SHOULD AD HOC COMMITTEES HAVE FIDUCIARY DUTIES?: JUDICIAL REGULATION OF THE BANKRUPTCY MARKET

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SHOULD *AD HOC* COMMITTEES HAVE FIDUCIARY DUTIES?:
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This Article is the first to substantively and directly address the question of whether informal creditor groups in bankruptcy cases could and should have fiduciary duties to other creditors. The rise of activist investors and claims traders in bankruptcy proceedings has significantly changed the bankruptcy process, to much controversy. One particularly contentious topic is the growing presence of informal, or “ad hoc,” creditor groups. Proponents argue that these groups are beneficial by enabling creditors to work together efficiently and effectively, but critics view their actions as disruptive and often unfair to other creditors. A recent decision in the Washington Mutual reorganization surprised many practitioners by claiming that informal creditor groups may owe fiduciary duties to other creditors. Such a finding would significantly alter the dynamics, tactics and incentives of the parties in a bankruptcy proceeding. After proposing legal theories that could justify imposing fiduciary duties on informal creditor groups, this Article argues that there are nevertheless strong practical and normative reasons why a court should not choose to impose such duties.

Keywords: bankruptcy, restructuring, distressed investing, claims trading, ad hoc committees, fiduciary duties, hedge funds, private equity, Washington Mutual

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INTRODUCTION

One common understanding of bankruptcy law is that the Bankruptcy Code effectively solves a collective action problem.\(^1\) Absent bankruptcy law, multiple creditors facing an insolvent debtor would be forced to engage in a creditors’ race to extract whatever limited value is left in the debtor company before a competing creditor can do the same. This race to collect from an insufficient pot will destroy any synergies or going concern value gained from an intact company, resulting in diminished returns to creditors. Creditors could enter into sophisticated contracts in order to avoid the race and the resultant loss of value, but this would require significant time and expense. The Bankruptcy Code functions as the contractual bargain that the creditors would make, but does so more cheaply by avoiding transaction costs involved in negotiating for these results.

On the flip side, the Bankruptcy Code is seen as a way to provide distressed debtors some “breathing room” to sort out their financial situation, and to assist debtor companies in reorganizing and rehabilitating when possible. For a corporate debtor, as opposed to an individual debtor, the purpose is to maximize the company’s value, not merely to have it survive for its own sake.\(^2\)

The tension between debtors and creditors can be seen in the list of bankruptcy system goals provided by the National Bankruptcy Conference: “debtor rehabilitation, equal treatment of similarly situated creditors, equally well off.”

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\(^2\) See, e.g., Douglas Baird, *Elements of Bankruptcy* 59 (5th ed. 2010) (“In the case of an individual debtor, Chapter 7 . . . allows an individual to enjoy a new life free of the burdens of unmanageable debt. A corporation is different. We may care about the workers or the shareholders or the creditors, but the corporation itself is merely a legal fiction. It is not a sentient being, and there is no virtue in preserving a corporate charter for its own sake.”).
preservation of jobs, prevention of fraud and abuse, and economical insolvency administration.” Debtor rehabilitation helps the debtor and often its creditors as well; equal treatment of similarly situated creditors helps the group of creditors as a whole; preservation of jobs helps one group of creditors (the employees), the debtor (indirectly through rehabilitation), and the wider economy; prevention of fraud and abuse helps all parties; and economical insolvency administration helps everyone (but particularly creditors).

The common narrative is that the Bankruptcy Code strikes an appropriate balance between debtors and creditors, and is a system uniquely suited for situations involving multiple creditors. The judges are similar to referees in that they oversee the process, ensure that things go smoothly, and enforce the rules when necessary.

In recent years, however, professional distressed investors have become increasingly involved in bankruptcy proceedings. A prominent

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4 See, e.g., BARRY ADLER, DOUGLAS BAIRD & THOMAS JACKSON, BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 29 (4th ed. 2007) (“In short, the Bankruptcy Code serves three purposes: (1) saving creditors the costs of a destructive race to the debtor’s assets, (2) helping individuals overburdened with debt, and (3) reorganizing the capital structure of firms in financial distress.”).
5 Id. at 23 (“At its core, bankruptcy forces creditors to work together collectively. . . . When the creditors are diverse . . . cooperation [outside of bankruptcy] is often not possible. The creditors suffer from a collective action problem.”).
6 See, e.g., Letter from Hon. Robert E. Gerber, to the Advisory Committee on Bankruptcy Rules, re: Fed. R. Bankr. P. 2019, at 3-4 (Jan. 9, 2009), http://html.documation.com/cds/NCBJ2010/PDFs/017_6.pdf (“[A] major element of any bankruptcy judge's workload, at least in the larger cases, is on matters of discretion. We exercise our discretion to determine what is best for the future of the case—a decision that can involve a host of concerns, but which typically includes efforts to maximize the value of the estate, to maximize the ultimate return to creditors, and to save as many rank-and-file jobs as possible. On those discretionary calls, and there are many of them, stakeholders—including, and perhaps especially, distressed debt investors, or ad hoc committees—regularly weigh in.”). See also BAIRD, supra note 2, at 23 (“Modern bankruptcy judges . . . oversee the administration of the bankruptcy estate.”).
strategy is to purchase bankruptcy claims from smaller creditors and aggregate them to create a larger claim. Often, multiple investors, hedge funds and claims traders will work together in informal, or “ad hoc,” groups, sharing resources and cutting administrative costs. Many bankruptcy practitioners and commentators view these participants as disruptive of the traditional bankruptcy process, skewing the delicate balance created by the Code and enforced by the judges.\(^7\)

In order to counter the rise of activist bankruptcy investors, some judges have become more aggressive in reasserting judicial control over the bankruptcy proceedings. This has been accomplished in a number of different ways, including the enforcement of rules that had been unenforced for many years,\(^8\) the reapplication of the equitable subordination doctrine,\(^9\) and consideration of insider trading claims.\(^10\) In many ways, the recent judicial pushback against the rise of hedge funds and investor groups in bankruptcy proceedings can be characterized as a reassertion of the equity

\(^7\) A clear example of judicial distrust of hedge fund involvement is Judge Peck’s criticism of the Cyrus Fund in *In re ION Media Networks, Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009). The first sentence of the Judge’s opinion reveals this sentiment when it begins: “Cyrus Select Opportunities Master Fund Ltd. ("Cyrus") is an activist distressed investor that purchased certain deeply discounted second lien debt of ION Media Networks, Inc. . . . for pennies on the dollar”, *id.* at 588; and that “Cyrus is using the bankruptcy process to its own economic advantage”; *id.* at 589 n.1; although the price at which a claim was purchased is irrelevant. Further, the Wall Street Journal reported that in oral argument, according to a transcript, Judge Peck told Cyrus: “So you’re looking at a free shot to continue your terrorism in this case at different levels of the federal system?” to which Cyrus's lawyer responded: “Not at all, your honor, and from my client's perspective we object to the use of terrorism here.” Mike Spector and Tom McGinty, *Bankruptcy Court is Latest Battleground for Traders*, WALL STREET JOURNAL (Sept. 7, 2010), available at http://online.wsj.com/article/SB10001424052748703309704575413643530508422.html.


power of bankruptcy judges.\footnote{See 11 U.S.C. § 105(a) (“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.”).} There are many areas where bankruptcy judges are tasked with equitable decision-making.\footnote{Over subject matter that falls within their jurisdiction, bankruptcy judges have broad equitable powers. See, e.g., Pepper v. Litton, 308 U.S. 295, 304 (1939) (“By virtue of s 2 [of the Bankruptcy Act] a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the act, it applies the principles and rules of equity jurisprudence.”).} The Supreme Court has emphasized that the judge in a court of equity must ensure “that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done.”\footnote{Id. at 304-05.} While this power has never really been questioned, recent cases have seen judges asserting these equitable powers in new ways, in response to what they see as gamesmanship and misbehavior on the part of some investors.

One recent example of the courts exercising equity powers occurs in the possibility that informal creditor committees may have fiduciary duties towards other creditors. Hints of fiduciary duties owed by ad hoc groups appeared in dicta in a number of instances during the (now mostly resolved) Rule 2019 debates, specifically in the \textit{Northwest Airlines} case and, more directly, during the \textit{Washington Mutual} reorganization. A determination that informal creditor groups owe fiduciary duties to other creditors or to the bankruptcy estate would cause a significant shift in the dynamics of bankruptcy proceedings. On the surface, it seems clear that informal groups do \textit{not} have any duties to anyone besides their own members (if they even have that), since they are a self-created, ad hoc collection of creditors or interested parties acting on their own behalf and not claiming to represent anyone else. Yet because of the broad equitable power granted to the
judges, such duties may be imposed on them. A closer look at the cases that discuss potential fiduciary duties owed by these groups is warranted in order to understand if and how any duties may arise, and how the parties in a bankruptcy proceeding should react to these duties. This is still very much an open issue, as no court has yet addressed the question directly.

This article proceeds as follows. Section I discusses the two recent cases that have sparked debate about whether informal groups have fiduciary duties. Section II explores definitions of fiduciary duties, and discusses both relationship-based and situation-based tests for fiduciary duties. A review of these definitions shows that the rationales for relationship-based duties do not fit with the ad hoc group/non-member-creditor relationship; however, there is some justification for situation-based fiduciary obligations—specifically, through a “controlling creditor” and/or a “representative” approach. Section III argues that these justifications for fiduciary obligations are weak, would have negative effects, and overall, would promote bad policy.

This paper ultimately argues that the claims traders, hedge funds, and activist creditors that usually comprise the ad hoc groups also serve to balance the bankruptcy process, but in different ways than judges. While judges regulate through their equitable powers, making determinations based on fairness and other standards, activist claims investors create dynamic markets that tend toward efficient results, and may in some cases be preferred over judicial intervention. Bankruptcy investment activities and markets should therefore be encouraged, rather than viewed with suspicion as it is now, and judicial oversight of these activities should be more limited. However, if distressed investors want judicial assertion of equitable powers to be less likely, they should demonstrate that they respect the bankruptcy process and do not seek to control it.
I. COURTS RAISING THE POSSIBILITY OF FIDUCIARY DUTIES FOR AD HOC COMMITTEES

A. Northwest Airlines

In *Northwest Airlines*, the question of fiduciary duties arose when Judge Gropper denied the ad hoc equity committee’s request to file its Rule 2019 disclosure statement (which it was ordered to file in a prior ruling) under seal. The group wanted to protect sensitive information detailing the time and purchase price of its members’ individual acquisitions from public scrutiny. The judge partially justified his ruling by stating that requiring public disclosure of private trading data “is not unfair because *their negotiating decisions as a Committee should be based on the interests of the entire shareholders’ group*, not their individual financial advantage.”

Judge Gropper specifically characterized the Committee as a subset of the shareholders’ group, rather than as a separate group unto themselves: “Rule 2019 protects other members of the group—here, the shareholders—and informs them where a committee is coming from . . . .” Not only that, but he considers them as acting as the “champions” of the larger group: “Rule 2019 gives other members of the class the right to know where their champions are coming from.” A champion is one that acts on behalf of others. The fact that a subset of the equity shareholders are acting together as shareholders means that the members of the subset may owe

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16 *Id.* at 709.

17 *Id.* (emphasis added).
fiduciary duties to act on behalf of all equity shareholders.\textsuperscript{18} The court does not directly say that the Committee is a fiduciary to the larger class of shareholders, but raises the possibility and then, putting it off for another day, “[a]ssum[es], arguendo, for purposes of this motion that the Committee does not act as a fiduciary.”\textsuperscript{19}

The explanation the court gives is that disclosures assist other parties in evaluating whether the ad hoc group properly represents their interests. First, the court explains that non-group members have a right to receive information about the Committee that would help them determine whether to rely on the Committee to properly represent their interests.\textsuperscript{20} Second, if other shareholders believe that the Committee will not represent their interests in the way they would like, then they may think about forming their own committees.\textsuperscript{21} Third, full disclosure benefits all parties, not just other shareholders, because it “gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy case and play a major role.”\textsuperscript{22} These benefits fall somewhere halfway between fiduciary duties and no fiduciary duties: if ad hoc groups \textit{had} fiduciary duties to other parties there would be no need to enable parties to assess whether to trust these groups; but if ad hoc groups do \textit{not} have fiduciary duties, there would be no need to allow parties to decide whether to act as if they did have such duties.

\textsuperscript{18} Id.
\textsuperscript{19} Id.
\textsuperscript{20} Id. (“Rule 2019 is based on the premise that the other shareholders have a right to information as to Committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own.”) (emphasis added).
\textsuperscript{21} Id. (“Rule 2019 is based on the premise that the other shareholders have a right to information as to Committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own.”) (emphasis added).
\textsuperscript{22} Id.
B. Washington Mutual

The possibility that ad hoc committees might owe fiduciary duties to other parties was raised again more directly in the Washington Mutual [“WaMu”] case. Judge Walrath, in deciding that Rule 2019 applied to the ad hoc committee, stated that “[t]he case law . . . suggests that members of a class of creditors may, in fact, owe fiduciary duties to other members of the class.” As in Northwest Airlines, she stopped short of defining these duties, but left the matter for a later date: “It is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class.” We are left with a vague assertion that informal creditor groups have obligations to other class members, but we do not yet know what they are.

The reasoning for the proposition that ad hoc creditor groups may owe fiduciary duties to other similarly situated creditors is not clear. These duties, if they exist, do not arise either statutorily or contractually, but are “implied.” Are any of these scenarios that give rise to “implied” fiduciary obligations supported by prior case law? Are any of them justifiable on their own? This paper explores these questions. It argues that it is indeed possible for courts to find such duties, but that they should not do so.

24 Id. at 279 (emphasis added).
25 Further, even if a fiduciary relationship exists, the specific characteristics and contours of the obligations must be spelled out. As the Supreme Court explains: “[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?” Tamar Frankel, Fiduciary Duties, in 2 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 127, 129 (citing SEC v. Chenery Corp., 318 U.S. 80, 85-6 (1940)) (Peter Newman ed., 1998) http://www.tamarfrankel.com/support-files/palgrave-fiduciary-duties.pdf.
II. SITUATIONS GIVING RISE TO FIDUCIARY OBLIGATIONS

A. Relationship-Based Tests

1. Common Features and Tests

There are a number of different definitions and types of fiduciary relationships, sharing similar characteristics. Fiduciary relationships have evolved throughout history within courts of equity to address different classes of relationships, beginning with trusts in the middle ages, through partnerships and agents, and more recently, union officers, doctors, clergy, guardians, attorneys, social workers, and corporate officers and directors. An inquiry as to whether a particular type of relationship deserves fiduciary status begins with looking at the types of relationships that courts have

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traditionally considered fiduciary in nature. However, judges continue to recognize new forms of fiduciary relationships when appropriate.

The most common feature of fiduciary relationships is the duty for one party to act on behalf of and for the benefit of another. In fiduciary relationships, one party gives over power to another party—such as a doctor, lawyer, employee, trustee—to provide some service to them. Consent by both parties is usually required for most types of fiduciary relationships (such as trustees or agents), but is not always necessary; sometimes fiduciary relations can be created without consent by the "operation of law," such as in partnerships, or situations involving minors or incompetents.

Various tests have been proposed to decide if a type of relationship deserves fiduciary status. The Second Circuit employs both an "expectations of the parties" test and a "practical implications" test. This circuit has said that if a court is going to find a new type of fiduciary

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28 See Weinberger v. Kendrick, 698 F.2d at 78-79 ("[The fiduciary relationship] ordinarily has been limited to relationships such as those between 'guardian and ward, trustee and cestui que trust, attorney and client, and physician and patient' . . . with more recent extensions to relationships such as those between social worker and client . . . and nursing home and patient . . . [as well as, "for nearly a century"] between a manager of a corporation and its shareholders.") (citations omitted).

29 See Restatement (Third) of Trusts § 2 cmt. (2003) ("Despite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship"). See also Restatement (Third) of Trusts § 2 (2003) ("[A trust is] a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of [another person]."); and Restatement (Third) of Agency § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

30 See, e.g., In re Premier Int'l Holdings, Inc. ("Six Flags"), 423 B.R. 58, 65 (Bankr. D. Del. 2010) (stating that a person can only "represent" a group (the key element in agency law) if it obtains that group's consent, or "by operation of law"). See also Uniform Partnership Act of 1997 § 202(a) (stating that a fiduciary partnership is formed by "the association of two or more persons to carry on as co-owners a business for profit . . . whether or not the persons intend to form a partnership") (emphasis added).
relationship, it must undergo a “judicial inquiry into the legitimate expectations of the parties and, more generally, the practical implications of recognition of a fiduciary relationship . . .”31 Consistent with the “expectation of the parties” notion is the understanding of law and economics scholars, like Judge Easterbrook and Daniel Fischel, that fiduciary duties are fully contract-based, and that courts fill in the gaps to reflect what the parties would have contracted for in situations where high transaction costs make such contracting prohibitive.32

Delaware state courts have been “reluctant to extend too broadly the applicability of fiduciary duties,”33 and only do so where a “special relationship” exists, where “one party places a special trust in another and relies on that trust, or where a special duty exists for one party to protect the interests of another.”34 In contrast, Delaware courts exclude general “relationships where an element of trust, as commonly understood, is present,” such as a hired workman, or where the relationship is “an arm's-length contractual relationship.”35 The Delaware Supreme Court understands fiduciary relationships as ones where “the interests of the fiduciary and the beneficiary incline toward a common goal in which the fiduciary is required to pursue solely the interests of the beneficiary in the property.”36 Thus, it denies fiduciary status when the interests of the parties

31 Weinberger v. Kendrick 698 F.2d 61, 78 (2d Cir. 1982).
32 Frankel, supra note 25, at 131. See also FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92 (1991) (“The fiduciary principle is an alternative to elaborate promises and extra monitoring. . . . Socially optimal fiduciary rules approximate the bargain that investors and managers would have reached if they could have bargained (and enforced their agreements) at no cost.”).
34 Id. at 624-25.
35 Id. at 625-26.
36 Id. at 626 (citing Crosse v. BCBSD, Inc., 836 A.2d 492, 495 (Del. 2003)) (emphasis added).
“are not perfectly aligned.”

Several standard legal dictionaries provide functional definitions of fiduciary relationships, attempting to summarize the similarities among the different types. Black’s Law Dictionary says that: “Fiduciary relationships usu. arise in one of four situations: (1) when one person places trust in the faithful integrity of another, who as a result gains superiority or influence over the first, (2) when one person assumes control and responsibility over another, (3) when one person has a duty to act for or give advice to another on matters falling within the scope of the relationship, or (4) when there is a specific relationship that has traditionally been recognized as involving fiduciary duties . . . .” Of the four situations mentioned, only the first could conceivably apply to ad hoc committees: where the non-member creditors “place[] trust” in the committee, despite being told not to do so by that same committee. However, another leading dictionary says that “actual reliance by one person on another [does] not create fiduciary relationships.” The reliance by one person on the other cannot be unwarranted, unreasonable, or unexpected- it must somehow be consistent with the “legitimate expectations” of the other party.

The New Palgrave Dictionary of Economics and Law explains that “[c]ourts recognize new fiduciary relations when, in their opinion, the historical protections of entrustors have eroded.” This definition provides

37 Id.
39 The second reason is not applicable because the committees expressly deny any control or responsibility over non-members. The third does not apply because the committees have no duty to act on behalf of anyone else. The fourth does not apply because this relationship has never been recognized as fiduciary.
40 Frankel, supra note 25, at 128.
41 Weinberger v. Kendrick 698 F.2d 61, 78 (2d Cir. 1982).
42 Frankel, supra note 25, at 128. The examples of new fiduciaries are physicians, clergy, and, in Canada, accountants. The author goes on to say, however, that “[t]he reverse is also true. When outside controls over fiduciaries tighten, courts are likely to
that courts enforce duties in order to minimize agency costs for socially beneficial relationships, such as, for example, when the cost to the principle of monitoring the fiduciary exceeds any benefits the principle might gain from the relationship.43

2. Applying the Relationship-Based Tests

Admittedly, some of the common features of fiduciary relationships do appear in the context of an ad hoc committee and non-member creditors, especially those agency cost issues mentioned in the New Palgrave Dictionary regarding the difficulty and expense involved in non-member creditors obtaining information about the ad hoc committee’s motives, financial incentives, or actual economic stake in the debtor. This informational asymmetry problem is minimized with the enhanced disclosure requirements of Rule 2019. For courts to go further and impose fiduciary obligations, however, would be problematic, because the creditor group and the non-member creditors are not actually in a direct relationship: the relationship is a parallel one, where both are creditors of the same debtor. More significantly, ad hoc groups have no power or control over the non-member creditors or their property, the defining feature of all fiduciary relationships.44 Further, ad hoc committees are not subject to the relax their supervision over these fiduciaries,” as they did with securities brokers. Id.

43 Id. at 127-28.
44 See, e.g., Svanoe v. Jurgens, 33 N.E. 955, 957 (Ill. 1893) (“There cannot be any very material difference between the interests and obligations of a person who acts in a fiduciary capacity or character and those of a person who receives or holds money in trust.”); WILLIAM T. ALLEN, REINIER H. KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 34 (3d ed. 2009) (stating that a fiduciary relationship exists when “legal power over property (including information) held by the fiduciary is held for the sole purpose of advancing the aim of a relationship pursuant to which she came to control that property”).
control of non-members and do not work directly on anyone’s behalf. Finding fiduciary obligations would lead to absurdities such as the rule that “fiduciaries may not compete with their entrustors,” although clearly creditors in bankruptcies must and do frequently compete with each other.

A glaring issue with the “legitimate expectations” test is the fact that ad hoc committees generally specifically and publicly deny working for the best interests of other creditors. For instance, the Northwest Airlines informal committee aggressively advocated for the creation of an official equity committee to represent all shareholders, acknowledging that it was not only unwilling but also unable (due to the number of shareholders) to properly represent the interests of the other shareholders.

The Northwest and WaMu courts give more weight to the expectations of the non-member parties. In fact, the disclosure obligations were justified as enabling the shareholders to determine whether or not to rely on the ad hoc committees. So the question of fiduciary obligations

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45 See, e.g., Restatement (Third) of Agency § 1.01 (2006) (“Agency is the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.”).

46 Frankel, supra note 25, at 129 (discussing Duty of Loyalty).

47 See Northwest Airlines II, 363 B.R. 704, 708 (Bankr. S.D.N.Y. 2007). (“[The Ad Hoc] Committee contends that it did not take on any fiduciary responsibility to the shareholders as a group when it appeared in these cases.”). See also In re Nw. Airlines Corp., 2007 WL 128356, Memorandum of Law of Ad Hoc Committee of Equity Security Holders In Support of Motion for an Order Compelling the Acting United States Trustee for Region 2 to Appoint an Official Committee of Equity Security Holders, at *23 (Bankr. S.D.N.Y. Jan. 11, 2007) (“[T]he Ad Hoc Committee . . . is not a fiduciary.”).

48 See In re Nw. Airlines Corp., 2007 WL 128356, Memorandum of Law of Ad Hoc Committee of Equity Security Holders In Support of Motion for an Order Compelling the Acting United States Trustee for Region 2 to Appoint an Official Committee of Equity Security Holders, at *23 (Bankr. S.D.N.Y. Jan. 11, 2007) (“The reality is that an informal group of shareholders who have no fiduciary duties to the tens or hundreds of thousands of holders cannot represent all Northwest public stockholders. In cases of this size and complexity, equity holders will be shut out without official representation through a lack of access to the Debtors' management and other necessary resources from the Debtors.”).

49 Northwest Airlines II, 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007) (“[T]he other shareholders have a right to information . . . so that they make an informed decision
for these courts hinged primarily on the expectations of the other creditors vis-à-vis the ability and probability of the ad hoc committees to properly represent their interests, but ignored (and in fact, opposed) the expectations of the informal committees. Moreover, the courts were willing to consider these factors despite the well-established notion that “actual reliance by one person on another [does] not create fiduciary relationships.”\(^{50}\) Such a holding would pervert the “expectations of the parties” test to favor one side, no matter how unreasonable is that side’s reliance.

Moreover, courts have frequently held that parties engaged in arms-length negotiations and commercial transactions do not have fiduciary obligations towards each other.\(^{51}\) This has been held true in the context of the relationship between a lender bank and the security holders of the borrowing corporation,\(^{52}\) an insurance company and its insured,\(^{53}\) as well as between a business and the factor that purchases accounts receivables.\(^{54}\) The reasons given for refusing to define the relationship as fiduciary were that (a) there was no support in prior case law; (b) the relationship involved arms-length negotiations; and (c) the parties did not expect that fiduciary...

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\(^{50}\) Frankel, *supra* note 25, at 128.

\(^{51}\) See, e.g., *In re W. T. Grant Co.*, 4 B.R. 53, 75 (Bankr. S.D.N.Y. 1980), aff’d by *Cosoff v. Rodman* ("*In re W. T. Grant*"), 699 F.2d 599, 610 (2d Cir. 1983) (explaining that “[p]arties may assuredly deal at arm’s length for their mutual benefit without raising a confidential relationship between them . . . It may be that his conduct did not conform to the highest ethical standards, but having no fiduciary relationship, his duty arose no higher than the morals of the market place.”) (quoting *Rader v. Boyd*, 252 F.2d 585, 587 (10th Cir. 1957)). See also *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939) (“The essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain. If it does not, equity will set it aside.”).

\(^{52}\) *Weinberger v. Kendrick* 698 F.2d 61, 78-79 (2d Cir. 1982) (holding that the “relationship between a lending bank and the security holders of a borrowing corporation” is not an established fiduciary-creating relationship).


\(^{54}\) *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844) (holding that a factor did not have fiduciary obligations to a business when the factor failed to give the business the money for the property he had sold on the business’ behalf).
obligations were being created. The Supreme Court long ago distinguished between fiduciary relations and relations based on competitive commercial transactions: “In almost all the commercial transactions of the country, confidence is reposed in the punctuality and integrity of the debtor, and the violation of these is, in a commercial sense, a disregard of a trust. But this is not [a fiduciary relationship].” Because there are so many commercial transactions involving some degree of trust, if the court found fiduciary duties merely by its presence, almost every type of debt, and almost every commercial transaction, would be subject to fiduciary obligations. Antagonistic creditor negotiations and battling investors are quintessential examples of competitive, commercial transactions.

Further, self-interested behavior is not in itself a breach of trust. The Uniform Partnership Act of 1997, for example, states that a partner does not violate a fiduciary obligation to the partnership “merely because the partner’s conduct furthers the partner’s own interest.” In a reorganization, everyone is assumed to be acting in their own best interests, and through complex negotiations a sufficient plan should emerge.

However, the Second Circuit admitted—at least in the context of a lender bank and the borrower’s shareholders—despite all the reasons against such a finding, that it “is not beyond the realm of possibility” for another court to find that fiduciary obligations exist. Thus, the possibility of a court finding fiduciary obligations between parties in arms-length transactions.

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55 *Weinberger v. Kendrick* 698 F.2d 61, 79 (2d Cir. 1982) (stating that “it would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table”). See also *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844).


57 *Id.* at 208 (arguing against using a broad definition of fiduciary because “it will be difficult to limit its application”).


commercial transactions is not completely foreclosed. And, even if relationship-based definitions do not provide a strong case for creating fiduciary obligations, numerous fact-specific contexts can create fiduciary duties, especially given bankruptcy judges’ broad equity powers.

B. Situation-Based Tests

Beyond the traditionally recognized relationships and relationship-based factor tests, fiduciary obligations have been found in other, fact-based situations.

1. “Donning the Mantle”

One fact-based situation that may occur is one party attempting to act on behalf of a class and, in doing so, portraying itself as a fiduciary. This happened in Mirant, where a shareholder “donned the mantle of a fiduciary” by acting as a shareholder representative throughout the case, creating a website apparently advocating for the shareholders, claiming to be counsel to an ad hoc committee, and seeking compensation from the estate.\(^6\) This scenario is quite different from Northwest and Washington Mutual, since the groups in those cases actively disavowed working to further the interests of anyone other than themselves.\(^6\) A finding of fiduciary obligations in a case like Mirant is fact based and case specific.

A weaker version of the “donning the mantle” test is found in


\(^{6}\) However, in Northwest, Judge Gropper made note of the fact that the ad hoc committee statement left open the possibility of the estate reimbursing the committee for attorney’s fees, and considered this evidence that the ad hoc committee may be asserting itself as a representative for other similarly-situated creditors. See Northwest Airlines I, 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007).
Northwest Airlines, where the court was concerned that other creditors may believe that the creditor group is acting on their behalf, despite the group’s assertions to the contrary. As discussed above, however, this view favors one party and is a weak basis upon which to find fiduciary obligations.

2. Temporary Insider

A second situation that may give rise to fiduciary duties occurs when a party is a “temporary insider” of the company. In such a case, the temporary insider would have similar duties as the company’s management has. Washington Mutual is an example of this scenario in a bankruptcy case. There, the ad hoc creditor group was accused of trading on non-public information it had received while engaging in negotiations to craft a reorganization plan. The court agreed that there was a “colorable claim” of insider trading. The court reasoned that the group may be considered a temporary insider under either securities or bankruptcy law, because it received non-public information “to further the Debtors’ efforts to effectuate a consensual plan of reorganization, which was the common goal of both the Debtors and the [informal creditor group].” Under this theory, the ad hoc group would take on the duties of corporate management. Yet, under current Delaware state law (which would be applicable to debtors incorporated in Delaware, and thus to most cases filed in the District of

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63 In re Wash. Mut., Inc., 461 B.R. at 263.
Delaware Bankruptcy Court), corporate managers of an insolvent company only have fiduciary obligations to the corporation and to shareholders, not to creditors.\(^6^4\) However, the portion of the ruling discussing insider trading was vacated as part of later settlement negotiations, so the precedential value of this decision to support a temporary insider theory is diminished.\(^6^5\)

3. Derivative Claimant / Representative

A third scenario raising fiduciary obligations arises where a creditor sues under a derivative claim, even if the creditor disavows representing others. Derivative shareholder actions are actions brought by shareholders against corporate directors and officers, on behalf of the corporation itself. The Supreme Court has held that shareholders bringing derivative claims become quasi-fiduciary representatives of the other shareholders:

A stockholder who brings suit on a cause of action derived from the corporation assumes a position, not technically as a trustee perhaps, but one of a fiduciary character. He sues, not for himself alone, but as representative of a class comprising all who are similarly situated. The interests of all in the

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\(^6^4\) See N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92 (Del. 2007) (holding that directors of an insolvent company do not owe fiduciary duties to creditors, and that the directors’ obligations are only those contained in the creditors’ contracts). Insider trading may give rise to other liabilities, but we do not address these issues here. The immediate point is that a “temporary insider” theory that places certain creditors in the role of management is problematic because (a) managers do not have fiduciary duties to creditors, (b) managers are employees and agents of the company, and (c) creditors and debtor’s management generally have adverse interests. A topic closely related to the “temporary insider” theory (and more applicable) is the controlling shareholder/creditor scenario, addressed in Section II(B)(4) below.

redress of the wrongs are taken into his hands, dependent upon his diligence, wisdom and integrity. And while the stockholders have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self-chosen representative and a volunteer champion.\textsuperscript{66}

But what is the reason for this? In some sense, when individuals sue for themselves on the basis of a claim arising from their membership in a class, the rights of the individuals and the rights of the other group members are “inseparable.”\textsuperscript{67} This is so because the “success or failure of the [lawsuit] [is] bound to have a substantial effect on the interests of all other [class members],”\textsuperscript{68} primarily because the winnings go to the corporation, to be shared by all creditors.\textsuperscript{69} But because smaller, dispersed shareholders face a collective action problem, in that their interest in the case is far smaller than the cost of pursuing the claim, entrepreneurial attorneys step in to litigate the claim.\textsuperscript{70} These attorneys hold fiduciary duties towards the shareholders, in the same way that directors owe duties towards the shareholders.\textsuperscript{71}

If plaintiffs’ attorneys in a derivative action are fiduciaries to other class members because they are directing the claim for the entire group,

\begin{itemize}
  \item \textsuperscript{66} Cohen v. Beneficial Indus. Loan Corp. 337 U.S. 541, 549 (1949).
  \item \textsuperscript{67} Young v. Higbee Co., 324 U.S. 204, 209 (1945).
  \item \textsuperscript{68} Id.
  \item \textsuperscript{69} ALLEN ET AL., supra note 44, at 364 (“[T]he derivative suit advances a corporate claim, which implies that any recovery that results should go directly to the corporation itself.”).
  \item \textsuperscript{70} Id. at 367 (“Where all investors hold small stakes in the enterprise, no single investor has a strong incentive to invest time and money in monitoring management. . . . In form, [the attorneys who step in to litigate derivative actions] are the economic agents of their shareholder-clients. In substance, they are the legal entrepreneurs motivated by the prospect of attorneys’ fees.”).
  \item \textsuperscript{71} Id. at 371 (“Legally, the plaintiffs’ lawyers are agents of shareholders, just as the corporate defendants are fiduciaries charged with acting for the corporation and, ultimately, for its shareholders.”).
\end{itemize}
then this could be true in a bankruptcy as well, where a creditor is directing a derivative action that will bind all group members. The *Northwest Airlines* case hinted at this reasoning, without making it explicit. The court asserted that the ad hoc committee’s “negotiating decisions as a Committee should be based on the interest of the entire shareholders' group, not their individual financial advantage.”\(^2\) The explanation could be that, as the *Northwest* court explained (and as the committee’s counsel “admitted”\(^3\)): “in negotiations between a committee and other parties in interest, the question is whether a tranche is being treated fairly, not the price at which individual members might be induced to sell.”\(^4\) That is, the causes of action granted in the Bankruptcy Code, which enable parties to advocate for their interests, may imply some sort of duty to other similarly situated parties. This idea is broader than a derivative action, since it includes negotiations and direct or individual claims, not just derivative litigation. The parties that are not bringing the suit or engaging in the negotiations will be substantially affected by the result of those who are. These duties do not arise either statutorily or contractually. If they exist, they flow from the way in which the committee members are permitted to argue within the Bankruptcy Code.

The Supreme Court long ago found at least a duty of good faith for shareholders bringing a derivative claim under an early version of the Bankruptcy Code. In *Young v. Higbee*, the Court said: “[The plaintiffs], by appealing from a judgment which affected a whole class of stockholders owed an obligation to them, the full extent of which we need not now delineate. Certainly, at the very least they owed them an obligation to act in

\(^3\) Id. at 709.
\(^4\) Id. at 708.
The Court explained this good faith requirement because the individuals bringing the suit “temporarily control[led]” the interests of all the preferred shareholders, whose interests were “necessarily involved in the appeal.” Thus, “[t]his control of the common rights of all the preferred stockholders imposed on [the individuals] a duty fairly to represent those common rights.”

Like in Bankruptcy Court, the individuals in Young were relying on their “statutory privilege of litigating for the interest of a class,” because their cause of action only derived from the statute (in this case the Chandler Act, an early version of the Bankruptcy Code). In the context of contemporary bankruptcy practice, Young could allow for the imposition of a duty of good faith towards other class members onto any party that brings a case through the statute qua class member.

However, the idea that ad hoc committees are fiduciaries in the same way that derivative claimants are fiduciaries is difficult to accept because there are a number of differences between the limited case of a derivative action and the broader case of bankruptcy claims.

One difference between derivative actions and bankruptcy claims is that plaintiffs’ attorneys leading derivative actions are definite fiduciaries whereas ad hoc committees are only potential fiduciaries in some instances (assuming, as the Northwest-WaMu line of cases does, that this is even possible). Attorneys must lead a case through a rigorous certification process in the beginning, but ad hoc committees may bring any claim, whether a class action, a derivative claim, or something else. The payment

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75 324 U.S. at 210.
76 Id. at 212
77 Id.
78 Id. at 213. Note that the term “class” refers to a class of the Bankruptcy Code’s classification scheme—such as the class of shareholders or the class of unsecured creditors—and not to a group represented in a class action suit.
structures reflect these differences: plaintiffs’ attorneys are generally guaranteed a percentage of the recovery if they win; but informal creditor committees must still meet the “substantial contribution” test.79

Another difference is that derivative actions are more stringently regulated, since they settle the claim for class members who are often absent, unknown by the court, uninformed that there is a case pending at all, or rationally indifferent to the outcome. Thus, their input, ability to speak up for themselves, or involvement in the case is basically zero, while the plaintiff representative controls their claim. For bankruptcy claims, similar lack-of-incentive issues may apply, but are already handled by the claims application process and the official creditors’ committee, and not by individual actions during the case. Creditors that fail to file a claim by the claims bar date are barred from participating in the bankruptcy process,80 and all debts are wiped out when the debtor emerges from bankruptcy, so absent creditors have no further remedies. Moreover, there are additional procedural safeguards in place when creditors file a suit, similar to those of derivative actions: plaintiffs must give notice to absent parties of interest; other parties may petition to join the suit; settlements may only be approved after notice and hearing, including a judicial review for fairness.81 Thus, bankruptcy’s parallel to the shareholder derivative action (with its high procedural hurdles) is the claims application process and subsequent representation by the official creditors’ committee, and such a process cannot be accomplished by an informal creditor group whether or not such a group brings an action affecting the other creditors.

Moreover, the mere fact that a bankruptcy action by one creditor

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79 See 11 U.S.C. § 503(b)(3)(D). This test is discussed below in Section III.
81 ALLEN ET AL., supra note 44, at 364. See also 11 U.S.C. § 342 (notice requirements); FED. R. BANKR. P. 7020 (permissive joinder of parties); FED. R. BANKR. P. 9019 (compromise and arbitration).
affects other creditors should not be dispositive. Other legal contexts allow individuals to bring claims that affect the broader public without restricting them with fiduciary obligations: for example, constitutional challenges and injunctions.\(^\text{82}\) Additionally, in a bankruptcy case, all parties are financially intertwined: one dollar allotted to party A is one less dollar that can be allotted to party B. So, all bankruptcy actions are “collective” in that respect. If we are going to admit any common law fiduciary responsibility, where would we draw the line?

4. Controlling Creditor / Shareholder

A fourth scenario giving rise to fiduciary duties is known as the “controlling shareholder” scenario. \textit{Washington Mutual} considered this situation in the context of a bankruptcy, where a creditor group held a blocking position in a voting class.\(^\text{83}\) The court reasoned that the ad hoc group “could be considered insiders of the Debtors because of their status as holders of blocking positions in two classes of the Debtors' debt structure. As such, it could be found that they owed a duty to the other members of those classes to act for their benefit.”\(^\text{84}\) That is, from the mere fact of having blocking positions in their voting class, they were considered insiders, a status which gives rise to fiduciary duties towards other creditors.

\(^{82}\) See, \textit{e.g.}, \textit{Awad v. Ziriax}, 670 F.3d 1111 (10th Cir. 2012) (individual successfully seeking an injunction preventing the enactment of an amendment to the Oklahoma state constitution that was approved by voters).

\(^{83}\) \textit{In re Wash. Mut., Inc.}, 461 B.R. 200, 263 (Bankr. D. Del. 2011), \textit{vacated in part}, No. 08-12229-MFW, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012) (“[T]he Equity Committee argues that the Settlement Noteholders only obtained the information because they had acquired blocking positions in two subordinated classes of creditors (the senior subordinated notes and the PIERS). It contends that this is sufficient to create a fiduciary duty on their part to those two classes of creditors.”). Note that this portion of the opinion was included in the vacated section.

\(^{84}\) \textit{Id.} at 264.
in the same class, irrespective of receiving insider information.\textsuperscript{85}

The controlling shareholder scenario may be more akin to the ad hoc committee than a derivative claimant or temporary insider scenario. In \textit{Pepper}, the Supreme Court said:

\begin{quote}
A director is a fiduciary. . . . So is a dominant or controlling stockholder or group of stockholders. . . . Their powers are powers in trust. . . . Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. . . . The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.\textsuperscript{86}
\end{quote}

Yet according to the theory advanced by the \textit{WaMu} court, (which relies on \textit{Pepper} as precedent) during a Chapter 11 reorganization, anyone can become a temporary “director” if he exercises control over the company. In so doing, he becomes a temporary fiduciary, representing the interests of the creditors. His duties are proportional to the “degree that his

\textsuperscript{85} In such a case, according to the ALI Principles of Corporate Governance:

A controlling shareholder may not use corporate property, its controlling position, or (when trading in the corporation’s securities) material non-public corporate information to secure a pecuniary benefit, unless: (1) Value is given for the use and the transaction [fulfills the duty of fair dealing] . . . or (2) Any resulting benefit to the controlling shareholder either is made proportionally available to the other similarly situated shareholders or is derived only from the use of controlling position and is not unfair to other shareholders, and the use is not otherwise unlawful.

\textit{American Law Institute, Principles of Corporate Governance} § 5.11(a) (1994).

representative character has given him power and control derived from the confidence reposed in him” by the creditors and shareholders of the company.\(^8\) In this way, the WaMu court views reorganizations as a collaborative group process, with all parties working to rebuild the company. It should be infused with “principles of morality, and freedom from motives of selfishness.”\(^8\)

The problem is, the Pepper court also emphasized that an actual contractual, consensual fiduciary-agency relationship must exist for these obligations of “candor and fair dealing” to be required of the temporary creditor-director.\(^8\) That is, the stockholders must have “appointed him their agent.”\(^9\) In Pepper, the “controlling shareholder” in question was literally an official director of the company.\(^9\) An amorphous doctrine of implied fiduciary relationships is completely new in WaMu. It is as if the WaMu court sees the reorganization process as opening up the corporation for collaboration by creditors, who become the reorganizing company’s directors.\(^9\) The reorganization process is one that “opens up” the company, figuratively, financially, and now literally—its financial statements and affairs are made public, its creditors appear and file claims, and now parties in interest can attempt to influence the structure and actions of the company. This, according to the WaMu court, must all be done altruistically.

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\(^8\) Id. at 307 n.14 (citing Twin-Lick Oil Co. v. Marbury, 91 U.S. 587, 589 (1875)).
\(^9\) Id.
\(^9\) Id.
\(^9\) Id.
\(^9\) Id. (discussing the situation where “the lender is a director, charged, with others, with the control and management of the affairs of the corporation, representing in this regard the aggregated interest of all the stockholders . . . .” (citation omitted).
\(^9\) In re Wash. Mut., Inc., 461 B.R. 200, 263 (Bankr. D. Del. 2011) (explaining that the informal group received non-public information “to further the Debtors’ efforts to effectuate a consensual plan of reorganization, which was the common goal of both the Debtors and the [ad hoc committee]”).
Yet this approach ignores the parties’ own understandings and definitions of their relationships, and ignores their expectations. It infuses certain moral principles and assumptions into the process. At no point were creditors appointed as agents by the creditor or debtor, no contracts were signed, no consent was given, and general business practices do not recognize an agency relationship between creditor groups and similarly situated creditors.93

C. Summary of Potential Sources of Fiduciary Obligations

This Section highlighted a number of ways in which a court might determine that an ad hoc group has fiduciary duties to other non-group parties: by using either a relationship-based test or a situation-based test. The biggest problems with the relationship-based tests is that (a) competitive commercial transactions are generally understood as being areas where adverse parties have no duties to act in the best interest of the other party; and (b) the ad hoc group relationship fails the “expectations of the parties” test. The situation-based theories are also problematic but more likely to be used by a court: the “donning the mantle” theory only applies if a party is advertising itself as a fiduciary and so does not apply here; but the temporary insider theory, the derivative-style representative theory, and the controlling creditor theory are fact-specific and could be applied in some

93 See, e.g., Weinberger v. Kendrick, 698 F.2d 61, 79 (2d Cir. 1982). It could be argued that any special privilege based on the creditors’ controlling position should create a parallel fiduciary duty. However, this rule should be applied uniformly to anyone invited to participate in negotiations, or not at all. Further, the Pepper creditor enjoyed this privilege by virtue of being a corporate director (and thus enjoyed a privilege that a creditor of equal size could not enjoy), not from merely owning a large claim. Certainly a reorganizing debtor would be inclined to pay more attention to a large claimholder owning a larger stake in the enterprise, but this additional attention is not an unfair privilege by itself, since a small creditor could purchase more claims or aggregate its claims with other small creditors.
circumstances by a court to discipline an active creditor group.

III. PROBLEMS WITH THE FIDUCIARY THEORY FOR INFORMAL CREDITOR GROUPS

Holding informal groups to fiduciary duties raises fundamental questions about the bankruptcy process itself. First, ad hoc informal groups are fundamentally different from Official Creditors’ Committees, which do have fiduciary duties to their members. Treating informal groups as official groups would undermine Congress’ distinction between two forms of collective action, and would unfairly burden the informal groups. Second, ad hoc groups are not so fundamentally different from some individual creditors as to justify disparate treatment between groups and individuals, and such treatment would create arbitrage opportunities. Third, informal groups are in a unique position to provide a corrective to an increasing trend of bankruptcy monopolization by secured creditors, and this should be encouraged (or at least not discouraged) in order to retain a balance of interests. Fourth, the idea that groups of investors should have fiduciary duties is based on the faulty assumption that other creditors are “victims” needing protection.

A. Distinct from Official Creditors’ Committees

1. Distinct Roles

Distressed investor groups have distinct roles from the Official Creditors’ Committee (and the Official Equity Committee), which do have
fiduciary duties towards the unsecured creditors (and equity holders). This
difference is a key reason why informal groups should not have similar
duties.

The Official Creditors’ Committee’s (OCC) main role is to represent
the various interests of its members during all aspects of the reorganization,
including negotiations with the debtor.⁹⁴ The OCC faces strong disclosure
requirements, and smaller creditors rely on the OCC for information and
representation.⁹⁵ The U.S. Trustee can form additional committees (or the
court, upon request, can order the U.S. Trustee to do so), if necessary.⁹⁶

The OCC can be effective in negotiations because Congress
expressly granted them many powers and duties. They eliminate the
debtor’s leverage over the scattered unsecured creditors by monitoring the

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⁹⁴ See 11 U.S.C. § 1102(b)(1) (“A committee of creditors appointed under subsection
(a) of this section shall ordinarily consist of the persons, willing to serve, that hold the
seven largest claims against the debtor of the kinds represented on such committee . . .”);
11 U.S.C. § 1103(c) (“A committee appointed under section 1102 of this title may—(1)
consult with the trustee or debtor in possession concerning the administration of the case;
(2) 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 or to the formulation of a plan; (3) participate in
the formulation of a plan, advise those represented by such committee of such committee’s
determinations as to any plan formulated, and collect and file with the court acceptances or
rejections of a plan; (4) request the appointment of a trustee or examiner under section
1104 of this title; and (5) perform such other services as are in the interest of those
represented.”). See generally Joel B. Zweibel & Adam C. Harris, The Role of the
Unsecured Creditors’ Committee in Workouts and Reorganizations, in Workouts and
Turnarounds: The Handbook of Restructuring and Investing in Distressed

⁹⁵ 11 U.S.C. § 1102(b)(3) (“A committee appointed under subsection (a) shall—(A)
provide access to information for creditors who—(i) hold claims of the kind represented by
that committee; and (ii) are not appointed to the committee; (B) solicit and receive
comments from the creditors described in subparagraph (A); and (C) be subject to a court
order that compels any additional report or disclosure to be made to the creditors described
in subparagraph (A).”).

⁹⁶ 11 U.S.C. § 1102(a)(1) (“[T]he United States trustee . . . may appoint additional
committees of creditors or of equity security holders as the United States trustee deems
appropriate.”); 11 U.S.C. § 1102(a)(2) (“On request of a party in interest, the court may
order the appointment of additional committees of creditors or of equity security holders if
necessary to assure adequate representation of creditors or of equity security holders. The
United States trustee shall appoint any such committee.”).
informal group have taken a major position or are threatening to take over the company.\textsuperscript{97} The OCC has access to a lot of information, and can threaten to move to appoint a trustee or examiner and remove current management.\textsuperscript{98}

Some unsecured creditors may feel that their interests are not being represented aggressively enough by the OCC, whose attorneys are trying to please all parties, or whose various factions cannot agree on a clear strategy, and so may choose to form their own group or groups. If the position of the members of an informal group are thus different from the other unsecured creditors (who are already represented by the OCC), there is no reason to place fiduciary obligations on them.

These informal groups may have stronger incentives to negotiate than the OCC, and may be more effective, depending on how aggressively the members of the OCC act. If the OCC is comprised, for example, of smaller trade creditors who do not have much at stake individually, the informal groups, whose members may have large direct investments on the line may be more aggressive. The same is true with shareholders on the Equity Committee, who may already assume that they will receive nothing.

A common complaint regarding the informal groups is that the distressed investors that often comprise these groups do not have a continuing business relationship with the debtor, so may not care if the

\textsuperscript{97} See Zweibel & Harris, supra note 95, at 393.

\textsuperscript{98} 11 U.S.C. § 1104. See also Zweibel & Harris, supra note 95, at 388-89. However, the bargaining power of the OCC is less when (a) it is comprised of smaller creditors and less total claims, and (b) when there are multiple unsecured creditor factions, so the focus is dispersed and the interests are not fully aligned. OCCs may often include creditors as diverse (and adverse) as insiders (such as managers who also hold claims against the company), competitors, union members, government units (such as receivers or liquidating entities), people currently in litigation with the debtor, different types of bondholders, etc. See Zweibel & Harris, supra note 95, at 371. If the negotiations focus on specific types of unsecured claims (perhaps because the debtor attempts to exploit these divergent interests), the OCC may become less unified and thus less effective. Further, if the major unsecured creditors are not serving on the OCC, but have formed their own group, the incentive for the debtor to negotiate with the OCC is weakened, especially when the creditors in the informal group have taken a major position or are threatening to take over the company.
debtor is reorganized or liquidated. However, distressed investors are often planning a takeover, M&A, or debt-to-equity strategy, so they are seeking to reorganize rather than liquidate. This is particularly true for equity investors (the situation in *Northwest Airlines*), who would collect nothing in a liquidation. Further, distressed investors may believe that the debtor company will do better as a going concern than the market does (since they purchased the distressed securities and claims as they were priced on the market), and their expertise and access to resources allow them to both unlock value in a failing company and speed up the reorganization process. For these reasons, the involvement of distressed investors generally improves the efficiency (and probability of success) of reorganizations.  

On the other hand, it is true that some creditors may benefit if the reorganization fails, by taking adverse or hedging positions in other financial instruments, such as credit default swaps or short equity positions that would produce a benefit if the underlying instrument (their claim) declined in value. However, the amended Rule 2019 disclosure

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99 See, e.g., Zweibel & Harris, supra note 95, at 373.

100 See, e.g., Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 64, 68 (2010) (“[R]ather than wreaking havoc on the bankruptcy process, claims trading may actually facilitate more efficient bankruptcy negotiations and help reorganizations.”). Indeed, one article has explained that the opportunity for distressed investing is primarily based on finding otherwise financially healthy companies with bargaining inefficiencies (such as contracting difficulties) and facilitating a faster reorganization, unlocking value. See Jongha Lim, The Role of Activist Hedge Funds in Distressed Firms (2010) (unpublished Ph.D. dissertation, Fisher College of Business, The Ohio State University) (available at http://www.cob.ohio-state.edu/~lim_806/Jongha%20Lim_JobMarketPaper_091310.pdf).

101 See, e.g., *In re Wash. Mut., Inc.*, 419 B.R. 271, 279 (Bankr. D. Del. 2009) (“Although much has changed in the financial universe since 1937, concerns regarding the actual economic interests of creditors participating in bankruptcy cases still exist. The proliferation of short-selling and the advent of myriad derivative products now allow creditors to take multiple stakes in the capital structure of debtors. Such varied holdings have the potential to create complex, conflicting incentives for large creditors.”). See also *In re Lyondell Chemical Co.*, 402 B.R. 571, 585 n.26 (Bankr. S.D.N.Y. 2009) (“[It is] reported that certain holders of credit default swaps have attempted to aggregate 25% of the
requirements largely remedy this problem by now requiring informal groups to disclose any “economic interest that is affected by the value, acquisition, or disposition of a claim or interest,”102 so judges and other parties will be aware of any adverse interests from the outset.

While disclosure should be sufficient, any additional issues can be resolved through vote designation via the “good faith” provision of §1126(e).103 This provision can be applied in rare cases when a creditor has an “ulterior purpose”104 and is acting “in aid of an interest other than an interest as a creditor.”105 But this “good faith” provision is much more limited than a fiduciary duty requirement: it covers activities unrelated to being a creditor, such as “pure malice, strikes, blackmail, and the purpose to destroy an enterprise in order to advance the interest of a competing business,”106 but does not include using a blocking position to advance

2015 Notes in order to accelerate them and create a “termination event” that would entitle them to payment on the credit default swaps from their swap counterparties. . . . Assuming that the report is true, any 2015 Noteholders who were also the beneficiary of credit default swaps might benefit from an acceleration (though of course at the expense of their swap counterparties.


103 11 U.S.C. § 1129(e) (“On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.”) See, e.g., In re DBSD N. Am., Inc., 421 B.R. 133, 138 (Bankr. S.D.N.Y. 2009) (explaining that “‘bad faith’—i.e., an absence of the requisite good faith—may be found where a claim holder attempts to extract or extort a personal advantage not available to other creditors in the class, or, as relevant here, where a creditor acts in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor”); In re DBSD N. Am., Inc., 634 F.3d 79 (2d Cir. 2011) (vote of creditor designated for lack of good faith).


105 Id. (citing 118 B.R. at 289).

106 In re Gilbert, 104 B.R. 206, 216 (Bankr. W.D. Mo. 1989) (“Good faith voting does not require nor can it expect, a creditor to act with selfless disinterest. . . . The test then, consonant with the United States Supreme Court’s standard, is whether a creditor has cast his vote with an ‘ulterior purpose’ aimed at gaining some advantage to which he would not
one’s interest as a creditor,\textsuperscript{107} and does not require a creditor to have “an interest in seeing the debtor reorganize.”\textsuperscript{108} This provision covers only the egregious cases where disclosure might not be enough.

Another common complaint with distressed investors is that they do not need to make 100% recovery in order to make money, so may be willing to give up early to the detriment of the other creditors.\textsuperscript{109} However, they are often more aggressive and experienced investors with large holdings in the debtor, so they have both the ability and the financial and reputational incentives to maximize returns as much as possible. In fact, regular unsecured creditors may give up sooner just to get paid faster, or because their small stake in the debtor makes them indifferent.

An additional issue is that investment funds may owe fiduciary obligations to its own investors, to maximize the return on their investment. Duties towards other creditors could create multiple (and often opposing) fiduciary obligations to different groups, leading to a chilling effect on distressed investments overall.

2. History of Official Creditors’ Committees

The history of the OCC goes back to the early days of bankruptcy law, specifically during large-scale railroad reorganizations, where lawyers

\textsuperscript{107} See \textit{In re Marin Town Ctr.}, 142 B.R. 374, 378-79 (N.D. Cal. 1992) (holding that exercising a blocking position by itself does not constitute bad faith, absent an “ulterior purpose of securing some advantage to which the creditor would not otherwise have been entitled”). \textit{Cf. In re Allegheny Int’l, Inc.}, 118 B.R. 282 (Bankr. W.D. Pa. 1990) (bad faith for seeking to gain control of the debtor).

\textsuperscript{108} \textit{Marin Town Ctr.}, 142 B.R. at 379 (“Section 1126(e) does not require a creditor to have an interest in seeing the debtor reorganize.”).

\textsuperscript{109} Id.
and railroad magnates creatively adapted existing laws to fit their goals of restructuring overleveraged railroads. To do so, they created Creditor Protection Committees (CPCs), who pressured the smaller bondholders to deposit their bonds with the company and acquired the voting rights, enabling the companies to alter the legal obligations of the debts. This often led to abuse, since the management was working together with the legal team who held the proxy votes. To stem these perceived abuses, the Securities Exchange Commission, led by the New Deal proponent William Douglas, issued a lengthy report detailing the reorganization process and recommending reforms. The SEC Report was primarily concerned with protecting “investors, unorganized and largely helpless to help themselves, [who] have little freedom of choice but to go along with those who, self-constituted and self-appointed, announce themselves as their protectors.”

The Report was concerned that these investors were locked in to a proceeding while represented by committees (through the “solicitation of proxies, deposits, and assents” who have “palpably conflicting or adverse interests.” The SEC wanted to protect individual investors from what it called a “‘Hobson’s choice’ of not depositing (or withdrawing their securities on payment of a penalty or assessment)—with the result that they get little or nothing—or going along with the committee and paying the


111 8 REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 310 (1940) [hereinafter SEC REPORT].

112 8 SEC REPORT 309.

113 Id. at 310.
committee such toll as the committee may dictate.”\textsuperscript{114}

To ensure that the Creditor Protection Committees were no longer “incompetent or faithless fiduciaries,”\textsuperscript{115} Congress created the rules governing the powers and responsibilities of the Official Creditors’ Committees, to make them competent and faithful, and to eliminate conflicts of interest through disclosure.\textsuperscript{116} Unlike the fiduciary OCC, which was formed in response to the corrupt Creditor Protection Committees, informal committees are quite different and do not deserve the comparisons to the CPCs that the \textit{Northwest} and \textit{Washington Mutual} courts have made. First, and most significantly, informal groups do not acquire control of non-members’ claims. The old CPCs had direct control over the claims, through “proxies, deposits, and assents.”\textsuperscript{117} This is the classic fiduciary scenario.\textsuperscript{118} Second, creditors in the time of the CPCs had no other option—either they refused to turn over their claims (in which case they almost certainly received nothing), or they turned over their claims (in which case they received something but much less than they should).\textsuperscript{119} Today, individual creditors have a different set of choices: go along with the Official Creditors’ Committee (which has fiduciary obligations to properly represent their interests), form a separate committee with like-minded creditors, or sell on the bankruptcy market. The creation of the OCC solved the problem of creditors unfairly receiving nothing. Moreover, with the development of

\begin{thebibliography}{99}
\bibitem{114} Id.
\bibitem{115} Id.
\bibitem{117} 8 SEC REPORT 309.
\bibitem{118} See, \textit{e.g.}, \textit{RESTATEMENT (THIRD) OF TRUSTS} § 2 (2003) (fiduciary relationship created when one party entrusts property to another); \textit{RESTATEMENT (THIRD) OF AGENCY} § 1.01 (2006) (fiduciary relationship created when one party assents to another party acting on her behalf).
\bibitem{119} The creditors faced a “‘Hobson’s choice’ of not depositing (or withdrawing their securities on payment of a penalty or assessment)—with the result that they get little or nothing—or going along with the committee and paying the committee such toll as the committee may dictate.” 8 SEC REPORT 310.
\end{thebibliography}
a competitive claims trading market, creditors can receive something immediately. Third, OCCs are tasked with representing the interests of all creditors, while informal groups have more specific purposes, depending on the needs of its members. To force informal groups to consider (at the threat of penalties) the interests of non-members potentially undermines the specific purpose for which the informal committee was formed, and also superfluously creates new judge-made rules that already do what the OCC is designed to do. To apply fiduciary duties to informal groups would turn them into another type of OCC. This undermines Congress’ intention to have both formal and informal groups participating in bankruptcy proceedings,\(^\text{120}\) because it renders both the OCC superfluous and the informal group less effective.

3. Distinct Reimbursement Structures

The Bankruptcy Code’s distinction between fiduciary and non-fiduciary groups can be further illustrated by the different reimbursement structures in the Code. Relying on informal creditor committees to represent all shareholders would place an unfair financial burden on the committee.\(^\text{121}\) The committee members would face a “significant reimbursement risk”\(^\text{122}\) because they would have to pay expenses upfront with the hope of getting repaid by the estate, but only if they can convince

\(^{120}\) See, e.g., 11 U.S.C. § 503(b)(3)(D) and (F) (contrasting “a committee representing creditors or equity security holders other than a committee appointed under section 1102” with “a committee appointed under section 1102”).

\(^{121}\) See, e.g., In re Nw. Airlines Corp., 2007 WL 128356, at *23 (Bankr. S.D.N.Y. Jan. 11, 2007) Memorandum of Law of Ad Hoc Committee of Equity Security Holders In Support of Motion for an Order Compelling the Acting United States Trustee for Region 2 to Appoint an Official Committee of Equity Security Holders (“This really asks the Ad Hoc Committee, which is not a fiduciary, to bear a significant reimbursement risk for the benefit of all equity holders.”).

\(^{122}\) Id.
the court that they made a “substantial contribution” to the case under §503(b)(3)(D).\textsuperscript{123}

This conditional reimbursement rule creates risk, which has a real effect on determining whether, or to what extent, to pursue a claim. Substantial contribution generally requires some intent to benefit the estate, but there is a split among jurisdictions over whether self-interested motivations should count against awarding reimbursement.\textsuperscript{124} Moreover, even if the group is reimbursed, its members are forced to raise the capital necessary to fund the litigation, and any reimbursements will come much later, perhaps years later. If the creditors cannot or will not pay, the burden is shifted to the lawyers to collect from the creditors and wait to be paid down the road. It also creates substantial freeloader problems, since non-member creditors will benefit at the ad hoc committee’s expense, especially if courts require ad hoc groups to act in the best interests of all creditors.

If a court holds that the groups are fiduciaries, this method of

\textsuperscript{123} To receive reimbursement under § 503(b)(3)(D), a party must satisfy the following test: (1) The actions must have benefited the estate; (2) the party must have “acted to benefit a class of creditors or interest-holders of which class it was a member,” or acted to “serve the more general good”; (3) the party would have done same thing without the expectation of reimbursement; (4) the benefits from the applicant outweigh the costs; (5) the group’s activities should be different from that of the official statutory committees; (6) if the group had negative effects on the estate, these could offset any benefit. See In re Mirant, 354 B.R. 113, 132-34 (Bankr. N.D. Tex. 2006).

\textsuperscript{124} See, e.g., In re Cellular 101, Inc., 377 F.3d 1092, 1097-98 (9th Cir. 2004) (discussing the split among jurisdictions and citing cases). New York and Delaware courts generally hold that there must be an intent to benefit the estate as a whole above and beyond any self-interested motivations. See, e.g., In re Enron Corp., Case No. 01-16034-AJG, at *7 (Bankr. S.D.N.Y. Dec. 28, 2005) (“While the applicants certainly participated extensively in these cases, there is no evidence that their actions were directly connected to concrete benefits to creditors that would allow for one of those rare grants of an award for a substantial contribution. Rather than being extraordinary, each applicant's participation in these cases was as an active creditor that seeks to protect its interests and in certain respects was duplicative of the protection provided by the Committee.”); see also Lebron v. Mechem Fin. Inc., 27 F.3d 937, 944 (3d Cir. 1994) (“Most activities of an interested party that contribute to the estate will also, of course, benefit that party to some degree, and the existence of a self-interest cannot in and of itself preclude reimbursement. Nevertheless, the purpose of § 503(b)(3)(D) is to encourage activities that will benefit the estate as a whole . . . .”).
reimbursement would create disparities between other fiduciaries who are guaranteed priority administrative expense claims. The fact that Congress established this payment system shows that they did not intend for ad hoc groups to be fiduciaries.

Indeed, as it works now, §503 actually creates an interesting incentive for ad hoc committees to act in the best interests of the shareholders as a group, mitigating some of the problems judges have found: if they meet the “substantial contribution” test, they get reimbursed; if not, they pay out of pocket. So, they will only get reimbursed if, after-the-fact, they acted in the best interests of all the shareholders.

Without the chance of reimbursement, a creditor would only spend one dollar if it generated more than a one-dollar return. With reimbursement guaranteed, the creditor has a blank check, and would spend more than one dollar (of the estate’s money) to generate less than (or equal to) a one dollar return. So forcing each party to pay her own way would restrict activities to those with a positive net benefit to the estate. However, some activities add value to the estate, and some merely redistribute value from one party to another. Courts should reimburse an actor if the activity accomplishes the former, but not if it merely does the latter. If parties do not get reimbursed for activities that increase value to the estate, some value-additive activities will not be pursued. This is because if the creditor pays, she will only spend one dollar to receive more than a one-dollar return to herself. That means, for example, if there are ten creditors with equal priority, the activity will need to produce more than ten dollars for the creditor to pursue it. If the one-dollar activity produces only nine dollars

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125 Mirant adds: “[T]he thrust of section 503(b)(4) should be to prevent a creditor or interest holder from suffering greater loss from a debtor’s bankruptcy than do its peers where that loss resulted from expenditures by the applying party that benefited those very peers.” In re Mirant, 354 B.R. at 134.
(or anything between $1.01 and $9.99), then that activity would create value for the estate, but the creditor will not pursue it since her return after distribution will be less than one dollar.

Thus, the rule should be to award reimbursement for value-additive activities and to not award reimbursement for value-redistributing activities.\(^\text{126}\) Such a rule would encourage value-additive activities, and mitigate some of the problems that judges have identified regarding contentious and expensive bankruptcy battles.

As it stands, if applied properly, the “substantial contribution” rule encourages value-additive behavior. If the ad hoc committees are considered fiduciaries of similarly situated creditors, then various agency problems could arise, by either over- or under-investing in the litigation and negotiations. If, as recognized fiduciaries, informal groups were guaranteed to meet the “substantial contribution” requirements and get reimbursed, they could bring frivolous suits and pursue “scare tactics” at the estate’s expense with the hope of redistributing wealth to its own group.\(^\text{127}\) If ad hoc committees are deemed fiduciaries but still face the reimbursement risk from §503, then they could under-invest in the litigation by stepping down once their own minimum payout is generated, not capturing as much in damages for the entire class as they otherwise could.\(^\text{128}\)

\(^\text{126}\) This concept has support in the idea in Mirant that the benefits of the creditor to the proceedings must outweigh the costs. See id. See also In re Enron Corp., supra note 126.

\(^\text{127}\) See, e.g., Allen et al., supra note 44, at 371-72 (discussing classic agency problems encountered in shareholder litigation).

\(^\text{128}\) More specifically, with reimbursement risk but no fiduciary duties, creditor groups will pursue either value-redistributive activities (and not get reimbursed) or value-additive activities (and possibly be reimbursed); §503 encourages more value-additive activities, but no fiduciary duties allows groups to also pursue value-redistributive activities on their own dime. With fiduciary duties and reimbursement risk, groups would face the same risk for value-additive activities, but much more risk for value-redistributive activities. Their total expected risk-adjusted return from the reorganization will be lower. They will thus be less likely to invest in the case, including in value-additive activities (which cannot be supplemented with value-redistributive activities to the same extent).
B. Similar to Individual Creditors

1. Blurry Distinction

Imposing fiduciary obligations for informal creditor groups would create unjustified disparities between informal groups and individual creditors.

It is well established that individual creditors owe no fiduciary duties to other creditors. Judge Friendly in In re W.T. Grant described the broad “permissible parameters” a creditor can work within to enforce its claim: “[A]part from [voidable preferences and fraudulent conveyances proscribed by the Bankruptcy Act] there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims.”

The broad “permissible parameters” that creditors enjoy is in sharp distinction to those announced by the Northwest Airlines and Washington Mutual courts:

By acting as a group, the members of the shareholders' Committee subordinated to the requirement of Rule 2019 their interest in keeping private the prices at which they

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129 Cosoff v. Rodman, 699 F.2d 599, 609 (2d Cir. 1983) (“A creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim.”).

130 Id. at 610. Judge Galgay, in the lower bankruptcy decision, explained that “[p]arties may assuredly deal at arm's length for their mutual benefit without raising a confidential relationship between them . . . It may be that his conduct did not conform to the highest ethical standards, but having no fiducial relationship, his duty arose no higher than the morals of the market place.” In re W. T. Grant Co., 4 B.R. 53, 75 (Bankr. S.D.N.Y. 1980) (citation omitted).
individually purchased or sold the Debtors' securities. This is not unfair because their negotiating decisions as a Committee should be based on the interest of the entire shareholders' group, not their individual financial advantage.\textsuperscript{131}

Judge Walrath warns of the “unique problems associated with collective action by creditors through \textit{ad hoc} committees or groups”\textsuperscript{132} that requires treating them differently from individual creditors, namely the fact that their ability to share resources, administrative costs, and the voting and negotiating power associated with large claims is a form of “leverage” whereby these creditors can extract more value from their claim while decreasing their individual risk. The \textit{Washington Mutual} court considered that the mere fact of working collectively as a group might create fiduciary duties towards those creditors who could potentially be in the group but are not.\textsuperscript{133}

However, she fails to explain why this “leverage” is a “problem[]” rather than a cost-effective way to pursue a claim. As another Delaware court asserted: “there is nothing neither nefarious nor problematic, in and of itself, in disparate parties banding together to increase their leverage. Indeed, enabling such is one of the primary rationales for the existence of the Bankruptcy Code.”\textsuperscript{134} If small trade creditors had shared an attorney,


\textsuperscript{132} \textit{In re Wash. Mut., Inc.}, 419 B.R. 271, 280 (Bankr. D. Del. 2009) (“Collective action of creditors through the use of an \textit{ad hoc} committee or group is a form of leverage, wherein the parties utilize other group members' holdings to obtain a greater degree of influence on the case. This enables theoretically better returns than if creditors were to act individually in a case. This is especially true, for example, where a group or committee controls one-third of a class of claims, which might allow the group to block confirmation of a plan.”).

\textsuperscript{133} \textit{Id.} at 279 (“It is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class.”).

\textsuperscript{134} \textit{In re Premier Intern. Holdings, Inc. (“Six Flags”)}, 423 B.R. 58, 76 (Bankr. D. Del.
the court likely would not have had a problem. Generally, sharing administrative costs saves money, which is particularly desirable for the estate as a whole considering that under §503(b) that the estate may have to reimburse the committee.

The distinction between single creditors and creditor groups is an arbitrary line-drawing choice by the Rules Committee, not an inevitable one. Indeed, Judge Walrath noted this when she wrote that the potential for conflicts of interest is really “a strong argument in favor of disclosure of

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2010).

As an illustration, the debate over Rule 2019 began when two industry groups argued that Rule 2019 should be appealed because it unfairly distinguishes between groups and individuals. The National Bankruptcy Conference replied that such a disparity called for broadening the rule to include individuals as well. The resulting amended Rule 2019, however, was a compromise that broadened the scope only to informal groups, not individuals. See Letter from Securities Industry and Financial Markets Association (SIFMA) and The Loan Syndication and Trading Association (LSTA), to Peter McCabe, Secretary, Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, re: Federal Rule of Bankruptcy Procedure 2019, at 17 (Nov. 30, 2007), http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202007/07-BK-G-.pdf (“To the extent that Rule 2019 provides the court and the debtor with an understanding of the motives of participants in the process, it is under-inclusive, because it does not require disclosures from all participants, just from ad hoc committees. Therefore, if transparency truly allows the court and the debtor to ‘root out’ investors who act in bad faith or to uncover conflicts of interest between committee members and their representatives, then the Rule should apply equally to all participants in a bankruptcy case and not just to members of ad hoc committees. For example, in the Papercraft and Mirant cases, the wrongdoers were individual creditors, not ad hoc committees or members thereof.”); Letter from National Bankruptcy Conference, to Advisory Committee on Bankruptcy Rules, at 5 (Jan. 29, 2010), http://www.nationalbankruptcyconference.org/images/NBC%202010%20Ltr%20to%20Rules%20Cte%20R%202019.pdf (“In its December 10, 2008 letter, the Conference recommended that disclosure of purchase price information and date of purchase be required only of members of ad hoc or unofficial committees or groups (however denominated) and individual creditors or equity holders that claim to be representative of (or to speak on behalf of) claims or interests similar to those represented on the committee or group or held by the individual. The Conference saw no need to require the disclosure of purchase price or date of purchase information from individual creditors or creditor groups that do not purport to speak for or on behalf of others.”) (emphasis added); Fed. R. Bankr. P. 2019(b)(1) (only applying to “every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one another.”).
the total economic interest of all creditors,” not just creditor groups.\textsuperscript{136}

2. Strategic Opportunities

Disparate treatment between single and multiple entities will produce strategic opportunities for creditor groups seeking to avoid disclosure obligations. Large distressed funds do not always require teaming up with other groups in order to gain advantageous positions in bankruptcy proceedings.\textsuperscript{137} If they go it alone, they can avoid the disclosure rules. They may also avoid the disclosure rules under a new feature of the amended Rule 2019, since the rule now only applies to entities that are “not composed entirely of affiliates or insiders of one another.”\textsuperscript{138} If fiduciary or other duties are recognized by courts based on the groups’ representation of other creditors, then avoiding the disclosure rule, for which “representation” is a prerequisite, will also avoid any implied duties associated with it.

For example, in \textit{Milacron},\textsuperscript{139} a recent Ohio case, two hedge funds, Avenue Capital Group and DDJ Capital Management pursued an interesting tactic to purchase the distressed company, a plastics manufacturer. Avenue and DDJ had originally hired the law firm Bracewell & Giuliani to jointly represent them,\textsuperscript{140} but about two months before the derivative lawsuit, Avenue (spread out across multiple funds) purchased DDJ’s holdings. The result was that the Avenue funds became the only movants in the case, and

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\item \textsuperscript{136} \textit{In re Wash. Mut., Inc.}, 419 B.R. 271, 280 (Bankr. D. Del. 2009).
\item \textsuperscript{137} See, \textit{e.g.}, \textit{In re Innkeepers USA Trust}, 448 B.R. 131, 144 n.25 (Bankr. S.D.N.Y. Apr. 1, 2011) (where the single creditor held “varied holdings, . . . pursuing its own pecuniary interests which may be at odds with the interests of other certificateholders”).
\item \textsuperscript{139} \textit{In re Milacron, Inc.}, 436 B.R. 515 (Bankr. S.D. Ohio 2010).
\item \textsuperscript{140} \textit{See In re Milacron, Inc.}, No. 09-11235-JVA, Amended Rule 2019(a) Disclosure Statement [Docket No. 978], at *8 (Bankr. S.D. Ohio Nov. 9, 2010).
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DDJ was no longer a client of the firm.\textsuperscript{141} The specific motivation for this transaction is unclear.\textsuperscript{142} However, the outcome was that the purchase price and other information relating to DDJ’s holdings were not disclosed: the amended statement lists the original acquisition dates and prices of only the pre-petition holdings, but not the holdings acquired from DDJ.\textsuperscript{143} Avenue’s basis in the company cannot be determined from the disclosure statement.

The remaining creditors in the lawsuit were all wholly-owned and wholly-managed subsidiary funds owned by Avenue Capital Group.\textsuperscript{144} Although the debtors admitted that the Avenue funds were the “only parties with a real economic stake in the derivative claims,”\textsuperscript{145} the court did not look past the formality of the parent fund’s structure, and ordered them to submit individual disclosures detailing their holdings, including the acquisition dates, number of shares, and purchase price, because they were an “entity representing more than one creditor” under the language of Rule 2019.\textsuperscript{146} If only one Avenue fund had been holding the claims, it would not have been subject to Rule 2019 and would have needed to disclose far less information.\textsuperscript{147} Yet under the new amended Rule 2019, the Avenue funds would not be required to file a disclosure statement. The new rule only

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\item Milacron, 436 B.R. at 516.
\item See \textit{Funds and accounts managed by DDJ fully realize investment in Milacron Holdings Inc.,} \textit{DDJ Capital Management News}, http://www.ddjcap.com/page/7/news/54/ (May 11, 2010) (only stating that the investment was “fully realize[d]”).
\item Id. 436 B.R. at 516.
\item Id. (“The nameless movants [were] Avenue Special Situations Fund IV, L.P., Avenue Investments, L.P., Avenue CDP Global Opportunities Fund, L.P., Avenue International Master, L.P. and Avenue Special Situations Fund V, L.P. (hereinafter the ‘Avenue Movants.’).”) The shares of DDJ Capital were purchased by the Avenue funds, who were the only movants in the case. \textit{See In re Milacron, Inc.,} No. 09-11235-JVA, Amended Rule 2019(a) Disclosure Statement [Docket No. 978], at *7 (Bankr. S.D. Ohio Nov. 9, 2010).
\item Milacron, 436 B.R. at 516.
\item Id.
\item However, perhaps the fact that this was a derivate suit would implicate the concern noted in \textit{Washington Mutual.}
\end{enumerate}
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applies to entities that are “not composed entirely of affiliates or insiders of one another.”\textsuperscript{148} This was the case here.

Thus, under the new amended Rule 2019, a creditor group could follow a similar strategy to avoid the disclosure obligations—namely, by setting up multiple subsidiary investment funds, and purchasing the claims of other hedge funds that are pursuing a similar strategy. Multiple subsidiary funds could help disperse risk across the funds by holding different classes of securities, allowing investors to choose which level of risk they prefer (i.e. from lower-risk secured debt to higher-risk equity), while maintaining control and privacy over the entire fund.

Moreover, since the amended Rule 2019 excludes groups that are “composed entirely of affiliates or insiders of one another,”\textsuperscript{149} groups could become affiliates through forming a parent umbrella company, or merging together.

It would be possible for groups that often sit at the same table in large bankruptcies to set up Special Purpose Vehicles (SPVs) to merge their holdings during the course of the case. To avoid being an “entity that represents . . . multiple creditors,”\textsuperscript{150} an SPV could “purchase” the claims in exchange for an option to buy the claims at a future date (with a strike price set to the value of the claims at the time of purchase by the SPV). The funds would buy back the sold assets if the price increased after the bankruptcy, and capture the profits. If the value of the claims goes down, the firms might try to avoid repurchasing the asset. So the SPV could purchase a put option from the firms in addition to the asset, where the firms promise to buy the asset if it falls below the strike price (set to equal the strike price of the call option). The parties would not need to show the

\textsuperscript{149} Id.
\textsuperscript{150} Id.
court a copy of the sale agreement.\textsuperscript{151} This setup would likely avoid the Rule. However, a judge may regard this as a sham sale. Further, since the investors no longer own the claims, trading would be restricted during the case (an SPV’s biggest drawback), though perhaps the traders could continue to sell their holdings to the SPV over the course of the reorganization.\textsuperscript{152} There would be no significant additional control issues, because the attorney would manage the SPV’s activities, and could consult with its clients.

The problem is that this could be costly to form and administer. It is unclear how costly the disclosure rule actually is, especially with the compromise requirement to only disclose the quarter and year of acquisition, not the specific date.\textsuperscript{153} So the avoidance may not be worth it. However, fiduciary duties would dramatically raise the stakes, since creditors could be faced with potential liabilities for making money at the expense of others. This would lead to more groups avoiding Rule 2019 through these tactics, resulting in poorer public bankruptcy data\textsuperscript{154} and a worse outcome for disclosure advocates.

An additional issue is that managers would lose control over their entities. There may also be ego clashes or other struggles between the

\textsuperscript{151} Rule 2019(c)(4) says to attach “a copy of the instrument, if any, authorizing the entity, group, or committee to act on behalf of creditors or equity security holders.” Fed. R. Bankr. P. 2019(c)(4). But this would be an outright sale, not an authorization to act of the funds’ behalf.

\textsuperscript{152} Assuming there are no insider trading questions as in \textit{WaMu}. Though with such a setup, it would be easier to set up an ethical wall. See \textit{In re Wash. Mut., Inc.}, 461 B.R. 200, 266 (Bankr. D. Del. 2011) (“[C]reditors who want to participate in settlement discussions in which they receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case.”)


\textsuperscript{154} See, e.g., \textit{Northwest Airlines II}, 363 B.R. 704, 706 n.1 (Bankr. S.D.N.Y. 2007) (“\textit{Bloomberg states that its motion is ‘an effort to ensure that the public has a full and accurate understanding of the events occurring in this Chapter 11 proceeding, including the motivations and interests of the players who seek to control an important public company.’”} (citing \textit{Bloomberg LLP}, Memorandum of Law, at *1).
strong personalities of fund managers.

Further, the rule’s application to groups or entities that are “acting in concert to advance their common interests” §2019(b)(1) leaves many questions open to future clarification (via costly litigation.) Most of the cases involved groups of creditors hiring the same lawyer: if multiple hedge funds hire separate counsel who just work together, would this avoid the disclosure rule?

Regardless, a loose assertion that creditors acting in concert are categorically more problematic than creditors acting alone is difficult to justify and will lead to odd and formalistic disparities.

C. Secured Creditor Monopoly

Like any individual creditor, a secured creditor has no fiduciary duties. If large secured lenders (such as banks) face no fiduciary obligations, and no expectation to act charitably (as long as they do not act fraudulently, or do something expressly impermissible by the Bankruptcy Code), it seems unfair to place such a burden on a group of creditors working together to aggregate claims in order to gain a bargaining position able to negotiate with a strong secured creditor (i.e. to get on an equal footing with the bank).

Judge Galgay explains that a bank is not considered an insider “[e]ven in the situation where a creditor exercises a significant degree of daily monitoring of its debtor,” i.e., where the bank has a significant informational advantage and familiarity with the financial affairs of the

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155 Cosoff v. Rodman, 699 F.2d 599, 609 (2d Cir. 1983) (“A creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim.”).

debtor. Moreover, for non-insider creditors, “[a] mere statement that the creditor is guilty of ‘inequitable conduct’ will not suffice.” That is, “inequitable conduct” is not illegal and does not force stricter duties or burdens on a creditor.

Moreover, a group of secured lenders in a syndicated credit facility likely do not have fiduciary obligations, since these types of creditor groups are explicitly excluded from the revised disclosure requirements. However, just like ad hoc groups, syndicated loans are designed to lower risk and create “leverage”—the factor that troubled the WaMu court—so the treatment in these cases of each party should be the same.

If banks can pursue such activities without facing any consequences, then an unsecured creditor bloc should be able to as well. This would allow less-regulated financial institutions (such as private equity and hedge funds) to compete in a way that reflects how the outside market functions. The fact that banks are more heavily regulated than private funds may be a reflection of Congress’ decisions about how to regulate economic actors. The Bankruptcy Code, which is also enacted by Congress, should reflect these decisions, and not seek to alter the balance between types of financial institutions by extra-statutory judicial decision-making. It may well be

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157 Id. Although the case was discussing equitable subordination, fiduciary duties are a prerequisite. “The remedy of equitable subordination has been applied only sparingly and is not to be used unless the claimant sought to be subordinated (a) has acted in a fiduciary capacity; (b) has breached a fiduciary duty; (c) that breach resulted in detriment to those claimants to whom a duty was owed.” In re W. T. Grant Co., 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980).

158 Fed. R. Bankr. P. 2019(b)(2)(B) (exempting “an agent for one or more other entities under an agreement for the extension of credit”).


160 See Butner v. U.S., 440 U.S. 48, 55 (1979) (holding that “[u]nless some federal interest requires a different result, there is no reason why [non-bankruptcy property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding”). See also Barry Adler, Douglas Baird & Thomas Jackson, Bankruptcy: Cases, Problems, and Materials 29 (4th ed. 2007) (“[I]n the absence of a specific bankruptcy provision to the contrary, bankruptcy takes nonbankruptcy rights as it
that Congress intended the regulatory landscape to allow private funds to function with fewer regulations. Possible rationales for such a decision may be: (a) it is a way to funnel riskier activities into private funds that are not backed by government-sponsored insurance (FDIC); (b) private funds do not engage in deposit banking activities so are less susceptible to wide-scale bank runs that would lead to systemic problems; (c) customers of private funds tend to be more sophisticated and higher net worth individuals, so they are better equipped to assess the risks of the investment strategy and suffer any losses that may occur; and (d) these sophisticated customers can indirectly shape the funds’ trading and investment strategies by choosing which funds to invest in (so unpopular or unprofitable investment strategies will fail to attract investor funding and will close down). If this is Congress’ intention, it may be more desirable to allow private funds to increase their involvement in bankruptcy proceedings, which are generally higher risk investments involving more sophisticated actors.

Competition between secured lenders and unsecured (or junior secured) creditors is desirable considering the increasing dominance and monopolization of secured lenders in the bankruptcy process.\textsuperscript{161} Banks often push a debtor into bankruptcy more quickly when a default provision is triggered, rather than negotiate with the borrower. They can control much of the process by providing access to DIP financing. They are often at an advantage vis-à-vis other potential lenders, through the use of roll-ups, credit bidding, and cross-collateralization, as well as through an informational advantage gained from audits and familiarity with the

\textsuperscript{161} See, e.g., DOUGLAS BAIRD, ELEMENTS OF BANKRUPTCY 222 (5th ed. 2010) (“In short, many large Chapter 11 cases today, the secured creditor is the eight hundred pound gorilla in the room. . . . Even though the Bankruptcy Code is built around the premise that general creditors are the residual claimants, there is nothing in the Bankruptcy Code that prevents a bankruptcy from going forward that benefits only secured creditors.”).
company over the history of the lending relationship. Allowing junior lienholders and other competing lenders to provide better financing would infuse competition into the process, lowering the cost of capital for a debtor seeking DIP financing, or raising the price of assets or the company in a §363 sale,\(^{162}\) benefiting the estate and its creditors as a whole.\(^{163}\) Although a bank could argue that it would not lend but for the roll-ups, cross collateralization, and other provisions, if other lenders would finance the debtor, then this bank should also be willing and able to finance without such provisions; thus, the bank receives a “bonus” when it gets these benefits, rather than a necessary term.\(^{164}\) Alternatively, if no one would lend absent these special provisions, then perhaps the debtor is not a viable company and would be more valuable if liquidated under Chapter 7. The only benefit of allowing these special provisions would be to enable the petition lender to cut its losses and recover more than it would otherwise.

\(^{162}\) Increased competition through § 363 sale auctions is preferred by a number of courts over judicial or “expert” valuation of assets. See, e.g., Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999) (holding that markets, not judges, should determine priority entitlements); Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935 (5th Cir. 1983) (advocating for market protections for creditors through auctions in § 363 sales); Statutory Committee of Unsecured Creditors v. Motorola Inc. (In re Iridium Operating LLC), 373 B.R. 283, 291 (Bankr. S.D.N.Y. 2007) (“The public markets constitute a better guide to fair value than the opinions of hired litigation experts whose valuation work is performed after the fact and from an advocate’s point of view.”) (adopting VFB LLC v. Campbell Soup Co., 482 F.3d 624 (3d Cir. 2007)). Further, some commentators argue that the market value of claims can be a better determinant of the value of the debtor’s securities than a judge. See Duston McFaul & Kirk Cheney, “Are a Debtor’s Trading Prices Reliable Evidence of Its Enterprise Value?,” 30 Am. Bankr. Inst. J. 56-7, 59 (Sept. 2011).

\(^{163}\) For example, regarding an employee buyout by Neuberger Berman of a 48% stake in its company owned by Lehman Brothers Holdings, Inc., financial advisor Jack McCarthy stated: “This transaction . . . delivers maximum value to Lehman’s creditors. We are very appreciative of the input we received from the ‘ad hoc group’ of creditors in advocating for the best return possible for the estate . . . .” See “Court Approves Neuberger Berman Acquisition of Lehman Brothers Holdings’ Remaining Equity Interest,” Lehman Brothers Holdings Inc. Press Release (Dec. 14, 2011), http://eon.businesswire.com/news/eon/20111214006150/en.

\(^{164}\) However, differences between banking and private equity regulations could make it that a bank would need additional provisions than private lenders to counter the more burdensome regulations.
and to enable the debtor to gamble to stay alive, at the expense of the other creditors.\footnote{165}

Banks may also help managers fund leveraged buyouts, which shift significant risk onto pre-transaction unsecured creditors. With so much secured debt, the manager gains the upside but the unsecured creditors get the downside, while the bank, holding secured debt, is mostly indifferent.\footnote{166} Often these LBOs and general overleveraging result in debtor bankruptcy.\footnote{167} Having strong, organized unsecured creditor groups would help protect the unsecured creditors from these scenarios.\footnote{168}

\textbf{D. Similar to Non-Traders: The “Victims” Theory}

There is a misunderstanding that, although bankruptcy—with all its fast-paced negotiations and mini-trials—is a dynamic process, the

\footnotetext{165}{However, maybe the other creditors want the debtor to gamble because they reap the benefits if the gamble pays off. This decision would depend on how much they would lose if the gamble fails and the expected value of the gamble, versus the amount they would recover in a liquidation. Yet when the secured creditor improves its position through these special provisions, the risk of the gamble decreases for the secured creditor and increases for the creditors.}

\footnotetext{166}{See, e.g., \textit{Moody v. Sec. Pac. Bus. Credit, Inc.}, 971 F.2d 1056 (3d Cir. 1992) (analyzing a failed leveraged buyout). However, the pre-transaction creditors can protect themselves with additional covenants in their contracts, though this is costly, and irrelevant for involuntary creditors.}

\footnotetext{167}{See, e.g. \textit{Weinberger v. Kendrick}, 698 F.2d 61, 66 (2d Cir. 1982) (where the plaintiffs contended that the bank had lent large sums of money, secured by assets, to the company leading up to the bankruptcy, which allowed them to “exercise considerable control over the management of the company in its final years”).}

\footnotetext{168}{Another example of a secured lender pursuing its own interests to the detriment of the unsecured creditors is \textit{In re Tropicana Entertainment LLC. Ad Hoc Consortium of Senior Subordinated Noteholders v. Liquidating Landco Debtors (In re Tropicana Entm’t LLC), Case No. 08-10856-KJC (Bankr. D. Del. September 22, 2010). The secured lenders (who had pushed the company into bankruptcy) were opposing the ad hoc groups’ reimbursement, solely because the priority expenses being asked for by the group would take priority over the secured lenders’ claim. The ad hoc committee had added significant value by advocating to replace incompetent management, “result[ing] in an actual and demonstrable benefit to the estate and the creditors,” and gaining the support of the OCC. \textit{Id.} at *3. Surprisingly, the banks actually won and the ad hoc group was not reimbursed.}
bankruptcy participants are static. The company’s creditors are pulled into the process along with the failing debtor, and we hope that the bankruptcy rules will help the creditors get back whatever they can from their lost money (cents on the dollar). Accordingly, a sharp distinction has been drawn between the “victims of financial distress” and “those who choose to enter [the bankruptcy system] to make a profit.”169 However, while some creditors may be more sympathetic than others (such as tort victims), this distinction is not a bright line, and should be avoided. The assumption that most creditors are financial victims is false.

First, voluntary pre-bankruptcy creditors entered transactions with the debtor, understanding (or able to learn) that bankruptcy is a risk of doing business, and this risk was (or should have been) factored into the transaction: such as by negotiating for higher interest rates, a security interest, higher priority, covenants, or other protections. Bankruptcy is not a segregated world, but is a part of business and financing. It is not clear why someone who becomes a creditor immediately before a bankruptcy petition is filed is different from someone who becomes a creditor

169 Hon. Robert E. Gerber, Prepared Testimony re: Rule 2019, at 3-4 (Feb. 5, 2010) http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/2009%20Comments%20Committee%20Folders/BK%20Comments%202009/09-BK-019-Testimony-Gerber.pdf (emphasis removed) (“While the bankruptcy system was initially created, and continued for many years, to serve the victims of financial distress, there’s more than enough room in the bankruptcy system to serve those who choose to enter it to make a profit. But the notion that the transparency and integrity of the system that investors choose to enter should be abandoned to suit their desires is offensive to me.”). See also In re Mirant, 354 B.R. 113, 135 (Bankr. N.D. Tex. 2006) (distinguishing between those who choose to enter the bankruptcy process—for whom administrative expenses are a “cost of doing business”—and those who enter against their will—for whom administrative expenses are more deserving of reimbursement). See also 8 SEC REPORT, supra note 113, at 310 (“On default, investors, unorganized and largely helpless to help themselves, have little freedom of choice but to go along with those who, self-constituted and self-appointed, announce themselves as their protectors. . . . An investor with an investment in an insolvent company holds the securities; his investment has already been made; his choice is drastically limited. It will be of small comfort to know that those who control his destiny are incompetent or faithless fiduciaries.”) (emphasis added).
immediately after a bankruptcy petition, except that with the first, bankruptcy was highly probable, not definite.

Second, creditors can always exit the system by selling their claim to a third party, discounted to reflect the claim’s expected recovery and time horizon. This strategy has a long history in bankruptcy practice. Similar strategies have been employed through “factoring” of accounts receivables.\(^{170}\)

Third, for those pre-petition creditors who choose to remain, many can alter their status or their claims once the bankruptcy commences. Most often, a pre-petition creditor will invest more money into the debtor, through debtor-in-possession (DIP) financing, through purchasing discounted securities,\(^{171}\) or just through continuing to do business with the debtor. Other times, pre-petition creditors can improve their existing claims through other methods. For example, pre-petition secured creditor banks often provide DIP loans through roll-up financing, where their pre-petition

\(^{170}\) Claims trading has a long history and is expressly permitted. See Fed. R. Bankr. P. 3001(e) (transferred claims). An active claims trading market existed during the Penn Central reorganization in the 1970s. See David Skeel, Jr., Debt’s Dominion: A History of Bankruptcy Law in America 212 (2001). Further, Rule 3001 was amended in 1991 to limit judicial scrutiny of claims trading. See Fed. R. Bankr. P. 3001(e) and Douglas Baird, Elements of Bankruptcy 213 (5th ed. 2010) (“In 1991 . . . the Rules Committee decided to deregulate claims trading, as existing judicial oversight was perceived to impair the liquidity of claims. The effect was to create a market in claims of large debtors.”).

\(^{171}\) In fact, the Washington Mutual case provides an example of one of these “victims” using the debtor’s financial distress as an opportunity for investment as well as to mitigate the losses from his initial, soured investment. Steven Church, “WaMu bankruptcy judge to approve $7 billion reorganization,” Bloomberg Businessweek (Feb. 28, 2012), http://www.businessweek.com/news/2012-02-18/wamu-bankruptcy-judge-to-approve-7-billion-reorganization.html. (“Florin Matache [is] a shareholder who estimates he lost about $10,000 on WaMu common stock purchased before the bankruptcy. . . . Matache, a 34-year-old pharmacist from Roseville, California, said he tried to cut his losses after the Chapter 11 filing by buying WaMu debt securities that had dropped in value. Should the reinsurance company be worth $140 million, as WaMu financial advisers estimated, Matache expects to break even on his post-bankruptcy investments.”) (emphasis added).
debt becomes post-petition super priority debt.\textsuperscript{172} Another method is cross-collateralization (or “bootstrapping”), where pre-petition loans are secured by the debtor’s post-petition assets.\textsuperscript{173} So in fact, many of the non-victim “profiteers” were involved with the debtor long before bankruptcy became inevitable.

In fact, many distressed investors that are considered problematic held significant holdings of debt or equity pre-petition. Based on various factors, some choose to keep what they have and participate, and some choose to purchase more post-petition (or to sell what they already have). So to distinguish between “victims” and “choosers” would put these creditors in the pre-petition “victims” category.

Fourth, a debtor often takes on many post-petition creditors, including administrators (attorneys, financial advisors, accountants and restructuring officers), ordinary course of business trade creditors, and new post-petition lenders. All these creditors choose to do business with a bankrupt company for a profit. It is not clear why bankruptcy courts should be more suspicious of post-petition creditors that enter indirectly through the secondary markets than those who enter directly through “primary markets.”

\textsuperscript{172} An example of this technique is the Lyondell reorganization. See Kelly Holman, \textit{Lyondell could usher in age of roll ups}, \textsc{Leveraged Finance News} (March 19, 2009), http://www.leveragedfinancenews.com/news/-191316-1.html (“In a roll-up, debt is converted into post-petition financing, giving it a higher-priority status in the company’s reorganization.”). \textit{See also} David Griffiths, \textit{Roll-up, roll-up, read all about it!}, \textsc{Weil Gotshal Bankruptcy Blog} (Oct. 6, 2010), http://business-restructuring.weil.com/dip-financing/roll-up-roll-up-read-all-about-it/axzz1jwB13STH.

\textsuperscript{173} \textit{See}, e.g., \textit{Otte v. Mns. Hanover Commercial Corp. (In re Texlon)}, 596 F.2d 1092, 1094 (2d Cir. 1979) (“What [cross-collateralization] means is that in return for making new loans to a debtor in possession under Chapter XI, a financing institution obtains a security interest on all assets of the debtor, both those existing at the date of the order and those created in the course of the Chapter XI proceeding, not only for the new loans, the propriety of which is not contested, but for existing indebtedness to it.”). The \textit{Texlon} court held that cross-collateralization may only be permissible after notice and hearing. However, a number of courts have held that cross-collateralization is impermissible. \textit{See}, e.g., \textit{In re Saybrook Mfg. Co.}, 963 F.2d 1490 (11th Cir. 1992).
Fifth, application of the economic concept of the “sunk cost” may further illuminate this distinction. At the time a bankruptcy petition is filed, all creditors own a particular asset (i.e., the debt owed to them by the debtor), which can be valued based on the expected payout. Any money spent previously to purchase the asset (e.g., lending money, selling goods on credit, providing services) is a sunk cost, and rationally should not be considered in making decisions going forward. Since the creditor’s claim can easily be converted into cash, a pre-petition creditor is ostensibly faced with the same investment decision as a distressed investor. A creditor must consider the best way to deploy its assets: it could either “invest” in the bankruptcy (for a pre-petition creditor, this means keeping its money in the claim; for a post-petition creditor this means taking its money and purchasing the claim) or invest elsewhere (which, for a pre-petition creditor, means collecting the cash by selling the claim and doing something else with it). The question is, going forward, what is the best use of the money, regardless of what happened previously, since any previous money has already been lost. The economically rational decision-making process should be identical for both pre- and post-petition creditors.

The distinction between pre- and post-petition creditors (or, more exactly, creditors who acquire pre-petition claims pre-petition and those who acquire pre-petition claims post-petition) breaks down for these reasons. At this point, the “problem” becomes one of motivation: is the

174 See, e.g., Hal Arkes & Catherine Blumer, The Psychology of Sunk Cost, 35 ORGANIZATIONAL BEHAVIOR AND HUMAN DECISION PROCESS 124, 124 (1985) (“[The sunk cost] effect is manifested in a greater tendency to continue an endeavor once an investment in money, effort, or time has been made. The prior investment, which is motivating the present decision to continue, does so despite the fact that it objectively should not influence the decision.”).

175 Real estate investor Sam Zell cleverly paraphrases this concept as: “Every day you’re not selling an asset that’s in your portfolio, you’re choosing to buy it.” See Zell’s Fundamentals, http://www.egizell.com/fundamentals.html#rule6 (2012).
creditor acting in a way that somehow undermines the bankruptcy process? However, distressed investors have many different motivations, strategies and tactics, and cannot all be lumped together.176

Should the distinction instead be made between those bankruptcy investors who invest directly with the company and those who invest through the secondary markets? With direct investments, the investors would cooperate and communicate with the management of the company, potentially gaining more information, and enjoying a “friendlier” and smoother relationship.177 In contrast, secondary market investors often appear adversarial to the debtor, which could make the process more contentious and make them less popular with the debtor and judge.178

The fact that secondary investors often appear adversarial, unlike a “white knight” or cooperative direct investor, sheds light on the topic raised by Judge Gerber about those creditors who deserve more suspicion (the investors who choose to enter the bankruptcy process) and those who deserve some sympathy (the “victims of financial distress”). Those suspicions tend to be directed towards the secondary market investors, not the direct investors. The real difference between these types of investing is that the debtor can choose which direct investors to deal with, but cannot

176 See, e.g., STEPHEN MOYER, DISTRESSED DEBT ANALYSIS: STRATEGIES FOR SPECULATIVE INVESTORS (2005) (discussing strategies such as active vs. passive investing, capital investment, acquisitions, restructurings, turnarounds, hedging and arbitrage opportunities).
177 Barry Volpert, Opportunities for Investing in Troubled Companies, in WORKOUTS AND TURNArounds: The HANDBOOK OF RESTRUCTURING AND INVESTING IN DISTRESSED COMPANIES 514, 534 (Dominic DiNapoli et al. ed., 1991) (“The key advantage of a direct investment is that no money is invested until the success of a restructuring has been determined. Management must generally cooperate for this to occur. . . . Moreover, the investment will have a ‘friendly’ character, with the investor appearing as a white knight.”).
178 Id. (“[A]n investment in existing securities in secondary transactions may appear adversarial to existing management, and an investor who has already put up her or his money may have less leverage than one who has not and is ready to offer new capital to the company.”).
choose its secondary investors. All creditors, whether pre- or post-petition, choose to participate with the company (for pre-petition creditors this choice comes from accepting the risk of default pre-petition, and choosing to keep their money in the bankruptcy post-petition rather than sell their holdings and purchase a higher-return investment elsewhere;\textsuperscript{179} for post-petition creditors this choice involves purchasing assets, investing money, or buying claims); but the debtor can only choose its direct creditors. To encourage sympathy towards those creditors chosen by the debtor but suspicion towards those not chosen betrays a bias towards debtors.

A primary reason why much of the recent criticism and pushback on claims aggregators have come from judges is that distressed investors are often uncooperative, aggressive, or even misleading.\textsuperscript{180} Normally the job of balancing the competing interests is assigned to the judge, who takes an active role and has power to rule on a broad range of discretionary equitable issues. It may be that distressed investors \textit{also} serve to balance the bankruptcy process, but in different ways than judges: the ad hoc committees provide balance through the dynamic movement of market forces (e.g., pushing for speedy and efficient reorganizations, providing exit opportunities for uninterested and smaller parties, increasing competition for financing), rather than through legal rules and standards.

Moreover, in some areas, claims traders may actually be better positioned than judges to balance the process—especially regarding

\textsuperscript{179} Except for involuntary creditors, such as tort victims, who did not accept the default risk of their claims, though they can choose to sell their claims or potential claims and exit the process.

\textsuperscript{180} Hon. Robert E. Gerber, Testimony before the Advisory Committee on Bankruptcy Rules, “In the Matter of the Proposed Amendments to the Federal Rules of Bankruptcy and Criminal Procedure” 18, 22 (Feb. 5, 2010), http://html.documation.com/cds/NCBJ2010/PDFs/017_11.pdf (“[T]he contrast between what was said and applied to me in those pleadings and what the 2019 revealed was dramatic. . . . [I]t painted a very different picture of the message that they were trying to communicate to me.”).
uncovering information, valuing assets, and analyzing whether there is going-concern value in the company. Their profit motive and personal investment give them strong incentives to uncover as much data as possible in order to arrive at accurate valuations of the company. A judge does not participate in negotiations, does not audit the company, does not witness the “behind the scenes” activities, but only receives his or her information from the parties’ testimony.\textsuperscript{181} Often, the management of the debtor has the greatest access to company information, and the secured creditor is less capable or less interested (especially if fully secured) in expending resources on monitoring. Bankruptcy courts should actually welcome claims traders, as they provide many benefits that could assist courts in overseeing successful reorganizations.

The debate about the rise of claims trading is, at its heart, a debate about striking a balance between market regulation and free market activity.\textsuperscript{182} But it is also a struggle over control of the bankruptcy process.\textsuperscript{183} Perhaps the lesson to be learned from the threat of fiduciary obligations and other assertions of judicial equity powers is that distressed investors need to work more cooperatively and demonstrate to the judge

\textsuperscript{181} See, e.g., \textit{In re Lyondell Chem. Co.}, 402 B.R. 571, 585 n.26 (Bankr. S.D.N.Y. 2009) (citing a distressed investing trade periodical with useful information, but then noting that “newspaper articles are hearsay” and recognizing “the parties’ (and the Court’s) inability to know all of the facts”).

\textsuperscript{182} See, e.g., Adam J. Levitin, \textit{Bankruptcy Markets: Making Sense of Claims Trading}, 4 Brook. J. Corp. Fin. & Com. L. 64, 67 (2010) (discussing the “Great Normative Bankruptcy Debate” about whether bankruptcy should be a market-driven or a rule-driven process, and arguing that claims trading can promote efficiency).

that they respect the reorganization process and the judge’s authority.

CONCLUSION

As the claims trading market becomes more robust, market regulators will seek to regulate it. A few recent high-profile bankruptcy cases raised the possibility of imposing fiduciary duties on informal creditor groups who were active in this market. This paper analyzed the legal justifications for creating new fiduciary obligations between informal creditor groups and other similarly situated creditors. While this scenario does not fit the traditional notions of fiduciary relationships—because creditors compete with each other, and are aware (or should be aware) that other creditors are not necessarily working for their best interests—it may fit the theory that a party can have fiduciary obligations if its right to sue is based on its status as a group member (as is the case with derivative actions) or if it has control over a group (as is the case with controlling shareholders). However, there are strong reasons why a court should not impose fiduciary duties on informal creditor groups: it would undermine the Official Creditors’ Committee, create unfair disparities between individual creditors and creditor groups, lead to wasteful strategic maneuvering, cede too much power to secured creditors, and reinforce a false assumption that other creditors are “victims” needing protection. This paper also posits that the source of the judicial concern over distressed investor involvement in bankruptcy comes largely from the fact that distressed investors often attempt to control the proceedings. This is unfortunate because distressed investors have much to add to the bankruptcy process.

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