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Law, Regulation, and Economic Growth

"Financial Innovation and the New Chapter 11"

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LAW & ECONOMICS COLLOQUIUM
Tuesday, December 2nd, 2008
4 p.m.
Schachtman-Gordon Hall
(Rubloff 339)

First Draft—March 2007
This Draft—August 2008

Financial Innovation and the New Chapter 11

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When the next wave of corporate bankruptcies crests, corporate reorganization law will be put under new stress.[1] Since the last round of large Chapter 11s, financial markets have undergone a revolution. Financial innovation has allowed investors to slice and dice cash flow rights and control rights into smaller and smaller pieces. Those charged with shepherding the business through the reorganization face a daunting challenge in trying to bring together the various stakeholders and accommodate the interests of each.

The players in the next round of reorganizations will be sophisticated distressed debt investors, each of whom holds novel and competing long and short positions, positions that are constantly shifting throughout the course of the case. Unsecured debt may exist in many flavors or be entirely irrelevant. Various investors may or may not participate in the reorganization process, may or may not want to act in concert with others, and may or may not care if the reorganization succeeds.

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[1] The last few years have seen a dramatic decline in the number of large companies that file for bankruptcy. In 2006 there were only 14 filings of large, publicly held companies, while in 2002 there were 120. Some of this downturn is cyclical. Hence, we can expect the number of cases to increase if credit markets dry up and distressed firms cannot find refinancing as easily as they can today. Nevertheless, the long-term trend is decidedly away from the traditional reorganization. For reasons as to why this is so, see Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751 (2002).

The challenge the legal system faces is much like assembling a city block that has been broken up into many parcels. This is quite at odds with the standard account of corporate reorganizations—that it deals with a tragedy of the commons, a world in which general creditors share dispersed, but otherwise similar interests. Instead, we face an anti-commons problem, a world in which ownership interests are fragmented and conflicting.[2] Senior creditors used to press for a sale; now they often favor a reorganization. Junior parties who used to fear sales now see it as way to protect their interests. In the past, creditors wanted a prominent seat at the bargaining table; now many large players want to stay in the shadows. Bankruptcy has become anti-bankruptcy.

In this article, we take stock of the recent changes and show how they will come to the fore when reorganization activity increases. The law of corporate reorganizations is best seen as a set of rules designed to induce stakeholders to settle upon a plan that maximizes the value of the assets at minimum cost. The bankruptcy judge is a market-maker who brings players together and facilitates trade. The bankruptcy judge strives to make substantive rights and procedures clear, costs of negotiating low, and stakes transparent.[3]

Viewed from this perspective, some features of the new bankruptcy regime seem unproblematic. The challenge faced in a world in which creditors were diverse was principally one of overcoming a hold-out problem and at the same time ensuring that all the stakeholders were adequately represented in the negotiations. In the next round, the stake-

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[2] On too small property rights creating an anti-commons problem, see Michael Heller, The Tragedy of the Anticommons: Property in the Transition from Marx to Markets, 111 Harv. L. Rev. 621 (1998).

[3] Even when the plan is as simple as an auction of the firm's assets to the highest bidder, the parties are far better positioned than the judge to decide upon the procedures for the auction. For a discussion of the difficulties of implementing an auction, see Lynn M. LoPucki, Bankruptcy Fire Sales, 106 Mich. L. Rev. 1 (2008) (arguing that sales under §363 bring lower returns than traditional reorganizations); Kenneth Ayotte & Edward R. Morrison, Creditor Control and Conflict in Chapter 11 (July 9, 2008). Columbia Law and Economics Research Paper No. 321 (available at SSRN: http://ssrn.com/abstract=1081661).

holders will be small in number and quite able to represent themselves. Far from being anonymous investors, they are professionals who know much more about the business than ordinary investors who hold diversified portfolios.

In this new environment, however, difficulties are likely to arise. Many of these financial innovations are untested. Over the long term, these innovations may accelerate the end of bankruptcy.[4] But it is unrealistic to think all the new financial innovations will work as planned. Much of the business—or at least the interesting business—of sorting through the next round of large Chapter 11 cases will arise from the disequilibrium that these new tools are likely to bring with them. Those who have stakes in the firm need to connect with those who control it.

And it is not merely a lack of coordination. As a result of financial innovation, some investors may hold short positions that are larger than their long positions. Indeed, they may stand to profit if the firm blows up. Investors may be less willing to negotiate if they fear they are dealing with such people. Some disclosure rules seem sensible, but one needs to be cautious. Few market-makers require those who come to trade to disclose everything. Traders are usually entitled to conceal information such as their reservation price and the amount at which they acquired their goods in the first instance. Disclosure rules that are too sweeping discourage people from entering the market in the first instance. Similarly, limiting the voting rights of players who hold complex positions makes holding such positions less attractive. Given the primitive state of our understanding of capital structures, such tinkering may do more harm than good.

Even after we solve these issues, however, we confront a final—and largely neglected—problem. Bankruptcy law is premised on the parties themselves or their representatives reaching agreement. By allowing for the appointment of representatives to act on behalf of diverse creditors and by allowing for supermajority voting, one could bring a small number of people to the bargaining table and they would agree on a plan

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[4] See Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 Stan. L. Rev. 673 (2003).

that was in their mutual interest. As long as the stakes and the rules were transparent, the parties' own self-interest led them to a consensual plan. In the next round of corporate reorganizations, it will be harder for parties to reach agreement, even though—and indeed perhaps because—transaction costs are low.

To use the language of game theory, in the past, while there were many equilibrium agreements (and might have been worked equally well), only a few were focal points.[5] This may no longer be the case. Without them, coalition formation is hard. Worse yet, it is possible in some cases that no stable equilibrium exists at all. The core may be empty.[6]

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[5] For the classic discussion of focal points, see Thomas C. Schelling, The Strategy of Conflict 57–58 (1960).

[6] An "empty core" exists when three or more parties cannot reach a stable agreement with each other because some other agreement always exists that some parties prefer, there is an empty core. In other words, one or more people will always defect from whatever tentative agreement that might be made and hence none ever is. Low transactions costs create a frictionless environment in which agreements cannot stick. For an accessible introduction to the problem of the empty core, see Lester G. Telser, The Usefulness of Core Theory in Economics, 8 J. Econ. Perspectives 151, 152 (Spring 1994). The problem of the empty core may require some qualification of the Coase theorem, as it is premised on the idea that parties can reach agreement with one another if transaction costs are low enough and information is perfect. See Varouj A. Aivazian & Jeffrey L. Callen, The Coase Theorem and the Empty Core, 24 J. L. & Econ 175, 176 (1981); Varouj A. Aivazian & Jeffrey L. Callen, The Core, Transaction Costs, and the Coase Theorem, 14 Con. Pol. Econ. 287 (2003). But see R.H. Coase, The Coase Theorem and the Empty Core: A Comment, 24 J. L. & Econ. 183 (1981) (arguing that the empty core and the Coase Theorem can be reconciled through penalty clauses, time constraints or participants realizing that negotiations would be endless, which leads to settling).

The empty core has been applied to antitrust, particularly industries in which high sunk costs (such as a railroad or airline) may create an environment in which there is no stable equilibrium. See George Bittlingmayer, Decreasing Average Cost and Competition: A New Look at the *Addyston Pipe* Case, 25 J.L. & Econ. 201 (1982) (applying empty core to antitrust to the *Addyston Pipe Case*);

Today those at the bargaining table are professionals, but they are less likely to be repeat players. They are so diverse that there are not obvious communities of interest. They are no longer organized groups (like agented lenders or even creditors' committees), but rather have "one off" relationships with the debtor entity (for example they are trading counterparties with individual repos or swaps). The types of institutions vary—from banks and broker-dealers to hedge funds and private equity firms, each of which has conflicting perceptions of the role they want to play in the debtor and the length of time they want to hold their investment. The current environment is one in which there are no natural leaders (or followers) among the creditors to perform the shuttle diplomacy required to build a consensus. A deal reached one day may fall apart the next.

Modern bankruptcy law is premised on the idea that parties can reach agreement with each other and it will stick. Some provisions of the Bankruptcy Code—such as the exclusivity period granted the debtor—may help make this happen. But other bankruptcy rules—such as the limitation on lock-up agreements inside of bankruptcy—have the opposite effect. Understanding how bankruptcy law leads parties to agreement should receive far more attention that it has to date.[7]

John Shepard Wiley Jr., Antitrust and Core Theory, 54 U. Chi. L. Rev. 556 (1987) (otherwise objectionable agreements among competitors may be efficiency enhancing because of the problem of the empty core); Paul Stephen Dempsey, The Financial Performance of the Airline Industry Post-Deregulation, 45 Hous. L. Rev. 421, 482–83 (2008) (summarizing the empty core as it applies to the airline industry and deregulation); Keith N. Hylton, Efficiency and Labor Law, 87 Nw. U.L. Rev. 471, 502–05 (1993) (applying the empty core to labor law and unions); Henry E. Smith, Structured Settlements as Structures of Rights, 88 Va. L. Rev. 1953, 1969-70 (2002) (applying the empty core problem to structured settlements).

[7] Some discussions of bankruptcy have mentioned the problem of the empty core in passing. See Daniel J. Bussel, Coalition-Building Through Bankruptcy Creditors' Committees, 43 UCLA L. Rev. 1547, 1605 n.219 (1996) (noting that coalitions formed in bankruptcy can experience empty core problems); Maxwell L. Stearns, The Misguided Renaissance of Social Choice, 103 Yale L.J. 1219, 1239 n.75 (1994) (warning that participants in bankruptcy cases may not

In the new world of Chapter 11 then, the challenge is threefold. First, the bankruptcy judge must work through the problem that arises over the short-term from the failure to allocate control rights effectively. Second, the bankruptcy judge must create a set of optimal disclosure rules. Finally, the judge must induce the parties to settle upon a plan that is mutually beneficial. After we review the developments in technology and finance that have changed the dynamics of corporate reorganizations in Part I, we examine each in turn. Part II reviews the challenges that these changes generate, emphasizing the short-term difficulties that may arise with some new instruments because of the failure to allocate control rights efficiently. In Part III, we show how many of the problems of financial innovation are, at bottom, problems that require a fundamental rethinking of our rules governing information and disclosure. Part IV looks at the problems that will still will exist even if these others were solved, and in particular how the bankruptcy judge should confront the risk that parties will find it harder to find common ground.

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be in best position to determine how assets are divided due to empty core problem); Michael A. Perino, Class Action Chaos? The Theory of the Core and an Analysis of Opt-out Rights in Mass Tort Class Actions, 46 Emory L.J. 85, 122–23 (comparing collective action problems in class actions to those in bankruptcy and applying core theory to the problem). None of these, however, has connected the problem to particular provisions of the Code or to the way in which bankruptcy judges can prevent an empty core.

Even if one takes the view, one that we share, that Chapter 11 should take advantage of markets wherever possible and that well-run auctions are good things, promoting agreement among the parties is still important, with respect to such questions as auction design. Before a firm can be auctioned, many issues, including whether to find a stalking horse bidder, must be settled. Auction design is a science unto itself. For a general discussion of auction design, see Paul Klemperer, What Really Matters in Auction Design, 16 J. Econ. Perspectives 169 (Winter 2002).

I. The New World of Chapter 11

Large Chapter 11s no longer play the role they once did.[8] Relatively fewer financially distressed firms need a collective bankruptcy proceeding to overcome a collective action problem among diverse creditors to preserve going concern value. Firms depend far less on assets that are firm-specific. Shutting down businesses that lack dedicated assets is less costly than shutting down one that has them. (A motion picture production company can be reassembled in a way that a railroad cannot, and firms today are more like motion picture production companies than railroads.) Firms are built with capital structures that lack the crazy-quilt character of the nineteenth century railroads and other first efforts at large corporate form. Finally, in modern capital markets sales even of the largest firms are completely feasible. These changes put the traditional accounts of large Chapter 11s under considerable pressure. Changes in the financial market transform the face of Chapter 11 further still.

A. The Decline of the Traditional Bank

Perhaps there is no more stock character in the discussion of bankruptcy policy than the senior bank. The bank has made a large loan to the company and has a security interest in most, if not all, of the company's assets. The financial interest of the bank is relatively straightforward. If it can realize the value of its collateral, it will be paid in full. As such, the lender has an incentive to turn its collateral into cash via some form of sale. The senior lender would seek to sell the discrete asset in which it had a security interest, and this would lead to the closure of the business. The lender is biased toward liquidation. Because it does not share in the upside should the debtor's fortunes improved, it does not take such possibilities into account. Rather, if it can force a liquidation today, it can be paid in full. It sees no need to risk continuation that can only reduce its return. Even if the company is to be sold, the bank cannot be trusted if it is owed less than the company is worth. In this situation, the bank may not seek top dollar. It will only look for a sale that

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[8] We have told this story elsewhere. See Baird & Rasmussen, supra note 1.

pays it in full. Given these incentives, the bank should not have its hand on the levers of control.[9]

Two changes in bank lending practice render this account obsolete. The first is the rise of the syndicated loan. Single banks no longer make loans to large businesses. Given the amount of these loans, any bank that funded the loan itself would be tying up a hefty portion of its capital with a single borrower. To take a simple example, assume that we have ten banks and ten borrowers. Each borrower wants to borrow $200 million, and there is a 10% chance that any given borrower will default during the term of the loan. In a world where loans were funded by a single bank, any bank loaning $200 million would have a 10% risk that a large portion of its capital would end up in default.

Syndication allows the banks to reduce this risk. By parceling out each loan among a consortium of banks, each bank can lessen its default risk. In our example, if each bank signed up to fund 10% of each borrower, it would have mitigated its risk. To be sure, by participating in more loans it is more likely that some debtor in its portfolio will default. Each bank expects to have to deal with a default on a $20 million commitment. It is much easier, however, for each bank to handle a $20 million default rather than a $200 million default. In exchange for taking on a greater risk that it will have to deal with some default, each bank has greatly reduced the risk that it will have a default that would threaten the viability of the bank.

Syndication has been with us for two decades.[10] It initially had little effect on bankruptcy practice. The lending agreement contained various covenants. If the borrower tripped up a covenant, it would have to procure a waiver. The contract governing the syndicate did not grant the lead bank the unilateral right to grant a waiver; rather, the waiver had to be approved by syndicate members holding a specified percentage of

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[9] See Thomas H. Jackson, The Logic and Limits of Bankruptcy 181–89 (1986) (secured creditors should receive the value of their rights, but the decision as to the fate of the corporation should be left to the general creditors).

[10] Syndication in its current form arose in response to Continental Illinois' failure due to its loan to Penn Square, a small bank in the oil fields in the 1970s.

the loan. By and large, however, syndicated members would follow the recommendation of the lead bank. The reason was that members of the syndicate generally had the same economic interests and instincts. Many were banks and, while at some level they were competitors, they also were repeat players. Any bank that reached an agreement with a borrower to fund a new loan would have to shop the loan to its brethren. Other frequent participants in these syndicates were pension funds looking for a safe return on their assets. These funds did not have the assessment capabilities of banks, and hence were even more likely to defer to the recommendation of the lead bank that arranged the syndicate. The general norm that developed was that, when decisions had to be made regarding the administration of the loan, there was a heavy presumption that the members of the syndicate would follow the recommendation of the lead bank. The lead bank, in essence, served as the monitor of the loan for the rest of the syndicate. Befitting the lead bank's status as the leader of the syndicate, the expectation developed that the lead bank would hold a portion of the loan that was larger than any other member.

The lead bank, in turn, would in effect demonstrate its commitment to performing its monitoring activities faithfully by holding onto the single biggest piece of the loan itself. By holding a share that was disproportionate to that of the other members of the syndicate, the lead bank would take a bigger economic hit should it fail to maximize the value of the loan. Making such a commitment made the loan easier to sell to other lenders.

The composition of lending syndicates, however, has changed recently. Membership is no longer limited to bank and pension funds. Hedge funds can participate in the syndication stage. To be sure, they do not have unfettered access to all syndicated loans. Some hedge funds, as discussed below, have reputations for being problematic, at least from the perspective of the borrowers. The current norm seems to be that borrowers can negotiate with the lead bank over excluding some hedge funds from being part of the lending syndicate.

The second development, however, makes these efforts to keep hedge funds out of the syndicate potentially futile. In recent years there

has developed a secondary market in syndicated loans. The advantage of this market to those lenders participating in the syndicate is readily apparent. Any member of the syndicate, including the lead bank, now has an exit option. It can sell its portion of the loan to a willing buyer.[11] These buyers, however, now include hedge funds. Given the desire of lending institutions to be able to exit a situation with which they are no longer comfortable, the loan syndicates by and large place no restrictions on the ability of all members of the syndicate, including the lead bank, from selling its interest in the loan in the secondary market.

Thus, when a borrower trips up covenants in its loan or files for bankruptcy, it will not necessarily be the case that all it has to do is to come to an understanding with the bank that has funded its senior debt. Today hedge funds can often purchase enough of the loan in the secondary market so that they have the power to block any waiver of default, proposed amendment to the credit facility, or plan of reorganization that does not meet with their approval.

A hedge fund that holds a position identical to the one held by a bank at an earlier time may view bad states of the world radically differently. It may have bought the loan with the view that, in the event of default, it would be left with the business and, given the amount at which it purchased the notes, it would not be a bad price at which to acquire it even if it were in financial distress. Banks want their money back; hedge funds loan to own. Far from having a liquidation bias, a hedge fund may affirmatively want to advance a reorganization plan in which it ends up with the equity of the business. Rather than push for a market sale, it prefers a judicial process that it can control. Not only can it push for a low valuation, but the managers of the business, people whose options will be reset upon emergence from Chapter 11, will push for a low valuation as well. In short, the senior lender in the identical place in the capital structure is doing exactly the opposite of its traditional counterpart: Instead of fleeing from the Chapter 11 process, it embraces it. Rather than terminating its relationship with the business,

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[11] The options provided to banks by the secondary loan market are in many ways similar to the options that claims trading in bankruptcy provides to the holders of claims.

it wants to run it. Rather than fighting the managers, it allies itself with them.

B. The Rise of New Investment Types

Bankruptcy law developed in a world of what today would appear as having limited financial instruments. Secured debt (generally held by banks), unsecured debt (generally held by banks), public investors and trade creditors, and stock (either closely held by those running the business or publicly held by dispersed individuals) exhausted the types of investments that comprised the capital structure of most businesses. In addition, investors tended to hold a single type of investment in the company. Shareholders held shares; creditors held debt, with banks holding secured debt. In this world, it was relatively simple to ascertain the incentives of any investor. Standard accounts of Chapter 11 assume the existence of a relatively limited type of investments in the debtor: secured debt, unsecured debt, and equity. The Code itself provides for secured claims, unsecured claims, interests, and pretty much nothing else.[12] When we think back to when the Code was drafted in the 1970s, these were the basic investments in a company. One could of course find some additional securities, but these were pretty much the exception. Put differently, the roots of the Bankruptcy Code predate Black-Scholes.[13]

The drafters of the Bankruptcy Code assumed that secured creditors, principally banks, could be trusted to look out for themselves. The

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[12] See 11 U.S.C. §506 (distinguishing between secured claims and unsecured claims) & 11 U.S.C. §501(a) (allowing equity security holders to file an interest). See also 11 US.C. §1129(b) (defining cram down procedure for secured claims, unsecured claims and interests). The one exception is the Code acknowledges, but steers a wide course around, certain derivative transactions.

[13] See Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637, 649–54 (1973); Robert C. Merton, Theory of Rational Option Pricing, 4 Bell J. Econ. & Mgmt. Sci. 141, 141–42 (1973). For an accessible discussion of how financial innovation alters our perception of capital structures, see Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 465–70 (1993).

banks tended to have a relationship with the debtor that it could exploit to glean information from the company. The lending agreement between the lender and debtor made sure that the bank would have access to the information that it needed in order to safeguard its own interests. By contrast, the unsecured creditors had two hurdles to overcome. One was that they were dispersed. Whereas the secured debt was concentrated in the hands of a single institution, various parties had held unsecured debt. These parties could include holders of public debt, trade creditors, land lords, tort creditors, and creditors who claimed that the debtor had breached its contract.

The problem was one of collective action. As a group the unsecured creditors may be better off by taking concerted action, but no one creditor is willing to take the laboring oar. The costs of participation fall on those who participate, but the benefits are distributed to all creditors. While for creditors as a group the best course of action may be to actively participate in the reorganization discussions, for each individual creditor the rational thing to do is stay passive. The nonbankruptcy rights are insufficiently tailored to allow them to act in a way that is mutually beneficial. Just as the agency issuing fishing licenses or regulating drilling in an oil field attempts to maximize value, those charged with overseeing the reorganization again take steps to preserve the value of the estate on behalf of general creditors who are presumptively similarly situated and entitled to equal treatment.[14]

In addition to the incentive towards passivity, unsecured creditors also lack the information necessary to participate in the reorganization. A central, perhaps the central, issue in any reorganization effort is valuation. What would the company be worth if liquidated, and what would it be worth if kept together. While creditors could, perhaps, piece together information on liquidation values from publicly available sources, putting a price on the company as a going concern is a more difficult endeavor. One has to know the future plans for the company, and what the plausible projections are for the future revenue stream. These both require information that the company has but that outsiders

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[14] See Jackson, supra note 9, at 10–19.

do not. Indeed, the creditors have no legal entitlement to such information.

The answer to these problems was the committee structure. A committee would be formed representing the interests of the unsecured creditors. The committee would be staffed with creditors holding the six largest claims against the debtor. The existence of the committee provided a mechanism by which private information could be shared with the creditors. The committee would negotiate on behalf of the unsecured creditors as a group. Moreover, the committee would be able to collect the information that it needed in order to make an informed judgment. It could hire accountants to investigate the books of the company. It could hire investment bankers to assess what options the company had. It is invested with the broad power to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case."[15] Also, to overcome the financial disincentives, the Code required that the debtor pay for the expense of the committee. The court would approve the law firms that the committee hired. Moreover, the debtor would pay for all of the committee professionals, such as investment bankers and accountants.

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

The final check on the committee process was voting. The committee had no power to bind all of the class members. Rather, a plan of reorganization was put up for a vote by all class members. A class of unsecured creditors would only be deemed to accept the plan if two re-

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[15] 11 U.S.C. §1103(c)(2).

quirements were met. The first is that at least half of the creditors in the class vote in favor of the plan. The second is that those voting in favor of the plan hold at least two-thirds of the total amount of debt in the class. Subjecting the work of the committee to voting by those with the same economic interest as the committee members allows for the creditor community to police the committee's efforts.

This approach—one that assumes common interests among creditors—fits awkwardly with types of investment instruments in use today. Stakeholders in distressed businesses are neither distant nor uninformed nor similarly situated. Far from being dispersed investors, each is a holder of a fragmented interested in fiercely determined to profit by taking strategic advantage of her position. Investors today exploit the lessons of put-call parity,[16] and they devise investment contracts narrowly tailored to their needs with various types of derivatives. Terms such as senior secured debt, junior secured debt, senior subordinated debt and junior subordinated debt are both common and carry little fixed meaning. Figuring out precisely what cash flow rights come with a certain investment often requires careful reading of a contract running for many pages. Far from having a relatively undefined right to the debtor's assets, these investors have particular and highly defined rights. The ownership interest is hardly as simple as holding a piece of senior or junior debt. Any particular investor holds a package of claims and derivatives.

To again return to the real estate analogy, the problem is not dispersed owners of a common asset, but a city block that has been divided many ways. There are easements, leasehold and reversionary interests, air rights, and many other sticks in the Hofeldian bundle that are held by sophisticated claimants. There is no easy way to decide how much weight to be given to any one. Someone who is the record owner of a particular type of bond may also be a credit protection buyer and his

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[16] See Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 465–70 (1993); Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637, 649–54 (1973); Robert C. Merton, Theory of Rational Option Pricing, 4 Bell J. Econ. & Mgmt. Sci. 141, 141–42 (1973).

total position may be short. Far from wanting the company to reorganize successfully, he may be better off if the business blows up. In addition to voting against plans of reorganization, he has an incentive to derail the reorganization process.

C. Claims Trading

Any creditor, no matter how large or small, that decides it no longer wants to maintain its relationship with the debtor now has an easy way out. There will be someone (usually a hedge fund) willing to buy its claims. This is a lightly regulated process where folks trade repeatedly even though both may have information that neither has disclosed to the other. Those on the outside have difficulty ascertaining precisely who is buying what. The one thing of which we can be confident, however, is that the players consist almost exclusively of professional investors who specialize in distressed businesses who are there by choice.[17] These are not people trying to cut their losses; these are investors looking to make a profit.

The ability to trade in claims against a Chapter 11 debtor has existed for over twenty years.[18] The increased presence and financial wherewithal of hedge funds, however, has increased the importance of this aspect of reorganization practice.[19] The basic notion of claims trading is

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[17] See David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 Cardozo L. Rev. 1905 (2004).

[18] See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11,* 12 Cardozo L. Rev. 1 (1990); Robert K. Rasmussen & David A. Skeel, Jr. *The Economic Analysis of Corporate Bankruptcy Law,* 3 Am. Bankr. Inst. L. Rev. 85, 101-04 (1995).

[19] See Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?,* 78 Am. Bankr. L.J. 153, 181 (2004) (noting that "distressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act"); Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy*, 11 Am. Bankr. Inst. L. Rev. 177, 177 (2003) ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound

quite simple. Chapter 11 cases can be long and drawn out affairs.[20] The holder of a claim may not wish to wait until the end of the proceeding for payment. For example, a trade creditor rarely expects to be a long-term investor in the enterprise. When a debtor files for Chapter 11, however, the debtor is prohibited from paying pre-petition debt.[21] All payments on such obligations, even if they are to be paid in full, must await the end of the case.[22] The trade creditor, however, is not set up to participate in the Chapter 11 proceeding. It has little knowledge of the ins and outs of bankruptcy practice. Perhaps even more importantly, its business model is not built around tying up its capital in bankruptcy proceedings. It depends on cash flow from the goods that it sells to run its own operations. Even if the trade creditor still wants an on-going relationship with the debtor, it is eager to monetize its claim for prepetition goods.

Those with money to invest can make a profit here. An investor with more knowledge about the likely outcome of the case and a longer time horizon can make a positive return. One way is simply by providing liquidity. Some claimants, such as the holders of trade debt, may be relatively impatient. Similarly, an individual may have bought a bond because she sought the regular interest payments that it provided. All

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liquidity in claims. . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader . . . ."). See generally Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 Colum. Bus. L. Rev. 191 (2005) (discussing the growing importance of role distressed debt investors play in Chapter 11).

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

[21] 11 U.S.C. 362(a).

[22] This requirement that payments be made only at the end of the case was a main reason as to why the Seventh Circuit cast a skeptical eye on critical vendor orders. See In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

things being equal, she would prefer to reinvest the value of her bond in a company that is still providing regular payments. To the extent that a bankruptcy filing changes the cash-flow characteristics of an investment, the holders of that investment may want out. Claims-trading allows such investors to turn their bankruptcy claim against the debtor into cash.

The new investors who come onto the scene after a Chapter 11 has been filed may also profit from their ability to negotiate the bankruptcy process. They may be better able to assess how much the debtor will ultimately be able to pay on its claims. Moreover, the investor may be able to find overlooked value in the instruments that the debtor has issued. Either way, the investor may be able to use its knowledge of reorganization process to generate a higher return than could the party that owned the claim when the debtor filed for bankruptcy.

To be sure, we should worry about the sophisticated fleecing the innocent. We do not expect trade creditors and individual bondholders to have any idea as to what they can expect to receive at the end of the bankruptcy case. They also do not necessarily understand all of the rights they may have against the debtor. Yet once we have a robust market for claims, competition will carry much of the load. When, say, three entities are bidding for claims, the holder of the debt needs only to compare their relative offers; she does not have to make an independent investigation of the likely outcome of the process. Here as elsewhere markets excel at providing pricing information.

The trading of claims in advance of bankruptcy itself eases the pressures that lead to Chapter 11 in the first place. By the time for Chapter 11 to become a serious possibility, most of its debt may be in the hands of perhaps only a few dozen distressed debt investors. The deficiencies in new financial instruments may lead to tough bargaining, but bargaining that takes place outside of bankruptcy. A Chapter 11, like any other corporate restructuring or control transaction, is expensive. It will likely consume 10% of the business's assets. Even professionals with dramatically opposing interests will work hard together to incur such an expense unnecessarily. Because they are no longer widely dispersed, the cost of Coasean bargaining among them is not high.

Forging an agreement among several dozen people, however sophisticated, is far from surefire. But these individuals are powerfully inclined neither to incur the costs of bankruptcy nor to lose the control that might come with it. Indeed, instead of arising because dispersed creditors cannot work together, modern Chapter 11s often arise because the distressed debt professionals have decided to enter Chapter 11 because it gives them a substantive benefit they could not find outside bankruptcy. They may well have agreed on a plan to deal with the debt of an airline, and use Chapter 11 to escape a collective bargaining unit; a retailer uses it to escape undesirable leases. The investors that took a firm through an unsuccessful LBO agree to restructure the debt, but must use Chapter 11 in order to step around the Trust Indenture Act. [23] The investors in a rent-a-car company agree that a sale is in their mutual interest and enter Chapter 11 merely to consummate a sale to a buyer according to terms already negotiated. As a matter of first principle, having these different substantive rules in bankruptcy is a bad idea (independent of what they are). Nevertheless, such cases accounted for something like ninety percent of the large reorganizations in the last round of Chapter 11s.[24] Put selling the assets, implementing a prenegotiated plan, and rejecting collective bargaining agreements and leases to one side, and you eliminate all but a handful of cases.

While trading of claims in the shadow of bankruptcy reduces the need for Chapter 11 altogether, the existence of claims trading inside of bankruptcy changes its dynamics when it does take place. Hedge funds (and other private investors) often buy claims in Chapter 11 for control rights that accompanying the claims that they purchase. The Bankruptcy Code provides certain rights to holders of claims. For example, claim holders may sit on the creditors' committee. The creditors' committee is a portal into the bankruptcy process. Whereas any individual creditor has to pay its own costs should it seek to participate in the reorganization proceeding, the creditors' committee can hire counsel and advisors

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[23] Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232 (1987).

[24] Indeed, sales and prenegotiated plans counted for eighty-five percent. See Baird & Rasmussen, supra note 4.

and have these fees reimbursed by the estate as an administrative expense. Also, the creditors' committee can press the debtors for concessions. It purports to speak for the creditors. As such, the debtor has reason to listen to its concerns.

Having a seat on the creditors' committee can provide an investor with a good deal of input into the way in which a bankruptcy case proceeds. At the same time, however, someone on the creditors' committee is supposed to attend to the interests of the general creditors as a whole. Reconciling the traditional committee structure with the new type of player requires forcing disclosures from the investor and limiting her range of action, especially with respect to trading. Whether this can be done in a way that keeps the largest players at the bargaining table has proved hard. In an environment in which sitting at the bargaining table requires representing others' interests as well as one's own, the most important players may stay away from the negotiations altogether. Again, there has been an inversion of the traditional process, one in which creditors wanted to be on the creditors' committee, rather than stay away from it.

The changing dynamic of who wants to be on creditors' committees illustrates the way in which trading changes the nature of the Chapter 11 process. Once claims trade freely and find themselves in the hands of comparatively few professionals, we are no longer in a world in which the players sit around the table and negotiate, but rather a conventional take-over contest outside of bankruptcy. The most notable example of the use of buying claims to get control of a company in bankruptcy is the Kmart reorganization. ESL, a well-heeled hedge fund, bought up $400 million of Kmart's debt. No other investor could confirm a plan of reorganization without ESL's support. Eventually, ESL agreed to invest an addition $100 million after the case emerged from Chapter 11.[25] The reorganization plan gave ESL the right to appoint four directors. Edward Lampert, the head of ESL Investments, appointed himself, two of his employees, and a major investor in ESL.

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[25] See Edward S. Lampert Appointed Chairman of the Board, Kmart Holding Corp., PR NEWSWIRE, May 6, 2003; Karen Dybis, Kmart adds financial control, DETROIT NEWS, Sept. 9, 2003, at 1C.

II. The Dark Side of Financial Innovation

Even as the professionalism of today's holders of distressed debt makes Chapter 11 less necessary, another force is pushing in the opposite direction, at least over the short term, to make it harder to pull off successfully. As rights against in the debtor become parsed more and more finely, and as the number of differing configurations of financial interests increase, the transaction costs of putting them back together increases. The incentive of individual investors to hold discrete pieces of the business (a short position in stock; a long position in a particular type of bond) may run contrary to the interests of all the investors as a group. Also, many make bets today based on the assumption that the current liquidity will persist. When money becomes less plentiful, hedge funds will find it increasingly difficult to exit a situation. The costs of fragmentation will increase and present problems that have not been fully anticipated. In this part, we review the types of problems that might arise.

A. The Second-lien Loan

Most debtors that file for bankruptcy tend to have a senior secured creditor. That creditor (or, more precisely, that lending syndicate) will have a security interest in virtually all of the assets of the company.[26] When the loan is made, however, it often will not be made to the limit of what the lender believes what the business is worth. Bankers term this "enterprise value." The lender when making the loan leaves a cushion between its assessment of enterprise value and the amount that it is willing to loan. The reason for acting in this manner is that the lender does not want to begin the life of the loan on the knife's edge. If the

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[26] There may be some assets here and there to which the creditor's lien does not extend. It may not be worth the effort to get the lien noted on the certificate of title of the debtor's used cars. For tax reasons, it may be that foreign subsidiaries do not guarantee the loan. It may not be feasible to have a security interest in all intellectual property as it is created. In the main, however, the debtor's bank is unlikely to leave substantial assets on the table. Not only does the bank wish to protect its loan as much as possible, but it does not want to have to deal with another lender should financial distress arise.

business begins to falter, it does not want this initial misstep to imperil its chance for full recovery. Moreover, the lender knows that valuation is more of an art than a science, and it wants to protect itself in case it has been unduly optimistic in assessing the debtor's enterprise value.

Debtors thus would have the large part of their financing from the senior lender, but there would be value in the company which exceeded the debt owed to this lender. Borrowers seeking funds would at times seek to access the remaining value in the business. In years past, the debtor would access this additional value through mezzanine financing on an unsecured basis. In the 1980s, this financing was provided by savings-and-loan associations and insurance companies. These were relatively passive investors who had little ability to affect the operation of the company. To the extent that any investor was monitoring the debtor, it was the lead bank in the lending syndicate.

Today, however, we see a new trend in the capital markets. The debtor accesses the difference between the senior loan and full enterprise value through a second-lien loan. The lenders take a security interest in the same assets as does the first lender. Their right to payment by and large is not subordinated to the senior debt. Maturity schedules are set so that the borrower is required to make payments on both loans. The second-lien lenders can seek to be repaid at the same time as the senior lender is being repaid. Moreover, unlike subordinated debt, they do not have to pay any monies that they collect to the senior debt. Rather, they are second only in terms of their claim on the collateral package. Only when collateral is sold is it the cash that the senior lender has first dibs. The second-lien loan market has exploded in the past five years. In 2001, according to Standard and Poor's, the total amount of second-lien loans was $65 million. By 2005, the market had grown to more than $16 billion. As with syndicated first lien loans, there is a robust secondary market for second-lien loans.

The second lender only comes onto the scene with the blessing of the first lender. This necessity for consent arises because the loan documents surrounding the senior loan typically restrict the ability of the borrower to grant a competing security interest in the company's assets. Few lenders would make a loan that would give the borrower the unfet-

tered ability to pledge the collateral it is relying on to another lending group. Thus, to the extent that the borrower wants to obtain financing based on a second lien, it needs the consent of its primary lender.

The primary lender may have a financial interest in agreeing to the second-lien loan. After all, the second loan benefits the first lender in that it puts more money into the business. This money can be used to generate additional revenues, some of which will be used to make payments to the senior lender. Yet the senior lender obviously wants some assurances that the new lender—which as with the senior loan is usually a group of lenders—will not cause it undue hardship. Granting a lien has consequences, both outside of bankruptcy and inside of bankruptcy. A second-lien holder, by virtue of its lien, can grab its collateral. After a bankruptcy petition has been filed, it can object to the use of its collateral and seek adequate protection of its interest. The second-lien lenders are sophisticated financial institutions who are well versed in pushing to the limit whatever legal rights they may have. Hedge funds are primary purchasers of second-lien debt.

The lynchpin of second-lien financing is the intercreditor agreement.[27] This contract specifies the relationship between the parties. It addresses in detail their respective rights should the borrower file for bankruptcy. For example, the intercreditor agreement often grants the senior lender the right to sell the collateral without the consent of the second-lien lender. The intercreditor agreement also gives the senior lender the right to finance the debtor post-petition and provides that this financing will have priority over the loan of the second-lien lender. This provision means that although the second-lien lender can ascertain how much the first lien lender is owed today, this amount could increase should there be a bankruptcy filing.

The intercreditor agreement may also provide that the second-lien lender will consent to any cash collateral order to which the senior lender has also agreed. Cash collateral, as its name implies, is cash in which the creditor has a security interest. In the case of second-lien lending, it

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[27] See C. Edward Dobbs, *Negotiating Points in Second-lien Financing Transactions*, 4 DePaul Bus. & Comm. L.J. 189 (2006).

will often be the case that both the first lien and the second lien cover these funds. The Bankruptcy Code places restrictions on the debtor's use of cash, as opposed to other, collateral, and it is common practice for debtors to attempt to seek the secured creditor's consent to cash collateral orders. Should the senior lender allow the debtor to use cash collateral, it may well be that should the debtor lose money in its operations, this money will come first out of the collateral that would have otherwise gone to the second-lien holder. In sum, the senior lender wants to make sure that it will "drive the bus" should the debtor file for bankruptcy.[28] Indeed, one often hears the phrase "silent" second liens. The word "silent" describes how the second-lien holder should act if the debtor files for bankruptcy.

To prevent the second-lien holders from interfering with the ability of the senior lending group to control the case, some intercreditor agreements provide that if the second-lien holder buys some of the first lien debt on the secondary market, the second-lien holder cannot participate in the decisionmaking process of the first lien group. While the loan that it buys allows it to vote on major decision involving the loan, the intercreditor agreement disenfranchises the second-lien holder from voting its first lien interest. One common way for the second-lien holder to protect itself is to insist on a provision in the intercreditor agreement with allows it to buy out the first lien once the loan is in default.

The effect of second liens has yet to be felt. Indeed, as Standard & Poors has noted, "[t]here is insufficient insolvency experience to confidently anticipate how either the judicial process or the relationship between first- and second-lien lenders may impact ultimate recovery." By and large, the last few years have been relatively quiet. Yet we can hazard some predictions. The first is that many cases will enter bankruptcy administratively insolvent. Under the Code, secured creditors receive the value of their collateral first. After that, the administrative costs of bankruptcy are paid. A case is said to be administratively insolvent when there is insufficient funds to pay off the administrative expenses.

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[28] This desire is a manifestation of the power that senior creditors exert in modern reorganization proceedings.

Who will fund the case? Common practice is for the secured creditor to agree to a so-called "carve out" of its lien. Basically, the secured lender devotes part of the value of its collateral to fund the costs running the proceeding. The question is going to be the extent of the carve-out. Secured creditors benefit from the basic operation of bankruptcy law. The bankruptcy process cashes out the shareholders without a liquidation of the company and provides clean title. The secured creditors are willing to pay for this benefit, as they should be. But they will not want to fund other activities. They have no interest in supporting a creditors' committee. Similarly, they do not want to use the assets in which they have a security interest to investigate the validity of that interest.[29]

Once the case is funded, we need to think about the effect of the intercreditor agreement. These contacts by and large tend to be clear, but they have yet to be tested in bankruptcy court. For example, in the *Maxim Crane* case, the senior lender gave up its rights to insist on absolute priority. It did this not because there was anything facially wrong with the intercreditor agreement, but rather because it "bought off" the rights of the junior secured lenders. While the first lien holders thought that their loan was a tad more than the company was worth, by agreeing to funnel 9% of the equity of the reorganized company down the priority ladder they were able to avoid a valuation hearing. While the plan thus not does comport with absolute priority, this may be the result of a good faith valuation dispute.[30]

The principal doubts with respect to second-lien financing revolve around the extent to which the traditional idea that bankruptcy is for the benefit of unsecured creditors exercises gravitational pull. Some academics—and perhaps some judges—think that a Chapter 11 reor-

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[29] For an excellent discussion of the issues surrounding carve outs, see Richard Levin, *Almost All You Ever Wanted to Know about Carveout*, 76 Am. Bankr. L.J. 445 (2002).

[30] The case is thus an illustration of the argument advanced by one of us (with Don Bernstein) that we would expect to see relative priority plans in a world committed to absolute priority. See Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930 (2006).

ganization done for the benefit of secured creditors is simply illegitimate.[31] A group of first- and second-lienholders should not be able to use Chapter 11 to effect a sale of the distressed business, but rather should rely instead on their nonbankruptcy foreclosure remedies. Modern bankruptcy judges are likely to resist such arguments. As a matter of history, Chapter 11 emerged out of the old equity receiverships of the nineteenth century railroad, and in those cases virtually all the debt was secured and the entire process revolved around sorting out the conflicts between secured creditors. Hence, the idea that a Chapter 11 run for the benefit of secured creditors is hardly without precedent.

More to the point, the modern bankruptcy judge sees herself as a market-maker. She is charged with creating a forum in which the stakeholders, whoever they may be, come together and negotiate. As long as the agreement adequately deals with the substantive and procedural rights of all involved, it is not for her to question its details, any more than it is for the New York Stock Exchange to review the price at which a given stock trades. She is indifferent to whether the agreement provides procedures for an auction of the assets (as is increasingly the case) or sets out a traditional plan of reorganization, spelling out in elaborate detail the capital structure of the reorganized firm (as is becoming increasingly rare).

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[31] See George W. Kuney, Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, 24-25 (2004) ("secured creditors capitalizing upon agency problems to gain the help of insiders and insolvency professionals [have] effectively take[n] over – or 'hijack[ed]' – the chapter 11 process and essentially create[d] a federal unified foreclosure process"); Stephen J. Lubben, The "New and Improved" Chapter 11, 93 Ky. L.J. 839, 841-42 (2004-2005) ("[I]t is not clear that this development promotes social welfare. Rather, lender control may only benefit lenders."); Harvey R. Miller & Shai Y. Waisman, The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases, 21 Bankr. Strategist 1, 2 (2003) ("The excuse ... of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower"); Jay Lawrence Westbrook, The Control of Wealth in Bankruptcy, 82 Tex. L. Rev. 795, 799 (2004) ("[W]idespread adoption of a privatized system depending upon dominant security interests is as undesirable as it is unlikely").

B. Credit Default Swaps

We generally analyze the economic incentives of a given creditor based on the type of claim it has against the debtor. We tend to believe that once we understand which financial instrument an investor holds we can ascertain its economic interest. Shareholders look for gains and worry little about losses. Debt holders seek to protect their principal and give little thought to foregone opportunities. The more senior the debt, the more the holder will favor conservative actions over aggressive ones.

Ascertaining economic interests is crucial to assessing bankruptcy policy. Investments come with both cash flow rights and control rights. Shareholders can vote for the board of directors. Creditors can invoke the machinery of the state to collect their debts. More importantly, credit contracts often give lenders the ability to affect the business in various ways. In the extreme case, the rights that a senior creditor has by virtue of its lending agreement give it the power to engineer a change in the corner office.[32] As a general matter, cash flow rights and control right work in tandem. It is the investor's cash flow rights that give it the incentive to exercise its control rights in a certain manner. We normally assume that an investor exercising a control right granted by a financial instrument that the debtor has issued is acting so as to maximize the value of that instrument.

Credit default swaps have rendered this assumption obsolete. A credit default swap is a two-party contract under which one—the protection buyer—enters into a contract with a counterparty, called the protection buyer, giving it the right, in return for an upfront payment, to exchange the loan for cash equal to the face amount of the loan if there is a default or some other "credit event."[33] For example, a holder of a GM bond may enter into a credit default swap that provides that, if GM

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[32] See Douglas G. Baird & Robert K. Rasmussen, Private Debt and the Missing Lever of Corporate Governance, 154 U. Pa. L. Rev. 1209 (2006).

[33] For a discussion of some of the ways in which credit default swaps are changing bankruptcy practice, see Frank Partnoy and David Skeel, The Promise and Perils of Credit Derivatives, 75 U. Cinn. L. Rev. 1019 (2007).

defaults on the bond, the holder can give the bond to its counter party in exchange for the face amount of the bond. In essence, the parties have "swapped" the risk of default. The extent of this market is quite large. There is no requirement that one actually own the underlying credit instrument in order to purchase a credit default swap. Indeed, the nominal value of credit default swaps is more than $60 trillion, far greater than the amount of debt outstanding.

Credit default sways are in the first instance merely another way for a lender to reduce its risk exposure, just as lenders do with the syndication process. Just as a bank faces less risk when it only has a piece of a $200 million loan than when it funds the entire loan itself, a bank that buys a credit default swap reduces its exposure to an even greater degree. Indeed, the advocates for credit default swaps argue that they promise to bring stability to the banking system. Banks by and large remain the originators of large loans. Private institutions such as hedge funds simply do not (at least yet) have the back office operations necessary to service a large loan. Credit default swaps allow the banks to off load some the risk of default outside the banking system. By removing risk from the banking system, this should bolster the banks' position should the economy hit a downturn.[34]

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

When a lender purchases a credit default swap, however, it retains the control rights that accompany the loan. If a waiver of an event of default is needed, the holder of the loan is free to vote as it sees fit. But now its economic interest has changed. In the extreme case, if the lender

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[34] Indeed, the proponents of credit default swaps have touted their ability to reduce the risk to the banking system.

has purchased more credit default swaps than it has at risk in terms of the loan itself, it may be the case that it will be to its financial advantage if the loan goes into default. While such a default and subsequent bankruptcy case may provide a lower return on its debt instrument than it would have received had the debtor procured a waiver, it may more than make up for this by collecting on its credit default swap contract.[35]

Moreover, there is no public record of who has purchased a credit default swap. In the bankruptcy proceeding, all holders of claims and interests have to file their claims and interests with the bankruptcy court. While it sometimes becomes unclear exactly who owns what, there is some information as to who holds the debtor's financial instruments. But since credit default swaps are private transactions, there is no way to know what the true financial incentives of any one is. A hedge fund that holds a large loan position that it has acquired in the secondary market may in fact be net short.

Credit default swaps, however, create a moral hazard problem only before the Chapter 11 begins and then in its immediate aftermath. A Chapter 11 case is a "credit event" that terminates the swap. The accounts are settled up and the control of the claim against the debtor soon is again placed in the hands of the person who holds the economic interest in it. Credit default swaps may seriously complicate (and potentially even distort) workouts that take place before a "credit event," but they are likely to matter in Chapter 11 only if crucial decisions are made at the start of the case and no one else is minding the store. But even if problems with credit derivatives are absent in the typical large Chapter 11, there may be cases in which it matters enormously. Much of the action in a large case takes place on the first day. Many issues—from the approval of the dip financing to the composition of the creditors' committee—are resolved in the first month. In some cases, the entire case is effectively wrapped up within 60 days. A case can arise in which the process of closing out positions takes place while the major controver-

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[35] Part of the standard credit default sway requires that the protection buyer deliver the underlying loan to the protection seller. The protection seller will now have the incentive, all else being equal, of maximizing the value of the loan. By this point, however, the borrower may be in bankruptcy.

sies in the Chapter 11 are being resolved and those who will be left holding the bag are left out of the process. Credit derivatives may trade multiple times, but a credit derivative is only as good as the counterparty that issues it. If there are enough credit events across enough different firms, sorting out who ultimately takes the fall when some counterparties prove insolvent may need to be done at the same time that various Chapter 11s are already in motion.

C. Total Return Swaps

The total return swap allows an investor (typically an SIV that is buying a portfolio of loans) to enjoy the economic rights associated without the control rights. In these cases, the contracts are not settled in the event of default. These are cases in which the owner of record is not the person with the economic interest and the holder of the economic interest is hidden from the rest of the world. The potential abuses of empty voting and hidden ownership are kept in check by the absence of any incentive on the part of the party that holds the economic interest in the claim to exercise it in a way that runs contrary to the interests of its counterparty. Again, this party will likely be a bank. It is a repeat player that has transferred a portfolio of loans to the special purpose entity. It is not a strategic investor who has another agenda. It faces a reputational penalty if it does something other than its counterparty's bidding. The risk here is not so much that the bank will vote contrary to its counterparty's interest, but rather that those with the economic interest to exercise controls right in the process that leads up to the plan and the vote will not have the knowledge or the expertise and that the bank will not have the incentive.

Over time, this problem may prove self-correcting. Those in charge of the SIV typically have the ability to sell the swap and those who value it most highly are likely to be the distressed debt professionals who will have both the expertise and the incentive to be active in the case. They too, of course, must rely on the willingness of the record owner to act as they wish, but in the typical case the record owner will have no reason not to do so and, to the extent that the tension exists, there will again be incentives for parties to recombine the control and formal

ownership. Winners and losers, however, may appear while this is being sorted out.

III. Information and Control

A. Wearing Multiple Hats

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

Hedge funds transform this schematic. Not only can a hedge fund buy into any part of a company's capital structure, but it can buy into multiple parts of the capital structure. Again, one can tell a good story and a bad story. The good story would be that the hedge fund could acquire a position so that its economic interest was coextensive with the interest of the corporation. By holding slices throughout the capital structure, the hedge fund could focus on maximizing enterprise value rather than only maximizing the value of its investment. To be sure, one way an investor can maximize the value of its investment is through maximizing the value of the business. Still, when an investor only holds a slice we worry that it will attempt to increase its slice by reducing the return to others.

Yet one can tell a bad story as well. For example, consider a company that files for bankruptcy. A hedge could, on the quiet, buy up a large portion of the unsecured debt. At the time, the equity is trading for trivial amounts. The hedge fund then buys up a large portion of the equity and makes this purchase public. Other investors, thinking that the hedge fund believes that there is value in the equity, reacts by bidding up the price of the unsecured debt. Surely if the smart money thinks that equity is the place to be, the unsecured debt must be a relatively safe investment.

Still, it may be the case that the hedge fund saw no value in the equity. The purchase of the equity was simply a loss leader. It can easily recover the money spent on the equity through the increase in the prices of its bonds. Indeed, no one may ever know that the fund ever held the bonds. It can both buy and sell the bonds in anonymity.

Other problems can exist as well. Chapter 11 is designed to be a bargaining process. As we have seen, hedge funds can pretermit this process to the extent that they can gain control over the company. But other times they cannot. Here, parties are assigned rights based on the investment they hold. But again the Code assumes that the investor's economic interest is directly related to the claim that she holds. One person on the creditor committee could actually be net short. She could then take an aggressive stand in the guise of promoting her investment, but in truth be seeking to ensure that no agreement is ever reached.

What if the hedge fund has a big investment in a competitor of the debtor? The competitor may benefit from the debtor's demise. The hedge fund could use its rights under the Bankruptcy Code to slow down and perhaps ultimately undermine the reorganization. We tend to assign control rights and cash flow rights together. Yet the incredible liquidity and secrecy that hedge funds bring to the process undermine these assumptions. Cash flow rights and control rights are parceled out in an infinite variety of ways. Many of the hedge funds are seeking to gain any advantage that they can.[36] To be sure, there often is more to be made by increasing the value of the pie rather than reallocating its slices. To the extent that a hedge fund can get a big enough interest, it may

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[36] Of course this is not limited to bankruptcy or even financial distress. Bernie Black and Henry Hu have demonstrated "empty voting," which is another manifestation of the same problem. See Henry T.C. Hu & Bernard S. Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Business Lawyer 1011 (2006). Recently, they too have recognized that the same problem extends to all types of investments. Henry T.C. Hu & Bernard S. Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. Pa. L. Rev. 625 (2008). The hedge fund buying the right to vote the shares has an economic interest that runs directly counter to those who hold the economic interest in the shares.

be good. But in some cases it may not be possible to rearrange the interests. The cash flow rights and the control rights may have been scattered in such a way that the transaction costs of putting them back together exceeds any gains that could be had.

This is an anti-commons problem. To return to the analogy of assembling the city block, even after one goes through the land records and figures out who holds what sort of interest, the interests are not homogenous. The person who holds a lease that expires in five years is in a completely different position from a landlord who owns the reversion.

Chapter 11 was created under the assumption that one could sensibly decide the fate of a firm by organizing claims against the firm into discrete classes. To solve the collective action problem, it provides that a supermajority vote binds dissident minority shareholders. As investors, the interests of all the claimholders in a particular class are presumptively aligned. An opportunity for strategic behavior does arise. A creditor who controls one class of claims can promote a plan that favors one class and disadvantages another by buying enough votes in the other class to ensure that other class approves the plan.

The opportunities for profiting from such activity in the traditional context are comparatively modest. To obtain the consent of the disadvantaged class, one needs to buy two-thirds of it. The amount it costs to buy out the two-thirds majority (and receive comparatively little for these claims under a plan that favors another class at the expense of this one) is likely to exceed whatever benefit it gets by squeezing out the minority interest. Indeed, the common case in which we see one class buying up a controlling interest in a junior class are ones in which the old equityholders are still in control and want to put in place a plan that favors them but is inefficient. The equityholders want to roll the dice by taking a rental apartment building condo. The senior creditors are severely disadvantage by this plan. To prevent its adoption, the seniors buy up all the claims in the junior class of creditors for 100 cents on the

dollar. The seniors are indeed acting strategically, but only to counteract out-of-the-money investors' ability to undercompensate them.[37]

The ability to separate ownership and control right, as well as the ability to short, increases the possibility of strategic behavior. By obtaining a blocking position in one class, an investor can thwart a reorganization and drive down the value of the debt. By shorting enough debt, such a strategy could in principle be profitable. Similarly, an investor in control of one class could acquire voting rights (but not the economic interest) of a class that is made worse off by the plan. Financial innovation has made naked shorting of debt possible. Similarly, total return swaps and other transactions make it possible to acquire the ability to vote on plans without holding the underlying economic stake.

In equilibrium in a well-functioning market, of course, such strategic behavior should not happen. The counterparty to the naked short would take steps to prevent such misbehavior or refuse to enter into the transaction altogether. Similarly, the person holding the economic interest would ensure that the person holding the vote did not engage in misbehavior. In addition, the bankruptcy judge possesses the ability to prevent such advantage-taking by disqualifying (or "designating") votes cast in bad faith or even equitably subordinating claims. There is relatively little law here, but it seems possible that judges will become more willing to exercise this power if they discover creditors amass complicated positions and use the rights they acquire to vote strategically. Investors are especially likely to encounter trouble if they sit on a committee, sit on the board, or otherwise are found to have fiduciary duties.[38] Indeed, there is some chance that the largest problem will not arise from actual strategic misbehavior itself, but from false positives—

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[37] See Figter, Ltd. v. Teachers Insurance & Annuity Association, 118 F.3d 635 (9th Cir. 1997).

[38] See Citicorp Venture Capital, Ltd v. Committee of Creditors Holding Unsecured Claims (In re Papercraft), 323 F.3d 228 (3d Cir 2003). For an excellent discussion of these dynamics, see Daniel Sullivan, Big Boys and Chinese Walls, 75 U. Chi. L. Rev. 533 (2008).

cases in which parties argue that another has manipulated the Chapter 11 process and should on that account have its vote designated.[39]

B. Information and Disclosure

Swirling around all of these developments are questions of information. One question goes to who owns what. A single hedge fund can buy any or all of the products spawned in today's financial marketplace. While there is a public record of who owns a debtor's stock, it is often less clear as to which institutions actually own loans or claims. The original holder of the claim has to file a proof of claim in the bankruptcy proceeding unless the debtor lists the creditor on its schedule. As these claims trade hands, however, it often becomes quite murky as to who the players actually are. Hedge funds often do not announce that they are seeking to purchase claims. Such an announcement would simply drive up the price of the claims that they wish to purchase. To guard their anonymity, buyers of claims often establish a new entity. The only task of this entity is to buy claims in a given bankruptcy case. The name of the entity gives no clue as to who the ultimate owner is.

A recent skirmish in the bankruptcy case of Northwest Airlines illustrates the extent to which the players in the new world of bankruptcy wish to keep their actions as private as possible.[40] A group of hedge funds who were buying the shares of Northwest formed an ad hoc equity committee. They formed the committee in order to coordinate their actions, but they decided not to seek official status from the bankruptcy court. They eschewed such status even though official status would allow them to seek reimbursement for their expenses, including profes-

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[39] A possible example is *Allegheny*, a case in which an outsider acquired control by buying up shares in much the fashion of a corporate raider outside of bankruptcy. See In re Allegheny International, Inc., 118 Bank. 282 (Bankr. W.D. Pa. 1990). This case arose in the 1980s and may no longer reflect current practice, at least when the investor acts at arm's length and owes neither the debtor nor the creditors' committee a fiduciary duty.

[40] In re Northwest Airlines Corp, 363 Bankr. 701, 704 (Bankr. S.D.N.Y. 2007).

sional fees. The reason is that they did not wish to disclose their holding.

In that case, the bankruptcy court held that Bankruptcy Rule 2019 required the members of the ad hoc committee to disclose their holdings, when they acquired them, and what they had paid for them. It was precisely to evade this requirement that the hedge funds had not sought official status. Both the hedge funds themselves and two trade groups dominated by hedge funds appealed this ruling, arguing that this ruling presents hedge funds with the draconian choice of either disclosing what they view as proprietary information or not participating in the bankruptcy. While the matter remains in litigation, the fervor with which the hedge fund community has opposed this order indicates the value that hedge funds attached to keep the details of their transactions quiet.

This quest for opaqueness makes it somewhere between difficult and impossible to assess a party's true economic interest. First, a hedge fund can buy into multiple parts of the capital structure. Investors seek to promote the interests of the investment that they hold. But when a hedge holds multiple investments, it only seeks to promote its total return; it cares little about how that return is allocated among its various investments. In some situations, it may be beneficial for the hedge fund to press for a lower return on one of its investments in order to secure a higher return on another one. Indeed, it may have bought the one investment precisely in order to gain leverage so that it could increase the return on a different instrument.

Finally there is the question of private information about the debtor. Covenants in credit agreements often provide private lenders with access to greater information than is otherwise publicly available.[41] The debtor is generally required to provide information when the lender re-

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[41] A recent paper suggests that institutional investors can use information gleaned from a loan to trade profitably in equity of other companies whose returns are correlated with that of the company whose loan it holds. See Victoria Ivashina & Zheng Sun, Institutional Investors and Loan Market Information Spill Over, Feb. 2007 draft.

quests it. This access to information is generally thought to be necessary for the lender to monitor the debtor effectively.

Difficulties arise, however, when the debtor becomes financially distressed. In workout negotiations, the banks and other large investors are supplied with large amounts of information about the debtor and its business. They retain, with the debtor's agreement and at its expense, legal and financial advisors to help them evaluate the information and alternative restructuring plans. The lender may have the right under the lending contract to talk with any member of the management team or any employee of the company, and the debtor provides the creditor groups and their advisors with direct access to its books, records, and employees for the purposes of permitting them to evaluate the company and its restructuring proposals. The managers, with the assistance of their own financial advisor, accounting firm, and turnaround experts, develops a long-range plan for the business, which includes detailed projected cash flows and estimates of debt capacity.

Once the debtor files for bankruptcy and creditors' committees are formed, these committees also receive nonpublic information. The debtor is trying to secure their consent to its reorganization efforts, and in doing so is offering its own financial projections that are not otherwise publicly available. Indeed, it is the duty of the committee to promote the interests of the creditors it represents, and the most effective way to discharge this duty is to aggressively gather information about the debtor's prospects.

The challenge is that institutions such as hedge funds may be both privy to private information and actively engaged in trading claims. Some devices have been developed to attempt to mitigate the potential for abuse. In terms of bank loans, when a party buys a piece of a bank loan, it can now choose whether its investment is on the public side or the private side. The lead bank will establish a virtual room where it places the information that it has about the borrower that it makes available to syndicate members. The information that any loan owner can access will depend on whether it is on the private side or the public side. To the extent that an institution is actively trading in the securities

of the company, the expectation is that it will limit itself to the public information.

A similar situation exists in bankruptcy. The court will often issue an order requiring that, if a hedge fund is serving on the creditors' committee, there has to be a wall between those with private information that they obtain by virtue of their committee service and those who are engaged in the trading.

The question, of course, is who polices these mechanisms. To the extent the hedge funds assiduously buy only on the public side when they want to trade in the debtor's securities, and to the extent that they ensure that no information seeps from those on the creditors' committee to those trading in the debtor's securities, we would worry less about potentials for abuse. We have little data, however, on how scrupulously all of the participants in the new environment hew to these requirements.

The differing levels of information in today's bankruptcy environment have led to the creation of so-called "Big Boy" letters.[42] Just as the five-year-old seeking new responsibilities attests that he is a "big boy," so too an investor can give up any right he might have to complain that he was taken advantage of by signing a letter to the effect that he is acquiring a claim where his trading opposite has private information and he is willing to accept whatever risks come with nondisclosure.[43] A Big Boy letter basically acknowledges that the person buying the claim un-

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[42] See Sullivan, supra note 38.

[43] Section 29(a) of the '34 Act prohibits the waiver of rights, but Big Boy letters might prevent those wishing to bring a 10b-5 from asserting the reliance that is an essential element of the claim. See Harsco Corp v. Segui, 91 F.3d 337, 341–48 (2d Cir. 1996); Jensen v Kimble, 1 F.3d 1073, 1074 (10th Cir. 1993). But see AES Corp. v. Dow Chemical Co., 325 F3d 174, 180 (3d Cir 2003). For a discussion, see M. Todd Henderson, Deconstructing Duff and Phelps, 74 U. Chi. L. Rev. 1739 (2007). Whether the claims transferred in bankruptcy are "securities" within the meaning the '34 Act is unclear. See Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 Am. Bankr. Inst. L. Rev. 569, 569 n.1 (Winter 2002). Also unclear is the bankruptcy court's equitable power to fashion regulations inside of bankruptcy analogous to Rule 10b-5.

derstands that the seller may have private information about the company that the seller is not disclosing. The buyer, however, is a "big boy" and promises that he will not sue based on this potential informational disparity. This big boy language has become so ubiquitous in trading claims and bank debt that its inclusion accompanying a trade does not necessarily signal that the seller in fact has private information.

The most immediate problem that we face is not in the Bankruptcy Code itself or any particular requirement. Through a wide variety of devices—from the discretion to approve a sale under §363 to the ability to designate votes under §1126—the bankruptcy judge has the power to curb abuse and prevent misbehavior. The difficulty is that there is not yet a clear understanding as to what counts as misbehavior and one can doubt that the bankruptcy judge is going to be well-positioned to identify it. But today's bankruptcy judges are a new breed. They do not assume they know what is fair and just in a corporate reorganization. They are more comfortable with the idea that, subject to the specific substantive rules placed in the Bankruptcy Code and elsewhere, their job is to vindicate the ex parte bargain among investors. The challenge they face is trying to understand their role as market-maker. On the one hand, market-makers, whether the Chicago Board of Trade or a medieval fair, do not do the actual bargaining, but merely provide the forum. On the other hand, part of creating a market is establishing the procedures and terms of trade to which all the players must bind themselves.

One can draw some general lessons that seem almost universal and they underscore the tension at work. Market-makers often qualify those who can trade. Those who wish to trade must identify themselves and establish their bona fides. On the other hand, they are not necessarily required to reveal on whose behalf they are trading. An agent with an undisclosed principal is liable, but there is no duty to disclose the identity of the principal. The market-maker can set the terms and conditions of trade, such as when trade make take place or the date by which accounts must be settled, but she does not set prices. Fraud is never permitted, but complete disclosure is never required. What is less clear is precisely the issue of how much disclosure is required. The pervasive theme, however, is whether the disclosure in question facilitates trade

and promotes agreement that is mutually beneficial. Too much disclosure can be as bad as too little. A world in which parties are required to disclose whatever they know and all things are common knowledge is a world in which no trade takes place at all. In the end, the bankruptcy judge should be guided by the right question—not whether a particular disclosure seems fair, but rather whether it is necessary to make the market, that is the bargaining process, work.

IV. Coalition Formation and the Problem of the Empty Core

The large firm that finds itself today in Chapter 11 seems to face few of the obstacles—high transaction costs and an abundance of private information—that might have prevented consensual agreement in earlier times. The key players are not hapless public investors, but sophisticated parties who have invested in this business because of the special expertise they bring. They want to be at the bargaining table. After control rights are properly defined and sensible disclosure rules are in place, it might seem that the bankruptcy judge needs to do relatively little other than provide rules that make trade reliable and transparent and a mechanism for resolving the disputes that arise. The chance of bargaining failure seems low. The players should reach agreement among themselves and the bankruptcy judge will have little more to do other than bless the agreement and adjudicate disputes among some of the players. But matters are not so simple.

Ironically, precisely here—a world in which everyone brings special expertise to the bargaining table and negotiates in an environment that is virtually frictionless—that a new difficulty arises. The parties must form a coalition around one of many possible agreements. In the past, parties came together around established focal points.[44] Conventions emerged and coalitions formed along predictable lines. In the round of Chapter 11s in the early 2000s, for example, it was manifest that out-of-the-money equity received nothing and played no role at the bargaining

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[44] For a discussion of how focal points play an important role in the context of bargaining between two parties, see H. Peyton Young, The Economics of Convention, 10 J. Econ. Perspectives 105, 116–21 (Spring 1996).

table. Plans that included equity, in the ordinary case, were no longer on the table.[45] Plans might include features that were in tension with appellate court decisions (such as the pervasive use of substantive consolidation), but as long as everyone at the table understood that the plan would have this element, it caused few problems. Whether a feature of a plan was embedded in blackletter law or even known to anyone else was not essential. As long as the repeat players who sat at the reorganization table knew it, that was enough.[46]

With the proliferation of new players and the introduction of new financial instruments, the old focal points may have disappeared. Reaching agreement is likely to become much harder, even though transaction costs are lower and information complete.[47] FiberMark shows how the problem of coalition formation may be larger now than it once was. FiberMark was a specialty producer of paper products based in Vermont. The company had been formed in 1989 by a man-

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[45] See Baird & Rasmussen, supra note 4, at 692.

[46] Many practices in modern Chapter 11 are well-known to insiders, but inaccessible to anyone else. For example, the fees of the indenture trustee are always paid, even though the Bankruptcy Code allows such fees only in the event of a "substantial contribution" in a case, 11 U.S.C. §503(b)(5). Experienced lawyers know not expend any energy on them. They are routinely, indeed invariably, included in the plan, without inquiry in to whether the indenture trustee's contribution was in fact "substantial." Junior associates sometimes find out about this feature of modern bankruptcy practice in a hazing ritual akin to the one in which the newest apprentice in a French restaurant is sent to retrieve soufflé weights lent to a rival. Aspiring bankruptcy lawyers are instructed to go to plan negotiations and to be unyielding on the question of allowing fees for the indenture trustee, only to be surprised when they are not taken seriously.

[47] Barry Adler has proposed a reorganization mechanism in which junior creditors propose a plan in which the senior creditor is given a take-it-or-leave-it offer. Such a mechanism might avoid an empty core problem. See Barry E. Adler, Game-Theoretic Bankruptcy Valuation (December 28, 2006) (New York University, Law & Economics Research Paper Series) (available at SSRN: http://ssrn.com/abstract=954147).

agement led buyout of a division of Boise Cascade.[48] The capital structure of the company was relatively simple. It had a secured credit facility of $85 million. Throughout the events surrounding FiberMark's financial distress, it was clear that the company had more than sufficient assets to pay off the facility in full, and the secured lender, GE Capital, did not play a role in the ultimate fight that erupted. The bulk of the rest of FiberMark's financing was through public bonds. These bonds had a face amount of $350 million. The remaining unsecured debt was roughly $17 million. In light of this capital structure, it was clear that whoever controlled the bond debt would control the outcome of the case. It was the fulcrum security.

While GE Capital may have had the ability to oust current management if it chose to do so, it had no economic reason to seek a change of control. The value of the business was sufficiently large and that the debtor even in bankruptcy would likely have been able to find a lender willing to lend enough to pay off GE Capital and take its place, albeit perhaps under different and less favorable terms. The value of the assets was such that there was little threat that the senior loan would not be repaid in full. The holders of the public debt, however, did not have the ability wrest control of the company away from its existing management team.

Looking at this capital structure, there was thus a concentrated interest at the senior level. Moreover, the equity interest was closely held as well. To the extent that there may have been a large number of investors, they would have been found in the public debt. Yet, as we will see shortly, this public debt became closely held as well, with over eighty percent of the bonds held by just three investors, all of which were hedge funds.

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[48] Almost half of the company's revenues came from overseas. FiberMark's foreign subsidiaries, however, remained outside of insolvency proceedings. To finance the foreign operations, the foreign subsidiaries obtained direct loans from a foreign bank and, as part of the debtor-in-possession financing package, FiberMark guaranteed the loan. This pattern of handling the financial distress of a transnational enterprise in a single court is quite common.

It might seem that things should go smoothly, but they did not. The company filed for bankruptcy in March 2004, and the company emerged over a year and a half later in November 2005. What took so long with what should have been a relatively straightforward process? The answer is that the reorganization proceeding eventually became brutal fight among three hedge funds that was only settled after the bankruptcy court intervened and appointed an examiner to investigate them.

Two of the hedge funds, AIG Global Investment Corporation and Post Advisory Group, acquired FiberMark bonds well in advance of bankruptcy. At the time that the bankruptcy petition was filed, AIG had about 19% of the outstanding notes and Post held another 15% of the notes. Neither acquired any more notes during the case. They thus had over a third of the outstanding notes at the time the case began (which meant that there would not be a consensual reorganization plan without their approval), and both were appointed to serve on the creditors' committee. The indenture trustee for the notes and a trade creditor holding a $50,000 claim were also appointed to the committee.[49]

Because the other creditors were not active, Post and especially AIG believed that they could control FiberMark and its reorganization. The representative of AIG dominated the creditors' committee. He took an active role in the case, worried about the amount of money being spent and tried to direct the actions of the managers on the theory that the public debt holders were the residual claimants. At the beginning of the proceeding, he favored a quick plan that basically wiped out the equity and converted the debt to equity. Such a course of action would have left AIG as the largest shareholder and firmly in control of the business. He made it clear that he had no confidence in the CEO.

AIG and Post were surprised to learn in the summer of 2004 that Silver Point had begun acquiring notes shortly before the case began and continued to do so while the case proceeded and already had acquired 35% of the bonds. (This ability to acquire such a significant stake

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[49] The trade creditor eventually sold its claim to Silver Point. As part of the sale, the trade creditor agreed to remain on the creditors' committee as an agent of Silver Point. Report at 10.

in the company without attracting the attention of other major investors illustrates how opaque the claims trading market can be, even to those who participate in it on a regular basis.) Silver Point was then asked to join the creditors' committee.

The drama of the case—one that lasted many months—consisted largely of the negotiations among the three hedge funds on a corporate governance agreement as to how the company was to be run after bankruptcy. Silver Point's arrival drastically altered the expectations of AIG and Post. Before they knew of Silver Point's investments in FiberMark, they believed that they would end up with de facto control of the reorganized company. Silver Point's large stake and intent to continue purchasing bonds made it clear that Silver Point would be the controlling shareholder of any reorganized company. Once AIG and Post saw the changed landscape, they focused on minimizing the power that Silver Point would have as the controlling shareholder of the reorganized FiberMark. (Indeed, it appears the Silver Point eventually acquired more than 50% of the outstanding bonds. The three hedge funds by the end of the case held well over 80% of the unsecured debt.[50])

When Silver Point came into the picture, the prospects for a quick reorganization evaporated. Basically, the three hedge funds could never reach agreement among themselves as to the respective rights of the three running the company post petition. What had been a corporate reorganization transformed itself into an ugly take-over battle in which AIG and Post, like entrenched board members, used their position on the creditors' committee to further their own interests rather than to advance the interest of the creditors as a group.[51]

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[50] Much of the remainder of the debt appears to have been held by hedge funds as well. Four hedge funds that held over 10% of the notes objected to the plan, but the court overruled these objections.

[51] The dealings among the three hedge funds became so acrimonious that the bankruptcy court appointed an examiner to investigate the situation. The impetus for the appointment was that AIG alleged that Silver Point had violated the court's trading order. The court selected Harvey Miller, perhaps the most noted bankruptcy attorney in the country to investigate the matter. Mil-

In FiberMark, the parties reached agreement only after a blistering report issued by the court-appointed examiner. To be sure, the parties involved took issue with many of the findings of the report, but it does seem that the highly public report refocused the parties' negotiations. It resulted in an agreement under which Silver Point bought out the interests of the other hedge funds as well as the notes held by other investors. *FiberMark* illustrates both the potential and perils of a world in which the liquidity of claims itself makes coalition building difficult.

Transaction costs do not drive this problem, but rather the difficulties associated with coalition formation. Consider the following hypothetical. There are four creditors, all of them at the same priority level. Each is a distressed debt professional who holds 25% of the outstanding debt, all of which is unsecured. None of them brings any special value to the business. Under these facts, there is no efficiency loss from any one plan coming into being rather than any other. But the plan does matter to the parties themselves. Section 1129 of the Bankruptcy Code allows any of the three to form a coalition in which they can cramdown a plan on the fourth. Various rules in the Bankruptcy Code try to ensure that similar claims are treated alike, but it is hard to bring this about in practice. For example, the plan of reorganization can provide that each receives 25% of the equity, but, as in FiberMark, the three plan proponents can effectively divide rights among themselves in a way that leaves the fourth in the unhappy position of a powerless minority shareholder in a closely held corporation.

Let us assume that Firm is worth $14 and that any three of the creditors can form a coalition in which they divide $12 among themselves and leave $2 for the creditor that is left out. Here the core is empty. The creditor who is left out of the coalition can propose a deal that gives two members of the coalition more and still be better off than if left out of the deal entirely. We face a danger that the bankruptcy process degenerates into repeated and costly attempts at coalition building.

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ler's report provides unique insight to some of the problems likely to arise in the new environment in which Chapter 11 now finds itself.

In an earlier era, one in which the dominant issue in corporate reorganizations is the collective action problem, the challenge of bringing diverse stakeholders together, this sort of problem may have not loomed large. The costs of putting together any coalition were sufficiently high that once a coalition formed, it was unlikely that anyone else would be sufficiently organized to break it up. Transaction costs and the frictions they cause kept the problem at bay. The dramatic decline in transaction costs and the ability of investors to interact with each other at low cost, however, now makes the empty core a problem one worth taking seriously.

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

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

little sympathy for interpretations that are out of step with what seems the plain language of the statute.

Under these facts, it might seem that the judge should simply put a gun to the parties' heads and threaten to sell the firm to the highest bidder if the parties cannot reach agreement within an hour. Milton Pollock did essentially this in the bankruptcy of Drexel Burnham. Parties found the judge's threat credible and feared that a sale would make them all worse off (believing that the assets, in particular junk bonds, were worth far more than the market would pay for them). Notwithstanding weeks of deadlock, they locked themselves in a conference room and reached an agreement that was scribbled on a yellow legal pad and initialed by each of the parties just before time expired.

The use of this "nuclear" option may be a way to induce agreement, and the threat may only rarely need to be carried out. Moreover, little going-concern value may have been at risk in many cases. The social cost of carrying out the threat may be small. Again, the assets involved in Drexel were securities. Even if the market undervalued them, there is no social loss associated with selling them quickly. But we need to consider the cases in which there are a variety of different plans and only one of them preserves going-concern value. In such cases, relying on the parties to reach agreement has its greatest value. When the parties themselves know the highest and best use of the assets, but others do not, inducing such an agreement may be the best way to maximize the value of the assets.

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

HedgeFund, Supplier, and Manager all bring value to the business. HedgeFund knows how to reshape and modify the business plan in a

way that puts Firm back on track. Supplier provides a crucial component and has expertise in designing the next generation of the product. Manager knows the customer base and the best way to operate the business. If all three agree to work together, Firm is worth $24. Any of the two, however, could also work together and bring added value to Firm. HedgeFund and Manager could work together and realize $22, less $3 they must give Supplier if it is left out. Similarly, Supplier and Manager will realize $20 less $10 they must give HedgeFund if it is left out. Finally, HedgeFund and Supplier could reach a deal with each other, realize $21 and exclude Manager. (Manager would still capture the $2 she would get in the event of a liquidation, but $21 would still be left over.) All this is known to the parties, but not to the bankruptcy judge or to outsiders.

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

Assume, for example, that a plan is put forward in which HedgeFund, Supplier, and Manager join forces and HedgeFund receives $13, Supplier receives $6, and Manager receives $5. They are all receiving more than they would in the event of a liquidation of Firm, but it is not a plan that the parties will agree on. Supplier, for example, rather than accepting this deal can propose to HedgeFund that they dump Manager and that HedgeFund take $14, leaving $7 for itself. HedgeFund and Supplier are both better off than they would be if they joined forces with Manager. Such a deal is not stable either: Manager would go to HedgeFund and suggest that it dump Supplier. Manager could offer HedgeFund a share of $16 and still leave $3 for itself. Supplier in turn could bribe either Manager or HedgeFund to abandon this coalition, and so

forth. Under these assumptions, the core is empty. There is no agreement among the players that is a stable equilibrium.[52]

This hypothetical is, of course, only that. We still need to know whether the problem of the empty core is one worth worrying about in practice. The empty core exists in our example only because HedgeFund, Supplier, and Manager each bring value to the business. Take away the synergy and the core ceases to be empty. As we have discussed elsewhere, modern firms have relatively little value as going concerns. There are few railroads today. The typical large firm can be sold as a going concern. Rarely will a major investor, supplier, and manager all contribute substantial value to the business. Moreover, in those cases in which such synergies exist, as they might in some high technology ventures, the players have a strong incentive to prevent a capital structure from arising that, in bad states of the world, allows the core to be empty. Again, capital structures, like cars, are now designed with failure in mind.

Nevertheless, paying attention to how coalitions come into being should inform our understanding of the Bankruptcy Code. As noted above, rules on solicitation can exacerbate the empty core problem, but others can reduce it. A judge who worried about the empty core will, for example, be more vigilant in enforcing the rules of the classification of claims and ensuring that claims in the same class are treated similarly. A judge who prevented side deals on governance rights, such as the one we saw in the first hypothetical, would make it more likely parties would reach a deal.

Another example of a rule that might prevent the core from being empty is the one that gives the existing managers of the firm the exclusive right to propose a plan of reorganization at the outset of the case. This rule effectively removes one possible coalition from the table in our second hypothetical. (This is the coalition between HedgeFund and Supplier that eliminates Manager.) Eliminating some coalitions may increase the chance that the core is not empty. This is the case with our

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[52] For a discussion and formal proof of the conditions necessary under these assumptions, see Aivazian & Callen, supra note 6, at 179–80.

example there is the equilibrium plan in which Manager is given $10, HedgeFund $10, and Supplier $4. Neither HedgeFund nor Supplier can do a deal with Manager in which Manager receives more than $10 and either is left with more than it receives in the proposed plan. HedgeFund and Supplier could, of course, do much better if they were able to propose a plan that excluded Manager, but the exclusivity rule prevents this from opening and thereby creates an equilibrium solution. The rule of *Northern Pacific Railway v. Boyd* might also prohibit the deal between HedgeFund and Manager, if Manager were also the owner of the business.

The problem of the empty core cannot, of course, provide a complete justification for either rule. These rules serve other functions and may compromise other goals of bankruptcy policy. Moreover, it is a rationale that depends crucially on each of the players bringing something to the table. When they do not, rules such as the one in *Boyd*, may have the effect of making bargaining harder rather than easier. Nevertheless, looking at the Bankruptcy Code and asking whether it promotes or impedes coalition-building is an inquiry that has been too long neglected.

V. Conclusion

Judges are quite likely to follow the lead of professional investors when they present a united front. Modern judges are likely to enforce intercreditor agreements as written, but in a world in which the financial instruments are new, the agreements are likely incomplete and some recourse to gap-filling is necessary. While things will sort themselves out eventually, life is not going to be easy during the interim. Perhaps the most important thing that courts can do in fashioning rules is ensuring that whatever is put is place gives clear benchmarks that future investors can use to navigate their way. The current disequilibrium is the result of instruments that have already been written. Investment going forward will use different and improved ones. What may matter most is the ability of different investors to write new ones, learning from past mistakes and being able to predict how judges will respond to new provisions.

The larger lesson is a more general one. The life blood of corporate reorganizations is and always has been negotiation. Creating the optimal environment for facilitating such negotiations is the principal business of those who shape the law. The conventional wisdom has long recognized a number of features that the law should have. The bargaining environment needs to be one in which transaction costs are low. Bargaining for its own sake is a cost, not a benefit. The bankruptcy judge in the first instance is a market-maker who is bringing together different stakeholders. Second, bargaining becomes easier the easier it is to tell who own what. Bankruptcy law should make it easy for parties to understand both the substantive rights they hold and the procedures that will be used to vindicate them. There is no virtue in priority rules that are fuzzy or procedures that are clouded in mystery. Some aspects of the bankruptcy process—in particular the valuation mechanism employed to establish the relative rights of the parties—are necessary imperfect and uncertainty, but the closer these mechanisms track those that private parties would adopt in an ex ante bargain, the easier it will be for parties to reach an agreement in their shadow.

The most direct lesson of all this for the bankruptcy judge is likely one that the best have intuited long ago: She should not interpret the Bankruptcy Code in a way that creates an empty core, that leads to a bargaining environment in which it is unlikely that a equilibrium plan exists. A simple and transparent bargaining environment in some cases may not be enough. Precisely because it is simple and transparent, there is an increased danger that parties will find it hard for stable coalitions to emerge. It also suggests that much of recent bankruptcy reform—changes that have added complexity to the Code and sought to corral the bankruptcy judge's discretion—are headed in the wrong direction. The problem of ensuring coalition formation requires giving bankruptcy judges more discretion, not less.

If past is prologue, the uncertainties that financial innovation brings with it are likely to be resolved satisfactorily, even if not immediately. We do not believe that this anti-commons problem—and the associated empty core problem that may come with it—will be an enduring feature of corporate finance, only that the next round of Chapter 11 will

revolve around these problems precisely because they are new. Our experience with large corporations competing in a market economy is only about a century and a half old. Capitalism is still very much a work in progress and the science of corporate finance in an early stage.