim for prepetition goods and services. 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.⁴⁰

Claims trading flourishes because it is attractive to buyers as well as sellers. 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. They earn a premium from impatient creditors looking to turn their claims into cash. The new investors may also profit from their ability to navigate the bankruptcy process. They may be better able to assess how much the debtor will ultimately be able to pay on its claims. 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.⁴¹

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 take-over 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 ob-

⁴⁰ 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. LAW ●●● (forthcoming 2009).

⁴¹ For example, just days after essentially buying Kmart out of Chapter 11 bankruptcy for nearly \$1 billion, hedge fund ESL Investments it 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 BUSINESS, December 1, 2008, at 33.

tain 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.⁴² The reorganization plan gave ESL the right to appoint four directors. Edward Lampert, the head of ESL, appointed himself, two of his employees, and a major investor in ESL.⁴³

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.⁴⁴ FiberMark was a specialty producer of paper products based in Vermont. The company had been formed in 1989 by a management-led buyout of a division of Boise Cascade. The capital structure of the company was relatively simple. It had a secured credit facility of \$85 million. 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 ultimate fight that erupted. The bulk of the rest of FiberMark's financing was through public bonds. These bonds had a face amount of \$346 million. The remaining unsecured debt was roughly \$12 million.⁴⁵ In light of this capital structure, whoever controlled the bond debt would control the outcome of the

⁴² See Harner, *supra* note 2, at 725–27. Other recent examples of 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.

⁴³ *Id.* at 726. See also Edward S. Lampert Appointed Chairman of the Board, Kmart, PR NEWSWIRE, May 6, 2003.

⁴⁴ The fight in FiberMark is set out in detail in Report of Havey R. Miller, as Examiner, In re Fibermark, No. 04-10463 (Bankr. D. Vt.) (August 16, 2005) [hereinafter Report].

⁴⁵ For a brief account of the history and pre-petition debt structure of Fibermark, see Report, *supra* note 44, at 27.

case. It might seem that things should go smoothly, but they did not. The reorganization proceeding eventually became a brutal fight among three hedge funds that was only settled after the bankruptcy court intervened and appointed an examiner to investigate them.⁴⁶

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. Neither acquired any more notes during the case. 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. The indenture trustee for the notes and a trade creditor holding a \$50,000 claim were also appointed to the committee.⁴⁷

Because the other creditors were not actively involved, Post and especially AIG believed that they could control the committee and hence FiberMark and its reorganization. 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.⁴⁸ By con-

⁴⁶ See *In re Fibermark, Inc.*, 330 B.R. 480, 489–93 (D. Vt. 2005).

⁴⁷ See Report, *supra* note 44, 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.

⁴⁸ 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).

trast, once in bankruptcy, a creditor holds only a generic “claim.” Any contractual protections that she obtained outside of bankruptcy disappear. The Bankruptcy Code homogenizes 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.⁴⁹

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.⁵⁰ 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.⁵¹ 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.⁵²

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 notes shortly before the case began and continued to do so while the case proceeded. 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.⁵³

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 bank-

⁴⁹11 U.S.C. § 1129(a)(7) (2006).

⁵⁰ Report, *supra* note 44, at 2–3.

⁵¹ *Id.* at 98–99.

⁵² *Id.* at 69–70.

⁵³ *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.

ruptcy. 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. Silver Point's large stake and 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 eighty percent of the unsecured debt.⁵⁴) 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.⁵⁵

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 the respective rights of the three running the company post petition. 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.⁵⁶

In FiberMark, the parties reached agreement only after a blistering report issued by the court-appointed examiner. To be sure, the parties involved took issue with many of the findings of the report, 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.⁵⁷ FiberMark illustrates the potential and perils of a world in which the liquidity of claims itself makes coalition building difficult. In addition, it un-

⁵⁴ *Id.* at 8.

⁵⁵ Report, *supra* note 44, at 5–8.

⁵⁶ See Terry Brennan, *Bankrupt*, FORBES, Oct. 31, 2005, at 60 (calling FiberMark “the ugliest Chapter 11 case of the year” and summarizing much of Miller's report).

⁵⁷ See Terry Brennan, *Turmoil Over, FiberMark Exits*, DAILY DEAL, Jan. 5, 2006.

derscores 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, some large players will no longer even want to serve.⁵⁸

II. The Transformation of Secured Debt

A. *The Decline of the Traditional Bank*

There is no more stock character in the discussion of bankruptcy policy than the senior bank. The drafters of the Bankruptcy Code assumed that secured creditors, principally banks, could be trusted to look out for themselves. The bank has made a large loan to the company and has a security interest in most, if not all, of the company's assets. The financial interest of the bank is relatively straightforward. If it can realize the value of its collateral, it will be paid in full. As such, the lender has 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 is biased toward liquidation. Because it does not share in the upside should the debtor's fortunes improve, it does not take such possibilities into account. Rather, if it can force a liquidation today, it can be paid in full. It sees no need to risk continuation that can

⁵⁸ 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"). An example of such a screening wall was used in the Fibermark bankruptcy. Silver Point agreed 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 Report, *supra* note 41, at 5.

only reduce its return. Even if the company is to be sold, the bank cannot be trusted if it is owed less than the company is worth. In this situation, the bank may not seek top dollar. It will only look for a sale that pays it in full. Given these incentives, the bank should not have its hand on the levers of control.⁵⁹

Two changes in bank lending practice render this account obsolete. The first is the rise of the syndicated loan.⁶⁰ Single banks no longer 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, it would have mitigated its risk. To be sure, by participating in more loans it is more likely that some debtor in its 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.

⁵⁹ 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).

⁶⁰ Syndicated loans grew from \$137 billion in 1987 to more than a trillion in 1997. See Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 J. FIN. INTERMEDIATION 404, 407 (2000). For a general discussion of syndicated lending, see ANDREW FIGHT, *SYNDICATED LENDING* (2004). See also AGASHA MUGASHA, *THE LAW OF MULTI-BANK FINANCING: SYNDICATED LOANS AND THE SECONDARY LOAN MARKET* (2007).

For each loan, one of the banks takes the lead role. It is charged with monitoring the debtor and overseeing the interests of the creditors as a group.⁶¹ 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.⁶² 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. Making such a commitment made the loan easier to sell to other lenders.⁶³

The lending agreement contained various covenants. The documents provided the lender with access to information generally unavailable to other investors. It could use this information to monitor the borrower. If the borrower tripped up a covenant, it would have to procure a waiver. 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 syndicate members. For the most part, however, syndicated 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.⁶⁴

⁶¹ For a discussion of loan syndication and typical structures, see Katerina Simons, *Why do Banks Syndicate Loans?*, 1993 NEW ENG. ECON. REV. 45.

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

⁶³ See *id.* at 665 (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 particular jurisdiction, affect the composition of the lending syndicate. See Benjamin C. Esty & William L. Megginson, *Creditor Rights, Enforcement, and Debt Ownership: Evidence from the Global Syndicated Loan Market*, 38 J. FIN. & QUANTITATIVE ANALYSIS 37 (2003) (suggesting a relation between syndicate structure and legal risk).

⁶⁴ See Sufi, *supra* note 62, at 632 ("[T]he lead arranger typically 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.").

Syndication has been with us for several decades. 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.⁶⁵ Other frequent participants in these syndicates were pension funds looking for a safe return on their assets.⁶⁶ These funds did not have the assessment capabilities of banks, and hence were even more likely to defer to the recommendation of the lead bank that arranged the syndicate.

The composition of lending syndicates, however, has changed recently. Membership is no longer limited to bank and pension funds. Hedge funds can participate in the syndication stage.⁶⁷ Moreover, there is a rapidly developing secondary market in syndicated loans.⁶⁸ The advantage of this market to those lenders participating in the syndicate is readily apparent. Unless restricted by the lead bank, a member of the syndicate has an exit option. It can sell its portion of the loan to a willing

⁶⁵ See Simons, *supra* note 61, at 46 (“[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.”), available at <http://www.bos.frb.org/economic/neer/neer1993/neer193c.pdf>.

⁶⁶ 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 this market include banks and other financial institutions such as insurance companies, pension funds, and mutual funds).

⁶⁷ 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) (reporting that hedge funds represent 29% of primary market for institutional loans with spreads of LIBOR + 400 basis points or higher in 2005).

⁶⁸ See Meredith Coffey, Robert Milam, Laura Torrado & Michele B. Piotrowski, *The Secondary Loan Market*, in THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING, *supra* note 67, at 393, 415–16 (noting that from 2000 to 2005 hedge fund trading in the syndicated loan market has risen from 10% to 30% of trading volume).

buyer.⁶⁹ Trading of these loans has increased dramatically in recent times.⁷⁰ Thus, when a borrower trips up covenants in its loan or files for bankruptcy, it will not necessarily be the case that all it has to do is to come to an understanding with the bank that has funded its senior debt. Today hedge funds can purchase enough of 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.⁷¹

A hedge fund that holds a position identical to the one held by a bank at an earlier time may view bad states of the world radically differently.⁷² It may have bought 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 notes, it would not be a bad price at which to acquire it even if it were in financial distress. Banks want their money

⁶⁹ See 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 required in fewer than half of the syndications); A. Burak Güner, *Loan Sales and the Cost of Corporate Borrowing*, 19 REV. FIN. STUD. 687 (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). 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.

⁷⁰ See Mugasha, *supra* note 66, at 201 (“[s]econdary loan trading has increased tenfold in the last five years”).

⁷¹ See, e.g., Jonathan Keehner, Caroline Salas & Jason Kelly, *Harrah’s Private-Equity Owners Said to Hedge Against Bankruptcy*, BLOOMBERG NEWS, March 13, 2009 (private equity firms that already hold equity buying debt to gain control of potential bankruptcy of Harrah’s).

⁷² See *Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?: Hearing Before the House Subcomm. on Commercial and Administrative Law of the House Judiciary Comm.*, 111th Congress, 1st Sess. (2009) (statement of Harvey R. Miller, senior partner, Weil, Gotshal & Manges LLP) [hereinafter Miller Testimony] (observing, in context of retailer bankruptcies, that financial institutions and members of lender syndicates have adopted a more distant and shorter term relationship with their debtor).

back; hedge funds loan to own. The same dynamic that plays out with respect to publicly traded unsecured debt now plays out with respect to the traditional bank debt as well.

As we have discussed, the Bankruptcy Code assumes these players will be interested in liquidating their senior claims. But this is no longer the case. 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 that it can control. Not only can it push for a low valuation, but the managers of the business, people whose options will be reset upon emergence from Chapter 11, will push for a low valuation as well.⁷³

In short, the senior lender in the identical place in 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, it 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).⁷⁴

B. The Second Lien Loan

It is not even the case anymore that the different players junior to the secured tranche will be general creditors. As we have noted, most debtors that file for bankruptcy tend to have a senior secured creditor. That creditor (or, more precisely, that lending syndicate) will have a security interest in virtually all of the assets of the company. The secured

⁷³ In Part III we take account of the rise of credit default swaps. 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.

⁷⁴ See Miller Testimony, *supra* note 72, at 5 (“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.”).

debt, however, will not exhaust the borrowing capacity of the business. Borrowers in need of additional funds can still borrow from lenders will to take a junior position (in return for a higher interest rate). In years past, the debtor would access this additional value through mezzanine financing on an unsecured basis. In the 1980s, this financing was provided by savings-and-loan associations and insurance companies.⁷⁵ 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.⁷⁶ 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.⁷⁷ The second lien market has exploded over the last several years.⁷⁸ As

⁷⁵ See CORRY SILBERNAGEL & DAVIS VAITKUNAS, BOND CAPITAL, MEZZANINE FINANCE 6 (Jan. 2006), http://www.bondcapital.ca/media/Bond_Capital_Mezzanine_Finance.pdf.

⁷⁶ See Marc Hanrahan & David Teh, *Second Lien Loans*, in THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING, *supra* note 67, at 108, 110 (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).

⁷⁷ See *Id.*

⁷⁸ 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 Corpora-

with syndicated first lien loans, there is a robust secondary market for second lien loans.⁷⁹

The second lender only comes onto the scene with the blessing of the first lender. This necessity for consent arises because the loan documents surrounding the senior loan typically restrict the ability of the borrower to grant a competing security interest in the company's assets. Few lenders would make a loan that would give the borrower the unfettered ability to pledge the collateral it is relying on to another lending group. Thus, to the extent that the borrower wants to obtain financing based on a second lien, it needs the consent of its primary lender.⁸⁰

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. 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. After a bankruptcy petition has been filed, it can object to the use of its collateral and seek adequate protection of its interest. Hedge funds are primary purchasers of second lien debt.⁸¹ They are well versed in pushing to the limit whatever legal rights they may have and contesting whatever limits the senior lienholder has tried to place on them.

tion). 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.*

⁷⁹ See Hanrahan & Teh, *supra* note 76, at 110 n.3 (noting that collateralized debt obligation collateralized loan obligation funds have started incorporating second lien loans into their portfolios).

⁸⁰ See *id.* 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.”)

⁸¹ See Harner, *supra* note 2, at 715 n.45.

The lynchpin of second lien financing is the intercreditor agreement.⁸² This contract specifies the relationship between the two lenders. 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.⁸³ The intercreditor agreement also typically gives the senior lender the right to finance the debtor post-petition and provides that this financing will have priority over the loan of the second lien lender.⁸⁴

The effect of second liens has yet to be felt. 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.⁸⁵ 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 proceeding.⁸⁶ 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 en-

⁸² See 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 78; George H. Singer, *The Lender's Guide to Second Lien Financing*, 125 BANKING L.J. 199 (2008).

⁸³ See Chamblee, *supra* note 78, at 18 (indicating that the ABA Model Intercreditor Agreement permits sales by the senior lender under section 363 of the Bankruptcy Code without consent of the second lien lender). See also Dobbs, *supra* note 82, at 218-19.

⁸⁴ See Dobbs, *supra* note 82, at 211-15.

⁸⁵ 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 is insufficient funds to pay off the administrative expenses.

⁸⁶ For an excellent discussion of the issues surrounding carve-outs, see Richard Levin, *Almost All You Ever Wanted to Know about Carve Out*, 76 AM. BANKR. L.J. 445 (2002).

forceability of provisions of the intercreditor agreement that tie the second lienholders hands during the bankruptcy process.⁸⁷

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 became increasingly 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). What matters is that the process is cost-effective and protects the rights of all the stakeholders.

C. *The Rise of Control*

More troubling than the existence of multiple levels of secured debt is the way in which secured creditors have ceased to be passive. This is in tension with the Bankruptcy Code’s assumption of a passive role for the secured creditor. Indeed, under old Chapter XI (which Chapter 11 supplanted in addition to old Chapter X in 1978), there was no mechanism for altering the rights of secured creditors.⁸⁸ Liens passed through

⁸⁷ For example, a provision that takes away from the second lienholder to exercise its right to vote on the plan of reorganization is suspect. See *Dobbs*, *supra* note 82, at 221 n.64 (setting out the differing views of courts on whether junior creditors can give up voting rights in bankruptcy).

⁸⁸ See Bankruptcy Act §§ 356, 357, 11 U.S.C. §§ 756, 757 (repealed 1978); *SEC v. U.S. Realty & Improvement Co.*, 310 U.S. 434, 452 (1940).

bankruptcy unaffected.⁸⁹ The problem with the capital structure was with the general creditors. It was their claims that needed to be restructured in order to return the business to financial health. Chapter 11 followed in the same fashion. It assumes that the general creditors are the residual owners of the business.

As long as there is an equity cushion,⁹⁰ secured creditors are allowed interest and fees arising from their claim.⁹¹ The secured creditor is entitled to “adequate protection” that ensures that the value of its collateral remains undiminished.⁹² It takes none of the risks of the reorganization, but it is entitled to none of the upside. Adequate protection cannot take the form of equity in the reorganized business.⁹³ If the plan leaves its security interest intact, it does not have any voice in the reorganization.⁹⁴ Changes to the secured creditor’s claim can affect only the terms on which it is being repaid. The plan can stretch out payments, but collateral must back it up, and fully adjusting for risk the note it is given must equal the value of its claim.⁹⁵

Senior creditors over the last two decades have learned how to gain more control over their debtor outside of bankruptcy.⁹⁶ The security in-

⁸⁹ This principle is one of very long standing. *See* Long v. Bullard, 117 U.S. 617 (1886).

⁹⁰ *See* In re Mellor, 734 F.2d 1396, 1400 n.2 (9th Cir., 1984) (“ ‘Equity cushion’ has been defined as the value in the property, above the amount owed to the creditor with a secured claim, that will shield that interest from loss due to any decrease in the value of the property during time [sic] the automatic stay remains in effect.”).

⁹¹ 11 U.S.C. § 506(b) (2006).

⁹² *See* 11 U.S.C. § 361 (2006).

⁹³ *See* 11 U.S.C. § 361(3) (2006).

⁹⁴ 11 U.S.C. § 1124 (2006).

⁹⁵ 11 U.S.C. § 1129(b)(2)(A) (2006).

⁹⁶ *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, *The “New and Improved” Chapter*

terest covers more assets and the lead lender controls all the cash that passes through the business. Moreover, secured creditors have learned, largely through debtor in possession (DIP) financing, how to gain control over the debtor during the bankruptcy itself.⁹⁷ The increase in control rights, combined with the heterogeneity 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.⁹⁸ This creates few problems when the DIP facility is in

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 excuse . . . of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower.”); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 799 (2004) (“[W]idespread adoption of a privatized system depending upon dominant security interests is as undesirable as it is unlikely.”).

⁹⁷ See Miller Testimony, *supra* note 72, at 11–12 (detailing commonly approved provisions in DIP financing orders, including: appointment of a CRO acceptable to the lender; cash-flow covenants that may compel the sale of assets or downsizing; provisions giving the lender control over disposition of the debtor’s assets; drop-dead dates or terms that provide for successively lowered advances to encourage liquidation; provisions that provide for the sale of the debtor or its assets within the limited period of time; provisions that subject the debtor’s plan of reorganization to some form of lender control, such as not allowing the debtor to file a plan of reorganization without lender consent, conditioning debtor exclusivity on lender consent, requiring the filing of a plan by a certain day, or specifying the contents of the plan).

⁹⁸ 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

the hands of a single lead bank. But the situation becomes significantly more complicated when those providing the DIP financing are a group of competing hedge funds, each pursuing its own agenda.⁹⁹ In theory, an agreement can be put in place that ensures that, at least 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 of two classes of creditors will have in bankruptcy.¹⁰⁰ 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 assumes that investors hold a single type of investment in the company. Shareholders own shares; creditors have debt, with banks holding secured debt. The Code itself provides for secured claims, unsecured claims, interests, and pretty much nothing else.¹⁰¹ When we think back to when the Code was drafted in the 1970s,

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 . . .").

⁹⁹ 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*, BLOOMBERG NEWS, Feb. 4, 2009.

¹⁰⁰ See, e.g., Dobbs, *supra* note 82, at 202 (setting out the "remedy block" first lienholders seek and limits second lienholders try to place on them).

¹⁰¹ See 11 U.S.C. § 506 (2006) (distinguishing between secured claims and unsecured claims) and § 501(a) (allowing equity security holders to file an interest). See also § 1129(b) (defining 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

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.¹⁰²

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 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 to either implement a restructuring already agreed upon or to sell off the company.¹⁰³ 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.

into by the debtor are excepted from bankruptcy altogether. *See, e.g.*, 11 U.S.C. §§ 362(b)(27), 555, 556 (2006).

¹⁰² *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649–54 (1973) (deriving a valuation formula for options and applying it 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., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 465–70 (1993).

¹⁰³ *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STANFORD L. REV. 751, 751–52 (2002).

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. Shareholders can vote for the board of directors. Creditors can invoke the machinery of the state to collect their debts. More importantly, credit contracts 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.¹⁰⁴ 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. We normally assume that an investor exercising a control right 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. 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.¹⁰⁵ 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

¹⁰⁴ See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1209 (2006) ("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.")

¹⁰⁵ See Lubben, *supra* note 7, at 411–12 (listing bankruptcy, failure to pay, and restructuring as typical credit events). For more information on credit derivatives, see generally Frank Partnoy & David Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CINN. L. REV. 1019 (2007).

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 \$55 trillion, far greater than the amount of debt outstanding.¹⁰⁶

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 to an even greater degree.¹⁰⁷ Indeed, the advocates for credit default swaps once argued that they promise to bring stability to the banking system.¹⁰⁸ Banks by and large remain the originators of large loans. 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.¹⁰⁹ Credit default swaps

¹⁰⁶ See International Swaps and Derivatives Association, *Summaries of Market Survey Results*, <http://www.isda.org> (follow “Surveys and Market Statistics” hyperlink; then follow “Summaries of Market Survey Results” hyperlink) (last visited Mar. 7, 2009) (“The notional amount outstanding of credit default swaps (CDS) dropped 12 percent to \$54.6 trillion in the first half of 2008. CDS notional growth was 20 percent for the year as a whole.”); Gillian Tett, *Unbound*, FIN. TIMES, Aug. 8, 2007, at 11 (“[T]he CDS market is now 10 times larger than the tangible cash bonds on which they are supposed to be based.”).

¹⁰⁷ See Partnoy & Skeel, *supra* note 105, 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).

¹⁰⁸ 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).

¹⁰⁹ For a discussion of the industry that services hedge funds, see Steve Bills, *JPM Buys Into Hedge Fund Middle Office*, AMERICAN BANKER, February 14, 2006, at 1 (discussing J.P. Morgan’s strategy for competing in the business of servicing hedge funds)..

allow the banks to offload some the risk of default outside the banking system. By removing risk from the banking system, this should bolster the banks' position should the economy hit a downturn or at least so the story went.¹¹⁰

Financing that leads to investment in the business grow out 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.¹¹¹ Indeed, some were 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 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

¹¹⁰ Indeed, the proponents of credit default swaps have touted their ability to reduce the risk to the banking system. *See supra* note 108. *But see* Partnoy & Skeel, *supra* note 105, 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 Phillips, *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.

¹¹¹ *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.").

case that those who own the loan have to make the decision. If you sell your piece of the loan in the secondary market, you lose your ability to have an input on any decisions that the syndicate has to make.

When a lender purchases a credit default swap, however, it retains the control rights that accompany the loan. 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 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.¹¹² In the extreme, those who bought credit protection on loans they did not hold may subsequently buy loans in the secondary market for the purpose of preventing a workout and forcing a default.¹¹³ 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.

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.¹¹⁴ 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, there is no way to know what the true financial incentives of anyone are. A

¹¹² See Henry T. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 730 (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).

¹¹³ See Partnoy & Skeel, *supra* note 105, at 1034–35 (describing 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).

¹¹⁴ See 11 U.S.C. § 501 (2006); Fed. R. Bankr. P. 3001–05.

hedge fund that holds a large loan position that it has acquired in the secondary market may in fact be net short.

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 the 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.¹¹⁵

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. 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.

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. The operations in the Netherlands, however, remained outside of any insolvency proceeding. This situation sparked a fight (still unresolved) over whether the American bankruptcy court would enjoin the holders of bonds issued by the Dutch entity from seeking recovery on those bonds. 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

¹¹⁵ 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).

that they held a large amount of credit default swaps which would pay handsomely upon default by the Dutch company.¹¹⁶

Credit default swaps create a moral hazard problem only before the Chapter 11 begins and then in its immediate aftermath. A Chapter 11 case is a “credit event” that terminates the swap.¹¹⁷ 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. Much of the action in a large case takes place on the first day.¹¹⁸ 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.¹¹⁹ A case can arise in which the process of closing out positions takes place while the major controversies in the Chapter 11 are being resolved.¹²⁰ Credit derivatives may

¹¹⁶ See *Burning down the House: Why Credit-Default Swaps Make Restructuring Harder to Pull Off*, ECONOMIST, Mar. 7, 2009.

¹¹⁷ See *supra* note 105 and accompanying text.

¹¹⁸ 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.”).

¹¹⁹ See *id.* at 911 (documenting trend in recent years of large firms entering bankruptcy with a prenegotiated arrangement to sell the business).

¹²⁰ 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, October 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*, NEW YORK TIMES, September 17, 2008,

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 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.

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.¹²¹ 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. 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

at C1 (reporting Barclays purchase of the bulk of Lehman's assets only two days after it filed for Chapter 11).

¹²¹ 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.92 (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.

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 follow 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 are separated.¹²² 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 need to worry about dispersed general creditors, there is still 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, you have no way either to verify their claims or know how large a stake they hold.¹²³

¹²² 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 problem of corporate finance are the agency problems arise when ownership and control are separated).

¹²³ 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.”).

The need to ensure negotiations upon which Chapter 11 depends may require disclosure, at least as to who owns what.¹²⁴ 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.¹²⁵ 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.¹²⁶ The law narrowly limits the types of ownership interests in land for exactly this reason.¹²⁷ Quite apart from whether you want to buy or sell land, you can use your own land more effectively if it is easy for 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 anyone 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.

¹²⁴ See Hu & Black, *supra* note 112, at 732–35 (discussing the need for disclosure of hidden debt hedges by creditors in bankruptcies).

¹²⁵ See Baird, *supra* note 40.

¹²⁶ Gary Libecap & Dean Lueck, *The Demarcation of Land: Patterns and Economic Effects* (Nov. 2008) (unpublished manuscript, available at <http://www.law.uchicago.edu/Lawecon/workshop-papers/lueck.pdf>) (reporting 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).

¹²⁷ Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000).

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. It does not take much imagination to posit a hedge fund that has a big investment in a competitor of the debtor. 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, 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 divided up roughly in accord with well-established priorities. To the extent that the current environment makes a sale of a large company difficult,¹²⁸ it increases the likelihood that the parties to the negotiation will not be able to assess the motivations of each other. 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

A large firm that finds itself today in Chapter 11 can identify the relevant players and their economic interests. It seems 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, but sophisticated parties who have invested in this business because of the special 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

¹²⁸ 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 \$200 million companies is more robust than is the market for \$2 billion 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 JOURNAL, November 1, 2006 (discussing how funds form “clubs” to do larger deals).

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.¹²⁹ Someone is recognized as the person who takes the lead. It is easier to reach a deal, when there are shared norms about who gets what.

In the past, parties came together around established focal points. 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.¹³⁰ Plans might include features that were in tension with appellate court decisions (such as the pervasive use of substantive consolidation¹³¹), but as long as everyone at the table understood that the plan would have this element, it caused few problems. Whether a feature of a plan was embedded in blackletter 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.¹³²

¹²⁹ 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. PERSPECTIVES 105, 116–21 (1996).

¹³⁰ See Baird & Rasmussen, *supra* note 5, at 692.

¹³¹ See Douglas G. Baird, *Substantive Consolidation Today*, 47 BOSTON COLLEGE L. REV. 5, 15 (2005) (“Substantive consolidation lacks the solid foundation one usually expects of doctrines so firmly embedded in day-to-day practice.”).

¹³² 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

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 complete. Consider the following hypothetical. There are four creditors, all of them at the same priority level. Each is a distressed debt professional that holds twenty-five percent of the outstanding debt, all of which is unsecured. None of them brings any special value to the business. Under these facts, there is no efficiency loss from any one plan coming into being rather than any other. Nevertheless, the plan does matter to the parties themselves. 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.¹³³ Various rules in the Bankruptcy Code try to ensure that similar claims are treated alike,¹³⁴ 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,¹³⁵ the three plan proponents can effectively divide rights among themselves in a way that leaves the fourth in the unhappy position of a powerless minority shareholder in a closely held corporation.

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 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.

¹³³ 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), and when a class accepts a plan, the judge can confirm it without going through the “cramdown” procedure. See 11 U.S.C. § 1129(a)(8) (2006).

¹³⁴ For a description of the provisions in Chapter 11 that bring this about, see text accompanying notes 15–22 *supra*.

¹³⁵ See discussion at text accompanying notes 44–58 *infra*.

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 creditor that is left out. Here the core is empty.¹³⁶ 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 left out of the deal entirely. We face a danger that the bankruptcy process degenerates into repeated and costly attempts at coalition building. A plan that discriminated so transparently would not pass muster, given the Bankruptcy Code's requirement that plans provide the same payout among claims in the same class, but the value can lie in control rights, such as the ability of the directors of the business going forward and, as we saw in FiberMark, these control rights can have dramatically different effects even across those in the same class.

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 low cost, however, now makes the empty core a problem one worth taking seriously.¹³⁷

¹³⁶ For the discussion of the empty core and its application in the law, see *supra* note 11.

¹³⁷ For a description of how low transaction costs actually create empty core problems and how this relates to the Coase Theorem, see *supra* note 11.

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. See Barry E. Adler, *Game-Theoretic Bankruptcy Valuation* (New York Univ. Law & Econ. Research Paper Series, Working Paper No. 07-03, 2007), available at <http://ssrn.com/abstract=954147>. Such a mechanism might avoid an empty core problem, as the ability to make take-it-or-leave-it offers dramatically narrow the range of possible equilibrium agreements.

The problem becomes worse when the competing investors 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 equity-holders 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 \$3 they must give Supplier if it is left out.¹³⁸ Similarly, Supplier and Manager will realize \$20 less \$10 they must give HedgeFund if it is left out.¹³⁹ Finally, HedgeFund and Supplier could reach a deal with each other, realize \$21, and exclude Manager. (Manager would still capture \$2 while the deal is being put in place, but \$21 would still be left over. All this is known to the parties, but not to the bankruptcy judge or to outsiders.

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 themselves. This deal, however, is not possible. No matter what share each is given in Firm, it will always be possi-

¹³⁸ 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) (2006).

¹³⁹ 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* 11 U.S.C. § 506 (2006).

ble 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. Supplier, for example, 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 go to 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 is a stable equilibrium.¹⁴⁰

This hypothetical is, of course, only that. We still need to know whether the problem of the empty core is one worth worrying about in practice. Nevertheless, paying attention to how coalitions come into being should inform our understanding of the Bankruptcy Code. For example, rules on solicitation can exacerbate the empty core problem, but others can reduce it. A judge who worried about the empty core will, for example, be more vigilant in enforcing the rules of the classification of claims and ensuring that claims in the same class are treated similarly and in particular how even nominally identical control rights may give disproportionate power to the majority coalition. A judge who prevented side deals on governance rights might make it more likely that parties would reach a deal.

Another example of a rule that might prevent the core from being empty is the one that gives the existing managers of the firm the exclusive right to propose a plan of reorganization at the outset of the case.

¹⁴⁰ For a discussion and formal proof of the conditions necessary under these assumptions, see Aivazian & Callen, *The Coase Theorem and the Empty Core*, *supra* note 11, at 179-80.

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.¹⁴¹ 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. The rule of *Northern Pacific Railway v. Boyd*¹⁴² might also prohibit the deal between HedgeFund and Manager, if Manager were also the owner of the business.¹⁴³

The problem of the empty core cannot, of course, provide a complete justification for either rule. These rules serve other functions and may compromise other goals of bankruptcy policy.¹⁴⁴ Moreover, it is a rationale that depends crucially on each of the players bringing something to the table. When they do not, rules such as the one in *Boyd*, may have the

¹⁴¹ 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.

¹⁴² 228 U.S. 482 (1913). *Boyd* established the absolute priority rule, in which a junior class could receive nothing until senior classes were paid in full, even if the senior class consented. This rule has been watered down by the current Bankruptcy Code enacted in 1978, which allows an out-of-the-money junior class to receive under the plan if the senior classes accepts it. See 11 U.S.C. § 1129 (2006). In fact, deviations from absolute priority are commonplace. See Baird & Bernstein, *supra* note 24, at 1932 n.2.

¹⁴³ In this case, Manager would be left with \$2 after Supplier and HedgeFund collect on their claims, because Manager, as an equityholder, is a residual claimant that collects only after the creditors are paid in full.

¹⁴⁴ One of us discussed these issues in Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988).

effect of making bargaining harder rather than easier because it increases the number of people who have to be part of any bargain. Nevertheless, looking at the Bankruptcy Code and asking whether it promotes or impedes coalition-building is an inquiry that has been too long neglected.

Some sections of the Bankruptcy Code exacerbate the bargaining problem. Most conspicuous are the rules governing solicitation 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.¹⁴⁵ 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 section 1125 violated by obtaining informal assurances from a creditor to support a particular plan.¹⁴⁶ 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 those who made them to the risk that their votes will not count.¹⁴⁷ Such doubt is itself an impediment to coalition building.

¹⁴⁵ 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).

¹⁴⁶ For a narrow reading of section 1125(b), see *Century Glove, Inc. v. First American Bank of New York*, 860 F.2d 94, 100-03 (3rd Cir. 1988) (interpreting “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 . . .”).

¹⁴⁷ See 11 U.S.C. § 1126(e) (2006).

In practice, bankruptcy judges have allowed parties to form coalitions without going through the hoops of section 1125.¹⁴⁸ Nevertheless, it is not certain that this will always be the case. A court interpreting section 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 section 1125 may run counter to some practices that have emerged in recent years and 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 the plain language of the statute.¹⁴⁹

Bankruptcy bargaining in the current environment may be one in which the core is empty. Different players are bringing something to the party, and the value of control allows those with control to stiff those without it. There are some steps that are necessary in order for the process to work, such as putting a stop to various bankruptcy rules that contribute to the fragmentation problem. These include the expansion of priorities, such as requiring assurance of payment to utilities¹⁵⁰ and payment in full to vendors who ship within 20 days before the filing of the petition.¹⁵¹ 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 trading and particularly what disclosure rules make sense. We can also figure out some way to identify stakeholders. Independent of optimal disclo-

¹⁴⁸ See DOUGLAS G. BAIRD, *ELEMENTS OF BANKRUPTCY* 265–68 (4th ed. 2006).

¹⁴⁹ See, e.g., *Perlman v. Catapult Entertainment, 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.”); *In re Kmart Corp.*, 359 F.3d 866, 971 (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.”).

¹⁵⁰ See 11 U.S.C. § 366 (2006).

¹⁵¹ See 11 U.S.C. § 503(b)(9) (2006) (classifying such payment as an administrative expense).

sure, 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. Consider, for example, the way in which the bargaining dynamic would be altered dramatically if the Bankruptcy Code were changed and gave the bankruptcy judge the power to order the sale of the business upon the motion of any party in interest. The costs of such a rule, of course, have been well explored.¹⁵² 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 go down.¹⁵³ But once the sale is ordered, the bargaining environment is altered. Ordering the sale of the firm to the highest bidder is a way of putting a gun to the parties' heads. 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.¹⁵⁴

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

¹⁵² See Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Firesales*, 106 MICH. L. REV. 1 (2007) (empirical evidence suggesting sales in bankruptcy yield lower values than when firms reorganize).

¹⁵³ 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 likely to be experiencing financial distress as well).

¹⁵⁴ Nancy Miller, *Judge Rules With Rod, Impish Smile*, USA TODAY, March 25, 1992, at 5B (discussing how Judge Pollock threatened dismantle brokerage firm on his own if the parties did not reach a deal before he returned from taking a phone call in his chambers).

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 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.

V. 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 are likely 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. Perhaps the most important thing that courts can do in fashioning rules is ensuring that whatever is put in place gives clear benchmarks that future investors can use to navigate their way. The current disequilibrium is the result of instruments that have already been written. Investment going forward will use different and improved ones. What may matter most is the ability of different investors to write new ones, learning from past mistakes and being able to predict how judges will respond to new provisions.

The larger lesson is a more general one. 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 re-

form—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 anti-commons 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 at an early stage.