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Confirmation and Claims Trading

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CONFIRMATION AND CLAIMS TRADING

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The buying and selling of claims against companies in financial distress is not a new phenomenon. In times of financial distress, liquidity has always commanded a profit. However, the late 1980s and early 1990s saw the first significant trading of claims under Chapter 11 of the Bankruptcy Code,[1] our relatively new and novel system of corporate reorganization. Traditionally scorned by the financial establishment, distress investment came into vogue with the "megabankruptcies" that followed in the wake of the leveraged buyout boom of the 1980s.[2] With its prospects for huge profits, claims trading in Chapter 11 became a Wall Street staple. Even mainstream mutual funds participated.[3] The size of the market was estimated to run as high as $300 billion.[4]

Another boom-and-bust financial cycle appears to be underway. "Speculation is flourishing."[5] The next wave of corporate bankruptcies is predicted to arrive shortly,[6] and it is sure to generate significant claims trading activity. An examination of the effects of claims trading on the Chapter 11 confirmation process is therefore timely.

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1 11 U.S.C. §§ 1101-1174 (1994). The Bankruptcy Code may be referred to herein as the "Code."

2 *See, e.g.*, Jaye Scholl, *Joy in Sorrow: A Pair of Young Money Managers Profit from Failure*, BARRON'S, Feb. 20, 1995, at 19. "[T]he investment strategy took hold in the 'Eighties, a decade whose financial history can be summed up in superlatives: a bumper crop of mergers and acquisitions, financed by mountains of high-yielding debt, followed by a record number of bankruptcies and an unprecedented amount of defaulted paper." *Id.* at 21.

3 *See* Diana B. Henriques, *The Vulture Game*, N.Y. TIMES, July 19, 1992, § 6 (Magazine), at 18.

4 *Id.* at 20 (quoting Herb Stiles, President of T. Rowe Price Recovery Fund).

5 Floyd Norris, *Market Watch: Investors Love Loans to Deadbeats*, N.Y. TIMES, Aug. 6, 1995, § 3, at 1 (commenting on proposed borrowing of $5.4 billion by Westinghouse Electric Corp. to finance acquisition of CBS Inc. and noting that the amount of borrowing exceeds total value of Westinghouse stock).

6 *See, e.g.*, *Book Review: The 1995 Bankruptcy Yearbook and Almanac*, BANKR. CT. DEC. WKLY. NEWS & COMMENT (LRP), May 30, 1995, at A9.

> The dramatic increase in high yield bond issuance, coupled with an apparent loosening of standards by bank lenders, has created a large pool of potential corporate bankruptcies. While the coming wave of big bankruptcies will be nowhere near the magnitude of the last bulge in 1987-1992, it should represent a significant increase from current levels. Whether the upturn in large filings occurs in 1995 or in 1996 may depend on the strength of the economy in the coming months.

Id. at A9 (quoting George Putnam III of New Generation Research, Inc., publisher of the *1995 Bankruptcy Yearbook and Almanac*); *see also* Scholl, *supra* note 2, at 21 ("Studies indicate there's a three-year lag between issue and default rates. Bankruptcies should return in big numbers beginning in 1995.").

Enacted as part of the Bankruptcy Reform Act of 1978,[7] Chapter 11 creates a reorganization regime premised on collective negotiation among the parties. To a greater degree than the reorganization statutes that preceded it, Chapter 11 distributes leverage to all parties in interest and depends on negotiated outcomes for both the ultimate terms of reorganization and resolution of the debtor's significant operating issues during the case.[8] Creditors matter in this process. Far from being mere placeholders, creditors in Chapter 11 have potentially significant influence over the course of reorganization.

This potential for creditor leverage has created lucrative opportunities for bankruptcy arbitrage—investment in claims against debtors in Chapter 11. Professional investors purchase bankruptcy claims at a discount from their face value, generally succeeding to the rights of their selling claimants. The willing sellers typically lack the capital, expertise, or patience to endure a reorganization process that for a large public company may last several years.[9] Cashing out is an attractive option for these selling claimants. For its part, the bankruptcy investor purchases claims strategically in order to exploit opportunities for creditor leverage in the reorganization process. It attempts to purchase a good seat at the negotiating table in order to influence the terms of reorganization. In particular, the bankruptcy investor will negotiate for optimal treatment of its claims under the plan of reorganization.

Unfortunately, claims trading has the potential to impede reorganization, imposing costs on the debtor company and its creditors. Because of Chapter 11's collective nature and the significant role of creditors in the process, instability in the creditor constituency may be disruptive. Throughout the course of a case, parties make significant reorganization-specific investment. They develop relationships with each other and acquire specialized knowledge about the business. They learn to cooperate. In this context, participants may not be fungible; the identities of particular creditors may matter. Creditor turnover may therefore destabilize the process. A significant creditor's exit from, or entry into, the process may render other parties' prior investment worthless, or may require significant additional investment by the parties.[10] Even the *potential* for trading may impose costs on the parties by deterring cooperation.[11]

[7] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (current version at 11 U.S.C. §§ 1101-1174 (1994)).

[8] *See infra* subpart II.A.

[9] *See infra* section I.B.1.

[10] *See infra* subpart II.B.

[11] *See infra* section II.B.3.

Courts and commentators have been slow to recognize and respond to these cost implications. The buying and selling of a bankruptcy claim has traditionally been conceptualized as a private transaction between willing parties in a free market, not subject to outside scrutiny or restriction. As with most economic rights, claims enjoy a strong presumption of free alienability. "The idea of the 'market' is extremely powerful in both economics and social theory,"[12] and its imagery figures prominently in discussion over the proper role for judicial supervision of claims trading. Commentators debating the propriety of various acts of judicial intervention have been mindful of the sanctity of the market and the potential chilling of this market from excessive judicial regulation.[13] Comparisons of the claims market with public securities markets, and claims with publicly traded securities, have been suggested.[14] From this perspective, judicial intervention is best limited to policing abuses at the fringes of the market. Fundamentally, however, the market should remain unsupervised.

In fact, judicial intervention has been limited to remedying specific perceived abuses. Courts have intervened, for example, to protect claimants from selling without adequate information,[15] to penalize purchasing by the debtor's fiduciaries,[16] and to disqualify votes of claims not purchased or voted in good faith.[17] In only a few isolated cases have courts noted the possibility of more general adverse effects from claims trading, and then only in the context of some specific perceived abuse.[18]

Commentators have generally failed to focus on process concerns and their cost implications, but instead have emphasized the benefits

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12 David E. Van Zandt, *The Market as a Property Institution: Rules for the Trading of Financial Assets*, 32 B.C. L. REV. 967 (1991).

13 *See supra* notes 110-112 and accompanying text.

There has been a surprising dearth of academic commentary focused specifically on claims trading. The major articles include Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990) [hereinafter Fortgang & Mayer, *Trading Claims*]; Herbert P. Minkel, Jr. & Cynthia A. Baker, *Claims and Control in Chapter 11 Cases: A Call for Neutrality*, 13 CARDOZO L. REV. 35 (1991); Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991) [hereinafter Fortgang & Mayer, *1991 Developments*]; Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733 (1993) [hereinafter Fortgang & Mayer, *1993 Developments*].

14 *See infra* note 112 and accompanying text.

15 *See infra* note 96 and accompanying text.

16 *See infra* note 101 and accompanying text.

17 *See infra* sections I.B.3, III.C.2. For a comprehensive summary of judicial intervention in the claims trading context, see Fortgang & Mayer, *Trading Claims*, *supra* note 13.

18 *See infra* notes 306-09 and accompanying text.

to be derived from trading.[19] Claims trading may certainly benefit willing buyers and sellers. It may help to facilitate reorganization in some cases.[20] However, trading is not an unqualified blessing. Costs may be imposed, even in situations in which trading may be deemed desirable or beneficent overall. Nonetheless, cost implications have to date been largely ignored.

Restrictions on trading may be justified in light of these cost implications, despite traditional notions of free alienability of property. The rights that are the subject of trade are actually *created* in Chapter 11. Claims are bundles of rights uniquely tailored to, and inextricably linked with, Chapter 11's collective settlement process. Moreover, it is the imposition of Chapter 11 that endows claims with their market value. To the extent their transfer imposes unacceptable costs on the reorganization process, restrictions are appropriate. The specific rehabilitative goals of Chapter 11 should take precedence over general notions of free alienability.

This Article concerns the confirmation process in Chapter 11, the relation between the process and the rights traded as Chapter 11 claims, and the costs that may arise from claims trading. The Article focuses not on the fringe of the market—situations traditionally perceived as potentially abusive. Instead, this Article focuses on "mainstream" trading in the context of large public companies: the acquisition of claims against a Chapter 11 debtor by outside investors unaffiliated with the debtor, with the intention of realizing profits through the plan process.[21] It shall be argued that even with mainstream claims trading, externalities may be visited on the estate and parties in interest, and that the cost implications justify equitable relief in certain contexts.

In particular, this Article's purposes are three-fold: first, to highlight potential adverse effects of claims trading on the confirmation process, effects that to date have not been emphasized in the bankruptcy literature; second, to propose a general justification for restricting transferability of claims in light of these adverse effects, despite the traditional presumption of free alienability of claims; and third, to outline the contours of appropriate equitable relief.

Part I describes the Chapter 11 confirmation process, the mechanics, economics, and benefits of claims trading in Chapter 11, and the traditional free alienability account of claims trading.

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19 *See infra* section I.B.2.

20 *See infra* note 329 and accompanying text.

21 While trading certainly occurs in contexts other than reorganizations of large public companies, the large cases probably account for most of the trading, and the ripple effects from the failure of large public companies suggest that much is at stake in their successful reorganization. *See infra* notes 22-23 and accompanying text.

Part II discusses the collective nature of Chapter 11, its devices for encouraging bargaining and cooperation among the parties in interests, and the significance of the parties' relationships developed over the course of the case. Part II further explains the externalities that claims trading may impose on the process and the particular role of the bankruptcy investor.

Part III presents a justification for limiting trading in response to these externalities and takes issue with the traditional free alienability account. Part III concludes by discussing precedent under the Code for courts' granting of equitable relief from claims trading.

Part IV describes a cost-based approach to such equitable relief. In particular, injunctive relief in the form of a "trading injunction" is described—both its contours and the contexts in which it should be available. Prospective benefits from claims trading are also considered in this formulation of appropriate equitable relief.

I. The Context

A. The Confirmation Process

Bankruptcy law has two general aims: to provide relief to the debtor from the collection efforts of its creditors and to treat all creditors equitably in distributing recoveries from the bankruptcy estate. Reorganization of a business under Chapter 11 is a collective proceeding that incorporates other aims as well. Reorganization is premised on the concept that the debtor is worth more as a going concern than in liquidation. That is, continuation of the debtor's business will create more value than will dismemberment and piecemeal sale of the assets.[22] Chapter 11 attempts to preserve the debtor's going concern value, thereby maximizing the value of the estate and creditor recoveries, while mediating conflicts among the debtor, its creditors, and other interested parties.[23]

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[22] This not only maximizes creditor recoveries, but also addresses a multiplicity of other interests implicated when a company faces the prospect of failure. While debtor-creditor issues are central to the proceedings, the complex web of relationships with which the company is involved includes noncreditor parties as well. For example, suppliers, customers, employees, local governments, or taxing authorities may or may not be creditors of the debtor, but may nonetheless be interested in the debtor's continuing viability. *E.g.*, Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336, 355 (1993) (noting Congress's recognition of the effect of business failure on the surrounding community and parties with no formal legal entitlements vis-a-vis the debtor, and the indirect way in which the Bankruptcy Code addresses this concern).

[23] The purpose of a business reorganization case . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-

The focal point for Chapter 11 is the plan of reorganization, which is a negotiated rearrangement of the debtor's obligations to its creditors and equity security holders. The rights and obligations among the debtor and its debt- and equityholders are adjusted so as to render the reorganized debtor a viable economic entity. A plan may reduce the interest rate or extend the maturity of certain debt obligations; it may satisfy other debt obligations with issuance of new equity; it may pay cash to certain creditors but at a discount from the full face amount of their claims. The particular adjustments to these rights and obligations are left to the negotiation of the parties, subject to only a few substantive limitations.

The scheme for formulating a plan borrows a basic notion from the securities laws:

> Parties should be given adequate disclosure of relevant information, and they should make their own decision on the acceptability of the proposed plan of reorganization. . . . The parties are left to their own to negotiate a fair settlement. . . . Negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. . . . [T]he outcome . . . must be somewhere between the going-concern value and the liquidation value.[24]

Beyond this limitation, the allocation of value is left to the parties' negotiation.

A plan that meets all the requirements imposed by the Code, including creditor and equityholder approval requirements, may be "confirmed" by the bankruptcy court,[25] in which case it becomes the definitive document under which the debtor's reorganization occurs.[26]

1. Formal Rules.—While the Code imposes few substantive limitations on the permissible outcome of plan negotiation, the "rules of engagement" are quite elaborate. The Code attempts to structure a framework for multiparty bargaining, in which (1) the debtor will initially control and coordinate the plan negotiation process, and (2) creditor consent must be obtained in order for a plan to be con-

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> term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 [hereinafter HOUSE REPORT].

24 *Id.* at 224. The floor of liquidation value is implemented through the requirement of § 1129(a)(7)(A) of the Code, which requires that any dissenting member of an accepting class receive no less under the plan than it would in liquidation. 11 U.S.C. § 1129(a)(7)(A) (1994). The ceiling of going concern value is implemented through § 1129(b), which embodies the Chapter 11 absolute priority rule. 11 U.S.C. § 1129(b) (1994).

25 11 U.S.C. § 1129 (1994).

26 11 U.S.C. § 1141 (1994).

firmed.[27] The debtor retains the exclusive right to propose a plan during the first 120 days of the proceeding,[28] and multiple extensions of this exclusivity period are routinely granted in the large cases.[29] In addition, the debtor generally continues to manage its business during the reorganization.[30]

Creditor consent is determined pursuant to the Code's elaborate voting provisions, which work as follows. The plan must classify claims,[31] with only "substantially similar" claims being allowed in the same class.[32] Voting is by class,[33] and all claims in the same class must receive the same treatment under a plan.[34] A class is entitled to vote

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27 Consent of equity interest holders may also be required. As a practical matter, however, their consent is rarely an issue at confirmation, either because their interests have been adequately represented by the debtor's management—in which case they will consent to the plan—or because the plan can usually be confirmed over their dissent via cramdown. *See infra* notes 39-45 and accompanying text. For this reason, the discussion of confirmation requirements that follows, while generally applicable to equity interests as well as claims, will refer only to claims.

28 11 U.S.C. § 1121(b) (1994). The court may, upon the request of a party in interest and for cause, shorten the initial 120-day exclusivity period, *id.* § 1121(d), but this rarely happens, especially in larger cases.

29 Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 693 (1993). "In most jurisdictions, . . . exclusivity is almost always maintained for the duration of the reorganization of a large, publicly held company." *Id.* at 693 n.90. Even after exclusivity terminates, in the large cases the plan that ultimately gets confirmed is almost exclusively a debtor-sponsored plan. *See generally* Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code? Second Installment*, 57 AM. BANKR. L.J. 247, 253 (1983) (discussing creditors' practical inability to propose credible operating plans).

30 11 U.S.C. § 1107(a) (1994). The Code provides for appointment of a trustee to replace the debtor's management in certain situations, *e.g.*, "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case." *Id.* § 1104(a)(1). However, especially in the cases involving large publicly held companies, appointment of a trustee is rare. *E.g.*, LoPucki & Whitford, *supra* note 29, at 699.

31 11 U.S.C. § 1123(a)(1) (1994). Certain types of priority claims, primarily administrative expense claims and qualifying tax claims, are not required to be classified, *id.*, and their treatment under a plan is explicitly prescribed in the Code. *Id.* § 1129(a)(9)(A), (C).

32 11 U.S.C. § 1122(a) (1994). The Code permits a fair amount of discretion in classifying claims, since even though claims that are "substantially similar" may be classified together, there is no explicit *requirement* that substantially similar claims be placed in the same class. Courts have, however, enunciated certain limitations on debtors' strategic use of classification. *E.g.*, Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1278-79 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992) (holding that "ordinarily," substantially similar claims should be classified together, and that separate classification must be motivated by reasons independent of debtor's desire to create consenting impaired class); Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581, 586 (6th Cir. 1986) (stating that "there must be some limit" to debtor's power to gerrymander creditor classes).

33 11 U.S.C. § 1126(c), (d) (1994).

34 *Id.* § 1123(a)(4). The holder of a claim may always consent to less favorable treatment of its claim than the rest of the class. *Id.*

only if its proposed treatment renders it impaired,[35] which basically means that its rights are proposed to be altered under the terms of the plan.[36] A class that is not impaired is deemed to have accepted the plan, and it does not vote.[37] As for class acceptance, a class of claims accepts the plan if both a majority in number of claims and two-thirds in dollar amount of claims in the class vote to accept.[38]

A plan may be confirmed if each impaired class accepts the plan.[39] However, if any impaired class votes to reject the plan, then the plan may be confirmed only under the "cramdown" provisions of the Code.[40] The most important cramdown requirement is that the plan be "fair and equitable" with respect to any rejecting impaired class.[41] Plan treatment of a rejecting impaired class is fair and equitable if the plan respects absolutely the priority of that class over junior classes. This "absolute priority rule" requires, for example, that in order for a plan to be confirmed over the objection of an impaired class of unsecured claims, the plan must provide either that such claims be paid in full[42] or that no class junior to the objecting impaired class receive any distribution.[43] In other words, for any rejecting impaired class of unsecured claims, the plan must not pay anything to any claim or interest junior to the rejecting class without first paying in full each claim in the rejecting class.[44] By rejecting, the impaired class basically insists upon getting whatever is left of the estate after senior classes have been paid,[45] up to the full amount of its claims. Only after full payment to that rejecting class may junior classes receive any consideration.

The classification, voting, and cramdown provisions, then, essentially work as follows. Within a class, an accepting majority may force the proposed class treatment on the nonaccepting minority, even though such treatment amounts to less than full payment. The only limitation on this tyranny of the majority is that each nonaccepting

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35 *See id.* § 1129(a)(8).

36 *See id.* § 1124. See *infra* note 57 and accompanying text for a discussion of the strategic significance of the impairment concept.

37 11 U.S.C. § 1126(f) (1994). A class that will receive nothing under a proposed plan also does not vote, but is deemed to have rejected the plan. *Id.* § 1126(g).

38 11 U.S.C. § 1126(c) (1994). A class of interests accepts if two-thirds in amount of interests vote to accept. *Id.* § 1126(d).

39 *Id.* § 1129(a)(8).

40 *Id.* § 1129(b).

41 *Id.* § 1129(b)(1).

42 *Id.* § 1129(b)(2)(B)(i).

43 *Id.* § 1129(b)(2)(B)(ii).

44 In this situation, the only alternative for the plan proponent—usually the debtor—is to modify the proposed treatment of the objecting class to render the class unimpaired, in which case the class is deemed to have accepted the plan.

45 No class may be paid more than the amount of its claims. HOUSE REPORT, *supra* note 23, at 414.

claim in the class must receive no less under the plan than it would have received in liquidation.[46] On the other hand, nonaccepting creditors in a class, by defeating either of the majorities required for acceptance by a class of claims, can block acceptance by that class. This prevents confirmation of any plan that proposes to pay any consideration to creditors junior to the nonaccepting class without paying in full all claims in the nonaccepting class.[47]

2. *Bargaining over the Plan.*—The formal rules alone do not capture the dynamics of plan negotiation. The rules merely provide leverage points for the various parties in interest. To a great extent, the negotiating skill of each party and its ability to use its leverage in Chapter 11 determine the consideration it ultimately receives under the plan. The terms of reorganization are set by the aggregate outcomes of the multiple negotiations.

Understanding the dynamics of the negotiations is critical to an understanding of the reorganization process, given that for large public companies, most plans are consensual. All impaired classes ultimately vote in favor of the debtor's plan.[48] This means that formal resort to the cramdown alternative under Section 1129(b) is rare,[49] and that despite their right to insist on absolute priority, creditors generally do not. Instead of strict absolute priority, plans generally offer some consideration to every class in order to facilitate consensus.[50]

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[46] *See supra* note 24.

[47] One additional significant confirmation requirement exists, which must be satisfied regardless of the outcome of class voting. It is the feasibility requirement, 11 U.S.C. § 1129(a)(11) (1994), which goes to the question whether the plan will work. *See* 5 COLLIER ON BANKRUPTCY ¶ 1129.02, at 1129-60 to 1129-64 (15th ed. 1995). Because a feasibility finding is required regardless of overwhelming creditor approval of the plan, it is an oft-litigated issue in contested confirmations.

[48] Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 137-38 (1990). In their seminal study of large public company reorganizations, Professors LoPucki and Whitford found a very high level of plan acceptance. Of all classes of claims and interests for the 43 reorganizations studied, only 5.6% (21 of 377 classes) failed to vote in favor of the plan, and of those, almost all (17 of the 21) were deemed rejections, *i.e.*, those classes were to receive nothing under the plan. *Id.* at 141; *see supra* note 37. Only 0.8% (3 of 377 classes) actively contested confirmation. LoPucki & Whitford, *supra*, at 141. LoPucki & Whitford, *supra* note 29, also came from the LoPucki and Whitford study.

[49] "[T]he conventional wisdom was that contested cramdown hearings were to be avoided." LoPucki & Whitford, *supra* note 48, at 144.

[50] Even in the case of insolvent debtors, shareholders usually received some distribution under the plan. *Id.* at 142-43. Insolvency in these cases was not seriously contested. *Id.* at 144. Therefore, an absolute priority distribution would have left shareholders with nothing. Senior classes in these cases willingly gave up value to junior classes in order to achieve consensus: "[T]he creditors' agreements to the equity distributions . . . were in no significant part the reflection of either real or supposed legal entitlements." *Id.* However, the actual deviations from strict absolute priority were found to be small in percentage terms. *Id.* at 178.

The formal rules of plan confirmation, then, create a bargaining regime in which leverage is distributed among the parties in such a way that each and all may influence the terms of reorganization. While the substantive rule of absolute priority would seem to favor senior creditors, procedural entitlements favor junior creditors and the debtor.

The debtor—in particular, the debtor's management—controls the plan formulation process. Through this control, the debtor will frequently attempt to extract value from senior classes in favor of junior classes[51]—either junior creditors or equityholders.[52] The debtor's

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According to the conventional wisdom, senior creditors' holdout power under the absolute priority rule is tempered by a desire to avoid extensive litigation over the panoply of cramdown and other confirmation requirements. In the cramdown situation, the court may have to determine, among other things, a valuation of the debtor and any securities proposed to be issued under a plan, in order to determine whether the absolute priority rule has been satisfied as to each rejecting impaired class. This valuation will generally involve a battle of expert testimony, with teams of investment bankers and accountants attempting to justify result-oriented projections of the debtor's future earnings and arguing over an appropriate multiplier in order to reach a desirable discounted cash flow valuation. *See generally* 5 COLLIER ON BANKRUPTCY, *supra* note 47, ¶ 1129.03, at 1129-102 to 1129-116 (describing valuation standards in detail).

Junior claimants have an additional incentive to avoid forcing this valuation. They run the risk that an unfavorable valuation may eliminate entirely their chance to participate in any distribution under the plan. Given the complexities of valuation, the expense of litigation, and the uncertainty of the outcome, all parties have incentives to settle.

> A premium is thus placed on obtaining the consent of all impaired classes in order to avoid application of the fair and equitable rule as embodied in section 1129(b). Thus, there is the incentive for the holders of the senior interests to share the distribution with junior interest holders so that the junior classes will accept the plan and avoid the necessity of a full-scale going-concern valuation of the debtor. There is, similarly, an incentive for the junior classes to accept the plan rather than run the risk of a valuation hearing under section 1129(b)(2)(B) or (C), which could result in a determination that they are not entitled to participate under the plan at all.

Lawrence P. King, *Chapter 11 of the 1978 Bankruptcy Code*, 53 AM. BANKR. L.J. 107, 130 (1979); *see also* Kenneth N. Klee, *All You Ever Wanted to Know About Cramdown Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 171 (1979) ("[T]he complexity of cramdown should encourage the debtor to bargain with creditors to gain acceptance of a plan in the majority of cases.").

In the LoPucki and Whitford study, numerous interviews with attorneys and judges elicited the general sentiment that every class had to receive some consideration in order to achieve consensus. LoPucki & Whitford, *supra* note 48, at 144. Among the reasons given for the overwhelming preference for consensual plans was the desire to avoid the expense of and delay associated with litigating a contested cramdown. *Id.* The authors question the factual basis for the perception that cramdown is economically undesirable. They assert that the costs of cramdown litigation do not fully explain the tendency toward consensual plans. Instead, they suggest that bankruptcy culture exerts significant influence. *Id.* at 154.

[51] Professors LoPucki and Whitford have shown the difficulty of attempting to generalize about whom management represents in the large reorganization cases. LoPucki & Whitford, *supra* note 29, at 742-47 (finding that such factors as the debtor's solvency and the presence of significant shareholders on the debtor's board of directors affect management loyalties, and that management might not align with any faction, but instead might pursue an independent policy of preserving the company or maximizing the estate).

control of the process allows it significant leverage toward effecting such a distribution.

The debtor's exclusivity is critical to its leverage in plan negotiation.[53] As every lawyer knows, simply controlling the drafting of the operative documents in negotiation creates substantial influence over the ultimate outcome. The debtor's exclusive privilege of drafting the plan has the same effect.[54] Because no other party may file a competing plan, the proposals initially under consideration are the debtor's.

As the protagonist, the debtor not only proposes the consideration to be received by various creditors as part of the reorganization, but may also influence the voting through the debtor's structuring of the plan. Under the elaborate creditor voting system, creditor consent need not be unanimous, and not all creditors are entitled to vote.[55] Which creditors vote, and how crucial their votes are, depend to a great extent on the debtor's classification of claims in the plan and the debtor's ability to render claims unimpaired. The debtor has some flexibility to dilute the voting strength of recalcitrant creditors by placing such creditors' claims in a class with cooperative claimants. Conversely, the voting strength of cooperative parties may be augmented

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52 In the LoPucki and Whitford study, management of insolvent debtors were very likely to align themselves with creditors. *Id.* at 745. From the management self-preservation perspective, this makes sense, as creditors would stand to receive significant blocks of equity in the reorganized company. *See generally* J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 218 (1991) (noting the potential divergence of interests as between management and old equity). Fiduciary duties of management also shift from equityholders to creditors upon a corporation's insolvency. *See infra* note 238. As an empirical matter, management of solvent companies always aligned with equity. LoPucki & Whitford, *supra* note 29, at 745.

Given the general preference for consensual plans, even when management aligns with creditor interests, this would not generally preclude some attempt by management to effect some distribution to equity. In any event, management's objectives in plan formulation generally include a scaling down of claims of senior classes from their absolute priority due in favor of junior classes.

53 *E.g.*, Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 192 (1989) ("Studies on agenda influence confirm the substantial leverage [exclusivity] provides the debtor (and existing management) in negotiating over any proposal to restructure the firm.") (citing Michael E. Levine & Charles R. Plott, *Agenda Influence and Its Implications*, 63 VA. L. REV. 561 (1977)); Johnston, *supra* note 52, at 275 ("The chance to be 'first out of the gate' with the initial plan in most cases allows the debtor to 'anchor' the terms of the final plan in its favor.").

54 The party that proposes the initial plan, even if it is just the first negotiating draft, will always prepare it in a way that strongly favors whatever positions can be proposed on behalf of that party or its constituents. Because it is likely that the initial draft will become the starting point from which the final plan will flow, the proponent-biased draft serves to shift the entire bargaining set of the parties toward the side favoring the "proponent" of the plan and insures that the final agreement will be more favorable to the party that proposes the plan than if the terms of the initial draft had been more even-handed.

Johnston, *supra* note 52, at 275.

55 *See supra* notes 31-38 and accompanying text.

by strategic classification.[56] In addition, the debtor's proposed plan treatment may render certain classes unimpaired under the plan, in which case they are conclusively presumed to have accepted the plan.[57]

Exclusivity also enables the debtor to control the pace of the reorganization and, if necessary, to use delay as a device to encourage settlement. The economics of delay allow the debtor's management to favor equityholders over creditors, or some creditors over others, since creditors generally accrue no interest on their claims during the case.[58] The filing of the Chapter 11 petition effectively forces creditors to extend credit to the debtor interest-free for the pendency of the case. The differing appetites of equityholders and various creditors to weather delay enable the debtor to favor some groups over others and to use delay to extract concessions from creditors.[59]

Once in bankruptcy, the debtor's management is generally authorized to run the business.[60] Management may use this control of the business to gain leverage in plan negotiations. Management may threaten to sell assets as a device to circumvent plan confirmation requirements.[61] Management may attempt or threaten to obtain

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56 "[D]etermining when a claim or interest is 'substantially similar' to others . . . is a major and strategically important task" because it allows the plan proponent some "ability to separate or combine certain claims to increase the chance of obtaining class acceptances." Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 329 (1982).

57 *See supra* note 36 and accompanying text. For example, the debtor may wish simply to reinstate a particular loan at its contract rate of interest. This may be cheaper for the debtor than attempting to cramdown the creditor if the contract rate of interest is below the market rate. Provided that all defaults are cured, and the claimant is compensated for any damages incurred, reinstatement renders such a claim unimpaired, 11 U.S.C. § 1124(2) (1994), and that creditor is deemed to have accepted the plan.

58 11 U.S.C. § 502(b)(2) (1994). The oversecured creditor accrues interest on its claim during the pendency of the case, but only up to the value of its collateral. *Id.* § 506(b). The allowance of this interest as part of the oversecured creditor's claim does not necessarily mean that the interest is paid currently, although it is not uncommon for the debtor to agree to do so in exchange for postpetition financing from the secured creditor. A secured creditor may also be entitled to adequate protection payments to the extent the estate's use or retention of the secured creditor's collateral results in a decrease in value of such collateral. *Id.* § 361(1).

59 "When management of a marginally solvent debtor is firmly in equity's camp, and particularly when pendency interest is unavailable, considerations of timing can be an especially important reason for creditor concessions to equity." LoPucki & Whitford, *supra* note 48, at 166.

60 11 U.S.C. § 1107 (1994).

61 While such a proposal requires notice and a hearing, 11 U.S.C. § 363(b)(1) (1994), and courts have scrutinized such proposed sales in light of their potential to circumvent plan confirmation requirements (*e.g.*, Lionel Corp. v. Committee of Equity Sec. Holders (*In re* Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983) (requiring "some articulated business justification" for sale); Braniff Airways, Inc. v. Pension Benefit Guar. Corp. (*In re* Braniff Airways, Inc.), 700 F.2d 935 (5th Cir. 1983) (disapproving sale agreement that purported to dictate some terms of future plan)), even the threat may generate concessions.

postpetition financing on terms unfavorable to existing creditors.[62] The debtor's investment strategy in Chapter 11 may also place a disproportionate risk on senior classes, who may bear the losses from a risky investment strategy, but may not realize the full amount of any gains.[63]

For their part, creditors and equityholders are also given leverage in the plan negotiation process. Creditors may vote to reject the debtor's plan, triggering the cramdown requirements and application of the absolute priority rule.[64] Because this may ultimately mean that certain junior classes will receive no consideration under the plan, a debtor interested in providing for some distribution to junior classes may wish to avert this confrontation. A consensual plan will therefore be preferred.

A stalemate in plan negotiation may also cause creditors to move to terminate the debtor's exclusivity in order to file competing plans. While termination of exclusivity in the large cases is rare,[65] the prospect that the debtor's management might lose control of the plan process may curtail its ability to use delay as a coercive device.

Creditors may threaten to oust the debtor's management. They may do so either by petitioning for appointment of a trustee[66] or indirectly through pressure for officers' replacement.[67] As with termination of exclusivity, appointment of a trustee rarely happens, but the threat does provide creditors with certain leverage.[68]

Widely dispersed creditors or equityholders may also benefit from the formation of official committees. The Code specifically provides for appointment of a creditors' committee to represent un-

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62 For example, management may agree to grant priming liens to the postpetition financer, which would have priority over existing liens of prepetition creditors. *See* 11 U.S.C. § 364(d)(1) (1994). Again, this requires notice and a hearing, but the threat itself may have some impact.

63 LoPucki & Whitford, *supra* note 29, at 683-84. For example, for the marginally solvent debtor, gains from a risky investment strategy will inure primarily to shareholders, while losses will be borne primarily by creditors.

64 Equity, as the most junior class, wields little leverage with its class vote because it does not enjoy priority over anyone. For the insolvent debtor, even a plan that provides no distribution to equity satisfies the absolute priority rule. The best the rejecting equity class could do is force a valuation. However, if the equity class opposes a plan, it may find other avenues for leverage. *See infra* notes 77-83 and accompanying text.

65 *See supra* notes 28-29 and accompanying text.

66 *See supra* note 30.

67 "CEO turnover frequently resulted from creditor pressure." LoPucki & Whitford, *supra* note 29, at 737. LoPucki and Whitford found that the rate of CEO turnover was much higher for distressed companies than for large public companies generally, and that in terms of timing, changes were concentrated around the filing of the petition and the confirmation date. *Id.* at 723-26.

68 *Id.* at 701.

secured creditors.[69] This committee is charged with negotiating the plan on behalf of its constituents, and generally acts as a watchdog on behalf of unsecured creditors during the case.[70] The creditors' committee provides a voice in plan negotiation that might otherwise be absent, given that widely dispersed small claimants may lack sufficient economic incentive to monitor or participate actively in a case.

Additional committees representing creditors or equityholders may be appointed as the court or the United States trustee deems appropriate.[71] When equity committees have been appointed, or when equity has been otherwise represented—for example, by management—the representatives have been instrumental in obtaining distributions for their equityholder constituents, in spite of any lack of formal legal entitlement to such distributions under the absolute priority rule.[72]

Although equity has no real voting leverage,[73] it may extract concessions in a variety of ways. An equityholder may use its position as a party in interest to obstruct the Chapter 11 process. Professors LoPucki and Whitford observed in their study a variety of tactics employed by equity:

> [I]f others wanted the case to move quickly, equity might threaten delay. Other tactics by equity included: combing through the financial affairs of the company looking for matters to litigate; bringing in prospective purchasers for the company who talked high prices even if they made no commitments; or threatening to oppose confirmation by presenting evidence on the issue of valuation.[74]

Equityholders have also created leverage by calling shareholders' meetings for the express purpose of electing new boards to replace debtor management.[75] While there are limits to the permissible scope

69 11 U.S.C. § 1102(a)(1) (1994). The United States trustee appoints the committee, which ordinarily consists of the seven largest unsecured creditors. *Id.* § 1102(a)(1), (b)(1). The committee may hire attorneys, accountants, and other professional advisers, *id.* § 1103(a), who are compensated by the estate. *Id.* § 330(a)(1).

In many cases, especially smaller cases outside of large metropolitan areas, the committee is never formed because of a dearth of creditors willing to serve. 5 COLLIER ON BANKRUPTCY, *supra* note 47, ¶ 1103.07, at 1103-28. However, this is rarely a problem in the large cases. *See* LoPucki & Whitford, *supra* note 48, at 160 (noting that with only one exception, an unsecured creditors' committee was formed in every case studied).

70 *See* 11 U.S.C. § 1103(c) (1994).

71 *Id.* § 1102(a).

72 LoPucki & Whitford, *supra* note 48, at 161. When the debtor is insolvent, its equityholders are usually playing only for some small share in the new equity of the reorganized debtor.

73 *See supra* note 64.

74 LoPucki & Whitford, *supra* note 48, at 161.

75 *See, e.g.*, Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60 (2d Cir. 1986) (holding that shareholders' meeting could not be enjoined absent finding of clear abuse and irreparable injury).

of this tactic,[76] it has been used with some success to improve equity's plan treatment.[77]

B. Claims Trading

The basic premise that drives investment in bankruptcy claims is that the purchaser of a claim, as with the purchase of most other assets, generally succeeds to all the rights of its seller.[78] Perhaps the most important of these rights from the purchaser's perspective is the right to demand payment in full on the claim, regardless of any discount in the purchase price.[79]

1. Incentives to Trade.—The claim purchaser values the claim more highly than the seller, hoping to profit either through treatment

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[76] *Id.*; *see also* LoPucki & Whitford, *supra* note 29, at 694-95 (discussing "clear abuse" standard).

[77] LoPucki & Whitford, *supra* note 29, at 697-98.

[78] Wilson v. Brooks Supermarket, Inc. (*In re* Missionary Baptist Found. of Am., Inc.), 667 F.2d 1244 (5th Cir. 1982) (holding that store that had cashed payroll checks for debtors' employees was assignee of employees' priority wage claims); Dorr Pump & Mfg. Co. v. Heath (*In re* Dorr Pump & Mfg. Co.), 125 F.2d 610 (7th Cir. 1942) (determining that priority wage claim remained priority claim after assignment to director and shareholder); *In re* Zipco, Inc., 157 F. Supp. 675, 677 (S.D. Cal. 1957), *aff'd sub nom.* Bass v. Shutan, 259 F.2d 561, 563 (9th Cir. 1958) (noting that priority wage claim remained priority claim after assignment to stockholder); *In re* Stultz Bros., 226 F. 989 (S.D.N.Y. 1915) (A. Hand, J.) (stating that claimant who cashed checks given by debtor to his employee is entitled to preference as assignee of wage claim); Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 13 n.74 (citing Shropshire, Woodliff & Co. v. Bush, 204 U.S. 186 (1907) (holding that priority wage claims remained priority claims in purchaser's hands)). *But cf.* Holt v. FDIC (*In re* CTS Truss, Inc.), 868 F.2d 146 (5th Cir. 1989) (determining that debtor could not equitably subordinate bank claim now held by FDIC as successor to insolvent bank, though bank acted inequitably); SEC v. Albert & Maguire Sec. Co., 560 F.2d 569 (3d Cir. 1977) (noting that co-obligor on debt to securities customer was not entitled to customer's priority when it paid customer's claim).

The claim will generally also suffer the same infirmities and limitations in the hands of the buyer as it had in the seller's hands. For example, if the claim is subject to avoidance because its original holder received a preference or a fraudulent transfer of property of the estate, *see* 11 U.S.C. § 502(d) (1994), or the claim is subject to equitable subordination based on the seller's inequitable conduct, *see* 11 U.S.C. § 510(c) (1994), or if the claim is for damages resulting from the termination of a lease of real property the allowable amount of which is limited by 11 U.S.C. § 502(b)(6) (1994), the claim in the purchaser's hands will be subject to the same infirmities and limitations. *See* Goldie v. Cox, 130 F.2d 695, 720 (8th Cir. 1942) (stating that assignee is subject to all equitable claims against assignor).

[79] Kremer v. Clarke (*In re* Frank Fehr Brewing Co.), 268 F.2d 170, 180 (6th Cir. 1959), *cert. denied*, 362 U.S. 963 (1960); Lorraine Castle Apartments Bldg. Corp. v. Machiewich (*In re* Lorraine Castle Apartments Bldg. Corp.), 149 F.2d 55, 57-58 (7th Cir.), *cert. denied*, 326 U.S. 728 (1945); *In re* Executive Office Ctrs., Inc., 96 B.R. 642 (Bankr. E.D. La. 1988); *In re* Automatic Equip. Mfg. Co., 106 F. Supp. 699, 707 (D. Neb. 1952), *appeal dismissed sub nom.* Automatic Equip. Mfg. Co. v. Goodall, 202 F.2d 955 (8th Cir. 1953)); Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 14 n.76 (citing Moulded Prods., Inc. v. Barry (*In re* Moulded Prods., Inc.), 474 F.2d 220, 225 (8th Cir.), *cert. denied*, 412 U.S. 940 (1973).

of its claim under the plan or by reselling its claim at a profit prior to plan confirmation.

This difference in valuation as between buyer and seller may result from any of several factors. Sellers may be trade creditors or small, dispersed bondholders, who may not be sophisticated financial players. They may not be institutionally equipped to follow complex reorganization cases that may take years to resolve. They may simply lack the economic stake in the reorganization to justify the costs of monitoring and actively participating in the case. Their preferred course may be to cash out at a discount, rather than attempt to deal with the perceived vagaries of the reorganization process and the financial markets generally. By contrast, the purchaser will very likely be a professional bankruptcy investor, with the expertise to assess reorganization risk and participate actively in plan negotiation.[80]

The bankruptcy investor, by accumulating multiple claims, may also realize certain economies of scale. Given its increased stake in the fortunes of the reorganization as compared to dispersed small claimants from whom it may have purchased, the bankruptcy investor can more readily justify the costs of monitoring and participating in the case. With numerous small claims under common control, the bankruptcy investor reduces the costs of coordinating action which would be incurred among disparate creditors.[81]

Once a critical mass of small claims is accumulated, the bankruptcy investor becomes a force to be reckoned with in plan negotiation. The investor may, for example, be the only creditor in a class actively participating in negotiations if the other claims in the class are small and widely dispersed. This role may allow the investor significant sway over the votes of other creditors in the class. If the investor buys more than one-third in face amount of the claims in the class, it

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> 80 The purchasers typically are investors who believe they can make a profit by buying the claims and shares for less than they will yield after confirmation of a reorganization plan. Some of these investors buy substantial holdings in a particular creditor class. They then use those holdings to participate aggressively in the reorganization case, either as a committee member representing that class's position or as a holder of claims whose votes will be necessary if that class is to approve the plan. By acquiring a large amount of claims that will be exchanged for stock as part of the plan, an investor might even gain control of the emerging company.

LoPucki & Whitford, *supra* note 48, at 162.

> 81 If claims such as publicly held debentures are widely dispersed, no one holder may have the incentive to ensure that the interests of the class are fully asserted. By aggregating the claims, an investor acquires an interest sufficient to warrant exploitation of the bargaining leverage of the class and the realization of its potential under the reorganization plan.

Id. at 163.

The prospects for appointment of official committees to represent widely dispersed unsecured creditors, *see supra* notes 72-78 and accompanying text, may possibly provide comparable economy of scale advantages. *But see* LoPucki, *supra* note 29, at 249 (discussing the limitations of committees in Chapter 11).

holds a blocking position in the class and may effectively veto any plan not to its liking.[82]

Others besides small claimants may also have incentive to sell their claims. Large institutional creditors may also wish to cash out early on in the process. In regulated industries like banking and insurance, regulators may require an institution to write down the value of a particular bankruptcy claim, forcing the institution to show a loss on its books. If the new lower book value is less than the price for which the claim could be sold to a bankruptcy investor, then the institution can actually book a profit by selling, even if at a discount from the claim's original face value. Therefore, regardless of the institution's own estimation of its possible recovery in bankruptcy, it has incentive to sell. Selling the claim also allows the creditor to control the timing of its loss for tax purposes.

2. *The Benefits of Trading.*—The benefits available to creditors from an active market in claims have been well-documented.[83] Provided creditors are given sufficient information to make informed selling decisions, an active market benefits the creditors holding the marketable claims. The existence of willing purchasers for those claims allows the fortunate creditors to cash out, whereas their capital might otherwise be tied up in reorganization for several years. From this perspective, the bankruptcy investor plays a beneficent role, providing liquidity to those creditors holding claims that provide attractive investment opportunities.[84] In addition, to the extent that the existence of willing purchasers allows claimants to reduce their bankruptcy losses, claims trading may indirectly reduce overall borrowing costs. In effect, the bankruptcy investor serves as the risk arbitrageur of last resort, willing to assume reorganization risks that some creditors would rather avoid. Presumably some of the savings to selling

[82] In many cases, the cramdown and non-impairment alternatives may simply not be viable strategies for the debtor.

[83] *E.g.*, Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 4-9; Minkel & Baker, *supra* note 13, at 35-37.

[84] Of course, the bankruptcy investor does not provide liquidity for the sake of the market and has no obligation to do so. The liquidity is incidental to the bankruptcy investor's pursuit of profit. Compare the specialist's role in the stock exchange:

> The specialists' responsibilities to trade . . . require them . . . to temper sudden price movements and keep any general price movements orderly. In this regard, the specialists are expected to buy for their own accounts to offset order imbalances when the price of their stock is falling and to sell when the price is rising. This proprietary specialist activity is expected to alleviate temporary disparities between supply and demand so that advances and declines will occur smoothly.

SEC Staff Report, The October 1987 Market Break 4-3 (Feb. 1988). *See infra* notes 265-66 and accompanying text.

claimants from the reduction in bankruptcy losses would be passed on to borrowers.[85]

Other creditors in the same class with the bankruptcy investor may also benefit from its presence. Especially in a class of otherwise small, widely dispersed claims—for example, a class of widely held, publicly traded bonds—the sophisticated bankruptcy investor holding a significant block of claims may be the only creditor in the class with the expertise and economic stake in the reorganization willing and able to participate actively in plan negotiation. Its ability to negotiate improved plan treatment for its claims generally redounds to the benefit of all creditors in the class.[86]

Claims trading may also hold benefits for debtors and for creditors remaining in the case who do not hold marketable claims. In some situations, the debtor and nonselling creditors might welcome the investor's participation. A purchase of claims may be part of a larger deal that would benefit the reorganization. For example, an investor may agree during the reorganization to make an equity investment in the reorganized debtor. One way to accomplish this transaction is for the investor to purchase claims at a discount from their face amount, and then to receive new stock under the plan as consideration for the purchased claims. This device effectively cleans up the capital structure while enabling equity investment in the reorganized debtor.[87]

A professional investor may be more willing and able to accept new securities as consideration for its claims under a plan. By contrast, the selling claimant may find securities an undesirable form of plan consideration. A supplier, for example, might not be in the business of buying and selling securities. Even if the securities were liquid, which is not always the case, the typical supplier does not have a trading desk and may not have the institutional expertise to value securities or to trade them profitably. With illiquid securities, of course, the problems are even worse.

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85 On the other hand, if on balance, trading imposes higher costs on debtors and nonselling creditors than it avoids for selling claimants, claims trading may increase borrowing costs overall.

86 All claims in a class must receive the same treatment, absent consent of any particular holder to less favorable treatment. *See supra* note 34 and accompanying text. Situations may arise in which small claimants are unable to share the potential class-wide benefit created by the bankruptcy investor. For example, the plan consideration negotiated by the bankruptcy investor may not be in a form that is useful to small claimants and that cannot easily be liquidated. For small claimants, equity in the reorganized debtor may not be an attractive form of plan consideration, whereas the bankruptcy investor receiving a controlling block of equity may have a rosier view.

87 *See infra* note 329 and accompanying text.

Creditors in regulated industries—such as banking—may be restricted in their ability to accept or hold securities.[88] In this situation, a bankruptcy investor's involvement indirectly performs a capital raising function for the reorganized debtor. By accepting securities under the plan in lieu of cash, the investor allows the debtor to retain its precious cash at confirmation, effectively raising capital for the reorganization effort.[89] Conserving the debtor's precious cash improves the prospects for successful reorganization.

To the extent that relations between the debtor and a major creditor have turned hostile, the hostile claimant's exit and its replacement by the fresh face of the bankruptcy investor may advance the progress of plan negotiation. A supplier's willingness to extend postpetition credit to the debtor may improve if it can mitigate the effect of the debtor's bankruptcy by liquidating its claim.

The transfer of claims, then, may not only benefit the particular purchasers and sellers. In some circumstances, it may also promote the rehabilitative goals of reorganization to the debtor's benefit and the benefit of the creditors remaining in the case.

3. *Formalities and Restrictions on Claim Transfer.*—The bankruptcy formalities required in order to transfer claims postpetition are few and straightforward. Once the substantive deal is reached between buyer and seller, the basic bankruptcy formality is contained in Bankruptcy Rule 3001(e)(2).[90] It requires that the transferee of a claim file evidence of the transfer with the court.[91] As long as the alleged transferor does not file a timely objection after notice from the clerk, "the transferee shall be substituted for the transferor."[92]

The current language is the product of a recent amendment, which makes clear that only the alleged transferor has standing to object to a transfer.[93] The amendment also eliminates the general re-

88 *See, e.g.*, 12 U.S.C. §§ 24, 1843(a), (c)(2) (1994); 12 C.F.R. §§ 1.1-1.140, 225.21 (1995) (stating general requirement that nationally chartered banks, bank holding companies, and subsidiaries of bank holding companies must dispose of stock received in exchange for debt previously contracted within two years).

89 Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 8; Minkel & Baker, *supra* note 13, at 36.

90 FED. R. BANKR. P. 3001(e)(2).

91 *Id.* This requirement applies only as to outright transfers (not merely for security) after proof of claim has been filed. *Id.* For such transfers made before proof of claim is filed, only the transferee may file the proof of claim. FED. R. BANKR. P. 3001(e)(1). The "evidence of transfer" requirement also does not apply to any claim based on a publicly traded note, bond, or debenture. FED. R. BANKR. P. 3001(e)(2). Other rules apply to transfer of claims for security. FED. R. BANKR. P. 3001(e)(3), (4).

92 FED. R. BANKR. P. 3001(e)(2).

93 H.R. DOC. No. 102-80, 102d Cong., 1st Sess. 306-10 (1991) (as amended August 1, 1991).

quirement for a hearing and court order to effect a transfer.[94] Several courts had relied in part on the prior language in the rule[95] to condition trading in response to particular perceived abuses.[96] However, the 1991 amendment to Rule 3001(e)(2) narrows its scope, addressing the rule only to particular disputes between assignor and assignee.[97]

In addition to the filing requirement of Rule 3001(e)(2), section 1126(e) of the Code provides that a party in interest may petition the court to designate (disqualify) any plan vote that "was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title."[98] "Good faith" is not defined in the Bankruptcy Code. However, section 1126(e) has been invoked to disqualify votes of claims purchased immediately prior to the confirmation hearing, when the purchaser's express purpose for buying the claims was to block confirmation in an effort to acquire control of the debtor via a competing plan.[99] Bad faith designation was also deemed appropriate in a case in which competitors of the debtor purchased claims in order to destroy the debtor's business by blocking plan confirmation.[100]

In addition to the constraints of Rule 3001(e) and section 1126(e), parties in interest have successfully challenged perceived abuses arising from claims trading in particular cases, largely in reliance upon the court's general equitable powers. For example, creditors have histori-

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94 A hearing and court order are still required if the alleged transferor files a timely objection. FED. R. BANKR. P. 3001(e)(2).

95 Before August 1, 1991, Rule 3001(e)(2) stated:

> If a claim other than one based on a bond or debenture has been unconditionally transferred after the proof of claim has been filed, evidence of the terms of the transfer shall be filed by the transferee. The clerk shall immediately notify the original claimant by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed with the clerk within 20 days of the mailing of the notice or within any additional time allowed by the court. If the court finds, after a hearing on notice, that the claim has been unconditionally transferred, it shall enter an order substituting the transferee for the original claimant, otherwise the court shall enter such order as may be appropriate.

FED. R. BANKR. P. 3001(e)(2) (amended as of August 1, 1991).

96 For example, in *In re* Revere Copper & Brass, Inc., 58 B.R. 1 (Bankr. S.D.N.Y. 1985) and *In re* Allegheny Int'l, Inc., 100 B.R. 241 (Bankr. W.D. Pa. 1988), courts concerned about potential informational asymmetries as between assignors and assignees conditioned approval of proposed claim assignments on the taking of remedial measures to provide full disclosure to assignors. Another court, concerned that claim splitting—assignments that did not transfer assignors' entire interest in particular claims—would increase administrative burdens on the estate, refused to approve assignments until remedial measures were taken. *In re* Ionosphere Clubs, Inc., 119 B.R. 440 (Bankr. S.D.N.Y. 1990).

97 *See generally* Fortgang & Mayer, *1991 Developments*, *supra* note 13, at 2; Minkel & Baker, *supra* note 13, at 38.

98 11 U.S.C. § 1126(e) (1994).

99 *In re Allegheny*, 118 B.R. at 289. *See infra* section III.C.2.

100 *In re* MacLeod Co., Inc., 63 B.R. 654 (Bankr. S.D. Ohio 1986). *See generally* Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 91-99; Andrew Africk, Comment, *Trading Claims in Chapter 11: How Much Influence Can Be Purchased in Good Faith under Section 1126?*, 139 U. PA. L. REV. 1393 (1991).

cally been able to challenge trading by fiduciaries of the debtor, with purchased claims being allowed only in the actual amounts paid.[101] Debtors have also been successful in obtaining orders limiting trading in cases in which such trading created potential negative tax consequences for those debtors.[102]

On the whole, however, claim transfers have been viewed as private transactions, subject to third-party challenge or court scrutiny only in special circumstances.

C. *Free Alienability of Claims*

Free alienability of property has historically been regarded as the rule, and intervention that impairs or altogether prohibits alienability the exception.[103] Discussion over transferability of claims in Chapter 11 has generally hewed to this traditional idea. "The freedom to buy and sell one's property is a right not lightly trammelled upon in this country. The numerous laws prohibiting restraints on alienation attest to that."[104] Moreover, a claim assignment is generally regarded as a private transaction between a willing buyer and willing seller, which "simply substitutes one creditor for another."[105] The assignee merely "stands in the shoes of the original claimant."[106] Therefore, each claimant should be free to sell, and each purchaser should succeed to all the rights of its assignor.

Outside of bankruptcy, the analysis goes, a creditor's right to payment is freely transferable, and bankruptcy law should not casually disrupt prebankruptcy entitlements.[107] The oft-cited *Butner*[108] deci-

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101 "Based on the fundamental principle that a fiduciary cannot profit from the trust, courts have historically held that the claims or interests purchased by fiduciaries may be limited to the discounted amount paid rather than the full face value of the purchased claim or interest." Scott K. Charles, *Trading Claims in Chapter 11 Cases: Legal Issues Confronting the Postpetition Investor*, 1991 ANN. SURV. AM. L. 261, 264 (citing *In re* Gladstone Glen, 739 F.2d 1233, 1236-37 (7th Cir. 1984); Monroe v. Scofield, 135 F.2d 725, 728 (10th Cir. 1943)); *see also In re* Papercraft Corp., 187 B.R. 486 (Bankr. W.D. Pa. 1995) (holding that allowed amount of claims purchased by insider was limited to purchase price because of insider's failure to disclose its status prior to purchase). *See generally* Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 25 (discussing historical treatment of fiduciary trading and uncertainties under the Code).

102 *See infra* section III.C.1.

103 "The assignability of intangible rights is the general rule, non-assignability the exception." *In re* Marin Town Ctr., 142 B.R. 374, 382 (Bankr. N.D. Cal. 1992) (quoting 7 Cal. Jur. 3d (Rev.), Assignments § 3 (1989)) (holding that stipulation in single asset bankruptcy, granting relief from stay to senior secured lender should debtor fail to refinance by a date certain, may be assigned along with lender's claim).

104 Fortgang & Mayer, *1993 Developments*, *supra* note 13, at 759 (citing U.C.C. § 9-318(4) (1992); RESTATEMENT (SECOND) OF CONTRACTS § 322(1) (1981)).

105 Minkel & Baker, *supra* note 13, at 43.

106 *Id.* at 44.

107 *See generally* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) (arguing that because of the problem of forum

sion succinctly captures the relation between bankruptcy and nonbankruptcy law:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy.[109]

Commentators have cited *Butner* for the general proposition that courts should generally not interfere with the creditor's prebankruptcy entitlement freely to assign its rights against its debtor-borrower.[110]

To the extent that a market develops to facilitate trading in these rights, this market merely serves to enhance the ability of individual claimholders to exercise free choice concerning disposition of their property. Legal intervention should apply only at the fringes of the market, in order to right specific wrongs or curtail specific abuses. At its core, the argument goes, the market for claims—like any other market in which property is bought and sold—functions best when left alone. The individual acts of rational self-interested actors in the market will result in desirable outcomes.[111] The public securities markets provide a helpful model of efficiency.[112]

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shopping, bankruptcy rules should depart from nonbankruptcy rules only if justified by some specific bankruptcy policy).

108 Butner v. United States, 440 U.S. 48 (1979).

109 *Id.* at 55 (quoting Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603, 609 (1961)).

110 "Until relatively recently, absent the existence of fraud, misrepresentation, overreaching or violation of fiduciary obligations, courts generally refused to interfere with the transfer of claims." Charles, *supra* note 101, at 272 (citing *Butner* and *In re* Lorraine Castle Apartments Bldg. Corp., 149 F.2d 55, 57-58 (7th Cir.), *cert. denied*, 326 U.S. 728 (1945)).

111 Fashioning judicial "remedies" to deal with the perceived inequities of claims trading chills the market for claims. . . . In an efficient market, the transaction costs and economic risk imposed on claims purchasers will be shifted to claims sellers through lower prices for claims. . . . The imposition of ad hoc rules on claims trading to "protect" selling creditors effectively taxes those creditors who would like to convert their claims into ready cash. Absent a complaint of fraud, misrepresentation, or other cognizable wrong from a party with standing, or a clear congressional mandate, courts should not deprive creditors of the advantages of claims trading based on judges' personal views of its merits or demerits. Regulation of the marketplace is within the sound discretion of Congress and not an appropriate subject for judicial "legislation."

Minkel & Baker, *supra* note 13, at 52-53.

112 *See, e.g.*, Fortgang & Mayer, *Trading Claims*, *supra* note 13.

> [T]he best protection for the unwitting claims seller is an efficient market. The widow from Dubuque can sell her General Motors stock at a fair price on the New York Stock Exchange . . . primarily because there is an active and deep market for her stock. . . . [T]he market for claims against chapter 11 debtors is growing stronger.

Id. at 56. *See also id.* at 46 ("The time may come when this entire area of bankruptcy jurisprudence melts into the securities laws, which would make sense. If claims trade like securities, regulations of such trading should mimic the securities laws.").

1. Historical Context: the Bankruptcy Act. —Certainly under the Bankruptcy Act,[113] the predecessor to the Bankruptcy Code, the free alienability of claims was assumed. Claims trading was circumscribed only at the margins.[114] Only purchases that involved, for example, bad faith[115] or breach of fiduciary duty[116] drew censure from the courts. In the main, however, trading claims in bankruptcy was simply treated as a free transfer of property from a creditor to a willing purchaser and was presumptively valid. "For over eight decades, federal courts from the Supreme Court on down have unanimously held that a claim in the hands of a buyer is no different than a claim in the hands of a seller. The entire market for claims against Chapter 11 debtors is based on that principle."[117]

A review of the reorganization regimes that preceded Chapter 11—Chapters X and XI of the Bankruptcy Act—suggests, however, that free transferability of claims did not have the same disruptive potential for those regimes as does claims trading in Chapter 11. The respective structures and processes of Chapter X and XI were fundamentally different from those of Chapter 11. In Chapter X, a court-appointed trustee dominated the process. In Chapter XI, the debtor dominated the process. In either case, creditor influence over the terms of reorganization of large public companies was far less significant than in Chapter 11. Creditors were not interdependent to the degree they are in Chapter 11, and relationships and cooperation among parties in interest were not critical.[118] Claims trading therefore would not have presented the same problems under those systems.

a. Chapter X.—Enacted in 1938 as part of the Chandler Act,[119] Chapter X offered a very highly structured reorganization procedure for large companies with many creditors and complex capital structures. It was "principally the work of the Securities and Exchange Commission,"[120] designed as a "complete reorganization vehicle"[121] to be dominated by public officers and agencies: the

113 Bankruptcy Act of 1898, Pub. L. No. 62-57, 30 Stat. 544-66 (1898) (amended 1938) (repealed 1978) [hereinafter the Bankruptcy Act], *reprinted in* COLLIER ON BANKRUPTCY, *supra* note 47, §§ 1-7031 app. 1.

114 *See generally* Fortgang & Mayer, *Trading Claims*, *supra* note 13.

115 *Id.* at 93.

116 *Id.* at 25.

117 Fortgang & Mayer, *1993 Developments*, *supra* note 13, at 759 (citation omitted).

118 *See infra* Part II.

119 Act of June 22, 1938, ch. 575, 52 Stat. 840-940 (repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549).

120 Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1335 (1939).

121 Coogan, *supra* note 56, at 311.

bankruptcy judge, a court-appointed trustee, and the SEC.[122] The debtor's management was almost always displaced by a disinterested court-appointed trustee,[123] who undertook not only to manage the debtor's business, but also to investigate the financial condition of the debtor, to report to the judge concerning fraud or mismanagement,[124] and to formulate a plan of reorganization.[125] The trustee was "the prime agent in the formulation and presentation of a plan of reorganization."[126] All types of debt—secured or unsecured, fixed or contingent—and equity could be modified in a Chapter X plan.

As a substantive matter, Chapter X plans were required to follow strict absolute priority.[127] "Beginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate."[128] Central to the court's absolute priority scrutiny was its going concern valuation of the debtor.[129] This valuation was required in order to determine the value of the securities issued under the plan and compliance with the absolute priority rule: in particular, whether any class had received more or less

122 Rostow & Cutler, *supra* note 120, at 1336. Prior to enactment of the Chandler Act, public company reorganizations under the then-prevailing structures were perceived to have allowed corporate insiders to divert to themselves reorganization values that rightly belonged to public investors, primarily public bondholders. At that time, senior bonds were the most common publicly held corporate securities, with equity more often privately held. HOUSE REPORT, *supra* note 23, at 222. In reorganization, public bondholders could not effectively organize to protect their rights against insider equityholders, who along with their investment bankers generally controlled the reorganizations. *See generally* SECURITIES & EXCH. COMM'N, 1 REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL & FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 243-670 (1937). This control allowed insiders to propose plans of reorganization that favored equityholders at the expense of creditors, who should have enjoyed priority over equityholders. *Id.* at 87. In addition, insider control of a reorganization avoided serious scrutiny of the pre-reorganization conduct of management and any lucid accounting with respect to the company's assets. *Id.* at 870-71.

Chapter X instituted elaborate procedures and oversight by both the court and the SEC for the protection of public investors. HOUSE REPORT, *supra* note 23, at 225. As a result of the dominant role of public officers, "management and committees controlled either by management or by the house of issue find the area within which they may act to press their interests correspondingly reduced in size and importance." Rostow & Cutler, *supra* note 120, at 1336.

123 Bankruptcy Act § 156, 11 U.S.C. § 556 (repealed 1978). For a debtor with liquidated, noncontingent indebtedness not exceeding $250,000, appointment of a trustee was discretionary. *Id.* However, by 1977, such small cases were "exceedingly rare." HOUSE REPORT, *supra* note 23, at 224 n.23.

124 Bankruptcy Act § 167, 11 U.S.C. § 567(g) (repealed 1978).

125 *Id.* § 169, 11 U.S.C. § 569 (repealed 1978).

126 HOUSE REPORT, *supra* note 23, at 224.

127 Securities & Exch. Comm'n v. American Trailer Rentals Co., 379 U.S. 594 (1965).

128 6A COLLIER ON BANKRUPTCY ¶ 11.06, at 210-11 (14th ed. 1976) (citing Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941)).

129 "The valuation consists of an estimate of the earning power of the reorganized debtor, and the appropriate market capitalization rate of that estimated income stream." HOUSE REPORT, *supra* note 23, at 225.

than its absolute priority entitlement. The valuation was "employed to foreclose the interests of junior classes of creditors and stockholders, and no securities [would] be given any class unless all prior classes [were] 'fully compensated.' "[130]

The SEC also scrutinized the plan, producing an advisory report for the benefit of creditors and stockholders.[131] The SEC's report could take anywhere from one to six months.[132]

Given the structure of Chapter X and the active involvement and supervision by the trustee, the court, and the SEC, creditors had much less influence over the process than in Chapter 11. While the trustee could entertain proposals or suggestions by parties in interest with respect to plan formulation, the trustee was "the key [person] in the process of arriving at a reorganization plan," who was "under no obligation to adopt any plan or proposal suggested." The trustee had "the ultimate and sole responsibility; whatever plan is presented to the court, it is the *trustee's* plan."[133]

Moreover, the significance of creditor voting and creditor opposition to the plan in Chapter X was quite different from Chapter 11. In Chapter 11, the typical goal of the debtor's management in the plan formulation process is to scale down senior claims in order to be able to provide some value in the reorganized debtor to junior claims or interests.[134] Chapter 11 contemplates the possibility of such a distribution—given that there are few substantive limitations with respect to the plan distribution scheme[135]—but only with creditor approval. Only by class vote may creditors agree to take less under a plan than their absolute priority entitlement.[136] Distribution of value under the plan is therefore a central focus of debtor-creditor negotiation in Chapter 11, and creditors may withhold or threaten to withhold their consent in order to prevent plan confirmation in hopes of negotiating improved treatment.

By contrast, in Chapter X, holding out by creditors attempting to improve their plan treatment was less significant an issue. The distribution scheme under a Chapter X plan was constrained by a rule of strict absolute priority, irrespective of creditor voting. In other words, absolute priority and creditor approval were separate and independent requirements. Creditor class approval of a plan could not operate

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130 Rostow & Cutler, *supra* note 120, at 1346.

131 Bankruptcy Act § 172, 11 U.S.C. § 572 (repealed 1978). Referral to the SEC was mandatory for a debtor with indebtedness exceeding $3 million, and discretionary otherwise. *Id.*

132 House Report, *supra* note 23, at 225.

133 6 Collier on Bankruptcy Pt. 2, ¶ 7.31, at 1285 (14th ed. 1976) (emphasis in original). Also, unlike Chapter 11, in Chapter X classification of claims was up to the judge. Bankruptcy Act § 197, 11 U.S.C. § 597 (repealed 1978).

134 See *supra* notes 51-52 and accompanying text.

135 See *supra* note 24 and accompanying text.

136 See *supra* section I.A.1.

as a waiver of the absolute priority entitlement of that class, unlike Chapter 11. Therefore, the nominal value of creditors' claims could not be scaled down in the plan, even with their consent. Each class was entitled to full payment before any class with lower priority received any distribution.[137] In addition, the court-appointed Chapter X trustee was required to be disinterested. The trustee therefore had no strong stake in attempting to redistribute value from senior to junior claims via the plan, unlike the Chapter 11 debtor. The Chapter X trustee's task in formulating the plan was essentially to effect an absolute priority distribution. If that meant that junior claims or interests were eliminated from participation, then so be it. In Chapter X, therefore, the plan distribution scheme was simply less susceptible of negotiation, and creditors therefore had less to gain by opposing the trustee's plan.[138]

The trustee's management of the debtor's business during reorganization also meant that creditor influence over any operational rehabilitation was minimal compared to Chapter 11.

In no sense did Chapter X treat creditors as owners of the firm.[139] Chapter X did not rely on collective negotiation among private parties in order to allocate losses or make asset deployment decisions. Instead, it relied on the trustee's plan formulation, following a rule of strict absolute priority and the trustee's role as the debtor's management. "[A]ll activities in the case are under the sole control of one individual."[140]

In this context, claims trading could justifiably be described as merely substituting one creditor for another, without the imposition of externalities on third parties. Claims trading in Chapter X had far less potential for disrupting that reorganization process than trading in Chapter 11.

b. Chapter XI.—Chapter XI was a very different system from Chapter X. It was envisioned as an informal, inexpensive, and

[137] This is not to suggest that valuation is not a speculative process or that widely dispersed creditors were as effective at asserting their absolute priority entitlements as sophisticated investors. Professor Coogan's famous bon mot describes the valuation process as "an estimate compounded by a guess." HOUSE REPORT, *supra* note 23, at 225. However, the likely range of deviation from "strict" absolute priority was certainly much narrower under Chapter X than under the Bankruptcy Code.

[138] Any creditor class rejecting the plan was entitled to "adequate protection for the realization by them of the value of their claims." Bankruptcy Act § 216(7), 11 U.S.C. § 616(7) (repealed 1978). This latter determination was of course up to the judge. For example, a rejecting class of creditors could simply be cashed out at the appraised value of its claims. Bankruptcy Act § 216(7)(c), 11 U.S.C. § 616(7)(c) (repealed 1978).

[139] *Cf. infra* note 168 and accompanying text.

[140] HOUSE REPORT, *supra* note 23, at 235 (explaining relative inactivity of creditors' committees in Chapter X compared to Chapter XI, in part because of limited creditor influence in Chapter X).

expeditious process for the arrangement of the unsecured debts of smaller enterprises. "Chapter XI was designed to eliminate small businesses ('hot dog stands') from the complications of full-blown corporate reorganization."[141] However, it became the reorganization chapter of choice for large businesses as well as small.[142] It offered a less cumbersome process than Chapter X and allowed the debtor to maintain control of the business.[143] Unfortunately, because of its simple structure, it lent itself to debtor domination of the proceeding at creditor expense. It further proved inadequate for addressing the complex issues arising in the reorganization of large public companies with complex capital structures.[144]

The debtor largely controlled the process, with little formal oversight by the court or any public officer. In addition to maintaining control of the business, only the debtor could propose an arrangement[145] or a modification thereof.[146] "It was contemplated that the debtor would usually be in charge, would sound out the creditors, would devise a plan, and would try to persuade the creditors to accept it."[147] Required disclosure to creditors was minimal.[148] The un-

141 ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 189 (2d ed. 1991).

142 HOUSE REPORT, *supra* note 23, at 222. Less than ten percent of all business reorganizations were in Chapter X. *Id.*

143 HOUSE REPORT, *supra* note 23, at 233. Congress did not foresee that major industrial enterprises would attempt to reorganize under Chapter XI. Quite the opposite. Chapter X included a provision *limiting* access to those cases in which "adequate relief" was not obtainable under Chapter XI. Bankruptcy Act §§ 141, 146(2), 11 U.S.C. §§ 541, 546(2) (repealed 1978). Chapter XI, however, was the preferred reorganization vehicle. Corporate managers disfavored the cumbersome Chapter X process, including the SEC's participation and oversight. The attendant delay might ensure the demise of the business. In addition, corporate managers were reluctant to relinquish their positions of control, especially to a court-appointed trustee unfamiliar with the business. Corporate lawyers also had some influence as to this trend:

> The reason underlying the preference of lawyers for Chapter XI is obvious, although not often stated. A debtor initiates a Chapter XI proceeding, and only the debtor can propose a plan under Chapter XI. The debtor is normally allowed to operate the business. A concomitant of continued management is the continuation of the employment of the debtor's attorney. On the other hand, if a Chapter X proceeding is initiated, a disinterested trustee is appointed and counsel for the debtor has a greatly reduced function. Although proponents of the Chapter XI generally talk about speed and economy, control and the "best interests" test obviously are the dominating reasons for the preference.

REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, July 1973, at 247.

144 Formally, only unsecured debt could be affected in Chapter XI. Rights of secured creditors and equityholders were not subject to modification. Bankruptcy Act § 356, 11 U.S.C. § 756 (repealed 1978). This formal limitation in Chapter XI ultimately did not prevent debtors from modifying the substantive rights of equityholders by diluting their holdings through issuance of additional equity to creditors as part of their arrangements. HOUSE REPORT, *supra* note 23, at 226.

145 Bankruptcy Act § 323, 11 U.S.C. § 723 (repealed 1978).

146 *Id.* § 363, 11 U.S.C. § 763 (repealed 1978).

147 Walter J. Blum & Stanley A. Kaplan, *Affecting Rights to Equity Interests Under Chapter XI of the Bankruptcy Act*, 1972 WIS. L. REV. 978, 982.

secured creditors' only involvement was their right to vote for or against the proposed arrangement.[149] Unlike Chapter X and Chapter 11, creditors in Chapter XI were entitled only to liquidation value.[150] This allowed stockholders to retain the difference between going concern value and liquidation value.

Together these provisions allowed the debtor to dominate the Chapter XI proceeding. While negotiation was perhaps more important in Chapter XI than in Chapter X,[151] the debtor's exclusive right to file the Chapter XI plan basically allowed it to force settlement on unsecured creditors.[152]

Because the debtor dominated the process, Chapter XI did not depend heavily on relationships or cooperation among the parties in interest. Therefore neither the financial restructure nor the business was significantly affected by changes in the identity or composition of creditors.[153] Claims trading in Chapter XI could not effect the same disruption as in Chapter 11.

2. *Chapter 11 by Comparison.*—Chapter 11's central theme is that the distribution of value is up to the parties' negotiation.[154]

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148 HOUSE REPORT, *supra* note 23, at 225.

149 Bankruptcy Act §§ 361, 362, 11 U.S.C. §§ 761, 762 (repealed 1978).

150 HOUSE REPORT, *supra* note 23, at 223 (citing Bankruptcy Act § 366(2), 11 U.S.C. § 766(2) (repealed 1970)).

151 *See id.* at 235 (comparing creditor committee activity in Chapter X and Chapter XI and significance of creditor influence). Unlike Chapter X, Chapter XI explicitly provided for an official creditors' committee, whose counsel was compensated from the estate. *Id.* (citing FED. R. BANKR. P. 11-29 (1978)).

152 [C]hapter XI gives the debtor the exclusive right to propose a plan. Creditors are excluded. The exclusive right gives the debtor undue bargaining leverage, because by delay he can force a settlement out of otherwise unwilling creditors, and they have little recourse except to move for conversion of the case to [C]hapter X. That is contrary to their interests as it is to the debtor's, and thus is rarely done. The debtor is in full control, often to the unfair disadvantage of creditors.

HOUSE REPORT, *supra* note 23, at 231.

Likewise, while unsecured creditors could move to dismiss a Chapter XI petition, this was hardly an attractive alternative, especially in the large cases. Dismissal would simply allow secured creditors to capture the lion's share of the debtor's remaining value, leaving little for unsecured creditors.

153 Perhaps the Chapter XI debtor's worst fear came not from the prospect of recalcitrant creditors but from the SEC. While the SEC had no formal role in Chapter XI as it did in Chapter X, a common SEC response to the filing of a Chapter XI petition by a large public company was to move for conversion to Chapter X. *E.g.*, Securities & Exch. Comm'n v. American Trailer Rentals Co., 379 U.S. 594 (1965).

Ultimately, the SEC developed the practice of using this credible threat of conversion to negotiate with the debtor over the treatment of public debt- and equityholders in the Chapter XI arrangement. HOUSE REPORT, *supra* note 23, at 223.

154 Klee, *supra* note 50; Coogan, *supra* note 56.

Chapter 11, like one of its predecessors, [C]hapter XI, allows and almost compels the parties to negotiate with each other. While [C]hapter X turned over the reorganization problem to outside experts—the trustee, the judge, and the SEC—Chapter 11, like [C]hapter XI, leaves

Chapter 11 was intended to combine all of the best qualities of Chapters X and XI into one all-purpose reorganization statute, while remedying their perceived shortcomings. Chapter X had been deemed too rigid, both in terms of the structure of the process and the substantive requirements for the plan of reorganization. Chapter XI allowed the debtor to dominate the process and provided only incomplete relief for large public companies because of the inability to modify secured debt or equity. The negotiation regime of Chapter 11 seemed an appropriate response to these various shortcomings.

However, one issue relating to this more flexible structure, which was not an issue under Chapter X or XI and which appears to have received little if any attention, is the possibility of disruption to the process from active claims trading. Consensus and cooperation were not as critical in Chapter XI as in Chapter 11, and even less important in Chapter X. Creditors had less leverage and less interdependence in proceedings under Chapter X and Chapter XI.

The significant role for creditors and the centrality of bargaining in Chapter 11 make the process more fragile than either of its predecessor reorganization regimes. Exit of a significant creditor or creditor block, or entry by a bankruptcy investor with its new money perspective,[155] may significantly alter the course of the reorganization. Even the *prospect* of creditor turnover from the collective process changes the dynamics of negotiation and visits costs on the process.[156] Chapter 11 is therefore less robust than its antecedents with respect to instability in the creditor constituency.

The pre-Code practice continues to influence contemporary thinking about claims trading, however. Arguments for free alienability of claims generally rely on pre-Code decisions—some involving single-asset debtors[157]—which hold that the face amount and priority of a claim should generally be respected in the hands of a purchaser, regardless of any discount on the purchase price.[158] Decisions under the Code simply echo the pre-Code rule—and even cite to pre-Code

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the problem in the hands of those financially interested—the debtor, the creditors, the equityholders, and their committees.

Coogan, *supra* note 56, at 348.

155 *See infra* subpart II.C.

156 *See infra* section II.B.3.

157 In single-asset cases, the debtor's primary asset is overencumbered real estate. The undersecured mortgage holder is the dominant creditor, and general unsecured creditors are relatively few and their claims relatively small. The debtor and mortgage holder dominate negotiations in these cases, and general unsecured claims do not exercise much influence. Those claims are small enough that some nontrivial consideration can usually be allocated to them under any plan to assure their assent. In this context, the structure of negotiation is relatively uncomplicated. The possibility of disruption of the process from trading of claims is minimal. Therefore, single-asset cases under the Act supply particularly weak authority for the proposition that claims should be freely traded in Chapter 11.

158 *See supra* notes 78-79 and cases cited therein.

editions of *Collier's*[159]—without analysis of any relevant distinctions between systems of reorganization.[160]

Because of the differences between reorganization under the Code and reorganization under the Act, a free trading rule has very different consequences under the different systems. Pre-Code cases do not directly address questions of free alienability, free markets, or externalities, but merely presume a free trading rule. This should not surprise, of course, since the stakes were different under the Act. A free trading rule was relatively costless with respect to those reorganization processes. However, without a considered analysis of the effect of a free trading rule in Chapter 11, these pre-Code decisions should not be authoritative on this question. The consequences of trading claims in Chapter 11 differ from the consequences of trading claims in Chapter X or Chapter XI and from the consequences of selling creditor rights outside of reorganization. A rule of free trading under any of those other regimes cannot be imported uncritically into Chapter 11.

II. Adverse Effects of Trading on the Confirmation Process

The literature on claims trading focuses primarily on the benefits that may derive from trading.[161] The most significant problem, according to this body of commentary, is how to preserve a well-functioning market for claims. Commentators lament bankruptcy judges' inexplicable tendency to want to regulate the market from the bench.[162] While some will admit that abuses exist that courts should address—for example, lack of adequate disclosure or bad faith claims acquisition and voting—the discussion presumes that the proper sphere of such "regulation" is at the margins.[163] Fundamentally, however, the market should be unimpeded, so that all parties in interest may enjoy the benefits of active trading.

159 *E.g.*, *In re* Executive Office Ctrs., Inc., 96 B.R. 642, 649 (Bankr. E.D. La. 1988).

160 *E.g.*, *In re* Marin Town Ctr., 142 B.R. 374, 383 (Bankr. N.D. Cal. 1992); *Executive Office Ctrs.*, *supra* note 159, at 642. In fairness, these two Code cases involved small real estate debtors with simple capital structures. Claim assignments in those cases did not implicate potential disruption or cost issues. *See infra* Part II. However, for this same reason, those cases are not helpful to our inquiry. Small real estate cases do not resemble "megacases" in the structure of the debtor or the complexity of plan negotiation.

161 *See supra* section I.B.2.

162 *See, e.g.*, discussion, *supra* note 111 and accompanying text.

163 In regulating the sale of claims in situations like *Revere* [*see supra* note 96], the courts should strike a proper balance. They should preserve the integrity of the bankruptcy process through the zealous protection of those who need it without chilling the markets for [C]hapter 11 claims by judicially freezing transactions between responsible parties who can take care of themselves.

Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 56.

Claims trading is not an unmixed blessing, however. Its generic effect on the confirmation process has not been examined. Trading may offer benefits to some, particularly to purchasers and sellers. It may even expedite a reorganization to everyone's benefit.[164] However, it also has potentially adverse effects to third parties and the reorganization process. Claims trading effects creditor turnover. The collective and consensual nature of the Chapter 11 process makes it susceptible to disruption from this instability in the creditor constituency. Trading may therefore impose costs on the estate and parties in interest.

This section discusses such detrimental effects on the confirmation process. Based on this discussion, the remainder of the Article takes issue with the free alienability, market-based account of claims trading and suggests an alternative approach.

A. *Collective Decisionmaking in Chapter 11*

As earlier discussion concerning bargaining in Chapter 11 might suggest,[165] Chapter 11 effectively creates a participatory, collective scheme for decisionmaking regarding the terms of reorganization. This scheme diverges sharply from the prebankruptcy situation.

The ordinary nonbankruptcy debtor-creditor relationship is a bilateral relationship, involving borrower and lender and possibly a limited number of third parties—for example, guarantors. However, as the borrower approaches financial failure, the relationship between creditor and debtor becomes more complicated. A given creditor's recovery begins to depend not only on the debtor's business performance, but on the behavior of the debtor's other creditors.[166] However, outside of bankruptcy, creditor remedies are generally bilateral in form. The creditor's state court lawsuit to collect on its debt does not formally involve other creditors. Each creditor's right to payment against the debtor stands independent of any arrangement between the defendant debtor and any of its other creditors. Likewise, each creditor's collection remedies at state law formally involve only the debtor, not competing creditors.[167]

Invocation of Chapter 11 transforms each creditor's prebankruptcy bilateral relationship with the debtor into a multilateral rela-

164 *See supra* section I.B.2.

165 *See supra* section I.A.2.

166 For example, once the debtor has defaulted on its obligations to its senior secured lender, the fate of its unsecured creditors to a great extent depends on whether the senior lender responds by foreclosing on its collateral or by working out new terms.

167 Of course, ultimately the winner in the race of the diligent under state law depends on the field of contestants. *See generally* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. Rev. 311, 314-52 (describing various functions performed by state law collection regime).

tionship with the debtor and its other creditors. A community of sorts is created, in which each creditor receives a unique set of bankruptcy entitlements, armed with which it negotiates with the other community members—the debtor's management, other creditors, the bankruptcy court, equityholders, committees, and the United States trustee—over a whole range of operational and financial issues, including treatment of its claim under the plan and protection of its interests during the pendency of the case, which for a large publicly traded company will typically last several years. Commentators have suggested that Chapter 11 in effect creates a "firm" in which the creditors act as "owners."[168]

Over the course of the reorganization, negotiation among the debtor and creditors effectively remakes the firm. Fundamental changes are certainly effected in negotiation over the plan. In addition, creditors in Chapter 11 are given oversight over the debtor's significant operational and financial decisions during the case. Negotiation over these issues may also effect fundamental change in the firm.

With respect to plan formulation, negotiation among the debtor and creditors does not simply resolve individual disputes over the distribution of value. Key decisions are made concerning both the reorganized entity's postconfirmation operations and its capital structure. While each creditor's ultimate concern is treatment of its claim under the plan, the creditor must also concern itself with the reorganized debtor's financial and operational health, in order to assure that the promised plan treatment of its claim will come to fruition.

Instead of using precious cash to satisfy claims, the plan will generally call for the reorganized debtor to issue securities or other instruments evidencing claims against postconfirmation earnings. The plan will offer to each class of claims a payout different from its prebankruptcy entitlement. The interest rate may be different; the term will typically be extended; if secured, the claim's collateral may be adjusted. In effect, the reorganized debtor satisfies its prepetition obligations with postconfirmation claims against its projected future earnings. Because the income stream is limited, one central focus of plan negotiation for a large public company is the terms of securities to be issued to each class. By altering the rights of each class of claims and interests through this negotiation, not only does the plan process mediate particular conflicts among the parties as to distribution of value, but it also sets the reorganized entity's capital structure.

168 *See, e.g.*, James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2109 (1990) (suggesting the firm analogy and questioning whether the costs of administering the firm and mediating the conflicts among agents and owners may be so high that the firm's formation and existence cannot be justified).

Whether these new postconfirmation obligations are ultimately paid depends not only on the reorganized entity's capital structure but also on its postconfirmation operations. Parties in interest therefore will generally want to assure that any operational problems are fixed under the plan and that the plan is feasible. Disagreements as to how best to accomplish this goal must be resolved in plan negotiation. For example, whether an ailing business segment can be revived postconfirmation, or whether it should be sold to raise cash to fund plan payments, is a significant question with both operational and financial significance, over which parties in interest are likely to disagree.[169] The community of interests in Chapter 11 must address these issues as well as individual issues of claim treatment.

In addition to the terms of reorganization, each claimant will also be concerned with the conduct of the ongoing business during the case. While the debtor is initially charged with managing the business during reorganization, the scope of its discretionary authority is generally limited to conducting business in the ordinary course. Any non-ordinary course use, sale, or lease of estate property or non-ordinary course incurring of debt requires the debtor to give notice to parties in interest, who may object and request a hearing.[170] In addition, certain of the debtor's activities, whether in the ordinary course or not, require notice and a hearing. The debtor's use of cash collateral,[171] the proposed settlement of any controversy,[172] and payment of professionals retained by the debtor or an official committee[173] all require notice and hearing. All sorts of management decisions are subject to creditor scrutiny. Therefore, it generally behooves the debtor to consider creditors' concerns as part of its business planning.[174]

The Code, then, explicitly recognizes the interests of creditors in the ongoing operation of the debtor in possession and provides for the mediation of conflicts relating to those operations. Pending confirma-

169 The divergence in risk preferences as between senior and junior claimants is discussed in LoPucki & Whitford, *supra* note 29, at 683.

170 "After notice and a hearing," the debtor in possession may use, sell, or lease property of the estate outside the ordinary course of business, 11 U.S.C. § 363(b)(1) (1994), or may incur debt not in the ordinary course. *Id.* § 364. The phrase "after notice and a hearing" is a bankruptcy term of art, which does not necessarily mean that a hearing will actually be held. *Id.* § 102(1). However, in the case of a debtor's proposed non-ordinary course disposition of estate property, creditors will generally be given some opportunity to object. FED. R. BANKR. P. 2002(a)(2) (stating general requirement that creditors receive 20-days' notice of proposed non-ordinary course disposition of estate property).

171 11 U.S.C. § 363(c)(1) (1994). Cash collateral, *see id.* § 363(a), is subject to special supervision by the court. It may be used by the debtor only upon authorization of the court after notice and hearing or by consent of each entity with an interest in such cash collateral. *Id.* § 363 (c)(2).

172 FED. R. BANKR. P. 9019(a).

173 11 U.S.C. § 330 (1994).

174 Conversely, the debtor's management may use its control of the business to exert leverage over creditors. *See supra* notes 60-61 and accompanying text.

tion of a plan, the creditor's claim entitles it to participate in the oversight of the debtor's business activity to protect its interests.

Over the several years that a large company may be in Chapter 11, significant creditors and the debtor will deal with each other repeatedly, both as to plan negotiation and significant operating issues. In this fashion, collective decisions are made.

B. Relationships, Cooperation, and the Shadow of Claims Trading

Chapter 11 creates a community of interests by providing a bargaining framework and devices to encourage cooperation among the various actors in the reorganization. As the community struggles through its collective decisions, the parties acquire highly specialized knowledge and experience concerning the debtor company and the workings of the community. Relationships develop among the actors within the community. Because the process is collective, and in large measure consensual, participants develop a certain interdependence among themselves. These relationships form the foundation for cooperation and are therefore integral to the ultimate success of the endeavor.[175]

Claims trading may destroy these valuable relationships. Major new creditors may buy into the reorganization; existing creditors may exit by selling. Relationships must be realigned, squandering the parties reorganization-specific investment and increasing transaction costs to the remaining parties in interest and the estate. Even the potential for trading deters parties from investing in relationships and from cooperating. As a result, significant costs may be imposed on the community and the estate, and ultimately the character of the entity emerging from reorganization may be adversely affected.

1. Relationships in Chapter 11.—Just as the debtor, its customers, suppliers, and employees develop relationships in the course of the debtor's operations, the debtor and its significant creditors and committees build relationships throughout the course of the reorganization. Parties interact over plan negotiation; they deal with each other on a whole host of financial and operational issues. The first negotiation in Chapter 11 may relate to the debtor's proposed use of cash collateral or proposed postpetition financing. In large reorganizations, substantive discussion over plan terms may not even begin until the business is stabilized, a process that may demand the undivided attention of the debtor's management and counsel for several months. In the meantime, the reorganization community is formed, as

[175] For a different account of relationships and community in bankruptcy, see Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991) (attacking economic account of bankruptcy and proposing "group therapy" value-based account).

parties in interest participate in the initial skirmishes that precede plan negotiation.

Through these initial skirmishes and subsequent interaction, creditors and the debtor invest in reorganization-specific knowledge and working relationships. They become educated not only about the debtor's financial and operational issues, but also about the institutional goals and constraints of other parties in interest and the personal concerns of the individuals assigned to represent such institutions in the reorganization. The parties in effect invest in each other, gaining familiarity with their collective decisionmaking process. An economist would describe this as idiosyncratic investment—highly specialized and not transferable.[176] Moreover, the investment is specific not only to the reorganization, but also to the particular parties involved.[177]

These relationships are personal. They may or may not turn on trust or warm feelings for one's competitors. What is critical is the belief that the parties will encounter one another over and over again in the course of the reorganization.[178] This belief in the continuity of

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176 *See generally* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. ECON. 233, 238-45 (1979) (describing transaction-specific investment in contractual relations and its significance for determining appropriate governance structure).

177 *See id.* at 240 (describing transaction-specific human-capital investment in the context of idiosyncratic supply contracts).

> Familiarity . . . permits communication economies to be realized: specialized language develops as experience accumulates and nuances are signaled and received in a sensitive way. Both institutional and personal trust relations evolve. Thus the individuals who are responsible for adapting the interfaces have a personal as well as an organizational stake in what transpires. Where personal integrity is believed to be operative, individuals located at the interfaces may refuse to be part of opportunistic efforts to take advantage of (rely on) the letter of the contract when the spirit of the exchange is emasculated. Such refusals can serve as a check upon organizational proclivities to behave opportunistically. Other things being equal, idiosyncratic exchange relations which feature personal trust will survive greater stress and display greater adaptability.

Id.

Chapter 11 in essence replaces the debtor's multiple bilateral prebankruptcy obligations with a sort of multilateral relational contract. *See generally* Ian R. Macneil, *Contracts: Adjustment of Long-term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978). Parties' interaction in Chapter 11 exhibits the three significant factors distinguishing relational contracts from traditional discrete transactions: uncertainty, recurring exchange among the parties, and transaction-specific investment. *See* Williamson, *supra* note 176, at 239. While any prebankruptcy obligation might simply have been a discrete "right to payment" against the debtor, a Chapter 11 claim represents far more. *Cf.* 11 U.S.C. § 101(5) (1994). It allows participation in Chapter 11's "political and social processes" that adjust each claimant's rights. Any discrete prebankruptcy rights to payment are replaced by multiple relations that create "a minisociety with a vast array of norms beyond the norms centered on exchange and its immediate processes." Macneil, *supra*, at 901.

178 In a related context, Robert Axelrod made the following observation:

> [O]nce a manufacturer begins to go under, even his best customers begin refusing payment for merchandise, claiming defects in quality, failure to meet specifications, tardy delivery, or what-have-you. *The great enforcer of morality in commerce is the continuing relationship*, the belief that one will have to do business again with this customer, or this supplier, and

the interaction—the relationship—is important for the ultimate success of the endeavor. Relationships facilitate cooperation. Cooperation enables mutually beneficial outcomes that might not otherwise be possible. A cooperation theorist tells us:

> The foundation of cooperation is not really trust, but the durability of the relationship. . . . Whether the players trust each other or not is less important in the long run than whether the conditions are ripe for them to build a stable pattern of cooperation with each other.[179]

2. *Transaction Costs from Claims Trading.*—Reorganization is complex and expensive under the best of circumstances.[180] If in addition to the existing complexity of this multiparty bargaining game, significant creditors or creditor groups sell out, or new participants enter with no prior connection to the debtor or the ongoing negotiation, the complexity of the process is magnified significantly.

A special sort of firm-specific capital, unique to the reorganization, is lost when a significant creditor exits by selling out or enters by buying in.[181] When a significant creditor sells out, its accumulated knowledge of the case becomes useless.[182] Prior negotiation may have been for naught. Relationships with that exiting creditor are destroyed, squandering the parties reorganization-specific investment.

> when a failing company loses this automatic enforcer, not even a strong-arm factor is likely to find a substitute.

ROBERT M. AXELROD, THE EVOLUTION OF COOPERATION 60 (1984) (emphasis added) (quoting M. MAYER, THE BANKERS 280 (1974)).

179 *Id.* at 182.

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> A reorganization . . . involves a very complicated bargaining game in which many claimants try to maximize their own self-interest. The fear that a firm is or may soon become insolvent causes various claimants on the firm to engage in behavior that is not joint wealth maximizing. The inability of all involved to work together collectively often leads to protracted negotiations that have enormous transaction costs in terms of professional fees. Even more importantly, during this period, the current operations of a company can be severely hampered. Relations with customers, suppliers, and bankers can all be disrupted. Attention may be diverted and the quality of service may decline. Key employees may leave, and a vast amount of firm-specific capital may be lost because of uncertainty about the structure or needs of the reorganized firm.

Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding* Pennzoil v. Texaco, 75 VA. L. REV. 295, 313 (1989).

181 The two do not necessarily happen simultaneously. A bankruptcy investor can become a major creditor in the reorganization by aggregating small claims, without having to purchase from an existing major creditor. Conversely, a major bondholder could simply liquidate its holdings in the public securities market, effectively replacing itself in the reorganization with widely dispersed new claimants. Even assuming sufficient liquidity in the public markets, the selling bondholder will almost certainly take a loss with this strategy, since with large blocks of securities in the secondary markets, the sum of the parts is generally worth less than the whole. The selling bondholder could generally achieve a higher recovery by selling its holdings in a block in a private transaction—provided a buyer could be found. Flooding the market would also cause the market price to drop, further depressing the selling bondholder's overall recovery.

182 This wasted reorganization-specific capital affects not only the exiting creditor. To the extent other parties invested in that exiting creditor's accumulated knowledge, *e.g.*, by educating that creditor about the debtor's business, their investment is also wasted.

Relations among the remaining creditors must be realigned to account for the exiting creditor's absence. Likewise, when a significant creditor buys in, it must be integrated into the community, and relationships must be realigned.

Realigning relationships and integrating a new significant creditor into the community require additional investment by the parties in interest.[183] For instance, a professional bankruptcy investor may take an approach to reorganization very different from that of a bank with a long lending history with the debtor. When the bank sells its claim to the bankruptcy investor, the debtor and other parties in interest may need to adjust their expectations, goals, and respective approaches in negotiation. The bankruptcy investor may not value the prospect of a continuing corporate client postconfirmation, as the selling bank claimant would have. The bankruptcy investor may not be interested in providing postpetition or postconfirmation financing to the debtor, as the bank might have. The bankruptcy investor may not be interested in receiving its plan consideration in the form of bank-type debt—that is, a collateralized floating rate privately held note.[184]

All other parties in interest have a stake in these differing goals as between buying and selling claimants. The form of plan consideration affects the debtor's capital structure. The exit of a prospective post-confirmation lender means that new postconfirmation financing must be found. Parties in interest must forge relationships with the new entrant and adjust to new issues that arise.

Committees pose special problems in this regard. The creditors' committee is charged with fiduciary duties to its constituent creditors.[185] It is meant to play a watchdog role: overseeing the debtor's operations, investigating the debtor's financial dealings, representing unsecured creditors in plan negotiation, and possibly moving for appointment of a trustee or examiner.[186] The committee is meant to be a "key player" in the reorganization process.[187]

Claims trading may destabilize committees. Committee members who sell their claims will generally resign once they have sold, and purchasers may attempt to get appointed to committees.[188] The Code,

183 Resentments may be created, both toward any "deserter" and any late entrant. Because of the collective nature of the process, all creditors have an important stake in the composition of the community. However, they have no say in the exit of a selling claimant or the identity of any new participant, the size of its stake, or the timing of its entrance into the case.

184 *See infra* note 225 and accompanying text.

185 5 Collier on Bankruptcy, *supra* note 47, ¶ 1103.07, at 1103-26.

186 11 U.S.C. § 1103(c) (1994).

187 5 Collier on Bankruptcy, *supra* note 47, ¶ 1103.07, at 1103-27.

188 *See, e.g.*, Anthony Baldo & Everett Clayton, *Hills Talks Go Silent, but Heavy Claims Trading Continues*, Mergers & Acquisitions Report, May 4, 1992, at 1, 14 (noting that in bankruptcy of Hills Department Stores, Inc., committee members sold their claims and then resigned, and that purchasers had applied to be on committee).

however, contains no explicit provision governing removal of committee members or reconstitution of a committee.[189] Instability in and uncertainty with respect to a committee's composition, or outright turnover of influential members, may cause confusion as to a committee's previous strategies, positions, and promises. It may be unclear—to committee members as well as other parties in interest—who speaks for the committee. Committee counsel and other professionals may be unsure to whom they should look for direction. Committee infighting may arise. In any event, the disruptive potential is evident. Given the committee's critical role in reorganization, chaos in the committee may easily lead to more generalized chaos in the reorganization.

In addition to the new relational and other reorganization-specific investments that may be required as a consequence of claims trading, there are other cost implications. If prior negotiations are rendered meaningless by the exit or entry of a new significant participant, the reorganization may be prolonged, increasing the expense to the estate. In the large cases, professional fees alone will consume significant estate assets. The estate must pay fees and expenses for lawyers, accountants, appraisers, investment bankers, and other professionals retained by the debtor and official committees.[190] These costs are ultimately passed on to creditors in the form of lower recoveries in bankruptcy. To the extent that interjection of a new participant or exit of an existing player requires retrading of deals already struck, or significant redirection of negotiation, administrative expenses for past negotiations were for naught.[191] Retrading deals in response to significant claims trading will impose additional costs on all remaining participants.[192]

This delay from prolonged and redirected negotiation hurts the business as well. The debtor's management has two major tasks in Chapter 11—running the business and negotiating the plan. The longer the case takes, the greater the diversion of management attention from running the business. The cost implications are not limited to out-of-pocket costs; prolonging the case imposes opportunity costs. Professors LoPucki and Whitford observed a pattern of conservative investment behavior by management of Chapter 11 debtors.[193] They found that for the duration of the Chapter 11 proceeding, manage-

[189] 5 Collier on Bankruptcy, *supra* note 47, ¶ 1102.01[6], at 1102-25.

[190] 11 U.S.C. § 330 (1994).

[191] One prominent attorney estimates that significant renegotiation occurs in 98% of the cases in which bankruptcy investors become involved. Telephone interview with Harvey R. Miller, Esq., Partner, Weil, Gotshal, and Manges (Apr. 4, 1995).

[192] This effect is greater, of course, the longer the case has been going. Trading shortly after the case has been filed will generally not have the same impact as significant creditor turnover after several years of plan negotiation.

[193] LoPucki & Whitford, *supra* note 29, at 749.

ment generally follows a path of "prudent investment,"[194] avoiding risky new investment that would have adverse distributional effects on certain classes of claims and interests, in favor of simply preserving the existing business.[195] Debtors with particular strategies for acquisition of new businesses or companies believed that implementation of these strategies would have to wait until the debtors had emerged from bankruptcy.[196] To the extent that this "holding pattern" mentality causes debtor management to adopt too conservative an investment strategy and forego new business opportunities that might maximize the value of the estate, all parties in interest lose.

With delay, much traditional firm-specific capital may be lost, as employees, suppliers, and customers defect. The bankruptcy filing itself will cause many who dealt with the debtor in the past to abandon even long-term relationships with the debtor.[197] These relationships are valuable to the debtor and will be difficult and costly to replace. Even for those initially willing to stick with the debtor in bankruptcy, the disruption and uncertainty caused by significant trading may cause their eventual defection. Depending on the timing of the trading, exit of a major creditor or entry of the bankruptcy investor may throw existing negotiations into disarray, causing confusion as to the fate of the business and eroding the debtor's ability to salvage key long-term relationships.

3. Cooperation in the Shadow of Claims Trading.—Even the *possibility* that claims may be traded may have detrimental effects on the reorganization. The potential for significant trading modifies the shadow under which bankruptcy bargaining occurs. The perception of ready exit opportunities discourages all parties from adopting the long-term perspective necessary for development of relationships, upon which cooperation depends.[198]

If a creditor perceives that it may likely be able to settle with a third party for a sum certain as consideration for its claim, its incentive

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194 *Id.*

195 *Id.* at 778.

196 *Id.* at 749.

197 Bankruptcy sends a signal to everyone dealing with a bankrupt debtor: "Get out now with as much as you can as fast as you can." With respect to the bankrupt debtor, bankruptcy suggests that there is no long-term worth worrying about. Suppliers are less likely to ship for fear of not getting paid. Customers are less likely to order for fear of not being able to rely on the debtor's existence, much less the debtor's timely performance. Employees and managers become nervous and less faithful and may leave.

Theodore Eisenberg, *Bankruptcy in the Administrative State*, 50 LAW & CONTEMP. PROBS., Spring 1987, at 3, 33.

198 "The evolution of cooperation requires that individuals have a sufficiently large chance to meet again so that they have a stake in their future interaction." Axelrod, *supra* note 178, at 20.

to cooperate is diminished considerably.[199] Pending exploration of its exit opportunities, the potential seller may be unwilling even to devote resources to participating in the process. Relationships fail to develop. Cooperation among the parties becomes difficult. If this potential seller happens to be a significant claimholder, its recalcitrance—or outright indifference to the progress of reorganization—can seriously undermine the reorganization effort.

This short-term perspective will afflict all parties, even those without any realistic prospect of exiting by selling. The debtor and others that know they are in for the long haul will be less willing to cooperate with creditors who may be gone tomorrow. The prospect of having to retrade the same deal with a new creditor dampens everyone's enthusiasm for finding mutually acceptable solutions to the myriad issues that arise in the several-year course of the reorganization. The mere perception of the availability of this exit option serves to make all creditors more recalcitrant, and to make debtors less willing to compromise. Relationship building and the fruits of cooperation are sacrificed to the short-term perspective.[200]

The opportunity for a quick exit tends to frustrate in a fairly direct way the rehabilitative goals of bankruptcy. As Professor Eisenberg has noted, the Code includes many devices for fostering relationships and enhancing cooperation among the parties.[201] For example, bankruptcy law provides incentives for creditors to continue to deal with the debtor in Chapter 11. Administrative expense priority encourages extension of postpetition credit to the debtor.[202] The debtor's prepetition lenders and suppliers are thereby given incentive not only to hope for the debtor's survival as a going concern, but also to finance its recovery and increase their stake in the reorganization.

199 Upon initial consideration, it might appear that for holders of publicly traded debt, this "easy exit" effect exists independent of bankruptcy. That is, the public markets would provide an easy exit whether a bankruptcy system existed or not. However, as a practical matter, for any holder of a large block of public debt, exit via the public markets is less than ideal. A more profitable method of exiting would be to negotiate a private deal for the entire block. *See supra* note 183.

Because Chapter 11 enhances the marketability of such a block, *see infra* subpart III.A, the attractiveness and availability of a private exit may be improved by the fact that Chapter 11 exists. Therefore, while the "easy exit" problem of reduced cooperation would exist with respect to public debtholders independent of Chapter 11, it is probably more pronounced because of Chapter 11.

200 *Cf.* Williamson, *supra* note 176, at 241 (noting that assurance of a continuing relation is necessary to encourage idiosyncratic—transaction-specific, nonmarketable—investment).

201 Theodore Eisenberg, *Commentary on "On the Nature of Bankruptcy": Bankruptcy and Bargaining*, 75 VA. L. REV. 205, 208 (1989). "If the foundation of cooperation is not merely trust but is also, as a cooperation theorist puts it, 'the durability of the relationship,' bankruptcy law may be seen as trying to foster 'a stable pattern of cooperation' with the attendant payoffs that cooperation yields." *Id.* at 217.

202 11 U.S.C. §§ 364, 503(b)(1), 507(a)(1) (1994).

Priorities for prepetition[203] and postpetition wage claims[204] likewise encourage employees to stick with the debtor through the reorganization. The provisions concerning executory contracts force third parties who dealt with the debtor prepetition to continue to deal with the debtor postpetition.[205] Keeping these parties in the reorganization "can lead to bargaining conversations that might not exist absent these provisions."[206]

Bankruptcy law also contains devices for keeping secured creditors and their collateral involved in the reorganization. The automatic stay initially prevents the secured creditor from exiting with its collateral.[207] In addition, other provisions in the Code render uncertain the secured creditor's entitlements in bankruptcy. The amount of its secured claim[208] and its hopes of obtaining relief from stay[209] both depend on valuation of its collateral, always a speculative endeavor.[210] This uncertainty, along with the indefiniteness of the adequate protection standard, encourage the secured creditor to bargain with the debtor. If its entitlements were clear in bankruptcy, the secured creditor would be encouraged to stand on its rights and not to bargain.[211]

Chapter 11 supplies numerous incentives for the parties to bargain, and the bargaining conversations that occur over the course of a complex reorganization lead to the establishment of relationships, which are critical to cooperation.

> If people must get along for a minute, they may do so, but they have little incentive to probe for mutually beneficial transactions. If they must get along for a year, they have dramatically different incentives. If long-term relationships generate cooperative behavior, and cooperative behavior yields economic payoffs, then long-term relationships may be

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203 *Id.* § 507(a)(3).

204 *Id.* §§ 503(b), 507(a)(1).

205 *Id.* § 365.

206 Eisenberg, *supra* note 201, at 209. In the context of utility bankruptcies, Professor Eisenberg summarizes the likely effect of keeping the players in the game:

> The inability of the debtor's relations immediately to extricate themselves from involvement with the debtor becomes a reality unto itself. The debtor's relations must think in terms of long-term interactions because they find themselves in a long-term relation. The "get-out-now" mentality is cushioned by planning in light of the new, longer relationship with the debtor. All parties have increased incentives to discover mutually beneficial transactions. The payoff is a larger pie for all of the relations to share.

Eisenberg, *supra* note 197, at 36.

207 11 U.S.C. § 362 (1994).

208 *Id.* § 506(a).

209 *Id.* § 362(d).

210 "Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a) (1994).

211 "Bankruptcy law promotes bargaining by creating uncertainty about participant rights. The secured creditor who 'knows' that it is entitled to a particular amount in bankruptcy has little incentive to bargain. The uncertainty that bankruptcy creates about such a creditor's rights . . . brings the creditor to the bargaining table." Eisenberg, *supra* note 201, at 209.

> normatively desirable. . . . [O]ne important task of a bankruptcy law may be to convince the debtors' relations that there is a long term worth worrying about or at least to raise the cost to the debtor's relations of disentangling themselves from the debtor.[212]

To the extent that it is perceived that certain creditors may not have a long-term worth worrying about, the benefits of cooperation are denied to the estate.

C. The Bankruptcy Investor

The adverse consequences from an unstable creditor constituency suggest generic problems of changing horses in midstream, which has historically been recognized as problematic.[213] With claims trading, the nature of the new horse should also be considered. The creditor that enters a case by purchasing claims typically differs from the selling claimant in important ways. The purchasing creditor is usually a professional bankruptcy investor; the selling claimant usually is not.[214] Unlike most other creditors, the bankruptcy investor typically had no interaction or relationship with the debtor prior to its entry into the case, and it typically does not contemplate long-term involvement with the reorganized debtor once the case is over. The professional bankruptcy investor brings with it an economic perspective and legal and financial sophistication that inform all its activities in the reorganization—its entry into the case, its behavior during the case, and its exit—changing the dynamics of the community in fundamental ways.

The bankruptcy investor's very entry into the case sets it apart from other creditors. At a very basic level, its economic perspective differs from the perspective of the ordinary bankruptcy creditor. The selling creditor, by selling, has unmistakably evidenced its desire to strike a deal quickly and a willingness to settle at a discount. By contrast, the professional bankruptcy investor has invested new money with the intent of realizing a profit. It must insist on a higher consideration for its acquired claim than it paid. The selling creditor would have settled for less; in fact it did so. By contrast, given its fine appreciation for the time value of money, the investor knows that the longer the process takes, the greater a recovery it must secure in order to make the investment worthwhile. Far from expanding the common ground for agreement on plan treatment, then, the introduction of this new money perspective into plan negotiations may have a ratcheting

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212 Eisenberg, *supra* note 197, at 35.

213 *See, e.g.*, DAN FOGELBERG, *Changing Horses*, *on* SOUVENIRS (Epic Records 1974) ("Changing horses in the middle of a stream gets you wet and sometimes cold.").

214 While selling claimants may sometimes be sophisticated financial institutions, selling is probably more common for trade creditors or public debt holders.

effect.[215] Unlike the exiting creditor, which has resigned itself to taking a loss, the bankruptcy investor, with its new money basis in its investment, will not easily agree to plan treatment that fails to produce an acceptable return. The bankruptcy investor's perspective is not one of damage control but profit maximization.[216] To the best of its ability, the investor will attempt to cut a tougher economic deal with the debtor than the selling creditor would have.[217] This effect is magnified, of course, with the bankruptcy investor's purchase of multiple claims.

The bankruptcy investor will generally purchase claims strategically, in order to maximize its leverage in plan negotiation.[218] What any particular claim gets paid at the end of the day, and the overall distribution of value among competing claimants, depend on many factors besides the face amounts of claims. The relative negotiating skill and bargaining power of claimholders are critical. The elaborate plan bargaining framework[219] suggests that by purchasing strategi-

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215 "The [claim] acquiror's objective of achieving a stupendous return on investment colors all of its actions." Letter from Harvey R. Miller, Esq., Partner, Weil, Gotshal and Manges, to Frederick Tung, Associate Professor of Law, University of San Francisco School of Law (Apr. 17, 1995) [hereinafter Miller Letter] (on file with author). *See generally* Stephen M. Bundy, *Commentary on "Understanding* Pennzoil v. Texaco*": Rational Bargaining and Agency Problems*, 75 VA. L. REV. 335 (1989) (discussing the concept of a "positive settlement gap" and the factors affecting likelihood of settlement).

216 The bankruptcy investor's business *depends* on its profits from investment in Chapter 11 claims. By contrast, the selling creditor and other creditors remaining in the case are unlikely to be in the bankruptcy investing business or the collections business; they operate other commercial pursuits from which they derive profit. Therefore, ordinary creditors generally will not have the bankruptcy investor's aggressive profit motive with respect to their bankruptcy claims. Instead, they will simply seek to minimize their losses.

217 It has been suggested that the bankruptcy investor entering the reorganization process may be more solicitous to the process than the exiting seller. Having invested new money, the entering investor appreciates more seriously the time value of money and is therefore more eager than its predecessor to strike a deal quickly. Because it has purchased at a discount from face, the new entrant also has a lower basis in the investment, and therefore may have more flexibility as to the terms of an acceptable deal. Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 6-7.

This argument fails to appreciate the selling creditor's position. While the selling creditor may have been carrying its claim on its books at par, sale of its claim at a discount clearly evidences its willingness to compromise its claim. There may be other reasons why the substitution of the new participant into the plan process moves the process forward, but the simple economics of the trading transaction do not support such an assertion.

218 *See, e.g.*, Margaret A. Elliott, *The Wonderful World of Bankruptcy*, INSTITUTIONAL INVESTOR (Int'l ed.), Nov. 1988, at 66 ("You have to pick the instrument with the most leverage and be prepared to fight for your rights in a reorganization or bankruptcy.") (quoting Shelley Greenhaus, Senior Vice President of Oppenheimer & Co.); John Cassidy, *America's Top Stories Reopen Hostilities*, SUNDAY TIMES, Jan. 9, 1994 ("My guiding philosophy is that you really need to get into a controlling position in Chapter 11 and really be able to dictate what your stakes in the outcome will be.") (quoting Daniel Harmetz, Manager of Fidelity Investment's Capital and Income Fund).

219 *See supra* subpart I.A.

cally, the bankruptcy investor can acquire not merely a seat at the negotiation table, but a good seat. It can establish a position of great leverage, for example, by acquiring more than one-third in face amount of the claims in a class. With this blocking position in the class, it can basically prevent class acceptance of any plan not to its liking.[220] Only by rendering the class unimpaired or by paying the class its absolute priority entitlement may the debtor confirm a plan over the dissent of the blocking bankruptcy investor.[221] Even without invoking the absolute priority rule, the claimant holding a blocking position in a class can divert significant value to its class.[222]

The professional bankruptcy investor's sophistication means a more formidable presence in negotiation generally, with respect to both the plan and the other collective decisions of the community. To the extent that the exiting claimant or claimants were widely dispersed or lacked the economic stake or institutional backing to hire sophisticated legal and financial advisers, the bankruptcy investor's entry changes the overall complexion of the case.[223]

The bankruptcy investor may be able to create leverage in more imaginative ways than by simply purchasing a blocking position in a class. For example, by acquiring claims, bankruptcy investors have purchased standing to bring suit against other parties in interest on colorable legal claims. These investors used their threat of litigation as leverage to improve their plan treatment.[224]

Unlike trade and bank creditors, which had relationships with the debtor prebankruptcy and which will likely continue to do business with the reorganized debtor postconfirmation, the bankruptcy investor often retains no interest in the reorganized debtor's long-term via-

220 *See, e.g.*, Stephen E. Clark et al., *The Black Prince of Wall Street*, INSTITUTIONAL INVESTOR, Aug. 1991, at 15 (explaining blocking strategy of bankruptcy investors: "Apollo (like Water Street, Icahn and others) is what's known as a blocking creditor.... It... buys enough of any one class... to give it so-called blocking power.... Apollo acquires veto power over a reorganization by buying up more than one third of a class.").

221 While confirmation based on new value is a theoretical possibility, *see generally In re* Bonner Mall Partnership, 2 F.3d 899 (9th Cir. 1993) (recognizing new value exception to absolute priority rule), *cert. granted sub nom.* U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 114 S. Ct. 681, *motion to vacate denied and dismissed*, 115 S. Ct. 386 (1994), its application is unlikely in the reorganization of large public companies.

222 *See* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: the Case of Divorce*, 88 YALE L.J. 950 (1979) (discussing effect of formal legal entitlements on informal bargaining).

223 As a veteran bankruptcy investor described, "[w]e acquire as much of the senior securities as necessary to prevent a company from reorganizing—unless we say so." Kate Campbell, *Vulture Capitalists: Investment Activities Taking Advantage of Troubled Firms*, CAL. BUS., Jan. 1993, at 36, 40 (quoting Martin J. Whitman).

224 *See* LoPucki & Whitford, *supra* note 48, at 163, for war stories of investors purchasing positions in junior debt, then successfully developing: (1) a fraudulent transfer action against bank creditors (*Saxon Industries*), and (2) a breach of indenture covenant action against a debtor (*Wilson Foods*), to extract improved plan consideration.

bility. Instead, its investment strategy will include provision for a quick exit, sometimes even before the plan becomes effective. The bankruptcy investor will often negotiate for plan consideration in the form of publicly tradeable securities, or some other debt instrument for which an active private market exists and which can be "flipped" close to confirmation.[225] In this situation, rehabilitating the debtor company only matters to the extent it affects pricing of the bankruptcy investor's postconfirmation securities. The terms of the securities are critical; the reorganization itself merely serves as a marketing tool.[226]

The bankruptcy investor's short-term, quick exit perspective may have adverse consequences for the debtor and other creditors. With its sophistication and its purchased leverage, the bankruptcy investor usually exerts significant influence over the terms of reorganization. Its effectiveness in leveraging the reorganization process means that any plan that emerges may have to compromise the debtor's long-term viability for the bankruptcy investor's short-term return.[227] Claims trading therefore not only tends to destroy relationships already established, but the new ones forged with the bankruptcy investor may not favor a lasting rehabilitation for the debtor.

III. The Case for Limiting Transferability of Claims

Even given the potential adverse effects of claims trading on Chapter 11's collective process, there remains the fundamental ques-

225 For example, fixed-rate, medium-term notes sell well to insurance companies and other financial institutions looking to fund payments on fixed-rate obligations such as annuities.

It is not uncommon for the bankruptcy investor to be able to liquidate its new securities even before they are issued. Once the capital markets reach some level of comfort that the terms of the reorganization securities are set, it is common for reorganization securities to trade on a "when-issued" basis. *See, e.g.*, Gautam Naik, *Lone Star Industries Ready to Emerge From Chapter 11; Troubled Cement Maker Hopes Many of Its Problems Are Behind It*, WALL ST. J., Mar. 4, 1994, at B4 (discussing trading of stock of reorganized debtor on when-issued basis); Dana Milbank, *LTV's New Common, to Begin Trading Soon, Carries More Than Just Post-Chapter 11 Risks*, WALL ST. J., June 18, 1993, at C2.

226 It should be noted that not all bankruptcy-claim purchasing is done for the purpose of short-term financial speculation. Investors have also used claim purchasing as a vehicle to effect long-term investment in a reorganizing company. For example, in the bankruptcy reorganization of R.H. Macy & Co., its competitor, Federated Department Stores, Inc., purchased $500 million in face amount of secured claim against Macy's as part of Federated's strategy—ultimately successful—to acquire Macy's. *See also infra* note 324. *See generally* Cassidy, *supra* note 218 (describing Federated's purchase of secured claim against Macy's as part of acquisition strategy). This type of transaction raises interesting and important issues that are unfortunately beyond the scope of this Article.

227 "The acquiror generally has no long-term perspective and is not particularly concerned about economic viability after its contemplated departure from the scene from a capital markets exit or otherwise. . . . [F]rom my perspective, there are a significant number of Chapter 11 debtors compelled to emerge from Chapter 11 before the illness that precipitated the Chapter 11 case is cured." Miller Letter, *supra* note 215, at 2.

tion whether, to what extent, and under what circumstances circumscription of claims trading may be appropriate.

Buying distress debt at a discount is not a new investment strategy.[228] The negative effects of claims trading may simply be costs of living in a system in which economic rights are generally freely alienable. One might wonder what is special about Chapter 11 such that rights of creditors to assign their claims should be curtailed. In some cases, trading not only benefits buyer and seller, but may promote—or at least not inhibit—the rehabilitative goals of reorganization.[229] Even for those cases in which trading may be inimical to reorganization,[230] we must consider nonbankruptcy values and interests that may be implicated. Claims deserve at least the initial presumption of free alienability so fundamental to our notions of private property and individual liberty. The basic bankruptcy policy of minimizing bankruptcy's infringement of creditors' rights outside of bankruptcy must be considered.[231]

In this Part, a general justification for limiting transferability of claims is developed. The following Part proposes certain equitable relief from adverse effects of claims trading.

A. *Claims and Prebankruptcy Entitlements*

Claims are bankruptcy-created bundles of rights reflecting Chapter 11's unique approach to collective settlement of multiple obligations. While the substantive right to payment derives from each creditor's prebankruptcy entitlements, Chapter 11 *creates* the critical procedural rights that replace nonbankruptcy enforcement rights and enable each creditor to participate in determining its ultimate recovery. Moreover, it is the imposition of Chapter 11 from which claims derive their value as marketable commodities. Because Chapter 11 creates the bundles of rights and gives them value—which they lack outside of Chapter 11—it is argued that trading may justifiably be circumscribed when it frustrates the reorganization process and threatens to undermine achievement of the rehabilitative goals for which

228 Fortgang and Mayer recount the story of the members of the First Congress buying up war bonds issued by the states to fund the Revolutionary War. Members bought at a deep discount while they were also considering legislation to have the new federal government assume these liabilities and pay the bonds in full. The legislation passed, but because the debt purchasing members were primarily from northern states, critical votes of southern congressmen were obtained only by the northerners' promise to move the capital to a site between Maryland and Virginia on the Potomac River. Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 25-26 (citing C. BOWERS, JEFFERSON AND HAMILTON: THE STRUGGLE FOR DEMOCRACY IN AMERICA 43-48, 64-67 (1966)).

229 *See supra* section I.B.2.

230 *See supra* Part II.

231 *See supra* notes 107-10 and accompanying text.

Chapter 11 was intended. These goals should take precedence over general notions of free alienability of economic rights.

A Chapter 11 claim is an unusual asset. Its attributes are largely a creation of the bankruptcy system, designed to help facilitate reorganization while preserving the debtor's going concern value.[232] Claimants' bundles of rights are uniquely tailored to, and inextricably linked with, Chapter 11's collective, consensual process. The bundles of rights enable claimants to participate in this process.

As to each creditor's bankruptcy entitlements, underlying substantive prebankruptcy rights are certainly discernible. The face amount of the claim, of course, derives from the debtor's prebankruptcy obligations to the creditor, and a claim's secured status generally depends on prebankruptcy arrangement.[233] However, while the bankruptcy bundle of rights is based on prebankruptcy entitlements, once in bankruptcy, the creditor's right to payment becomes something far more complex.

Chapter 11 alters each creditor's prebankruptcy rights in fundamental ways. Certain prebankruptcy entitlements are eliminated, and other entitlements unique to Chapter 11 are appended. Once in bankruptcy, creditors are no longer entitled to pursue individual remedies in nonbankuptcy fora or seize the debtor's assets in satisfaction of debts even justly owed.[234] The race of the diligent outside of bankruptcy is replaced with a rule of "equity is equality," and individualized collection efforts are replaced with Chapter 11's collective system. For the sake of the collective settlement, each claim is stripped of its prebankruptcy procedural rights, namely, its enforcement rights under nonbankruptcy law,[235] while retaining its substantive right to payment and its prebankruptcy priority.[236] In place of prebankruptcy enforcement rights, each claim is imbued with special procedural and participatory rights fundamental to the Chapter 11 process.

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232 Chapter 11 modification of state law rights

> are designed to defuse the conflict and resulting bargaining impasse arising under nonbankruptcy law and lead to a consensual settlement of the debtor-creditor dispute through bargaining that maximizes the value available to satisfy the claims against the firm.... [Chapter 11] alter[s] ... these entitlements and ... add[s] ... unique reorganization entitlements ... designed to enhance the bargaining process and produce superior resolution of debtor/creditor disputes.

Johnston, *supra* note 52, at 257 (footnote omitted).

233 *E.g.*, Butner v. United States, 440 U.S. 48 (1979).

234 11 U.S.C. § 362 (1994).

235 This disability may only be temporary, of course, given the possibility that the creditor may be successful in obtaining relief from stay. *Id.* § 362(d).

236 Bankruptcy does, however, create priorities for certain types of claims, which will be paid ahead of general unsecured claims, *e.g.*, administrative expense claims, 11 U.S.C. § 507(a)(1) (1994), and priority wage claims. *Id.* § 507(a)(3).

In effect, a new "firm" is created in bankruptcy, and claimants as the new "owners" are given a voice in firm management. The creditors must be consulted, even wooed. Outside of bankruptcy, creditors are generally relegated to the terms of their contracts.[237] Inside bankruptcy, however, creditors are given a say in the terms of the plan and the ongoing business. They are entitled to vote on the plan. They may propose their own plans to compete with the debtor's for the requisite creditor approvals. They may be heard on numerous issues such as proposed non-ordinary course transactions of the debtor,[238] payment of professional fees, assumption of executory contracts, and proposed settlement of controversies. They are provided representation at the estate's expense, in the form of the creditors' committee. They may threaten, and in some cases effect, management's ouster.

Each claimant's rights in the community—and indeed the community itself—diverge sharply from the prebankruptcy situation. These participatory rights are unique to the Chapter 11 proceeding. Bankruptcy law creates and defines these rights, which form an integral part of the collective process.

Moreover, the Chapter 11 modifications of creditors' prebankruptcy entitlements effectively create the "commodities" worth trading and the market therefor.[239] Without Chapter 11, investing in distress debt would be far less attractive. Ironically, the problems meant to be addressed by the creation of the federal bankruptcy system are also the ones that, absent Chapter 11, would impede the buying and selling of creditors' rights against the debtor in distress.

Outside of Chapter 11, a purchaser of debt would generally have to expend far more time and money—and incur greater risk—pursuing the debtor in order to obtain satisfaction of its debt obligation. The purchaser of unsecured debt would have to win a judgment or judgments against the debtor and then attempt to enforce those judgments, perhaps in several different state fora. This process could eas-

237 *E.g.*, Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986). Several courts have held that once a firm becomes insolvent or approaches insolvency, the fiduciary duties of its management shift from shareholders to creditors. *E.g.*, Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. No. 12,150, 1991 Del Ch. LEXIS 215 (Del. Ch. Nov. 6, 1991). However, creditors are given far more protection and a far greater oversight role in the debtor's operations in Chapter 11 than under nonbankruptcy fiduciary duty rules.

238 While certain creditors might exercise similar oversight over the debtor's business activities outside of bankruptcy by virtue of contractual covenants related to credit extensions, such rights in bankruptcy accrue to all creditors and other parties in interest, without regard to their particular nonbankruptcy bargains with the debtor. Moreover, these participatory rights are part of the package of the collective proceeding in Chapter 11, and do not depend on the existence or nonexistence of such rights outside of bankruptcy.

239 "By the filing of a bankruptcy case, a market in nonpublicly traded securities is created." *In re* Allegheny Int'l, Inc., 100 B.R. 241, 243 (Bankr. W.D. Pa. 1988) (Cosetti, J.).

ily take several years, and all the while, the debt purchaser would have to worry about other competing creditors' progress in the race to execute on the debtor's scarce assets, or the debtor's preferential payments to competing creditors. The debt purchaser could very well invest several years' worth of time and legal fees in its collection efforts, only to find at the end of the day that the debtor's assets had already been exhausted satisfying competing creditors. This possibility, along with the difficulty of obtaining current information concerning the status of competing creditors' legal actions and collection efforts, makes distress debt investing outside of Chapter 11 relatively unattractive.

By contrast, Chapter 11 solves several problems for the distress debt investor. The automatic stay gives some assurance against the debtor's dismemberment by competing creditors.[240] Disclosure rules require the debtor to provide information not readily available outside of bankruptcy,[241] thereby enabling creditors both to monitor the debtor's performance in Chapter 11, and to police the debtor's eve-of-bankruptcy payments.[242]

More specifically, bankruptcy disclosure rules provide information critical to the bankruptcy investor, which it would have no way of obtaining absent bankruptcy. The simple device of the debtor's schedules facilitates claim acquisition, and for trade claims becomes the basis for the market itself.[243] Schedules are meant to enhance the ability of the court and creditors to monitor the case. However, by identifying specific claimants and the face value of their claims, the schedules enable the bankruptcy investor to target particular strategic claims for purchase, and to negotiate individual terms with each targeted claimant. Absent such a convenient ledger—compiled by the debtor, no less—the prospective investor would at the very least incur higher investigation costs with respect to purchased claims.

At least as significant as the informational advantages, the structure of collective plan negotiation, grounded in the absolute priority rule and class voting, allows the outside bankruptcy investor to

240 In addition, any motion for relief from stay generally requires notice. FED. R. BANKR. P. 4001(a).

241 11 U.S.C. § 521, (Official Bankruptcy Form 6 (Schedules) and Form 7 (Statement of Financial Affairs)) (as amended prior to Nov. 1, 1994).

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

David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 507 (1993) (footnotes omitted).

243 Fortgang & Mayer, *1993 Developments*, *supra* note 13, at 760 ("As is true in virtually every large case, Federated's schedules became the basis for a market in trade claims.").

purchase a position of great negotiating leverage. By purchasing claims strategically, the bankruptcy investor becomes an important constituent in the collective, which enhances the investor's ability to negotiate for a profit. It may acquire a blocking position in a class of claims, thereby obtaining holdout power to block confirmation of any plan not to its liking.

This prospect of leverage is critical to the claim's investment value. In Chapter 7, by contrast, "[c]laims trading is virtually unheard of,"[244] even though claims are as available for purchase in Chapter 7 as in Chapter 11. The bare right to payment inherent in a claim against a Chapter 7 debtor is simply not an attractive investment. It represents merely a pro rata right to payment against the debtor's assets in liquidation. Because the distribution of value in Chapter 7 is not subject to collective negotiation, holdout opportunities are not available for purchase. Such leverage is available for purchase only in Chapter 11. Without Chapter 11, the rights to payment are not worth buying.

In addition, the overall scaling down of debt in Chapter 11 improves the reorganized debtor's ability to make good on payment of its postconfirmation obligations.[245] Without such scaling down of debt, the enterprise would be less viable. It would have limited free assets, and therefore fewer resources with which to satisfy demands of holdouts. Each creditor benefits from the discharge of other creditors' claims against the debtor, and a bigger pie allows the bankruptcy investor a greater opportunity for profit.

That Chapter 11 creates "commodities" worth trading and that a market for claims may develop in a given case are simply unintended consequences of Chapter 11. Claims trading is not necessary to the purposes and policies underlying Chapter 11, and in given cases may be undesirable.

Because the claimholder's bankruptcy rights differ significantly from the creditor's bundle of rights outside of bankruptcy—and the collective bankruptcy regime likewise differs from debt collection outside of bankruptcy—a claim transfer in Chapter 11 is a transaction with implications very different from an assignment of creditor rights outside of bankruptcy. Free alienability of creditor rights outside of bankruptcy therefore does not necessarily suggest that free transferability of bankruptcy claims should be the rule.[246] The bromide of respecting nonbankruptcy rights in bankruptcy does not apply neatly to

[244] Minkel & Baker, *supra* note 13, at 44 n.32.

[245] The Code also empowers the debtor to reject unprofitable executory contracts. 11 U.S.C. § 365 (1994).

[246] *Cf.* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60, 67 (2d Cir. 1986) (recognizing that even with solvent debtor, if Equity Committee's state court action to compel shareholders' meeting to replace directors caused "real jeopardy to reor-

this question, since the critical component of the commodity being traded is invented in Chapter 11.[247] To the extent free transferability may be deemed a right unto itself outside of bankruptcy, the effects of its exercise in Chapter 11 should inform the extent of its survival therein.[248] When general notions of free markets and alienability of property conflict with and imperil the rehabilitative goals of Chapter 11, rehabilitative goals should prevail.

B. *Claims and Markets*

The notion of the "market for claims" deserves special scrutiny. The free alienability account of claims trading tends to adopt the language and imagery of public securities markets,[249] implying a free market model of trading[250] and impugning judicially imposed restrictions on trading as simply meddling in the market.[251] As part of this market rhetoric, the free alienability account tends to conceptualize the Chapter 11 claim as a discrete, self-contained object, a "black box"

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ganization prospects," shareholders' right to compel such a meeting could be overridden in Chapter 11).

247 *Cf.* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987), in which the court considered, *inter alia*, a Commerce Clause challenge to an Indiana antitakeover statute that effectively conditioned acquisition of a qualifying Indiana corporation on majority approval of disinterested shareholders. Upholding the constitutionality of the state statute, the Court noted that "[t]he very commodity that is traded in the securities market is one whose characteristics are defined by state law," and that the state statute merely defined the attributes of shares in such Indiana corporations. *Id.* at 94.

248 *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

> Respecting [nonbankruptcy] rights in full . . . can conflict with the core role of bankruptcy to maximize the value of assets in the face of pressures to ignore the collective weal for individual gain. Thus, it is necessary to weigh the damage that recognizing a particular nonbankruptcy right would cause to collective action against the costs of any incentives that would be potentially created by upsetting that right. Because the collective damage resulting from adhering to a right may sometimes exceed any benefit, a bankruptcy statute sometimes *must* replace nonbankruptcy rights with something else.

Id. at 28 (emphasis in original).

249 *See supra* note 112.

250 In the paradigmatic free market,

> the participants trade a standardized contract such that each unit of the contract is a perfect substitute for any other unit. The identities of the parties in any mutually agreeable transaction do not affect the terms of exchange. The organized market itself or some other institution deliberately creates a homogeneous good that can be traded anonymously by the participants or their agents.

Lester G. Telser & Harlow N. Higinbotham, *Organized Futures Markets: Costs and Benefits*, 85 J. POL. ECON. 969, 997 (1977). The public securities markets are perceived to approximate the paradigmatic free market. *See, e.g.*, Van Zandt, *supra* note 12.

> Of all the real world markets, the markets for secondary trading of financial assets seem most accurately to reflect th[e] ideal description [of the market]. On first glance and in the popular imagination, these markets in which large sums change hands at breakneck speed are the epitome of the free market: they consist of helter-skelter trading driven only by the avariciousness of the individual participants.

Id. at 968.

251 *See supra* subpart I.C.

or "widget,"[252] the transfer of which concerns none but the purchaser and seller. The relational aspects of claimants' rights in Chapter 11[253] are ignored. Only by relying on this characterization can the assertion be made that assignment of a Chapter 11 claim "simply substitutes one creditor for another," and that the assignee merely "stands in the shoes of the original claimant."[254]

However, claims are not widgets, and the claims market functions nothing like the public securities markets.

Notwithstanding the Code's arid definition of a claim as a "right to payment,"[255] a claim is hardly a discrete right or set of rights. It encompasses far more than simply an opportunity to howl at the debtor's doorstep for payment. A claim allows entrée to an entire process by which the debtor is remade. The bankruptcy investor buys not simply a static and discrete right to demand payment,[256] but a panoply of rights that allows it to haggle with the other interested parties in the reorganization over a broad range of operational and financial issues, including consideration for its claims.[257]

Once the relational aspects of the claim are acknowledged, it becomes apparent that claim assignments are more than private transac-

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252 *Cf.* Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976) (arguing that economists have overstated their case against economic regulation by suppressing relational aspects of contract in favor of a "paradigmatic contract" involving "a discrete transaction conveying a well-defined object (the ever popular widget) in exchange for cash," and proposing that theorists instead "open up the 'black box' of contract").

253 *See supra* subparts II.A-B.

254 *See supra* notes 105-06 and accompanying text.

255 11 U.S.C. § 101(5) (1994).

256 *Cf.* Goldberg, *supra* note 252, at 427-28 (citation omitted):

> The pure discrete transaction of economic theory involves the contemporaneous exchange of claims or rights between the contracting parties. The identity of the parties and the social milieu within which the contract is consummated are irrelevant. The exchange is cloaked in anonymity with one party selling to the market and the other buying from the market.

257 Nor is a claim the ideal standardized contract to trade in the free market. Claims are neither homogeneous nor fungible. Claims of equal face value but in different classes are not interchangeable. With the exception of claims based on public debt securities, even claims in the same class are not necessarily interchangeable. For example, the debtor may have defenses to one trade claim but not another. *See supra* note 78.

Moreover, the value to the bankruptcy investor of the last claim needed to amass a blocking position is worth proportionally more than the first claim purchased. *See, e.g., In re* Allegheny Int'l Inc., 118 B.R. 282, 290 (Bankr. W.D. Pa. 1990) (noting that bankruptcy investor paid proportionally more for last bank claim necessary to create blocking position in that class than it did for prior and subsequent purchases).

The same observation could be made with respect to the last share of stock necessary to take control of a company. However, this does not suggest that the claims market resembles the public securities markets, but may suggest an analogy to the market for corporate control. *See infra* note 264.

Nor is the market impersonal. The identities of the purchaser and seller matter. *See supra* Part II.

tions between willing buyers and sellers.[258] Trading may impose externalities on the community. The parties make reorganization-specific investments in the process, including investment in their relationships with each other. While the selling claimant should be free to forego the value of its own investment, a claim transfer unfortunately destroys the reorganization-specific investments of others as well. The course of negotiation, the substance of the collective settlement, the costs of the process, and the general functioning of the Chapter 11 community are all affected by the composition and stability of the creditor constituency.

Externalities from claims trading suggest that some restraints on alienation may be preferable to a "free market" approach. As Professor Epstein explained, "Rules restraining alienation are best accounted for, both positively and normatively, by the need to control problems of external harm and the common pool."[259] The externali-

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[258] *See* Goldberg, *supra* note 252, at 426-27 ("[The] discrete transactional mold is apt to be singularly inappropriate for representing relations which are to take place over a long period of time and in which the parties will have to deal with each other regularly over a wide range of issues (many of them unknown in advance).").

[259] Richard A. Epstein, *Why Restrain Alienation?*, 85 COLUM. L. REV. 970, 990 (1985). Professor Epstein presents two examples of common-law restraints on alienation intended to control imposition of external costs in a common pool situation. The common pool in Chapter 11 is similarly susceptible to externalities from claims trading.

Professor Epstein's first example involves restraint on the rights of riparian landowners to sell water rights. While the private sale presumably allocates water to a party who values it more highly, and "the two parties to that sale will both be gainers," the buyer's use "may also be a more intensive use, which means that any sale of riparian rights may diminish the correlative rights of other claimants to the common pool." *Id.* at 981. Partial restrictions on alienation serve to preserve the common pool while allowing transactions which move resources to higher-valued uses.

The second example involves the Roman law of usufruct. The holder of the usufruct interest—roughly analogous to a life estate—could not alienate its interest to a third party, but could release her interest back to the owner of the property. Likewise, under English law, an easement in gross was inalienable, and any attempt to do so created a mere license between the parties. These restrictions were intended to protect property owners from abuse of their land by users not of their choosing. *Id.* at 983-84; *see also* Susan Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931, 938 (1985) ("Externalities figure prominently in discussions of market failure and provide the most commonly recognized rationale for inalienability rules.").

Alienability of other bankruptcy-created rights is restricted. For example, "[t]he right to object to a debtor's discharge is *not a marketable commodity* which may be purchased by one party from another in order to inflict further punishment and discomfort on the debtor." *In re* Beugen, 99 B.R. 961, 965 (Bankr. 9th Cir. 1989) (emphasis added). In that case, as part of a personal vendetta against the debtor, the claim purchaser bought his claim solely to obtain standing to object to the individual debtor's discharge. *Id.*

The debtor's right to redeem personal property in Chapter 7, 11 U.S.C. § 722 (1994), is not assignable. *In re* Davis, 20 B.R. 212, 214 (Bankr. C.D. Ill. 1982) (citing S. REP. No. 95-989, 95th Cong., 2d Sess. 95 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5881); *In re* Fitzgerald, 20 B.R. 27, 29 (Bankr. N.D.N.Y. 1982). Congress was aware of the potential for abuse of the debtor's redemption right:

ties can be ignored only by suppressing the complexity of the bundle of rights subsumed within the Chapter 11 claim. Only in this way is the free market model of trading sustained.[260]

Moreover, a close look at the "market for claims" reveals critical distinctions between its functioning and that of the public securities markets. Claims are not really sold; claims are purchased. In other words, bankruptcy investors *are* the market. There are few passive or casual retail investors purchasing in the market,[261] as barriers to entry are high. The costs of investigation and participation in the reorganization process eliminate all but the professional bankruptcy investor, who alone has sufficient capital and sophistication to play. The "market," then, consists almost exclusively of bankruptcy investors purchasing claims from the debtor's prebankruptcy creditors or from other bankruptcy investors.

> To prevent abuses such as may occur when the debtor deliberately allows the property to depreciate in value, the debtor will be required to pay the fair market value of the goods or the amount of the claim if the claim is less. The right is personal to the debtor and not assignable.

S. REP. No. 95-989, 95th Cong., 2d Sess. 95 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5881. Assignability would do harm to consumer creditors. Undersecured consumer creditors would more frequently suffer strip down of their liens as a market developed in redemption rights and the personal property available for Chapter 7 redemption. Consumer creditors' leverage to negotiate reaffirmation agreements would also presumably suffer.

A family support obligation loses its priority status and nondischargeable character if assigned. 11 U.S.C. §§ 507(a)(7)(A), 523(a)(5)(A) (1994). These examples illustrate the personal character of certain bankruptcy entitlements meant to effect specific bankruptcy policies. Such rights are meant to be exercised only by the initial holders of such rights in bankruptcy. Even though assignment of such special rights might benefit both assignors and assignees, other affected parties might suffer adverse consequences from such assignments.

While these analogies are not perfect, they illustrate the general idea that certain rights subsumed within the claimholder's bundle should not trade as marketable commodities. Because trading in these entitlements would visit costs on third parties—and possibly assignors—the initial holders of such rights are not permitted to assign.

260 There is a certain irony to a market-based defense of unrestricted trading, given that bankruptcy is fundamentally antithetical to markets. Bankruptcy upsets outcomes which would otherwise be determined by competition among creditors and the debtor under decentralized state law collection regimes. Bankruptcy trumps private contractual arrangements. Bankruptcy replaces competition with collectivization and also attempts to promote cooperation. *See supra* subpart II.B.

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> The market for distressed securities is completely private. Says Don Gevirtz [of The Foothill Group], "We maintain regular contacts with banks' workout departments and let them know we want to buy loans or securities when they want to get rid of them." This kind of market information is strictly confidential. . . . "We're talking about a $284 billion market. . . . The market is too complicated, there are too many parties [involved], for it to ever be a retail market."

Campbell, *supra* note 223, at 41.

There may be small-scale postpetition trading in the debtor's public debt securities by passive investors. However, even the market for public debt securities is illiquid compared to equity markets. "[T]here is simply not a liquid auction market, or even continuous trading, in debt securities, at least not of the kind that is available for equity securities of the same issuers." John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1218 (1991).

Unlike the vast majority of investors in the public securities markets, the bankruptcy investor takes an active role in determining the fate of its investment. It does not purchase claims on the bland hope that the reorganization plan will bless its investment with a profitable return. It buys a strong negotiating position in the reorganization and attempts to maximize its return through active participation in the process. The object of trading in this market is therefore not simply the abstract right to payment represented by any individual claim. That bare right to payment is not an attractive investment.[262] The bankruptcy investor buys claims for their process rights—the prospect of leverage in plan negotiation.[263] In other words, there is really no market for claims *qua* claims; the market is a *market for leverage*.[264] The asset being acquired is influence over the plan process. Viewed in this light, the potential for imposition of externalities becomes evident.

This market for leverage is also highly illiquid, unlike public securities markets. While bankruptcy investors provide liquidity to the market in the process of assembling strategic blocks of claims, there is nothing approaching continuous trading. Purchasing is sporadic and idiosyncratic, and there is no centralized system for disseminating price information.[265] Compared to the securities markets, the claims

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262 *See supra* note 239 and accompanying text.

263 *See supra* notes 218-34 and accompanying text.

264 Rather than the public securities markets, the market for corporate control provides perhaps a closer analogy to the claims market. Participants in the market for corporate control purchase shares in the public equity markets, but the shares are not prized merely as passive investments. Participants acquire shares in order to aggregate controlling blocks of stock. Control is an asset distinct from other aspects of the issuer enterprise and is the actual asset being bought and sold in this market. Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Whether corporate control transactions are good or bad, and whether restrictions on these transactions are appropriate, may be the subject of some debate, but the terms of debate certainly *recognize* externalities as an issue. *See, e.g.*, John C. Coffee, Jr., *Regulating the Market for Corporate Control, A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1248-49 (1984) (recognizing that employees, suppliers, pensioners, and lower level managers have economic stake in a corporation and may be adversely affected by increased leverage or other substantial shift in direction of risk preference); Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1972 (1991) (explaining Delaware Supreme Court's decision in Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) as a reflection of "a widely-shared social sense that self-interested, market-oriented behavior had gotten out of hand in the takeover area," and of the notion that social values such as "loyalty, community, and cultural continuity" should be protected even in corporate context); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987). Gordon relies on Karl Polanyi's broader thesis that markets require regulation in order to prevent social dislocation. KARL POLANYI, THE GREAT TRANSFORMATION (1944).

265 *Cf.* Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1018 (1990) ("Exchanges enhance secondary market liquidity because they serve as central producers and disseminators of information.").

market is illiquid, discontinuous, and inefficient.[266] Transaction costs are high.

In this type of market, efficiency losses from restrictions on trading are likely to be negligible. The costs of participating are so high to begin with that any incremental increase from trading restrictions would not likely have the significant "chilling effect" bemoaned by commentators.[267] Applying a public securities market model to claims trading merely allows overstatement of the case against trading restrictions.[268]

Characterizing claims trading as a private transaction in the free and liquid market for claims tends to mask the collective nature of Chapter 11 and the complexity of the bundles of rights created thereby. Claims are not discrete commodities that should or do trade freely in impersonal markets. A free market model ignores much that is significant about claims and their trading.

C. Precedent under the Bankruptcy Code

Considering the historical development of Chapter 11, it is not surprising that the Code contains no explicit provision anticipating the adverse effects of claims trading on the Chapter 11 reorganization process. The respective structures of Chapters X and XI of the Bankruptcy Act help to explain why claims were presumed to be freely transferable under those reorganization regimes.[269] Moreover, no legislative history exists that would suggest that the drafters of the Code even considered such issues.

In spite of the absence of a specific statutory provision, courts have responded to deleterious effects of claims trading in the large cases with equitable or other discretionary remedies. While courts have generally not emphasized process concerns and externalities from claims trading even when granting relief, several decisions suggest some sensitivity to these issues. When trading threatens dissipation of estate assets, courts have relied on their general equitable

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266 *See id.* at 1014 ("Undeveloped, illiquid, thinly traded securities markets tend to be inefficient, while highly developed, liquid, thickly traded markets tend to be efficient."); *see also* Coffee & Klein, *supra* note 261, at 1219 ("A recent Wall Street Journal survey found that bonds that are not exchange-listed may be simultaneously traded at very different prices by different brokerage firms—the result one would expect from a market characterized by irregular trading and little publicly available information.") (citation omitted).

267 *See supra* notes 111, 163.

268 *See* Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 43 (1993) (arguing that a change in transaction costs will affect the price of a good more significantly if overall transaction costs are low than if they are high and that with illiquid markets, transaction costs from illiquidity are so high that "[a]n effort to reduce transaction costs appears pointless").

269 *See supra* section I.C.1.

powers under Section 105(a)[270] to address such problems. In addition, courts' construction of the "good faith" concept in Section 1126(e)[271] manifests some recognition of the cost implications of trading. The remainder of this subpart argues that even absent a specific statute addressed to claims trading, courts' equitable powers are broad enough to respond to its adverse effects. Moreover, courts' actions described below may be generalized to address the problems of externalities previously discussed.

1. Section 105(a).—Section 105(a) empowers the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[272] This grant of power is similar to that found in the All Writs Statute,[273] which "enables courts to address situations for which no specific process has been provided by statute."[274] While this equitable power is broad,[275] it is not limitless. Its exercise must be consistent with the provisions of the Code. It "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity."[276]

Courts have explicitly relied on Section 105(a) in several claims trading cases to fashion particular relief, responding to the threat of imposition of externalities on the estate. In *In re Ionosphere Clubs*,[277] Judge Lifland discussed as one of the " 'evils' spawned by bankruptcy claims trading in 'mega' cases, . . . the substantially increased burden associated with monitoring, administering and objecting to claims which have been filed against the estate. This increased administra-

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270 11 U.S.C. § 105(a) (1994).

271 11 U.S.C. § 1126(e) (1994) ("On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.").

272 11 U.S.C. § 105(a) (1994).

273 House Report, *supra* note 23, at 316-17.

274 2 Collier on Bankruptcy, *supra* note 47, ¶ 105.01[1], at 105-3.

275 *See* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60 (2d Cir. 1986) (holding that enjoining state court proceeding initiated by Equity Committee to compel shareholder's meeting for purpose of replacing debtor's directors was within court's equitable powers).

> [I]f the bankruptcy court may ever use its equitable powers under section 105(a) to enjoin actions pursued in other courts as "concerning the administration of the estate" under section 157(b)(2)(A), it may exercise that power where there is a basis for concluding that rehabilitation, the very purpose for the bankruptcy proceedings, might be undone by the other action.

Id. at 64.

276 United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) (citation omitted) (finding no authority under § 105(a) for court's award of monthly support payments to debtor's spouse from debtor's Chapter 11 estate). *See generally* 2 Collier on Bankruptcy, *supra* note 47, ¶ 105.01 (analyzing bankruptcy court's power under § 105).

277 119 B.R. 440 (Bankr. S.D.N.Y. 1990).

tive burden diverts the limited resources of the Debtor's estate and has the potential for impeding the reorganization process."[278] As to the authority of bankruptcy courts to respond to this problem, the court found that "[b]ankruptcy courts are afforded the power to limit or prevent bankruptcy claims trading where taking such action is in furtherance of the court's exclusive jurisdiction over the administration of the debtor's estate and will relieve the debtor and its estate from a great administrative burden." While that court relied in part on a prior version of Bankruptcy Rule 3001(e)(2), which has since been amended to narrow the court's role in administrative aspects of claim transfers,[279]

> § 105 of the Code also authorizes this Court to fashion appropriate remedies to protect against threatened harm to, or interference with the sound administration of the estate. Indeed, both this Court and other bankruptcy courts have in the past acted to restrict assignments of claims where such action was in the best interests of the estate.[280]

The most dramatic instance of a court's grant of equitable relief from adverse consequences of claims trading came in the *Pan Am* bankruptcy, in which the debtors successfully petitioned the court for an injunction prohibiting all transfers of general unsecured claims and significant transfers of publicly traded bonds and debentures. Unchecked trading in claims, if allowed to continue, might have precluded the reorganized debtor from making full use of favorable tax attributes following confirmation. Like many Chapter 11 debtors, Pan Am had incurred severe losses prior to bankruptcy. Generally these losses may be carried forward by the reorganized debtor and deducted against future income earned, thereby reducing future income tax liability. In Pan Am's case, the debtor's disclosure statement valued these net operating loss "carryforwards" (NOLs) as high as $500 mil-

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[278] *Id.* at 444. For a discussion questioning the substance of Judge Lifland's concerns, see Fortgang & Mayer, *1993 Developments*, *supra* note 13, at 756 n.18 and accompanying text.

[279] *See supra* notes 93-97 and accompanying text.

[280] *Ionosphere Clubs*, 119 B.R. at 445 (citations omitted).

Some have asserted that the 1991 amendment to Rule 3001(e) precludes all parties except the transferor from objecting to a claim transfer. *E.g.*, Fortgang & Mayer, *1991 Developments*, *supra* note 13, at 4 ("[T]he amended Rule 3001(e) will stop third parties—most notably the debtor, but occasionally other creditors—from attempting to hold up court approval of a claims transfer to further their own private agendas."). Moreover, the Advisory Committee note states the intention of the amendment "to limit the court's role to the adjudication of disputes regarding transfers of claims." FED R. BANKR. P. 3001(e) advisory committee's note.

While the amendment may narrow availability of standing to challenge claim transfers under Rule 3001(e), it could hardly be read to restrict other provisions in the Code or Rules. In particular, equitable relief from trading may be appropriate in a given case, independent of Rule 3001. In that case, the contents of Rule 3001(e) would be irrelevant. Moreover, no Bankruptcy Rule or its amendment may "abridge, enlarge, or modify any substantive right." 28 U.S.C. § 2075 (1994).

lion.[281] This value could have been jeopardized by continued trading in Pan Am's publicly traded bonds and other unsecured claims.[282]

Relying on the concept embodied in *In re Prudential Lines, Inc.*[283] that the debtor's NOLs constitute property of the estate within the meaning of Section 541,[284] the court found that further trading that might jeopardize the reorganized debtors' use of such NOLs would violate the automatic stay's prohibition against "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."[285] The court issued an injunction under Section 105(a) in furtherance of the automatic stay.[286]

Along the same lines, courts should recognize other explicit and implicit costs that ill-timed trading could impose on the estate. These costs are borne by the estate no less than the NOLs preserved in *Pan*

281 First Amended Disclosure Statement with respect to the Revised Joint Consolidated Plan of Reorganization Proposed by the Debtors and the Official Committee of Unsecured Creditors for Pan Am Corporation and Its Affiliated Debtors, dated as of October 24, 1991, *In re* Pan Am Corp., Chapter 11 Case Nos. 91 B 10080 (CB) through 91 B 10087 (CB) (inclusive), at 93.

282 Section 382(a) of the Internal Revenue Code limits a corporation's use of its NOLs once there has been an ownership change—a greater than fifty percentage point change in the corporation's stock ownership over a three-year period. This limitation would normally be triggered in a large Chapter 11 reorganization, since the plan will typically distribute significant stock in the reorganized debtor to creditors who were not prepetition stockholders. Therefore, the statute also contains a special bankruptcy exception: the § 382(a) limitations will not apply if shareholders and creditors of the debtor corporation immediately before the ownership change in Chapter 11 end up holding at least fifty percent of the value of the reorganized debtor's stock following confirmation, provided that of the stock issued to creditors, only qualified "old and cold" creditors count. I.R.C. § 382(l)(5) (1994). A qualified "old and cold" creditor is one that has either held its claim for at least 18 months prior to the filing of the petition, or acquired its claim as a trade creditor and has continuously held the beneficial interest in such claim. Treas. Reg. § 1.382-9(d)(2)(i) (1992). For a complete discussion of this complex area, see 7 Mertens Law of Federal Income Taxation § 29.110 (1994).

Because of this "old and cold" creditor requirement, claims trading may make it impossible for the debtor to qualify for this exception. The bankruptcy investor will rarely qualify as an "old and cold" creditor. Trading may therefore endanger the value of the NOLs to the reorganized debtor. *See generally* Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 111-13; Minkel & Baker, *supra* note 13, at 46-51 (questioning rationale of NOL preservation in several cases in which trading injunctions issued).

283 928 F.2d 565 (2d Cir.), *cert. denied sub nom.* PSS Steamship Co. v. Official Comm. of Unsecured Creditors, 502 U.S. 821 (1991).

284 Property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1994).

285 11 U.S.C. § 362(a)(3) (1994).

286 Pan Am Corp. v. All Unsecured Creditors et al. (*In re* Pan Am Corp.), Adv. No. 91-6175A (CB) (Bankr. S.D.N.Y. Oct. 3, 1991).

Am and other cases.[287] Equitable relief under Section 105(a) is equally justified.[288]

Some commentators have argued that such equitable relief should be withheld absent a more specific statutory basis.[289] However, in his famous *Avon Park* decision,[290] Justice Douglas described courts' broad equitable powers to protect "investors against an inside few, or . . . one class of investors from the encroachments of another" in the claims trading context:

> [T]he court has ample power to adjust the remedy to meet the need. The requirement of full, unequivocal disclosure; the limitation of the vote to the amount paid for the securities; the separate classification of claimants; the complete subordination of some claims, indicate the range and type of the power which a court of bankruptcy may exercise in these proceedings. That power is ample for the exigencies of varying situations. *It is not dependent on express statutory provisions.* It inheres in the jurisdiction of a court of bankruptcy.[291]

Other courts have recognized Section 105(a) as authorizing equitable relief in the claims trading context. In *FSLIC v. Mmahat*,[292] the debtor moved under Section 105(a) to have a purchased claim reduced for "unfairness, unconscionability and the potential for abuse."[293] Remanding to the bankruptcy court for reconsideration of its denial of the debtor's motion in light of certain changed circumstances, the court noted: "The Bankruptcy Court, as a court of equity,

287 See Fortgang & Mayer, *1993 Developments*, *supra* note 13, at 757-58, for a discussion of *Pan Am* and other cases in which litigation occurred concerning the effect of claims trading on the estate's NOLs.

288 While the analysis is useful, the *Pan Am* decision may not be authoritative, as it was never published. Apparently, the issue was not fully litigated because no substantive objection was made. *Id.* at n.125.

289 "If Congress wants to preserve NOLs from accidental destruction by claims trading, Congress has the power to do so. We question, however, whether a bankruptcy court should assume such power in the absence of specific statutory authority." Fortgang & Mayer, *1993 Developments*, *supra* note 13, at 759.

290 American United Mutual Life Ins. Co. v. City of Avon Park, 311 U.S. 138 (1940) (Douglas, J.).

291 *Id.* at 146 (citations omitted) (emphasis added). In that case, the fiscal agent retained by the debtor municipality purchased claims for its own account and voted them in favor of the debtor's Chapter IX composition, but failed to disclose this interest to other creditors from whom it solicited votes for the plan. The Court held that the fiscal agent's failure to disclose this interest required reversal of a lower court order confirming the plan. *Id.* *See also* Fortgang & Mayer, *Trading Claims*, *supra* note 13. "The applicable law is not in the Code and it is not in the Rules, but it does reside in the general equitable powers of the bankruptcy court. The Supreme Court has held that *no specific statute* is needed to punish fiduciary trading." *Id.* at 33 (emphasis in original) (approving *Avon Park* description of court's broad equitable powers in context of fiduciary trading).

292 89 B.R. 573 (Bankr. E.D. La. 1988).

293 *Id.* at 574.

may look to the substance of a transaction and, if appropriate, devise new remedies where those at law are inadequate."[294]

2. Allegheny: *Good Faith under Section 1126(e).*—In various contexts, courts have relied on Section 1126(e) to disqualify claim purchasers' votes against a plan on the ground that the claims were not procured or voted in "good faith."[295] In the contested confirmation of *Allegheny*, the court disqualified votes against the debtor's plan because the claims voted had been acquired just prior to the plan balloting for the specific purpose of blocking confirmation.[296] The finding of bad faith in that case recognized that claims trading may impose unacceptable costs on the estate and frustrate the reorganization process. The holding can be generalized to justify equitable relief from trading in other contexts.

In *Allegheny*, the court was willing to: (1) disqualify votes of claims acquired at the eleventh hour by a bankruptcy investor, Japonica Partners, for the purpose of blocking confirmation of the debtor's plan; and (2) require that all stock in the reorganized debtor to be received by Japonica Partners under the debtor's confirmed plan be placed in trust for three years, depriving Japonica of voting rights for three years.[297] By the time of the confirmation hearing, the case had been running for over two years, during which time *ten* of the debtor's proposed plans had failed.[298] Japonica Partners was not a prepetition creditor or equityholder of the debtor.[299] It had for some months prior to the confirmation hearing been interested in acquiring control of the debtor, but did not purchase claims against the debtor until close to the conclusion of hearings on the debtor's disclosure statement.[300] For $2712, it purchased $10,000 in face amount of the debtor's public subordinated debentures.[301] This purchase enabled it

294 *Id.* at 575; *see also In re* Heritage Village Church & Missionary Fellowship, Inc., 87 B.R. 17, 19 (Bankr. D.S.C. 1988) (affirming court's equitable power under § 105 to deny unconditional transfer where court deems transfer inappropriate).

295 *See supra* notes 98-102 and accompanying text.

296 *In re* Allegheny Int'l, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990).

297 As part of the debtor's plan, the certificate of incorporation of the reorganized debtor contained a control provision, which basically stated that if any person acquired 30% voting control in the reorganized debtor within two years after the effective date of the plan, all other holders of common stock were entitled to put their shares to such person at a price equal to the highest per share price paid by such person for its shares. Responding to Japonica's express intent not to comply with this control provision, and relying on its equitable powers under § 105(a), the court ordered Japonica's shares held in trust for three years unless Japonica established its willingness and ability to comply with the control provision. *Id.* at 300-04.

298 *See* Minkel & Baker, *supra* note 13, at 75.

299 *Allegheny*, 118 B.R. at 286.

300 *Id.*

301 *Id.*

to qualify as a party in interest in order to file a competing plan,[302] which Japonica did just prior to approval of the debtor's disclosure statement.[303] Under Japonica's plan, it would have acquired control of the debtor. Following approval of the debtor's disclosure statement, during the vote solicitation period preceding the confirmation hearing on the debtor's plan,[304] Japonica commenced a program of strategic claim purchasing, acquiring blocking positions in the two senior impaired creditor classes, "ensuring that the debtor could not confirm its plan of reorganization."[305]

Japonica's blocking strategy may have worked too well. The court found that Japonica's position enabled it to "defeat any . . . plan and thereby obstruct a 'fair and feasible reorganization.' "[306] Relying on Section 1126(e), the court found that Japonica's claim purchases were made in bad faith. The court designated—that is, disqualified—Japonica's votes against the debtor's plan, enabling confirmation of the debtor's plan.[307] In so doing, the court expressed concern over the effect of Japonica's claims acquisition strategy on the confirmation process generally:

> If . . . an outsider to the process can purchase a blocking position, those creditors and interest holders are disenfranchised. . . . [T]he votes of the other creditors and interest holders are rendered meaningless. Moreover, Japonica, who chose to become a creditor, should not have veto control over the reorganization process.[308]

In contrast, the court denied Japonica's motion to designate votes of certain banks, noting that "[u]nlike Japonica, the banks have been parties to this case since that fateful Saturday afternoon in February 1988"[309]—the date the debtor's petition was filed. In other words, the banks invested in the process from the first day. Japonica's last-minute attempt to hold up and retrade this deal would have nullified the banks' investment, as well as the investment by the debtor and other creditors in the plan process.[310]

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302 *See* 11 U.S.C. § 1121(c) (1994).

303 After approval of the debtor's disclosure statement, the filing of a competing plan would generally have been time barred. FED. R. BANKR. P. 3016(a).

304 *Allegheny*, 118 B.R. at 286.

305 *Id.* at 290. Japonica had requested that the court delay the confirmation hearing on the debtor's plan in order to allow approval of Japonica's disclosure statement and joint balloting for the competing plans. The court refused this request. *Id.* at 286.

306 *Id.* at 289 (citations omitted).

307 *Id.* at 290.

308 *Id.*

309 *Id.* at 293.

310 This interpretation of "good faith" comports with the legislative history of § 1126(e) and its predecessor provision in the Bankruptcy Act. "[S]ection 1126(e) . . . is intended to forestall the 'nuisance blocker'—that is, the investor who waits for a plan of reorganization to be fully negotiated and only then invests in a 'hold-up' to extract more (even if on a class-wide basis) by the threat of delay." Fortgang & Mayer, *Trading Claims*, *supra* note 13, at 97 (citation omitted).

While the *Allegheny* decision involved several other complex confirmation issues in addition to the bad faith designation of votes—and generated controversy as to each[311]—the confirmation fight highlights the costs that might have been imposed on the estate from Japonica's last-minute attempt to hold up and retrade a deal already agreed upon by the parties. The general lesson of *Allegheny* may be:

> [T]he only acquiror who can buy claims cheaply is one who does so well in advance of any plan of reorganization—one who takes the risks of the plan process and not merely the rewards. Such sentiments run throughout Judge Cosetti's opinion, which essentially condemns any claims purchases related to confirming or opposing a plan. Those sentiments, and that holding, . . . [fit] rather well with Chapter 11's more overarching purposes of debtor rehabilitation and creditor protection.[312]

Eve-of-confirmation claim purchasing for the purpose of blocking a plan is simply the extreme case of frustrating the Chapter 11 process through claims trading. Bankruptcy investors should not be allowed to nullify other creditors' investment in the process at the eleventh hour. The court in *In re Applegate Property, Ltd.*[313] was also willing to address this type of disruption by designating blocking votes purchased at the eleventh hour:

> Sanctioning claims acquisition for purposes of blocking an opponent's plan would . . . ignite a scramble for votes conducted almost entirely outside the Code's carefully developed structure (plan, disclosure statement, equal treatment, regulated solicitation, court-supervised confirmation), leaving creditors to select not the best plan but the best deal they might be able to individually negotiate.[314]

Bad faith designation in this context is, however, only a partial solution. In addition to the costs *avoided* by the court's designation of the bankruptcy investor's votes in *Allegheny*, that decision highlights other costs as well, which the parties *actually* incurred, and to which bad faith designation does not respond: those expended in the confir-

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Cf. David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 513-18 (1992) (arguing for replacement of § 1126(c) supermajority creditor voting requirement with simple majority voting in order to diminish threat of holdup by blocking claim acquiror).

311 For contrasting views on the ultimate holding in the case, compare Fortgang & Mayer, *1991 Developments*, *supra* note 13, at 27 (approving holding that bankruptcy investor was "insider" but offering alternative analysis) with Minkel & Baker, *supra* note 13, at 71 (disagreeing with holding and both court's analysis and Fortgang & Mayer alternative analysis).

312 Fortgang & Mayer, *1991 Developments*, *supra* note 13, at 33.

313 133 B.R. 827 (Bankr. W.D. Tex. 1991).

314 *Id.* at 836. In the context of competing plans, an affiliate of the debtor purchased unsecured claims at face value, voting them in favor of the debtor's plan and against the creditor's. These claim purchases were not disclosed in the debtor's disclosure statement. The debtor defended such purchases as necessary to preempt the creditor proponent from purchasing the claims to assure confirmation of its own plan. Relying on § 1126(e), the court designated the debtor affiliate's votes against the creditor plan because such votes were neither acquired nor voted in good faith. *Id.*

mation fight and the unsuccessful negotiations preceding the fight, and the costs of failed or inhibited cooperation caused by the shadow of claims trading.[315]

Disqualification of votes after solicitation, balloting, and a contested confirmation hearing is inherently retrospective. By the time the votes are designated and the outcome of the hearing known, the parties have already incurred the costs of inhibited cooperation throughout the case. In addition, the bankruptcy investor's entry forces the parties to reinvest in new relationships and to incur the costs of ultimately unsuccessful negotiations that precede the contested confirmation. Finally, the parties—including the bankruptcy investor—are forced to expend scarce resources on a confirmation fight that is ultimately mooted by the designation of votes.[316] But this is not an efficient way to preserve the integrity of the confirmation process. In *Allegheny*, bad faith designation penalized the bankruptcy investor for a strategy that would have imposed further costs on the estate and other creditors by frustrating the plan process. However, this retrospective remedy does nothing to avoid or recover the costs actually incurred as a result of claims trading.

Equitable relief, by contrast, could be granted prospectively. A general cost-based approach to equitable relief, such as the proposal described below, would be effective if available well before the confirmation hearing. All parties, including the bankruptcy investor, would avoid the inefficiencies of fighting over issues at confirmation that could have been eliminated earlier in the case. In light of the rehabilitative goals of Chapter 11 and the possible pernicious effects of claims trading, parties in interest should be able to object to having to bear such costs.

IV. A Modest Proposal: Equitable Relief from Adverse Effects of Claims Trading

To this point, the tone of the discussion on claims trading may sound decidedly negative. However, this Article's purpose is merely to call attention to certain potential adverse effects on the confirmation process and the concomitant costs that may be visited on third

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[315] *See supra* section II.B.3.

[316] This problem could possibly be avoided by having parties bring their § 1126(e) motions early on in the confirmation process, or as early as the time trades are proposed. Perhaps preemptive use of § 1126(e) would spare the estate from having to cover costs of professional fees—both its own and those of the creditors' committee—for a contested confirmation. Application of this practice to publicly traded debt claims, however, may be problematic, since no court filing is required with respect to such trades. *See supra* note 91. It might therefore be difficult for any movant to bring its § 1126(e) motion until after such a trade has already occurred. On the other hand, it is not uncommon for a major claims acquiror to petition the court for clarification of its voting and distribution rights prior to consummating proposed transfers, even those based on public debt. *See infra* note 329.

parties—Chapter 11 debtors and creditors. Because of the potential benefits that may derive from claims trading,[317] a blanket prohibition is unwarranted. Moreover, given the complex and subtle predicaments that may arise in the course of any Chapter 11 case, as well as the law's general suspicion of restrictions on alienability, a blanket prohibition on trading would be overbroad, sacrificing possible benefits in a given case for the sake of overall administrative simplicity.

In this Part, a proposal is developed pursuant to which a party may petition the court for equitable relief from claims trading in certain circumstances. The form of relief—a "trading injunction" restricting certain trading under certain conditions—attempts to balance competing interests of selling creditors and other parties in interest, recognizing the benefits that may derive from trading, as well as potential harm to the reorganization process.[318]

A. *The Trading Injunction Concept*

Many of the problematic effects of claims trading on the reorganization process could be avoided by restricting significant trading after some initial period after the filing of the petition. In the initial period, claims trading should be freely allowed, subject to existing rules and limitations. During this period, claimants have the opportunity to decide whether to accept the risks of reorganization or to cash out. They have time to assess the debtor's reorganization prospects and their own particular interests. They have time to decide whether to liquidate their claims by selling or to undertake the risks of reorganization in hopes of a better payout. By the same token, prospective bankruptcy investors have an opportunity to assess the debtor's attractiveness from an investment perspective.

Following some initial period, a party in interest should be able to petition the court for a trading injunction—an order restricting trading in significant numbers or amounts. A debtor or significant credi-

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317 *See supra* section I.B.2.

318 The approach described below is by no means offered as an exclusive approach. Other circumstances as well may justify equitable relief.

For example, no attempt is made herein to describe a workable approach to dealing with the effects of the bankruptcy investor's new money perspective or strategic purchasing in reorganization. When the bankruptcy investor enters a case by aggregating a large block of small, widely dispersed trade claims, it will undoubtedly affect the course of the reorganization, sometimes to the detriment of the debtor and competing creditors. The bankruptcy investor's acquired position will simply enable it to demand more from the collective than the creditors it replaced. However, no suggestion is intended herein that the debtor and other creditors are generally entitled to preservation of the happenstance of widely dispersed trade creditors—weaker combatants in the negotiation—and that assignment to the bankruptcy investor should be enjoined on that basis alone.

In any event, availability of equitable relief should depend on the particular case at hand. Any prescription for equitable relief must by definition remain general and flexible.

tor may wish to assure that its investment and the collective investment by the parties toward consensus on the plan will not be dissipated by the exit or entry of a significant creditor.[319] Such an order, removing creditors' pre-confirmation exit options, would promote cultivation of relationships among the parties, with their accompanying cooperation benefits.[320]

Basically, each creditor and potential bankruptcy investor would have to make its "in or out" decision in the early part of the case. Absent special circumstances, those opting in would in effect be opting in for the entire case. Roughly speaking, a primary market in claims would be permitted—allowing original claimholders to sell—but only a limited secondary market.[321] Speculative investment decisions would have to be made early on in the case. Once trading were restricted, claimholders would become medium- to long-term investors, not traders. Such an arrangement allows small creditors to cash out of a large and complex case, for which they may not be equipped actively to participate.[322] It allows financial institutions—both original claimholders and bankruptcy investors—to make new investment decisions and to execute them.

Encouraging potential buyers and sellers to make their investment decisions early in the process reduces reorganization costs to the estate and other parties. It avoids the disruptive effects of significant creditors' exit or entry after parties have invested significant sums participating in the reorganization. Once the long-term players are identified, reorganization-specific capital is preserved. The disincentives to cooperate because of uncertainty over parties' commitment to the process is minimized.

The timing and scope of such an injunction is critical. The injunction should be tailored as much as possible to the complexion of the particular case, with an eye to preserving benefits that might be realized from claims trading to the extent not incompatible with the rehabilitative goals of Chapter 11. Because the terms of any trading injunction must seek to balance the negative effects of actual and potential creditor turnover against the possible benefits of trading, the timing and scope of the injunction will vary from case to case. Like any equitable remedy, the injunction should be subject to revision once issued in order to reflect changed circumstances.

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319 *See supra* section II.B.2.

320 *See supra* section II.B.3.

321 Any significant secondary trading would have to occur during the initial trading period.

322 Limitations on trading will to some extent reduce the consideration obtainable by selling claimants.

B. *The Contours*

Definitive rules with respect to scope and timing of trading injunctions would be difficult to describe except in general terms. But this is not unusual. The bankruptcy court's case-by-case determination of fundamental questions is pervasive in reorganization. The nebulous "for cause" standard, for example, appears throughout the Code in other contexts critical to the confirmation process: modification of exclusivity,[323] appointment of a Chapter 11 trustee,[324] and relief from stay.[325] The feasibility determination by its nature requires a case-by-case approach.[326] "Good faith" and "bad faith" are also sprinkled throughout the Code.[327] Such discretion comports with the bankruptcy court's role as a court of equity.[328]

1. *Timing.*—The appropriate duration for the initial trading period—and the stage in the case at which an order restricting trading would be appropriate—will vary from case to case and perhaps from class to class in a given reorganization. The trading period should be of sufficient duration to allow all interested parties to assess the debtor's financial condition, its operations, and the general condition of its business. This assessment will be a more complicated affair for a widely diversified debtor than for a company with only a few core businesses. The length of the trading period should account for the particular debtor and the complexity of the analysis required.

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323 11 U.S.C. § 1121(d) (1994).

324 *Id.* § 1104(a)(1).

325 *Id.* § 362(d)(1).

326 [T]he court should consider the adequacy of the capital structure, the earning power of the business, economic conditions, the ability of management, the probability of a continuation of the same management, and any other related matters which determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan.

5 Collier on Bankruptcy, *supra* note 47, ¶ 1129.02[11], at 1129-62.

327 *E.g.*, 11 U.S.C. § 109(c)(5)(B) (1994) (municipality may qualify for Chapter 9 filing although it failed to obtain agreement of required creditor majorities, if it negotiated with them in good faith); *id.* § 303(i)(2) (involuntary petitioner liable for bad faith filing); *id.* § 1126(e) (designation of votes not cast, solicited, or procured in good faith); *id.* § 1129(a)(3) (Chapter 11 plan must be proposed in good faith); *id.* § 1325(a)(3) (Chapter 13 plan must be proposed in good faith).

328 *See supra* section III.C.1.

Bankruptcy reorganization more closely resembles an administrative process than it does the traditional model of judicial resolution of bilateral disputes over rights. "Bankruptcy itself could be regarded as a form of regulation and there are occasional proposals to have the bankruptcy system run by an administrative agency." Eisenberg, *supra* note 197, at 5 n.11. The sort of discretion proposed is consistent with this idea.

Granted, several of these areas of judicial discretion have pre-Code antecedents—or at least legislative history—that help inform the exercise of discretion. The trading injunction's pedigree, however, is a bit less well-documented. As discussed previously, the negative effects of claims trading in Chapter 11 had no close pre-Code analog. Courts are only beginning to recognize and articulate the types of claims trading activity that justify equitable relief. *See supra* subpart III.C.

However, the duration of the trading period should generally not be affected by the timing of particular events external to the case that might affect buyers' or sellers' investment decisions. For example, prospective buyers and sellers might wish to wait for release of the next government reports on consumer spending before having to decide whether to opt in or out of the case. However, throughout the course of any case, the stream of significant external events that would affect investment decisions would be endless. The rationale for limiting trading to the initial period following the filing of the petition is to insulate the reorganization process from the vicissitudes generated by a secondary market in claims and the attendant costs imposed on the parties. No attempt should be made to mimic a secondary market in claims by allowing buying or selling in reaction to market news as it arises, whenever it arises.

2. *Scope.*—As for the scope of restrictions, only trading that would not affect the overall composition of the creditor polity should escape the trading injunction's general prohibition. For example, de minimis buying and selling of publicly traded bonds by small claimants during the injunction period should not be prohibited, given that such purchasing would not affect the reorganization process. By contrast, aggregation or sale of a significant block of bonds should fall within the prohibition. Whether the line between "de minimis" and "significant" trading should be drawn at one, five, ten percent, or some higher percentage of the total face amount of all bonds in the class, or at some specific dollar threshold based on face amount of bonds, should depend on the particular case and should be determined in light of the general goals described above.

Once entered, the trading injunction would not necessarily be irrevocable. Parties desiring to accomplish some transaction otherwise prohibited by the injunction could certainly move for its modification. After a trading injunction has been entered, for example, an outside investor may decide to make a significant investment in return for a significant equity stake in the reorganized debtor. One way to accomplish this transaction while cleaning up the debtor's capital structure would be for the outside investor to purchase junior claims, which would receive equity in the reorganized debtor as consideration under the plan. This allows for the retirement of debt at a discount while accomplishing the equity investment.[329] In this situation, as with

329 For example, in the bankruptcy reorganization of Carter Hawley Hale Stores, the Zell-Chilmark Fund made a public tender for the debtor's trade claims and public debt claims. Prior to making its tender, it obtained the bankruptcy court's blessing with respect to, *inter alia*, allowance of and voting privileges with respect to the tendered claims, and its good faith in making the tender offer. *See* Joint Motion for an Order Authorizing Transfer of Claims and Approval of Compromise (July 29, 1992) (Case No. LA-91-64140 JD). This tender was part of Zell-Chilmark's overall strategy to invest in the debtor, pursuant to which it ultimately received a

others relating to modification of the trading injunction, a "for cause" standard should apply. The court should weigh the potential benefits from the proposed trade and investment against the possible destabilizing effects and imposition of costs on the parties in interest.

Modification of the trading injunction might be justified when a claimant with a significant block of claims in a class wishes to increase its stake by purchasing small claims in the class. Especially if the claimant already holds a blocking position in the class, the disruptive effect of the proposed purchases would seem minimal. In that context, those small claimants wishing to exit should be allowed to do so. The benefit to them could be achieved with no disruption to the Chapter 11 community.

The same purchaser proposing to buy from another significant claimholder in the class presents a different and more difficult issue. If the proposed seller had been active in the case, transferring its block of claims into the hands of another significant creditor might disrupt the course of negotiation. A "for cause" inquiry might suggest that harm to the estate and parties in interest would result from destabilization of the plan formulation process, and therefore modification of the trading injunction would not be appropriate.

A proposed transfer of a significant block of claims to a complete stranger to the case would be even more objectionable. The trading injunction should clearly prohibit such transfers, as well as the sale of participations that would effect the same economic result.

Outright prohibition may not be the only possible solution to particular proposed trades that would otherwise violate a trading injunction. Situations could be imagined in which further claim transfers might be restricted to transfer of economic interests in the claims; voting power would not be transferred but would simply be foregone with the sale of the claims. In other words, the sale of claims would cause elimination of those votes from the class to which the claims belonged. Depending on the composition of the class, such an order could allow late-selling claimants to exit, but preclude newcomers from retrading deals already struck with the class as a whole.[330]

While no specific statutory authority exists for the concept of the trading injunction and initial trading period, equitable relief is consistent with decisions relying on courts' general equitable powers under Section 105(a) to prevent dissipation of estate assets. Especially after the case has been underway for some time, all parties have made significant investments in the process. These investments deserve to be preserved.

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controlling interest in the equity of the reorganized debtor. *See* Gregory A. Patterson, *Carter Hawley Files a Proposal To Reorganize*, WALL ST. J., July 8, 1992, at A3.

330 Allowing claims only in the amount of the consideration paid—for voting, or distribution, or both—might also be appropriate in a given context.

The trading injunction balances the interests of creditors, who may wish to cash out, with the overall needs of the Chapter 11 community in a stable creditor constituency. The option to sell is initially preserved, but as the stakes rise as parties become invested in the case, the sale option is curtailed in favor of preserving stability of the reorganization process.

V. Conclusion

Bargaining is central to Chapter 11. The solution to the debtor's financial distress is meant to be a product of the parties' collective negotiation. Invocation of Chapter 11's collective regime transforms each creditor's relationship with the debtor into a multilateral relationship with the debtor and other parties in interest. The structure of this negotiation regime renders it susceptible to disruption if the faces at the negotiating table change in significant numbers or at inopportune moments, or even if the faces *might* change.

Those wishing to leave the table will certainly have good reason to do so. Likewise for new participants at the table. However, others at the table may suffer as a result. Negotiation in Chapter 11 is not faceless or anonymous. Claimants' rights are not standardized or fungible, but contingent. What each claimant gets at the end of the day depends on who comes to the table and what she has to say. This is the essence of the bargaining regime.

A commodities market model is therefore a poor exemplar for devising rules for claims trading. While free alienability of rights should not lightly be infringed, consideration of the question should include clear assessment of all the consequences. Relationships matter in Chapter 11. Certainly at some point in the reorganization process, the parties' investment—in their relationships and in the reorganization generally—has reached a level of significance such that it should be considered in the balance. This Article asserts that that point will often be reached well before the confirmation hearing. Once the potential adverse effects of claims trading are recognized, the need for equitable relief becomes clear.