The Shadow Bankruptcy System

Jonathan C. Lipson
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This article exposes and explores a puzzle at the heart of the current economic crisis: The surprising under-use, and increasing misuse, of Chapter 11 of the United States Bankruptcy Code, the principal legal system for salvaging troubled businesses.

The answer offered here: The rise of the shadow bankruptcy system. “Shadow bankruptcy” describes the severely under-regulated non-bank financial institutions (e.g., hedge funds, private equity funds and investment banks) that increasingly dominate and manipulate Chapter 11 reorganizations.

Like the “shadow banking” system for which it is named, shadow bankruptcy thrives on and promotes opacity and undisclosed, possibly perverse, incentives. Shadow bankruptcy players exploit regulatory gaps to conceal their identities and motives, and so increase the uncertainty, complexity—and thus the cost—of negotiations to restructure distressed firms; they burden judicial resources through internecine fights of little benefit to reorganizing debtors; they have complex, multi-faceted hedging strategies that may effectively short-sell the debtor’s reorganization effort, resulting in depressed asset values and the premature liquidation of otherwise viable firms.

Shadow bankruptcy threatens Congress’ basic aspiration in creating Chapter 11: preserving going concerns and jobs through negotiated reorganizations. Shadow bankruptcy thus promises to do for corporate reorganization what shadow banking did for the global financial system: privatize gains and socialize losses.

This article explores the contours and costs of the shadow bankruptcy system. It also suggests some cures.

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THE SHADOW BANKRUPTCY SYSTEM

Alas for the affairs of men! When they are fortunate you might compare them to a shadow . . . .

The conduct of bankruptcy proceedings not only should be right but must seem right.

Who knows what evil lurks in the hearts of men? The Shadow knows . . . .

Who’s afraid of Chapter 11?

If responses to the current economic crisis are any indication, the answer is: lots of people. But this is puzzling. Despite the fact that we face the most significant financial trauma since the Great Depression, Chapter 11 of the Bankruptcy Code, the principal legal system for addressing business failure in the United States, is surprisingly under-used, increasingly misused, or both. Thus, in the most egregious examples—Bear Stearns, AIG and the auto industry—the federal government has chosen billion-dollar taxpayer subsidies in order to keep companies out of Chapter 11. In other cases, Chapter 11 has provided cover for what is, in reality, the liquidation of firms that might otherwise be viable going concerns.

Chapter 11 was enacted in 1978 to promote the renegotiation of a troubled firm’s debts, rather than liquidation or litigation. Although the system certainly has its critics,

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2 AESCHYLUS, AGAMEMNON 1.1327 (n.p. 458 B.C.).
3 In re Ira Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966) (emphasis supplied).
7 As discussed in Part 2.2.2 below, an especially troubling example of this involves the remarkable collapse of Steve & Barry’s, a formerly thriving discount retailer taken over by hedge funds.
8 See, e.g., Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship, 526 U.S. 434, 458 n.28
its overarching goal is to preserve going concerns and jobs, thus maximizing recoveries and preventing the collapse of otherwise viable businesses. Why, in the face of such serious financial distress, do we fear the very mechanism Congress created to prevent or remedy these sorts of problems?

One answer is the rise of the shadow bankruptcy system. “Shadow bankruptcy” describes the largely unregulated, non-bank financial institutions such as hedge funds, private equity funds and investment banks that increasingly dominate Chapter 11 cases. “Shadow bankruptcy” adopts and adapts the term “shadow banking,” which has been used to characterize the same players and their questionable activities in the larger financial system. While some may fear Chapter 11, those who operate in its shadows recognize that it can be a lucrative location.

As with shadow banking, shadow bankruptcy thrives in regulatory gaps and ambiguities. Rich and sophisticated private investors exploit interstices in Chapter 11, and between Chapter 11 and other laws that might check their behavior, such as the

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9 Compare, e.g., Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 YALE L.J. 1043, 1078-79 (1992) (“Chapter 11 should be repealed, abolishing court-supervised corporate reorganizations and, in effect, precluding residual claimants from participating in any reorganization of the firm”) with Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 MICH. L. REV. 336, 355 (1993) (“[T]he [Bankruptcy] Code carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt. The choice to make bankruptcy “rehabilitative” represents a desire to protect these parties along with the debtor and creditors who are more directly affected.”). See also Robert K. Rasmussen, An Essay on Optimal Bankruptcy Rules and Social Justice, 1994 U. ILL. L. REV. 1, 2-3 (1994) (“The debate over Chapter 11 reflects a division over which policies bankruptcy should embrace.”).

10 See H.R. REP. NO. 595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179 (“The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.”); 123 CONG. REC. H35, 444 (daily ed. Oct. 27, 1977) (statement of Rep. Rodino) (“For businesses, the bill facilitates reorganization, protecting investments and jobs.”).

federal securities laws. Shadow bankruptcy thus promises to do for the Chapter 11 system what shadow banking did for the larger financial system: Privatize gains and socialize losses, 12 in three related ways.

First, private investors are just that—private. Unlike traditional commercial banks and other regulated financial actors, hedge funds and private equity funds are subject to little regulatory or public scrutiny. Despite the fact that Chapter 11 is a highly public process, shadow bankruptcy players fight aggressively to conceal their identities, 13 and their investment strategies, 14 in the Chapter 11 cases in which they are involved. Complicating matters is the rise of a robust, largely unregulated—meaning private—secondary market for claims against debtors. 15 These claims can trade quickly among

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12 This phrase—“privatize gains and socialize losses”--was made famous in a September 22, 2008 speech by U.S. Representative Marcy Kaptur (OH):

Rule five: Always keep in mind the goal is to privatize gains to a few and socialize loss to the many. For 30 years in one financial scandal after another, Wall Street game masters have kept billions of dollars of their gain and shifted their losses to American taxpayers. Once this bailout is in place, the greed game will begin again.


14 As discussed in Part 2.1.2, below, federal securities laws that might require disclosure of attempts to take control of voting equity do not apply to attempts to take control of debt which will likely exert voting control in Chapter 11.

investors, potentially changing the composition of a debtor’s controlling stakeholders—secretly—overnight.

Second, and more important, is the complexity inherent in “hedging” strategies. Hedge funds often take multiple positions in a company, for a variety of reasons.\(^\text{16}\) Sometimes, these positions literally “hedge” risk. An investor may hold both senior debt and preferred stock in the same troubled company, in order to hedge against a rise or fall in a debtor’s value. If the debtor is worth more, both investments pay off. If the debtor is worth less, then at least the senior debt will still pay off. Other times, investors may hold multiple positions for more strategic reasons. Holding certain claims or interests might, for example, create the power to block confirmation of a reorganization plan, which generally can occur only with the support of a certain number and amount of claims and interests.\(^\text{17}\) That leverage might, in turn, enable the investor to extract rents from other stakeholders of the debtor who are committed to supporting the plan.

More ominously, in the very largest cases, investors may hold credit derivatives that pay off only if the debtor fails disastrously. For example, those who hold credit default swaps against certain large corporate debtors—think *Lehman Brothers*—might...

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\(^\text{16}\) The term “hedge fund” has “no uniformly accepted meaning, but commonly refers to a professionally managed pool of assets used to invest and trade in equity securities, fixed income securities, derivatives, futures and other financial instruments.” *DOUGLAS HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS* 1 (Am. Bar Ass’n 2005). Discussions of the role of hedge funds in bankruptcy appear in, e.g., Mark S. Lichtenstein & Matthew W. Cheney, *Riding the Fulcrum Seesaw: How Hedge Funds will Change the Dynamics of Future Bankruptcies*, 191 N.J.L.J 102, Jan. 14, 2008 (unpaginated original); *The Vultures Take Wing*, ECONOMIST, Mar. 31, 2007, at 77 (“Distressed investors participate in Chapter 11 reorganizations in several ways, in both debt and equity positions. Hedge funds, in particular, often invest in first- or second-lien secured debt and join lender groups; frequently they invest in unsecured subordinated notes, bonds and other debentures, and equity securities.”); Mark Berman & Jo Ann J. Brighton, *Will the Sunlight of Disclosure Chill Hedge Funds? The Tale of Northwest Airlines*, AM. BANKR. INST. J., May 2007, at 24 (noting that “hedge funds are not confined to a single type of investment and might acquire an interest at any one or more places in a company’s capital structure”).

\(^\text{17}\) The mechanics of plan confirmation are summarized briefly in Part 1.1, *infra.*
make more on the swap if the debtor is forced into bankruptcy, even if the debtor might be better off outside bankruptcy.\textsuperscript{18} As with the shadow banking system, shadow bankruptcy players may profit from short sale strategies. Here, however, those on the losing end of the short will be the debtor, its estate and its many other constituents, including employees, creditors and individual investors.

Third, private investors’ time horizons are opaque, but potentially problematic. Under the model Congress envisioned in the Bankruptcy Code, lenders could be cajoled into long-term investing through a reorganization plan that would satisfy claims with, among other things, new securities in the debtor (e.g., more debt, or equity, or both). Today’s private investors, however, may feel far greater pressure to cash out now, even if this destroys long-term value. Conversely, they may acquire control (through claims trading) before bankruptcy. They may use this control to strip—and then flip—assets, rendering an otherwise viable firm incapable of reorganizing.

Shadow bankruptcy thrives at the expense of one of the basic mechanisms of the reorganization system: transparency. Transparency has long been a vital feature of reorganization under Chapter 11, which has often been characterized as a “fishbowl.”\textsuperscript{19} “The key” to successful reorganization under Chapter 11, the Second Circuit famously observed in the \textit{Lionel} case, “is disclosure.”\textsuperscript{20} But the transparency Congress envisioned for Chapter 11 was largely a one-way mirror: It forces debtors, and certain statutorily created entities such as official creditors’ committees, to disclose certain information. But it also leaves opaque the identities and intentions of the debtors’ many other stakeholders, regardless of their guile or sophistication.

Because modern transaction technologies—the hedge fund and the claims trading market, for example—now permit the most sophisticated and aggressive of these stakeholders to manipulate the outcomes of reorganization, we have a fundamental mismatch between transaction technology and regulation. Just as the regulatory

\begin{footnotesize}
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\item \textsuperscript{18} See, e.g., Stephen J. Lubben, \textit{Credit Derivatives and the Future of Chapter 11}, 81 AM. BANKR. L. J. 405 (2007). A credit default swap is essentially a form of insurance that a creditor may purchase against the risk that a debtor defaults: if the debtor fails to pay, the insurer will. See id. at 411 (a credit default swap is a contract “covering the risk that a specified debtor defaults. One party (the ‘protection seller’) acquires the credit risk associated with a debt or class of debts in exchange for an annual fee from the counterparty (the ‘protection buyer’).”) See also Henry T.C. Hu & Bernard Black, Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications, 14 EUROPEAN FIN. MGMT 663 (2008) (draft of June 1, 2008) (available at http://ssrn.com/abstract=1084075) (discussing credit default swaps); John T. Lynch, Note, \textit{Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention - A Model for the Future of U.S. Regulation?}, 55 BUFF. L. REV. 1371, 1384 (2008).
\item \textsuperscript{19} See, e.g., James P.S. Leshaw, \textit{Acquisitions of Troubled Business: A Comparison of the Bankruptcy and Nonbankruptcy Alternatives}, 69 FL. BAR. J. 75, 75 (Dec. 1995) (“A company that files for bankruptcy is effectively required to operate in a fishbowl, disclosing to the world its assets, liabilities, creditors, customers, suppliers, revenues, and other proprietary information.”). As discussed in Part 1.3, below, much of the informational groundwork in Chapter 11 was laid in the bankruptcy reforms that grew out of the New Deal.
\end{itemize}
\end{footnotesize}
architecture meant to manage the larger financial system—i.e., the federal securities and banking regimes—failed to prevent the rise and abuses of the shadow banking system, Chapter 11 cannot interdict or manage the shadow bankruptcy system.

Yet, this it must do.

This Article exposes and explores the contours and consequences of this regulatory failure. It proposes to bring shadow bankruptcy out of the dark. This will not be popular with those in the shadows. Like the shadow bankers, shadow bankruptcy players have profited from secrecy, opacity and complexity. Shedding light will cost some of them real money. The important question, however, is whether the benefits to the larger economic system—in the form of companies and jobs preserved, or recoveries increased, for example—outweigh these costs. This Article argues that they do, if we can design fair and efficient disclosure mechanisms.

This Article, based in part on confidential interviews with system participants and recent-case studies, proceeds in three parts. Part 1 briefly describes the transparent reorganization system Congress believed it was creating in 1978 when it enacted Chapter 11. Part 2 describes the rise of the shadow bankruptcy system, and how it threatens to undermine Congress’ legitimate policy goals in Chapter 11. Part 3 suggests remedies for shadow bankruptcy, in particular an enhanced disclosure regime organized around emerging information technologies.

1.0 Standing in the Shadows—The Transparent System Congress Thought it Created

Chapter 11 is, like many legal structures, intended to be an information system. When it enacted Chapter 11 of the Bankruptcy Code in 1978, Congress created a system that it believed would maximize transparency. Transparency would, in turn, increase

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21 These interviews were conducted under an exception to an institutional review board granted by Temple University. The interview subjects included judges, lawyers and hedge fund managers. All spoke on condition of anonymity. The participants are all prominent participants in the Chapter 11 reorganization process, chiefly in New York City or Wilmington, Delaware, where most large Chapter 11 cases occur. They were selected based on their prominence in this field. They are neither a random sample nor (necessarily) representative of bankruptcy system participants generally. They are, however, actively engaged in, and likely well informed about, the practices and problems addressed in this Article.

22 Other legally-created information systems include the securities law system discussed in greater detail in Part 3, and the notice-filing system contemplated by Article 9 of the Uniform Commercial Code. Lynn LoPucki was one of the first to recognize and develop the insight that the UCC created an information system. See Lynn M. LoPucki, Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway, 55 LAW & CONTEMP. PROBS. 5, 7-9 (1992).

23 In the early 1990s--before the rise of the shadow bankruptcy system--David Skeel observed that--
recoveries and confidence in the system through informed stakeholder control.

Chapter 11 is thought to be transparent largely because it occurs in and around a court house. Although reorganization is designed to produce negotiated settlements rather than litigated judgments, no important matters, including the ultimate settlement device—the plan of reorganization for the company—can be effective unless blessed by a bankruptcy court. Since matters that require court approval are presumptively open to public scrutiny, much (but not all) of the important information about a reorganization should be available to “the world.”

In order to understand the shadow bankruptcy system, it is first necessary to understand the contours of the transparent system Congress believed it was creating—the system that increasingly stands in the shadows. This Part describes the informational features of that system. The next Part then describes how and why the shadow bankruptcy system subverts these features of Chapter 11 reorganization, and considers some of the costs of that subversion.

1.1 Transparency Events

Transparency in reorganization has partly been a product of certain events that must occur in any case. For example, a Chapter 11 case may be commenced only by filing a public document known as a bankruptcy petition that sets forth the debtor’s name, address, authorized agents, etc. A schedule of assets and liabilities should accompany the petition, or be filed early in the case, revealing financial and economic information that might not otherwise be available. The schedules should contain a wealth of information about the debtor, including its assets and liabilities, current income and expenditures, executory contracts and unexpired leases, and a statement of financial affairs, among other things.

11 framework contemplates a largely transparent process in which all constituencies resolve their conflicting interests through negotiations held under rules established in the Bankruptcy Code.

Bankruptcy Code section 107(a) provides that, subject to important exceptions, “a paper filed in a case under this title and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge.” 11 U.S.C. § 107(a). See also In re Gitto Global Corp., 422 F.3d 1, 9 (2005) (“[T]he plain language of § 107(a) evinces a clear congressional intent that papers filed in bankruptcy cases be available to the public. Many, if not the vast majority, of these papers will include material that is likely to affect an individual’s reputation in the community. Allegations of mismanagement or fraud, for example, might well cause a reasonable person to alter his opinion of the individual against whom the allegations are made.”).


See Tung, supra note 15, 1733 & n. 242 (citing 11 U.S.C. § 521) & (Official Bankruptcy Form 6 (Schedules) and Form 7 (Statement of Financial Affairs)) (as amended prior to Nov. 1, 1994); Fed. R. Bankr. P. 1007 (describing schedules to be filed). Under Bankruptcy Rule 1007(c), these schedules are to be filed in a voluntary case within 15 days of commencement of the case, unless extended for “cause.” See Fed. R. Bankr. P. 1007(c).

Fed. R. Bankr. P. 1007(c). Similarly, a public and somewhat formal examination of the debtor also occurs fairly early in the case under Bankruptcy Code section 341. See 11 U.S.C. § 341(a) (“Within a reasonable time after the order for relief in a case under this title, the United States Trustee shall convene and preside at a meeting of creditors.”). However, a section 341 meeting is “somewhat of an anachronism” and “most meetings are usually sparsely attended.” See Brad B. Erens & Kelly M. Neff, Confidentiality in
A second important information-generating event will often involve financing for the debtor’s case, either because a prebankruptcy lender permits the debtor to use “cash collateral,” or because the debtor obtains new financing under a “debtor in possession financing” (DIP) facility. But a debtor cannot obtain major financing without court approval, and no court would approve financing without significant amounts of financial and other important information about a debtor. Moreover, this is generally considered important information. Real money hinges on its accuracy. Objections to the financing (e.g., from other creditors, who think the terms too rich) may result in an early valuation of the debtor. This information may, in turn, be extremely useful to stakeholders trying to develop a strategy toward the debtor. Outside bankruptcy, such information is rarely made public.

More important still will be requests to sell assets during the case. At least until recently, there was reason to believe that non-ordinary course asset sales under Bankruptcy Code section 363 were becoming more common events. These transactions may involve the sale of a division or other property of the debtor, or the entire debtor as a going concern, subject to the requirement that the sale not circumvent the reorganization.

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Chapter 11, 22 EMORY BANKR. DEV. J. 47, 54 (2005). Nor is such a meeting required if a debtor has a proposed a “pre-packaged” plan, one that has been negotiated with major stakeholders before bankruptcy. See Joseph Šamet & Ira A. Reid, Business and International Law Amendments to the United States Bankruptcy Code—2005, 905 PLI/Comm 65, 71 (2008) (“A section 341 meeting of creditors is now lo longer required if the debtor has filed a plan as to which it solicited acceptances prior to the filing of the bankruptcy petition.”). See generally Ronald W. Goss, Meetings of Creditors Under Section 341 of the Bankruptcy Code: A Primer, 17 J. CONTEMP L. 9 (1991).


30 Valuation information in DIP financing is sought, and received, in many different forms. As one practice article explains--

Valuation analysts (analysts) are often called upon to value special-purpose industrial and commercial properties within a bankruptcy context. These valuations are performed to determine a secured creditor’s collateral position, to identify asset spin-off opportunities, to arrange sale/leaseback or other debtor-in-possession (DIP) financing, to assess the fairness of the purchase/sale of bankruptcy estate assets, to analyze the financial feasibility of a proposed reorganization plan and for many other reasons.


31 Compare Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 STAN. L. REV. 751, 752 (2002) (“Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure.”) [hereinafter, Baird & Rasmussen, End of Bankruptcy] and Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 STAN. L. REV. 673, 679 (2003) (“The large Chapter 11’s of 2002 confirm our claim in The End of Bankruptcy that going-concern sales and implementation of pre-negotiated deals now dominate the scene.”) [hereinafter, Baird & Rasmussen, Twilight] with Lynn M. LoPucki & Joseph W. Doherty, Bankruptcy Fire Sales, 106 MICH. L. REV. 1, 43 n.189 (2007) (presenting evidence that “[t]he numbers of section 363 sales of large public companies fell from seventeen in 2003 to five in 2004, and one in 2005. In 2006 there were two”) [hereinafter, LoPucki & Doherty, Fire Sales]. At least some of the cases cited by Professors LoPucki & Doherty were then pending, so it possible some may have had subsequent 363 sales.
plan process.\textsuperscript{32} These sales may only occur after notice and a hearing, which will often require disclosure of information about the assets sold, the price paid, competing bids (if any) and so forth. While there are serious questions about the value generated by such sales,\textsuperscript{33} at least in theory they are supposed to take place in a transparent environment that promotes bidding and confidence in the sale process.

Perhaps the most informationally significant event of all will be the promulgation and confirmation (approval) of a plan of reorganization. A plan of reorganization is, in simple terms, a new contract between a debtor and its many stakeholders. It may be confirmed only after a vote by informed stakeholders (creditors and shareholders).\textsuperscript{34} Stakeholders will, in turn, be informed only if the plan comes with a court-approved disclosure statement.

A bankruptcy court may only approve a disclosure statement if it contains “adequate information.”\textsuperscript{35} This is “information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records. . . that would enable [] a hypothetical investor of the relevant class to make an informed judgment about the plan.”\textsuperscript{36} For most plans, the disclosure statement need not reflect the kind of information or detail that would be found in securities law disclosures,\textsuperscript{37} although federal securities laws may provide an analogy in certain circumstances.

Federal securities laws will, however, matter (more) in the case of so-called “prepackaged” plans. These plans involve the solicitation of votes on a proposed plan before a bankruptcy case is actually commenced. If the proponents (e.g., management and certain investors) get enough votes for the plan, they will then commence a case, filing the plan with the bankruptcy petition and requested expedited confirmation.

\begin{footnotesize}
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\item \textsuperscript{32} See \textit{In re Lionel Corp.}, 722 F.2d 1063 (1983). As discussed below, the recent case involving the Steve & Barry’s discount store--where the debtor sold all of its assets before a plan was confirmed--suggests that courts are increasingly willing to tolerate sales that effectively circumvent the plan process. \textit{See In re Steve & Barry’s, Inc.}, No. 08-12579 (Bankr. S.D.N.Y. 2008). \textit{See also} Emily Chasen, \textit{Steve & Barry’s US store closings can begin: court, REUTERS, Nov. 24, 2008, available at} http://www.reuters.com/article/ousiv/idUSTRE4AN8F920081124.
\item \textsuperscript{33} See LoPucki & Doherty, \textit{Fire Sales, supra} note 31. As discussed in Part 2.2, shadow players may contribute to these depressed valuations. \textit{Infra}.
\item \textsuperscript{34} \textit{11} U.S.C. §§ 1126 & 1129(a).
\item \textsuperscript{35} \textit{11} U.S.C. § 1125(b).
\item \textsuperscript{37} \textit{See In re Applegate Prop. Ltd.}, 133 B.R. 827, 830 (Bankr. W.D. Tx. 1991) (discussing adequacy of a proposed disclosure statement in relation to securities laws requirements); \textit{In re Growthers McCall Patterns, Inc.}, 120 B.R. 279, 300 (Bankr. S.D.N.Y. 1990) (stating courts may analogize to reporting requirements of securities laws when considering whether to approve a disclosure statement).
\end{itemize}
\end{footnotesize}
Under Bankruptcy Code sections 1125(g) & 1126(b), prebankruptcy solicitations may be effective in bankruptcy, provided that they comply with “applicable nonbankruptcy law.” In general, complying with federal securities laws seems to satisfy these sections, at least where the debtor was a publicly traded company. This is, however, a murky area. As discussed below, there are important gaps between the informational architecture of the Bankruptcy Code and the federal securities laws. Shadow bankruptcy players can exploit those gaps.

1.2 Structural Transparency

Congress also built transparency into the system through the structures and entities common to Chapter 11 reorganizations. For example, official (or “statutory”) committees are ubiquitous in larger Chapter 11 reorganizations. These committees represent certain types of stakeholders, usually creditors. These committees—which, as discussed further below, stand in contrast to the more shadowy “unofficial” committees that hedge funds and private equity investors may create—perform a variety of functions, all of which depend on access to information about the debtor. They are expected to review and comment on the major events discussed above, such as obtaining financing or selling assets. They are expected to object to these proposals if they believe the debtor could get better terms. Such objections are expected to produce greater recoveries for the committee’s constituents.

A creditors’ committee can do none of these things without information. Thus, Chapter 11 expressly gives them the power to “investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business . . . .” Statutory committees usually retain professionals to conduct a wide range of investigations, most of which will tend to focus on some combination of the failures that led to bankruptcy, the debtor’s value, and/or its ability to reorganize.

Committees do not typically produce public reports about a debtor, and often the information they receive may be highly sensitive. Because official committees will often

38 See 11 U.S.C. §§ 1125(g) & 1126(b).
40 The creditors’ committee is ordinarily composed of holders of the seven largest unsecured claims. 11 U.S.C. § 1102(b)(1). More than one committee may be appointed. Id. at 1102(b)(2). Other official committees may be appointed if approved by the court. “Except as provided in paragraph 3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.” 11 U.S.C. § 1102(a)(1). “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.” 11 U.S.C. § 1102(a)(2).
41 11 U.S.C. § 1103(a), (c)(2); In re Moseley, 149 B.R. 458, 460 (Bankr. W.D. Ky. 1993) (allowing payment of fees for professional services performed on behalf of committee because committee was fulfilling its duty to thoroughly investigate financial affairs and activity of debtor).
have access to confidential information about a debtor, their members might be tempted to trade on this information. The problem here is akin to insider trading, which is generally prohibited by federal securities laws—when they apply. Insiders—committee members—may use information not available to the public to purchase or sell claims against or interests in the debtor. They may buy claims for less than they are actually worth, because they have reason to believe the company will perform better than predicted. They may sell claims for more than they are worth, because they have reason to know the opposite. Either way, the harm stems from the use of nonpublic, material information for gain.

The solution proposed by the court in the *Federated* case, and generally adopted elsewhere, has been “trading walls”—informational screens between those who might sit on a committee (and thus obtain confidential information) and other employees of that creditor who might be engaged in claims trading. A more recent, if awkwardly designed, response to this problem, appeared in the 2005 amendments to the Bankruptcy Code. These require committees to “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.” The problem is that this provision makes no distinction for confidential or sensitive information that might affect the market for claims against a debtor. Thus, it simply expands the pool of those who might trade on inside information.

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43 See Robert P. Enayati, *Undermining the Trading Wall: The BAPCPA’s Affront on the Creditors’ Committee’s Duties of Confidentiality in Chapter 11 Bankruptcies*, 21 GEO. J. L. ETHICS 703, 706 (2008) (“A creditor can sit on a committee and secure proprietary information and then use that information to gain an unfair advantage over the party from whom it is purchasing and over other creditors who are purchasing claims.”).

44 See Drain & Schwartz *supra* note 15, at 622 (“If bankruptcy claims were treated as securities, the SEC at least would be able to develop means to track claim trades and discern potential insider trading situations.”); Fortgang & Mayer, *supra* note 15, at 52-53 (“Because the Bankruptcy Code does not, on the distribution side, ordinarily differentiate between types of claims within a class, one can argue that for the purpose of the 1934 Act’s antifraud provisions a trade claim is no different than a publicly traded debenture. The trade claim in bankruptcy would not be the first instrument, which is not a security when issued but is a security when resold. Consider the humble home mortgage. When issued it is clearly not a security. When resold on the secondary mortgage market, however, it becomes a security.”).


48 See Enayati, *supra* note 43.

49 The court in the recent *Reeco* decision, however, provided that creditors’ committees may require those who request information to sign confidentiality agreements, thus managing to some extent the potential
Committees are not the only structural components that could contribute to transparency, if properly used. Specialized participants—in particular Chapter 11 trustees and examiners—could play important (albeit often indirect) roles in making sure that information flows in reorganization cases. For example, if a Chapter 11 case runs into serious problems, the court may appoint a Chapter 11 trustee, who will effectively displace management. Although not necessarily their principal function, Chapter 11 trustees will conduct an investigation into 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 . . . .”

If a trustee is not appointed, the parties may ask the court to appoint an examiner under section 1104(c) “to conduct such an investigation of the debtor as is appropriate.” Among other things, an examiner may be appointed to investigate “any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor of or by current or former management.” Congress created this position with transparency in mind: The examiner was, in some sense, a proxy for the investigative functions played by the Securities and Exchange Commission under prior law.

Yet, as with many aspects of the current system, its transparency mechanisms have been underappreciated or improperly used. Thus, while examiners have played important, often controversial, roles in some of our most recent, high-profile bankruptcy reorganizations, they remain extremely rare. When they are sought and appointed, it

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A recent empirical study of large chapter 11 cases found that trustees and examiners were sought in
would often appear to be due to breakdowns in negotiations among stakeholders, and not to promote transparency per se.

Another transparency-promoting entity in bankruptcy might be the Office of the United States Trustee (UST). Congress created the UST program in the 1978 Bankruptcy Code as a modest administrative adjunct to the largely judicial processes in bankruptcy. Unlike the Securities and Exchange Commission—which once played a more direct role in the oversight of disclosure in reorganization—the UST generally has existed to police the bankruptcy system for signs of conflicts of interest by professionals (lawyers), “cronyism” or debtor misconduct. Transparency might be a byproduct of the UST’s work, but it is not likely to be its principal focus.

Taken together, the important events and entities structured into the reorganization system make clear that Congress meant to create a highly transparent process. Yet, these transparency mechanisms have two flaws. First, they are often underused, poorly used or (as described in greater detail in Part 2) misused. Debtors’ schedules are notoriously unreliable, case financings and asset sales often result in purchases at far less than book (and perhaps market) value, and creditors’ committees may simply be tools of shadow bankruptcy players.

Second, and perhaps more basic, they create a one-way mirror. They demand disclosure by and about the debtor and, to a much lesser extent, professionals and official entities involved in the process. But, subject to a few controversial exceptions discussed in Part 2, below, Chapter 11 requires little reciprocal transparency of debtors’ stakeholders. Although a major creditor may be able to control a debtor’s fate—and thus

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<td>All Cases</td>
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Id.  


affect all of the debtor’s other stakeholders—Chapter 11 has largely permitted such stakeholders to remain in the shadows.

1.3 Past as Prologue—William O. Douglas and the Roots of Transparency

Although Congress designed Chapter 11 to promote transparency, the legislative history to the current law actually says little about the issue. This is doubtless because the important steps to make reorganization transparent came in the 1930s, well before the Bankruptcy Code was enacted, when William O. Douglas, then a commissioner of the Securities and Exchange Commission, remade the entire process. Before succeeding to the Supreme Court seat of Louis Brandeis—also a strong advocate for shedding light on shady financial practices—Douglas was a law professor at Yale, where he studied the bankruptcy system intensively.

Although we chiefly think of him as a left-liberal member of the Court—most notoriously the “penumbras” of his majority opinion in Griswold v. Connecticut—he was also among the most prominent bankruptcy scholars of the late 1920s and 1930s. In 1934, he joined the newly formed Securities and Exchange Commission, where he authored a massive, eight-volume report on failures in the reorganization system. This report, which was ordered in connection with adoption of the Securities Exchange Act of 1934, was heavily influential in laying the foundation for the current reorganization system, including much of its informational architecture. Its findings are eerily pertinent today.

The reorganization system as Douglas found it in the 1930s was in certain respects quite different from ours, really two distinct systems rather than one. On the

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58 “Publicity is justly commended as a remedy for social and industrial diseases,” Brandeis famously observed. “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 92 (Fredericks & Stokes Co. 1914).


61 See David A. Skeel, Vern Countryman and the Paths of Progressive (and Populist) Bankruptcy Scholarship, 113 HARV. L. REV. 1075, 1079 (2000) [hereinafter Skeel, Countryman] (“It is no exaggeration to say that, during the decade from roughly 1928 to 1938, Douglas figured prominently in every significant development affecting bankruptcy law and bankruptcy theory.”).


65 Of course, a logical inference from the basic claim of this paper—that there exists a shadow bankruptcy system—is that we really have two different systems today as well. The key differences between the world
one hand, there was the formal bankruptcy law in place at the time, the Bankruptcy Act of 1898, which governed individual bankruptcies and generally goaded business debtors toward liquidation rather than reorganization. It was not hospitable to the reorganization of the nation’s largest corporations, in particular the railroads, almost all of which encountered major financial distress at one time or another.

So, on the other hand was a second system that large corporate debtors used, the equity receivership. This was a process wholly outside the scope of the bankruptcy law at the time, and largely a creation of the managers, lawyers and bankers involved with the company—the “reorganizers,” in Douglas’s somewhat derisive terms.

Douglas believed that this system hurt individual investors. Through reorganization, he argued, investors sought “an expeditious, economical, fair, and honest readjustment of their company’s affairs.” The reorganizers’ goals, however, were often in conflict with the interests of investors, and it was the needs of the reorganizers that the reorganization system had evolved to meet.

Reorganizers at times have not been interested in fair reorganization, since fairness might seriously intrude into their own plans and affairs. Reorganizers at times have not desired honest reorganizations, in the investors’ sense of the word, because such reorganizations would be

then and now seem to involve the information and transactional technologies that support the systems. Today’s problems appear largely to involve information asymmetries, whereas earlier problems appeared to be much more brazen conflicts of interest.


67 Arthur Dean explained the mechanics of the process as follows:

The pattern, generally speaking, following the appointment of the receiver or receivers was for one or more of the various mortgage trustees to petition the receivership court for leave to foreclose the mortgage. The foreclosure action or actions were consolidated with the original general creditor’s bill, and the receivers for the latter were then usually appointed receivers for the mortgage bondholders . . . Following the formulation of a plan by the committee, the court on motion fixed an upset price for the sale of the mortgaged properties. Generally, the creditors or the reorganization managers bid in the properties, using the [bondholders’] deposited mortgage securities as part payment for the foreclosure price, and borrowed or raised enough cash to pay non-assenting or dissenting creditors. An agreement was then entered into with a new corporation created for the purpose, whereby, in consideration for the transfer to it of (1) the properties foreclosed at the foreclosure sale and (2) cash or securities to the extent provided in the plan, the new corporation would issue its securities in accordance with the reorganization plan.


68 Certain aspects of the equity receivership were ultimately codified in what came to be known as Section 77 (See Act of Mar. ch. 3, 1933, ch. 204 § 77, 47 Stat. 1474 (1933) (codified prior to repeal at 11 U.S.C. § 204 (1934)), pertaining to railroad reorganizations, and 77B, pertaining to other corporations.

69 Douglas Report, supra note 63, pt. 1, at 2 (emphasis added). Douglas notes, “[f]rom the investors’ point of view no reorganization could be thoroughgoing unless the reorganizers adhered to these objectives of expedition, economy, fairness, and honesty.” Id. at 3 (emphasis added).
costly to them. They have been motivated by other factors. And they have endeavored—in large measure with success—to mould the reorganization process so as to serve their own objectives.70

The tension between reorganizers’ and investors’ interests was exacerbated by the opacity of the reorganization system. “Outwardly, reorganizations will merely have dressed the procedure in familiar and respectable garb. In fact, these reorganization conventions will often conceal the real motives and objectives. Behind the scenes will appear a fight for control of the reorganization and of the new company.”71

These fights for control often involved conflicts between investors’ interest in an efficient and fair reorganization and management’s desire to retain control of the company.72 Yet lack of transparency was a problem for investors even in the absence of management impropriety.73 In cases where management failed directly or indirectly to dominate reorganization, outside speculators would swoop in, often rallying shareholders under the banner of a “better” reorganization, in an effort to dominate the reorganization process and gain control of the company.74

Reorganizers were able to manipulate the process chiefly through the device known as the “protective committee.”75 Protective committees were generally informal committees of bondholders organized by investment bankers for the debtors, which would try to persuade bondholders to deposit their securities with the committee. The committee would then exercise the bondholders’ rights, usually agreeing to the terms of the reorganization proposed by the reorganizers. Although these reorganizations had the trappings of creditor democracy, Douglas complained that “not infrequently these devices have been abused in such a way as to cause their functions to be perverted to serve the interests of reorganizers as distinguished from the interests of investors.”76 Intended to unify security holders and enable effective representation, protective committees were often hijacked by reorganizers and used for their own purposes, to investors’ detriment.77

70 Id. at 4.
71 Id. at 5.
72 One common scenario was collusion between management and investment banks. Management would exert control over the reorganization process, adopting a plan by which the colluding investment bank would acquire the company at a deep discount. In return, management would retain control.
73 See Douglas Report, supra note 63, pt. 1, at 99 (noting that “absence of effective control by management or [pro-management] bankers” contributed to problems).
74 Id. at 880. “At times powerful outside interests, who have had no previous connection with the company, seize upon the chaos of reorganization for the purpose of entering and taking possession of the company... . They are seeking control of the corporation and the possibilities of the great power and profits which control entails.” Id.
75 Id. at 1.
76 Id.
77 Id. at 1-2.
Another problem plaguing equity receiverships involved outsiders wishing only to disrupt the reorganization process in order to extort payment. 78 Both protective committees and individual plaintiffs employed this strategy. 79 In the context of protective committees, such practices clearly implicated the same transparency problems and solutions discussed above.

Whether brought by protective committees or individuals, reorganizers often preferred to settle such claims secretly, regardless of their legitimacy. 80 Predictably, Douglas preferred transparency. “[S]ecret settlement . . . is inimical to the interests of investors and creditors as a whole. . . . If a settlement is advisable to save expenses, it should be open and not covert . . . .” 81 In addition to the mere fact that a settlement occurred, settlement disclosure served to provide parties with information material to the reorganization. 82 Moreover, by making public the identities of parties to settlements, the practice of extortion by disruption would be deterred, thereby increasing efficiency of the reorganization process. 83

Douglas came to three basic conclusions about the equity receivership system. First, the interests of investors—not reorganizers—had to be paramount in reorganization. 84 “It is,” his report observed, “their investment which is at stake in any reorganization.” 85 Second, those who represent investors in reorganization had to recognize and act on their fiduciary duties to the investors they represented. 86 “It is,” he noted “intolerable that [reorganizers] should possess dual or multiple interests.” 87 Third, those strategies he considered most abusive had to be curtailed. Thus, the agency abuses of the protective committee as well as “[h]igh pressure salesmanship, misrepresentation and non-disclosure in solicitation methods must be controlled so that security holders

78 See id. at 706 (“Sometimes a protective committee without any financial stake or other connection with the company is organized [and] motivated principally by the desire to create a strategic or nuisance value which it will use . . . to force payment and settlement.”). Of course, it was difficult to distinguish between claims brought solely in pursuit of ransom and strategic blocking as leverage for legitimate claims. Id. at 693 (“[I]t is exceedingly difficult to distinguish between good and bad faith; between an honest claim, sincerely pursued, and an allegation of injury devised in order to create a nuisance value for a worthless position.”).

79 See id. at 706 (discussing independent committees); id. at 691 (discussing individual “strikers”).

80 Id. at 693 (discussing motivations for quiet settlement).

81 Id. at 693-94.

82 Id. at 694 (“[I]f the banker or dealer has in fact been guilty of fraud or misrepresentation, the secret settlement will suppress facts germane to the reorganization and to the qualification of those in control of it.”).

83 Id. (“[S]ecret settlement may encourage the growth of a sort of racketeering which, not being predicated upon genuine misdoing, is not in the public interest, and which is, in fact, merely a form of capital waste.”).

84 Id. at 897 (“It is essential that measures should be taken to place the control of reorganizations with bona fide security holders and their direct representatives.”).

85 Id.

86 Id. (“It is essential that renewed emphasis be given too the fact that representatives of security holders in reorganization occupy a fiduciary position.”).

87 Id.
may be assured of an honest and complete portrayal of all material facts affecting their investment.”

Douglas’ conclusions led to a series of reforms, some involving substantive control of the reorganization process, others involving improved disclosure. As discussed further in Part 3, below, those involving control—the mandatory appointment of a trustee to replace management, for example—whithered over time. Those involving disclosure have tended to survive. Thus, votes on reorganization plans should not be solicited “until the plan has been carefully scrutinized by the court and its submissions to the creditors and stockholders authorized.” This would be the forerunner of the disclosure statement. Today, as discussed above, the Bankruptcy Code provides that votes on a plan may not be solicited unless accompanied by a disclosure statement that contains “adequate information.”

Similarly, the Douglas report led directly to the adoption of Chapter X and Rule 10-211 thereunder, which provided for disclosure of the “personnel and activities of those acting in a representative capacity” in order to help foster fair and equitable plans free from deception and overreaching. As discussed in Part 2, below, this was the forerunner to Bankruptcy Rule 2019, which requires disclosures by informal (non-statutory) committees. These committees are often the organizational device of choice for shadow bankruptcy system players. They are not happy with its disclosure requirements, and so resist its force and seek its repeal.

### 2.0 Casting the Shadows: Three Challenges to System Transparency

The foregoing Part shows how and why Congress designed a reorganization system that was meant to be transparent. This Part describes three ways that the shadow bankruptcy system subverts transparency, and some of the costs created by that subversion.

#### 2.1 Who Goes There?

Identifying the real stakeholders in a reorganization has long been an informational challenge. The statutory committees described above, and rules forcing disclosure of circumstances where one party represents multiple claimants, all arose in response to the problems with protective committees identified by Douglas in the 1930s. Shadow bankruptcy works against these reforms. Similarly, recent developments in transaction technology—including a robust secondary market in claims against reorganizing debtors—have made it increasingly difficult to know with certainty

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88 Id. at 897-98.

89 Two central recommendations from the Douglas Report have not survived. One—the Report’s first—was that “[i]n every case a qualified and disinterested trustee should be appointed.” Id. at 899. Another was that an administrative body—in particular, the SEC—“be made available to the court as an aid in the administration of the estates,” Id. at 900-901. As discussed below, both became features of the Chandler Act of 1938, and both were abandoned in the current Bankruptcy Code.

90 Id. at 900.

91 Id.

92 See discussion in Part 1.3, supra.
who has important claims against a debtor at any given point in time. There is also the possibility that this high velocity system permits sophisticated players to obtain transitory control, and to exercise that control, in ways that may benefit the holder at the expense of the debtor and its other stakeholders. This sub-Part describes how and why participant identity has become a problem in the reorganization system.

2.1.1 Non-Statutory Committees—The Return of the Protective Committee?

Fights about transparency in the bankruptcy system often involve the simplest questions of identity: Who are you, and who do you represent? In recent years, this fight has taken place over the application of Bankruptcy Rule 2019. This rule requires any “entity” that represents “more than one creditor or equity security holder” to file a statement setting forth, among other things, “the name and address of the creditor or equity security holder . . . the nature and amount of the claim or interest and the time of acquisition . . . the name or names of the entity or entities at whose instances, directly or indirectly, the employment was arranged . . . [and] the amounts of the claims or interests . . . the times when acquired, the amounts paid therefor, and any sales or other dispositions thereof.”

This seemingly obscure, technical rule has been the basis for some serious fights in recent years, because shadow bankruptcy players often do not want to comply with it. Two recent, controversial opinions from the Northwest Airlines reorganization highlight the problem. In Northwest I, a group of hedge funds representing about 27% of the debtor’s equity had retained the law firm of Kasowitz, Benson, Torres & Friedman to represent them. They (through the firm) objected to the disclosures required by Rule 2019 on the rather improbable grounds that they did not in fact represent other shareholders—only themselves—and that the law firm was not an equity holder itself. Judge Gropper dismissed their position out hand. Citing Douglas’ major study of protective committees (discussed above), he concluded that Rule 2019 “cannot be so blithely avoided.”

Undeterred, the hedge funds then sought in Northwest II to disclose their positions, but only under seal, not publicly. Public disclosure, they argued, would reveal

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94 See In re Northwest Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (requiring ad hoc committee to comply with disclosure requirements of the Federal Rule of Bankruptcy Procedure 2019) [Northwest I]; In re Northwest Airlines Corp., 363 B.R. 704 (denying request by ad hoc committee to file Rule 2019 disclosures under seal) [Northwest II].

95 Supra Northwest I at 703 (“KBT & F contends that no member of the Committee represents any party other than itself, that only KBT & F as counsel represents ‘more than one creditor or equity security holder,’ and that KBT & F does not have any claims or interests in the Debtors or anything to disclose.”).

96 Id. at 703 (citing Douglas Report, supra note 63).

97 Northwest Airlines II, 363 B.R. 704. As noted above, Bankruptcy Code §107(b) provides in pertinent part that “the bankruptcy court shall . . . protect an entity with respect to a trade secret or confidential research, development or commercial information.” 11 U.S.C. § 107(b). Bankruptcy Rule 9018 similarly provides that “the court may make an order which justice requires (1) to protect the estate or any entity in respect of a trade secret or other confidential research, development, or commercial information . . . . “ Fed. R. Bankr. P. 9018.
their “bargaining position” by giving “counterparties an unfair advantage if they were to know our basis or acquisition cost of the assets we were trying to sell.” Here, too, Judge Gropper was unmoved.

It bears recalling that this Committee purports to control 27 percent of the outstanding stock of the Debtors . . . . By acting as a group, the members of this shareholders’ Committee subordinated to the requirements of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the Debtors’ securities. This 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 reasoned that any burden imposed by disclosure was “overridden by the interests that Rule 2019 seeks to protect.” These interests would have been the rights of similarly situated stakeholders: “Rule 2019 protects other members of the group—here, the shareholders—and informs them where a committee is coming from by requiring full disclosure of the securities held by members of the committee and the respective purchases and sales. . . .” This would, in turn, give “other shareholders . . . information as to Committee member purchases and sales so that they [may] 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.”

The Northwest rulings have been controversial precisely because shadow players do not want to reveal this sort of information. In response to the Northwest rulings, their trade associations, the Securities Industry and Financial Markets Association (SIFMA) and the Loan Syndications and Trading Association (LSTA), asked the Judicial

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98 Id. at 708 (quoting Decl. of Daniel Krueger, p. 3).
99 Id. at 708-709.
100 Id.
101 Id. at 709.
102 Id. (“It also 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.”).

The limitation in this analysis, as developed further below, is that it assumes that investors hold one--and only one--type of claim (or interest) against a debtor and thus that a particular committee (statutory or otherwise) could represent them. But, as we shall see, a new and confounding complexity here is the distinct possibility of hedging strategies whereby investors hold multiple positions against a debtor which, in turn, make radically more complex and indeterminate their goals in the debtor’s reorganization. It is, in short, true that other shareholders might benefit from knowing of the activities of the Northwest Airlines ad hoc shareholders’ committee. But should there also be an ad hoc (or statutory) committee of Northwest shareholders who happen to hold simultaneously Northwest bonds and senior debt and equity shorts?

Conference, which oversees the Rules of Bankruptcy Procedure, to repeal Rule for “important public policy reasons.”

Perhaps it would have been more accurate to say they wanted the rule repealed for important “private policy” reasons: their real concern, as explained in their letter, is that such disclosures may give others “knowledge of a particular long or short position” that would allow these other investors to “move the market in a direction adverse to the fund that was forced to disclose.” This would, in turn result in “an exodus of distressed investors from the market” which would “likely lead to a decrease in liquidity for the debtor and equity of bankrupt companies.” What they are really saying, of course, is that coming out of the shadows may produce competition that they fear. It might limit their ability to exploit the system.

Bankruptcy Judges Drain and Gerber have publicly opposed the SIFMA/LSTA request. Both judges have presided over some of the nation’s largest and most complex recent Chapter 11 cases. As public actors with no particular constituency to protect, their concerns are worth taking seriously. They see repeal of Rule 2019 as highly problematic because it would threaten system transparency. In the words of Judge Drain, “the repeal of Rule 2019 would make it much more difficult to know literally who the other side is.” According to Judge Gerber, the goal of shadow players is “less transparency.” But, he explained, “[t]ransparency must be maintained to permit parties in interest to participate meaningfully in cases . . . and to permit judges to continue to act to maximize value and to achieve the best outcome for all . . . .”

The reality is that it is impossible to know the severity of the Northwest problem. It may, in fact, not create quite the “battle ground” feared by some observers. In confidential interviews, some system participants indicate that some hedge funds are willing to go along with the decisions in letter if not in spirit. As one hedge fund

104 Id. at 6.
105 Id. at 24.
106 Id.
109 Judge Drain presides (or presided) over, among others, the Refco and Delphi cases. Judge Gerber presides (or presided) over, among others, the Adelphia and Lyondell Chemical cases.
110 Drain Letter, supra note 107.
112 Id. at 6-7.
113 See, e.g., Hu & Westbrook, supra note 12, at 1375 (reporting a “roaring controversy over [the] disclosure obligations” of hedge funds involved in bankruptcy cases); Coco, supra note 12, at 611 (“Debtors, creditors, and equity holders in Chapter 11 proceedings are waging war with one another”).
manager explained to me “they’re big boys, and they’ve swallowed the Northwest ruling. They have moved on.”

Moreover, other participants indicate that in most cases, activist investors will want their presence known. “They file notices of appearance because they want to receive notice of what’s going on,” one lawyer explained. In many cases, there is simply no strategic advantage to concealing one’s identity. Many distressed investors are activists, and activists cannot be wallflowers. As another hedge fund manager explained, “most entities that buy large positions want to be active, so they have no problem coming out and revealing themselves.”

Yet, Northwest is not the only case of its sort, doubtless because not all investors are activists all the time. Many participants interviewed for this paper acknowledged that they had participated in, or heard about, cases where a stakeholder with an undisclosed position surfaced late in the plan process, objecting to proposed treatment in ways that upset delicate negotiations. As one seasoned Chapter 11 lawyer explained “Today, I don’t know who’s sitting across the table from me. When somebody is in district court, I know what they want. But now, in bankruptcy, I may not know all the right players and, even if I do, I may not know their real incentives.”

2.1.2. Claims Trading

Problems of identity are magnified by the development of a robust secondary market for claims against (and interests in) distressed firms. This market exists to a significant extent as an unregulated securities market. This lack of regulation permits shadow players to move in and out of positions rapidly and often covertly.

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114 Telephonic interview with MC, Jan. 9, 2009.
116 Harner reports that 65% of 82 respondents to a survey indicated that they used distressed investing to influence board or management decisions. See Harner, supra, note 15, at 72.
118 At least one court has ruled in favor of hedge funds seeking secrecy, although the ruling lacks precedential value. In In re Scotia Pac. Co., LLC, the court held that a group of noteholders did not have to disclose the details of its members’ trading positions, ruling that an informal creditor group jointly represented by a single law firm was not the sort of “committee” that Rule 2019 was intended to address. See Order Denying Scotia Pacific Company LLC’s Motion for an Order Compelling the Ad Hoc Noteholder Group to Fully Comply with Bankruptcy Rule 2019 By Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests, In re Scotia Dev. LLC, No. 07-20027-C-11. The issue was also litigated, but ultimately settled, in Mirant. See Motion of New Mirant Entities to Compel Certain Holders of Class 3 Claims to Comply with Rule 2109 of the Federal Rules of Bankruptcy Procedure, In re Mirant Corp. No. 03-46590 (Bankr. N.D. Tx. May 16, 2007); Press Release, Mirant Corp., Mirant to Complete Settlement with Pepco, (Aug. 7, 2007), available at http://investors.mirant.com/releasedetail.cfm?ReleaseID=351384.
120 See Drain &Schwartz, supra note 15, at 622 (“It is not likely that there will be an opportunity [] to fulfill the anti-fraud goal of the securities laws as long as purchasers from unsophisticated sellers do not try to influence the plan process in a way that another party in interest opposes because . . . the court probably otherwise may never learn of concerted, manipulative marketing of unsophisticated sellers by sophisticated purchasers with material inside information. If bankruptcy claims were treated as securities, the SEC at
Claims trading is simply the buying and selling of claims against a debtor. This trading can occur before or during bankruptcy. Those who purchase claims—often hedge funds, investment banks or private equity funds—do so because they believe they will make money in doing so. According to one hedge fund manager interviewed for this paper, some investment banks maintain trading desks in claims against distressed firms.\(^{121}\) Usually, the theory is simply that they will purchase claims for a significant discount from the face amount of the claim.\(^{122}\) Claims purchasers make money in a variety of ways. They may capture the spread between the price paid and distributions in the case, which may be cash, new debt, or stock. They may resell the claim for a higher price.\(^{123}\) Being largely unregulated, it is difficult to estimate the size of this secondary market, but it is said to be in the hundreds of billions of dollars, if not more.\(^{124}\)

At least in theory, those who purchase claims against a debtor in bankruptcy will disclose this publicly under Bankruptcy Rule 3001(e). This rule provides that “[i]f a claim other than one based on a publicly traded note, bond, or debenture has been transferred . . . after the proof of claim has been filed, evidence of the transfer shall be filed by the transferee.”\(^{125}\) Before the provision was added, in 1991, bankruptcy courts had far greater control over claims trading, as they had to approve any such transfer.\(^{126}\) Now, claims trade without notice, disclosure of the purchase price, or any judicial oversight at all, except if there is a challenge to the authenticity of the transfer.\(^{127}\)

\(^{121}\) Telephonic interview, MC, Jan. 9. 2009.

\(^{122}\) See Harner, supra note 15, at 75 (“The amount of the discount [in a claims purchase] varies by situation, but can range from a low discount of 20% to a high discount of 60% or perhaps even 80%.”).

\(^{123}\) Id.

\(^{124}\) See Levitin, supra note 15, at 86 (“Although the exact size of the corporate bankruptcy claims trading market is unknown, it was estimated to be in the hundreds of billions of dollars about a decade ago and has seen a prodigious growth in recent years.”) (citations omitted).

\(^{125}\) Fed. R. Bankr. P. 3001(e).

\(^{126}\) The pre-1991 amendment version of Bankruptcy Rule 3001(e) provided, in relevant part:

1. Unconditional Transfer Before Proof Filed. If a claim other than one based on a bond or debenture has been unconditionally transferred before a proof of the claim has been filed, the proof of claim may be filed only by the transferee. If the claim has been transferred after the filing of the petition, the proof of claim shall be supported by (A) a statement of the transferor acknowledging the transfer and stating the consideration for the transfer and why the transferee is unable to obtain the statement from the transferor.

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

\(^{127}\) See Drain & Schwartz, supra note 15, at 579 (“amended Rule 3001(e) dispenses with notice (other than
The problem is that Rule 3001(e) is largely designed to aid a debtor in determining who should receive distributions under a plan (or otherwise). It is not designed to tell the debtor or its other stakeholders information that would aid negotiations or prevent misconduct. It does not apply at all to trading that may occur prior to commencement of a bankruptcy case. Nor does it apply before proofs of claim have been filed in respect of claims against the debtor (which may well not happen until late in the case). Nor does it require filings by those who purchase loan participations where represented by an agent bank. Nor is there any requirement that notice be filed at the time of the transfer. Nor would compliance with the rule tell other stakeholders much about the claim purchaser. There is no requirement that the purchaser disclose the amount of consideration paid for the claim. Nor is there any obligation to disclose other positions the purchaser might hold, such as credit-derivative or short positions.

The closest regulatory analogy to Rule 3001(e) is Rule 13d-1 of the federal securities laws. Under section 13(d) of the Securities Exchange Act of 1934, any person or group that becomes the owner of more than 5% of any class of publicly traded securities must, within 10 days of such acquisition, file with the issuer and the SEC a statement setting forth the person’s background, the source of funds used for the acquisition, the purpose of the acquisition, the number of shares owned and any relevant contracts, arrangements or understandings.

The purpose of Rule 13d-1 is fairly clear: It enables an equity issuer and its other shareholders to know whether someone is acquiring enough shares to influence the

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129 As Judge Gerber explained in his opposition to repeal of Rule 2019:

Many distressed debt investors continue to buy and sell debtors’ debt during the pendency of the chapter 11 case (as compared and contrasted to simply buying the debt and then awaiting the case outcome), and some ad hoc committees try to influence proceedings in the case even while their members are buying and selling debt whose prices or value might be affected by the rulings on the matters as to which they have sought to influence the court. These trading activities are normally not disclosed . . .


130 See 17 C.F.R. § 240. 13d-1 (2008). The rule provides as follows:

(a) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D (§ 240.13d-101)

(b)(1) A person who would otherwise be obligated under paragraph (a) of this section to file a statement on Schedule 13D (§ 240.13d-101) may, in lieu thereof, file with the Commission, a short-form statement on Schedule 13G (§ 240.13d-102).
issuer’s governance. The problem is that this rule does not apply to debt securities, even if they may be convertible into equity. Nor does it apply to derivative or short positions. Yet, as explained above, in bankruptcy, control is likely to be vested in creditors, not in shareholders, because creditors’ votes are likely to matter most in confirmation of the plan. Thus, the gap: Rule 3001 may reach claims traded late in a case, but nothing requires disclosure of the acquisition of a controlling position before or during (much of) a bankruptcy case, even though there is a good chance such claims may trade and, in any event, will have real voting power in a reorganization.

2.1.3 Empty Creditor Voting?

An extreme version of the problems created by claims trading involves the possibility of “empty voting.” Bernard Black and Henry Hu have in a recent series of articles articulated some of the problems that arise when control rights can be decoupled from economic rights for very brief periods. “Voting rights,” they argue, “can be decoupled from economic interests quickly, at low cost, and on a large scale. Investors can have greater voting than economic ownership, a pattern we termed ‘empty voting.’ . . .” The problem here, they argue, is informational: Being “hidden,” these control rights “can permit stealth takeover bids . . . [c]onversely, target companies can defend against bids by using decoupling to place votes in friendly hands.”

They have argued that this problem infects not only equity, but debt. Investors can purchase bonds and vote (or threaten to vote) to waive covenants, they argue. Loan participations may give the lead bank voting rights far in excess of its economic stake in the debtor. The ability to traffic in claims may also create the ability to traffic in voting control of those claims. While Bankruptcy Rule 3001(e) requires a creditor to file notice of the transfer of a proof of claim, it does not appear to require those who file these forms to indicate who actually has the right to vote them. As noted above, Rule 13d-1

132 GAF Corp. v. Milstein, 453 F.2d 709, 717,720 (2d Cir. 1971) (observing that “the purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control”).

133 See Anne Marra Huber & Thomas H. Young, Trading of Bank Debt In and Out of Chapter 11, 15 J. BANKR. L. & PRAC. 3, n.21 (2006) (“It is noteworthy that there is no need to file a 13D with the Securities and Exchange Commission when acquiring large amounts of claims against a debtor in bankruptcy, making acquiring control of a corporation in bankruptcy somewhat easier than acquiring a large block of shares in the open market, prepetition.”).


135 Harner reports that 65% of 82 respondents to a survey indicated that they used distressed investing to influence board or management decisions. See Harner, supra note 15, at 72.

136 See Hu & Black, supra note 18.

137 See Hu & Black, supra note 18, at 1.

138 Id.

139 See Hu & Black, supra note 18, at 17-18.
appears to play no role here. Thus, we have a regulatory gap that defeats transparency, potentially permitting shadow players to exercise remote and undetected control of the reorganization process.

2.1.4 Committee Manipulation and Information Arbitrage

While we do not know how pervasive empty voting is, we do know that shadow players are often lured out of the dark, and onto official committees, by the promise of access to confidential information about a debtor. Nothing prevents shadow bankruptcy players from joining official committees, and in some cases their presence has proved highly contentious.

In the Fibermark bankruptcy, for example, Silver Point L.P., a hedge fund that traded in distressed debt, was invited to join the official creditor’s committee after it acquired a large position in Fibermark’s public notes. The committee was, according to the report of examiner Harvey R. Miller, dominated by another creditor, AIG Global Investment Corp., and its workout specialist, Mark Musante. Conflicts between Silver Point and AIG resulted in significant and costly disruptions, including allegations (unsubstantiated) that Silver Point engaged in illegal trading in Fibermark claims. Committee members “resort[ed] to strategic litigation based upon doubtful claims [which] further inflamed an already counterproductive environment to the detriment and prejudice of the reorganization process and the interest of creditors other than AIG [] and Silver Point.” The Fibermark examiner estimated that the delay caused by these fights reduced the value of distributions to creditors by almost $60 million.

More egregious still was the behavior of one shadow player in the Worldcom bankruptcy. There, Blue River Capital, a hedge fund, essentially lied about its positions in order to obtain a seat on the creditors’ committee. According to an SEC administrative order, Van D. Greenfield, the manager and compliance officer of Blue River, caused Blue River to enter into simultaneous backdated purchases and short sales of WorldCom unsecured notes. Greenfield then wrote to the United States Trustee, claiming to hold $400 million of Worldcom bonds, and asking to be appointed to Worldcom’s creditors’ committee. Greenfield did not, however, disclose that Blue River


\[141\] Id. at 2.

\[142\] Id. at 11-12.

\[143\] Id. at 12.


\[145\] According to the Greenfield Order: “On July 25, 2002, Greenfield directed [Blue River trader] Reybold to execute a short sale of $400,000 in face value of the Notes in one Blue River proprietary account and a purchase of $400,000 in face value of the Notes in another Blue River proprietary account and to book both trades as having been made ‘as of’ July 19, 2002, the last business day before the Petition Date. In fact, Blue River had not traded any WorldCom securities on July 19, 2002.” Id. at 5, ¶ 20.
“had no net economic interest in the notes because it also held a $400 million short position in the Notes.”\footnote{Id. at ¶ 21 (nor did Greenfield’s letter disclose that “the transaction in the Notes had not yet settled, or that the purchase had occurred after the Petition Date but was backdated to a date prior to the Petition Date. A $400 million unsecured claim would have put Blue River among the top 20 unsecured creditors of WorldCom as disclosed in WorldCom’s schedule of the 50 largest unsecured claims against it that was filed on the Petition Date.”) Id.} Greenfield thereafter had the purchase cancelled, leaving it holding only a much smaller net claim against the debtor—one that would not likely have resulted in its appointment to the creditors’ committee.\footnote{Id. at 8, ¶ 34 (“By obtaining membership on WorldCom’s creditors’ committee . . . Greenfield’s actions also could have had the effect of depriving another legitimate creditor from obtaining a seat on WorldCom’s creditors’ committee.”).} Ultimately, Blue River’s duplicity was discovered. Greenfield and Blue River paid a $150,000 settlement to the U.S. Treasury, neither admitting nor denying wrongdoing.\footnote{Id.}

\subsection{The Costs of Shadow Identity}

Shadow player identity creates three related types of costs. First, and perhaps most prosaic, fights about identity are expensive. The debtor and other official entities—all of whom are paid by the debtor’s estate—will likely become involved in fights like those in \textit{Northwest Airlines} or \textit{Fibermark}. These fights may be worthwhile to the particular shadow player, but it is far from clear that they benefit the estate. They take judicial time and resources from a system that is already heavily taxed. As one judge explained: “The problem with the hedge funds is that they use the bankruptcy court as a battleground without paying any rent.”\footnote{Telephonic interview with RG dated Jan. 8, 2009. He elaborated: “They impose enormous costs on the system, but they pay nothing for it. The airlines have to pay for fuel, for gate charges, and so forth. But hedge funds and private equity funds get to use the bankruptcy courts for all sorts of strategic purposes without paying a nickel.”} These are, in short, often collateral, internecine disputes that have little clear benefit to the estate.

Second, and perhaps more important, it affects the dynamics of negotiations. Negotiation has a special role in Chapter 11 reorganization. In the eyes of many system participants, the whole point of the process is to come to some new agreement about the debtor’s capital structure.\footnote{See sources cited in note 8.} A court will impose a resolution—the “cramdown” of a plan or a liquidation—only if it is clear that negotiations are failing. Chapter 11 negotiations are thus premised on the complex proposition that value can be maximized for all stakeholders in a debtor if the debtor is given a reasonable opportunity to restructure its affairs.\footnote{See \textit{In re} Winshall Settlor’s Trust, 758 F.2d 1136, 1137 (6th Cir. 1985) (“The purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state.”).} When it enacted Chapter 11 in 1978, Congress reasoned that “it is more economically efficient to reorganize than liquidate [a debtor], because [reorganization] preserves jobs and assets.”\footnote{See H.R. REP. NO. 595, at 220 (1977), \textit{reprinted in} 1978 U.S.C.C.A.N. 5963, 6179.}

\begin{thebibliography}{99}
\bibitem{first} \textit{In re} Winshall Settlor’s Trust, 758 F.2d 1136, 1137 (6th Cir. 1985) (“The purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state.”).
\end{thebibliography}
bankruptcy reorganization law is that it provides incentives for debtors and their creditors, notwithstanding their disparate interests, to reach a voluntary agreement on the terms of the restructuring.” 153

Shadow bankruptcy obscures these incentives, and thus makes negotiation more uncertain and expensive. As Judge Drain’s letter to the Rules Committee regarding repeal of Rule 2019 noted—echoing sentiments of participants interviewed for this paper—it is hard to negotiate anything, much less a plan of reorganization, if you don’t “know literally who the other side is.” 154 He elaborated:

Thus, one may negotiate a settlement that results in the withdrawal of a pleading only to have another pleading spring up by someone who purports not to have been in the group that settled. Or one may negotiate a settlement with someone only to learn later that they were still helping to fund the law firm that was prosecuting a group pleading—or that the law firm is continuing to prosecute the pleading, ostensibly on behalf of the group, when, in fact, the group has shrunk because many of its members have settled. These are not hypothetical concerns. Each has occurred in cases before me, and reference to Rule 2019 helped to straighten out the situation and keep the parties’ positions clear. 155

Third, and perhaps more disturbing, cloaking identity may conceal the real sources of control in a reorganization. As noted above, there is a major gap between the disclosure requirements of federal securities law (in particular Rule 13d-1) and bankruptcy rules regarding the purchase and sale of claims. To the extent that voting rights under a plan can be separated from beneficial ownership of the claim, we have the possibility that the real actors in reorganization will simply be unknown.

Ultimately, the problem presented by shadow bankruptcy is that it is not clear how often parties ignore or subvert rules designed to promote transparency, such as Rules 2019 and 3001(e). According to Judge Gerber, “failures to provide the information actually required by Rule 2019 . . . are widespread, and failures to make all of the required disclosures are the rule, not the exception.” 156 Thus, as former Secretary of

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154 Drain Letter, supra note 107, at 1
155 Id.
156 Gerber Letter, supra note 108, at 5. As he further explained--
Defense Donald Rumsfeld might say, “we don’t know what we don’t know.”\footnote{As Rumsfeld famously observed “There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. There are things we don’t know we don’t know.” Donald Rumsfeld, Dept. of Defense news briefing, Feb. 12, 2002, http://www.brainyquote.com/quotes/d/donalsdrums148142.html (last visited Feb. 20, 2009).} We know, in other words, that there is good reason to believe that important players in the system withhold their identities when it suits their purposes—e.g., while other parties are negotiating a reorganization plan—only to surface and, in so doing, disrupt whatever balance was struck. In destabilizing negotiations, shadow players at minimum create uncertainty, cost and delay. At worst, they can, as in the *Fibermark* case discussed above, cost other creditors millions of dollars.

### 2.2 What Do They Want?

Why do shadow investors want to conceal their identities? It may be because, as their trade associations claim, disclosure reveals proprietary trading strategies, depriving them of a competitive edge. But in some cases, secrecy will be essential because they hold complex, multi-faceted—"hedged"—positions that are actually antithetical to the debtor’s success. Shadow players may gain more from the debtor’s failure than its success by “shorting” the reorganization process.\footnote{According to their trade association, transparency “can have a potentially counterproductive effect” because “distressed investors such as hedge funds employ aggressive and complex investment strategies.” *SIFMA/LSTA Proposal*, supra note 103. at 22-23.} If that is the motive, then concealment obviously makes sense. Even when they do not remain in the shadows, their tactics—like those of all rational self-maximizers—is to buy low and sell high. There is some evidence that the shadow bankruptcy system permits, perhaps promotes, this—to the harm of debtors and their larger constituencies.

#### 2.2.1 Hedging Strategies

Part of the problem here derives from the complex hedging strategies that shadow bankruptcy players might use. Private investors may acquire any number of positions against a debtor in bankruptcy. One hedge fund may, for example, acquire secured and unsecured claims, as well as preferred stock, or even common stock.\footnote{See, e.g., sources cited in note 17.} The economic goal may be to reach the “fulcrum” position, the point in the capital structure that achieves maximum control for minimum investment.\footnote{See, e.g., Lichtenstein & Cheney, *supra* note 16 (unpaginated original).}

According to interviews with participants, hedging in reorganization itself is not especially new.\footnote{Telephone interview with JP, Jan. 18, 2009.} But, it did not exist in anything resembling its current form when Congress enacted the current Bankruptcy Code in 1978. Nothing in the legislative
history to the current law directly addresses what sort of capital structure Congress envisioned when it enacted Chapter 11. Most likely, Congress had no particular structure in mind, since it designed a system that was meant to be highly flexible, to permit the reorganization of small, local firms as well as very large public companies. But, as one seasoned Chapter 11 lawyer explained, "The assumption was that [it] was a simpler capital structure at the time. The [] premise was that the parties would sit at the table and negotiate and know what one another wanted. Today, you have no idea what someone’s real incentives are." 162

The reason one may not understand other investors’ incentives is due to the ability to hold multiple positions against or affecting a debtor in Chapter 11. For example, an investor may acquire both the senior debt of, and a short position against, stock of a single debtor. If the reorganization plan severely dilutes or eliminates the stock, the debt and the short may pay. If the plan doesn’t do this, the holder may use the senior debt to block confirmation of the plan. The mere fact that the holder might hold a short position—which is disclosed nowhere—will distort negotiations. The possibility of multi-tranche holdings has at minimum an in terrorem effect that likely gives shadow players the capacity to influence reorganizations disproportionate to their actual holdings. No account whatsoever is taken of the effect this has on the bankruptcy estate or the reorganization process.

Neither the court nor other participants have any certain way to discover a holder’s multiple positions, until it is too late. A notorious example occurred in the Adelphia reorganization. According to a statement by Bankruptcy Judge Robert Gerber, who presided over the case:

[I]nvestors long in bonds of Adelphia Parent admitted to other investors that they had a short position in bonds of Arahova Communications, one of the Parent’s subsidiaries. The investors’ short position gave them an economic stake in a lower recovery for Arahova creditors and, as some argued, an economic stake from which the investors would profit from the failure or delay of the entire chapter 11 case. . . . 163

In Judge Gerber’s view, expressed in opposition to the proposal to repeal Rule 2019, the cure here would have been disclosure of the short position: “[D]isclosure of the short positions would seem to be essential to make that which was said about the long positions not misleading.” 164 As one participant interviewed for this paper explained “[t]he really important thing is to disclose the full position, including shorts and derivatives.” 165

An extreme example of hedging strategies that might harm debtors involve credit default swaps (CDS). As many have already observed, these instruments create a classic problem of moral hazard. In a CDS, a creditor of the debtor purchases what is effectively insurance from a third party (a “protection seller”) in the form of a swap. The insurance

162 Telephone interview with RL, Feb. 6, 2009.

163 See Gerber Letter, supra note 108, at 6, n. 11.

164 Id.

165 Telephonic interview with RL, Feb. 6, 2009. He went on: “Everybody says ‘we can’t reveal our trading strategies.’ Bullshit. This is about knowing who you are dealing with and what they want.” Id.
is that the protection seller will pay the creditor (the “protection buyer”) if the debtor encounters any number of forms of financial distress, including most importantly bankruptcy. CDS is, in many respects, a fancy term for a third-party guarantee.

As with guarantees, the creditor who benefits from the guarantee may decide that collecting on the guarantee is a more profitable option than trying to collect from the debtor. But the creditor can only do that if the swap has been triggered. If bankruptcy triggers the swap, the creditor may then seek to commence an involuntary bankruptcy proceeding against the debtor, not to collect from the debtor, but instead to collect from the swap protection seller.  

2.2.2 Buy Low, Sell High

It is not clear how often or destructive hedging strategies are. Indeed, as discussed in greater detail in Part 3, the lack of information here is part of the problem. But shadow players are sometimes happy to reveal their identities, and even their strategies, if doing so will enable them to obtain a quick profit at the expense of the estate.

One famous method here is the so-called “loan-to-own.” In a loan-to-own strategy, a private investor will acquire debt of a distressed firm before or during bankruptcy. It may then provide financing to the debtor in the form of cash collateral or a new debtor in possession facility, as discussed in Part 1. But the real goal of the loan is not the repayment of principal, plus interest, as one might expect from a conventional lender, but instead the conversion of that loan into a controlling equity position in the debtor.

A recent survey of hedge funds reports that a large number of respondents invest in secured debt of troubled companies with a view to acquiring a controlling equity interest. According to this study, 78 percent of respondents said “secured loans have become their primary investment vehicle for investing in distressed debt, up sharply from 43 percent in 2007.” Such “loan-to-own” strategies “provide the greatest opportunity to acquire an equity stake at a bargain basement price should the borrowers deleverage by swapping debt for equity in or outside of bankruptcy court.”

Consider also asset sale strategies. On a conventional view, non-ordinary course asset sales should be a good thing, because in a transparent system, bidding will be high, creating maximum value for stakeholders. According to some scholars—notably Douglas Baird—this is a good thing. “Today,” Professor Baird writes, “creditors of insolvent businesses . . . no longer need a substitute for a market sale. Instead of providing a substitute for a market sale, chapter 11 [bankruptcy reorganization] now serves as the

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166 See Lubben, supra note 18, at 427 (“Creditors will have every incentive to trigger the swap by filing an involuntary bankruptcy petition against the debtor, illustrating the important point that ‘bankruptcy’ is the one credit event that can be controlled by credit buyers.”).

167 See Dykema Survey, supra note 16, at 1 (unpaginated original).

168 Id.

169 Id.
forum where such sales are conducted.”\textsuperscript{170} Reorganization under Chapter 11 of the Bankruptcy Code “has,” according to Baird, “morphed into a branch of the law governing mergers and acquisitions.”\textsuperscript{171} This is said to be good because it is assumed that transparency will produce the highest and best price for an asset. As Baird (with Morrison) has explained—

A regime of mandatory auctions is strongly information forcing. It gives managers (and everyone else with an incentive to preserve the firm as a going concern) an incentive to make information available and verifiable to potential buyers. Such a rule destroys the option value associated with keeping the firm running for a short time (assuming no buyer is willing to purchase the firm in toto at the outset), but it gives the managers an incentive to ensure that a market for the firm’s assets always exists.\textsuperscript{172}

The predicate here is that sales will inevitably produce more and better information which will, in turn, produce higher and better valuations for the assets of reorganizing debtors that may be sold in a Chapter 11 case. In theory, of course, this should be right. If managers are acting on their fiduciary duties to maximize asset values, they would do this, because information will (at least in theory) tend to improve asset prices. Knowledgeable market actors are more likely to compete amongst one another for a debtor’s assets. The better informed they are, the more vigorous the bidding is likely to be.

But, of course, theory does not always comport with reality, and the assumption that managers want to maximize asset values (and produce information to do so) assumes away all the conflicts of interest they might experience. Say management has found a stalking horse to set a floor for bidding on certain assets—for example, a particular division of the company. The arrangement with the stalking horse would certainly give it access to confidential information about the company. And the auction procedures approved by the court would almost certainly require that the same information be provided to other bona fide bidders, in an effort to drive up the sale price.

But we would also expect that managers will have an abiding interest in their own welfare. Thus, if one bidder quietly promises them, individually, some better deal—say,


\textsuperscript{171} Baird, \textit{New Face}, supra note 170, at 75. \textit{See also}, David A. Skeel, Jr., \textit{Creditors’ Ball: The “New” New Corporate Governance in Chapter 11}, 152 U. PA. L. REV. 917, 918 (2003); (“The endless negotiations and mind-numbing bureaucratic process that seemed to characterize bankruptcy in the 1980s have been replaced by transactions that look more like the market for corporate control.”).

attractive new employment agreements—we might expect that management would prefer that bidder. Management might, under those circumstances, manipulate the flow of information to other bidders or stakeholders (such as the creditors committee), provide more (or better) information to the bidder that has offered the sweetheart deal, and so on.

Thus, some observers are not so sanguine about the virtues of the sale process, in particular because valuations often appear depressed. Professors LoPucki and Doherty, for example, have suggested that asset sales involving large, publicly-traded corporate debtors have been highly depressed.173 They have argued that conflicts of interest among investment bankers and the absence of competition among courts for large cases may explain this effect.174 This may well be true. But another possibility is informational: the parties—in particular, creditors or other potential bidders—lack the information to generate greater value.175 Consider, for example, their explanation of the sale of Polaroid’s assets:

Polaroid’s CEO resigned early in the bankruptcy case and was replaced by two lower-level employees as co-CEOs. One had a base salary as CEO of $375,000, the other $390,000. After they took the job, Polaroid adopted a retention bonus plan that resulted in their being paid $844,000 and $878,000 respectively in their final year of work. They sold Polaroid to the sole bidder, One Equity Partners Imaging Corp. (“OEP”), for a price that was widely condemned by the financial press as too low. Immediately upon closing the sale, OEP hired them to continue running the company as co-CEOs. The two swore under oath that they had no contract to work for OEP before they closed the sale. But they may not have needed one. The custom appears to be that if the buyer hires the selling managers, the selling managers get a share of the buyer’s equity in the company. Indeed, a year after the sale closing, Polaroid disclosed that each of the two employees in question owned stock in OEP valued at $3 million to $4 million.176

An even more egregious example involves the recent debacle in the Steve & Barry’s bankruptcy. On July 9, 2008, Steve & Barry’s, a discount retail chain started by some entrepreneurial University of Pennsylvania students, filed for bankruptcy.177 Before bankruptcy, it had been one of the nation’s fastest growing retailers, opening hundreds of

173 See LoPucki & Doherty, Fire Sales, supra note 31, at 24 (finding that “[c]ontrolling for the company’s earnings, reorganized companies recover about 75% of their book value, compared to a 29% recovery ratio for those that sell.”) & 44 (“on average, reorganizations yielded 80% or 91% of book value, while sales yielded only 35% of book value.”).
174 Id. at 40 (“We think court competition explains the bankruptcy courts’ passivity” in challenging low sales valuations.) & 44 (“The managers who decided to sell these companies rather than reorganize them frequently had conflicts of interest. So did the investment bankers who advised the managers and solicited bids.”).
175 See id. at 38 (“to know that the sale price is inadequate, a party may need to spend millions of dollars for an independent valuation.”).
176 Id. at 33-34.
177 In re Steve & Barry’s, Inc., No. 08-12579 (Bankr. S.D.N.Y. 2008).
stores selling clothing under the names of celebrities such as Sarah Jessica Parker, Venus Williams and Stephon Marbury.

On July 16, 2008—a week after it commenced its case—it sought authority to sell the entire business as a going concern.\footnote{See Debtors’ Amended Motion Pursuant to Sections 105(a), 363, and 365 of the Bankruptcy Code . . . for (i) Approval of Procedures in Connection with the Sale of all or Substantially all of the Debtors’ Assets; (ii) Authorization to Enter into Stalking Horse Agreements in Connection Therewith, (iii) Approval of the Payment of Stalking Horse Protections, and(iv) the Setting of Related Auction and Hearing Dates, In re Steve & Barry’s Manhattan LLC, No. 08-12579 [hereinafter Steve & Barry’s Sale Motion].} Despite the fact that no creditors’ committee had been appointed, the bankruptcy court approved bid procedures which ultimately led to a sale of Steve & Barry’s to the stalking horse,\footnote{See Declaration of Scot Sozio in Connection with BH S&B Holdings, LLC’s Offer to Purchase Substantially all Assets of the Debtors, In re Steve & Barry’s Manhattan LLC, No. 08-12579 (Bankr. S.D.N.Y. 2008).} investment firms Bay Harbour Management and York Capital Management, purchased the retailer for $168 million. This, despite the fact that the debtor’s own motion to create these procedures claimed that the debtor’s assets and annual revenues were worth nearly five times that amount on a book basis.\footnote{See Steve & Barry’s Sale Motion, supra note 178, at 4 (“As of May 31, 2008, Steve & Barry’s . . . consolidated assets totaled approximately $732.7 million . . . . Consolidated revenues for the twelve months ended May 31, 2008, were approximately $656.6 million.”).}

Despite buying the debtor for this fire sale price, the purchasers could not make a go of it. With a plan to liquidate the chain’s remaining 173 stores by early 2009, the new owners filed for bankruptcy protection a second time, less than four months later, in November 2008.\footnote{In re BH S&B Holdings LLC, No. 08-14604 (Bankr. S.D.N.Y. 2008) (commenced Nov. 19, 2008).} Steve & Barry’s previous owners raised objection to this by claiming that they still owned the inventory and other assets in about 65 of the remaining shops. The former owners also said that Bay Harbour and York Capital failed to fulfill some terms of the original asset purchase agreement. The judges approved a stipulation between the new and former owners of the company. The former owners were given access to about $7.4 million in cash and $11 million in various escrow accounts.

The net result? A business estimated to be worth over half a billion dollars was liquidated for a tiny fraction of its value. Creditors of Steve & Barry’s can expect to receive virtually nothing on account of their claims. Perhaps as important, Steve & Barry’s 8,600 domestic employees lost their jobs.\footnote{Steve & Barry’s Sale Motion, supra note 178, at 4.} At this point, it is difficult to know what to make of the Steve & Barry’s case. Much of the blame must be laid at the feet of the current credit crisis. According to the debtor, it was compelled to seek the immediate sale in the first case because its principal creditor, General Electric Capital Corporation, conditioned the debtor’s use of cash collateral on a sale of the debtor no later than August 15, 2008.\footnote{Id. at 2.} Without the consent of GECC, the debtors claimed they had no cash, and were thus unable to replenish inventory
and remain in business. Why GECC withdrew credit is not currently known. Certainly, Judge Gropper’s statement about the case must have some merit: “It is a terrible economic situation that we all face.”

Yet, Judge Gropper—who presided over the Northwest cases discussed above, and who is surely sensitive to the machinations of the shadow system—was also quick to absolve everyone involved. “I don’t think anyone can blame themselves,” he was quoted as saying after commencement of the second case.

This may be true, but it leaves many questions: What efforts had been made to obtain alternative financing or to use the powers given to debtors obtain permission to use GECC’s cash collateral? Under Bankruptcy Code section 363(c)(2), the Bankruptcy Court may permit the debtor to use cash collateral over the creditor’s objection. From the public pleadings, it would appear that no effort was made to use this cash collateral. Similarly, what sort of fees did Bay Harbour and York Capital take out of the company when they purchased it in the first case? What relationship, if any, existed between these investors and GECC? How vigorous could the bidding have been given the extremely short time frame allotted—less than a month?

There is, in short, likely more to the Steve & Barry’s story than simply the shadow bankruptcy system. Yet, the behavior of the participants creates grounds for serious concern. Would a more fully transparent system have produced a better result? We do not know. We do know, however, that the shadow bankruptcy players (GECC, Bay Harbour, York capital) caused (and perhaps suffered) serious losses.

Shadow bankruptcy players are like everyone else, only more so: They want to make the most for the least. Today, however, gaps in the reorganization system permit them to act not only for their own benefit, but also to the detriment of the debtor and its other stakeholders, in two ways.

First, in many cases, it will simply not be possible to know the stakeholder’s real aspirations. If a creditor or shareholder held only one position, it would be fairly easy to imagine how a given result in reorganization would affect that holder, and thus whether the holder would support or oppose a proposal. Multi-tranche positions tend to undercut one of reorganization’s chief mechanisms—the negotiated settlement. As one participant said to me “it’s very hard to shoot a moving target. I can’t negotiate with you if I don’t have some idea what you really want.”

Second, these positions may well lead to behavior that destroys value for the debtor’s other stakeholders. If a stakeholder’s short or derivative position pays only if the debtor’s reorganization plan fails, or assets are sold below a certain value, then the

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184 Id.
185 See Chasen, supra note 32 (quoting Judge Gropper).
186 Id.
188 See Hu & Black, supra note 18, at 19 (“[O]ne [bankruptcy] judge described a case in which a junior creditor complained that that firm’s value was too high, even though a lower value would hurt the class of debt the creditor ostensibly held.”).
stakeholder will act accordingly. While this may maximize value for that stakeholder, it may reduce recoveries for other stakeholders, destroy going concern value and needlessly eliminate jobs.

2.3 When Do They Want It?

The Steve & Barry’s case discussed above is an example not only of devastatingly low valuations, but also of a more specific and troubling feature of the shadow system: short, or at least unpredictable, time horizons. The model on which the current system is predicated assumes that investors would likely hold for long periods of time. Being heavily regulated, commercial banks—who were important creditors in the 1970s—were only permitted to make “safe and sound” loans which would amortize over a fairly lengthy and predictable term. Public investors—whether bondholders or stockholders—were also generally assumed to be investing for the long term. While bankruptcy reorganization would throw a wrench in those investment plans, it did not necessarily alter the underlying time horizon. Thus, reorganization under Chapter 11 was seen as a way of preserving and maximizing this long term value by saving companies that had at least the apparent possibility of a viable future.

Private investors, however, may have much shorter time horizons. As one hedge fund manager explained “creditors want cash, so the market is affecting going concern values.”189 Practitioners Robert Rosenberg and Michele Riela elaborate thus—

Some hedge funds seek a “quick flip” of their investments, while others engage in a “loan to own” strategy, in which they make loans to a distressed company with the intent to convert that debt to equity after the company defaults on the loans and restructures the debt in sum, hedge funds are more likely than more traditional investors to seek short-term returns that are not necessarily tied to the debtor’s successful reorganization.190

Private investors may look for a quick return because they are greedy. But they may also be subject to the capital calls of their own investors who, increasingly nervous and illiquid, need to exit an investment in the hedge fund, even if doing so today may produce a lower return than a long-term buy and hold strategy. This, in turn, may place private investors at odds with management of the debtor and other stakeholders in the debtor, who might want to reorganize the company and realize a return over a much longer period.191

Shadow bankruptcy presents other timing issues, as well. Perhaps the most important is that private investors can influence distressed firms before bankruptcy. This

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191 Id. (“Partly as a result of hedge funds’ short-term investment horizon and investments in multiple segments of a company’s capital structure, hedge funds’ interests are not always aligned with those of debtors and other parties. The focus by a number of hedge funds on the maximization of short-term returns often has caused tensions among the parties to a restructuring and may conflict with the Bankruptcy Code’s emphasis on the rehabilitation of debtors”).
may be for laudable purposes, such as to help finance an out-of-court restructuring. But it may also reflect a loan-to-own strategy that ultimately reduces value for the debtor’s other stakeholders. In some cases, private investors would rather keep the company out of bankruptcy, so that they can foreclose on assets acquired for far less than their fair market value.192

In either case, Chapter 11 has little regulatory reach here. As discussed above, sections 1125(g) & 1126(b) of the Bankruptcy Code deal with pre-bankruptcy solicitations in connection with a reorganization. And, of course, many of the avoidance powers in bankruptcy can cover significant pre-bankruptcy periods.193 But these are of limited force in the face of the shadow bankruptcy regime. Nothing in Chapter 11 requires disclosure of the purchase of claims or interests, even a controlling share. Nothing under applicable fraudulent transfer law will permit avoidance of a “regularly” conducted—meaning procedurally sufficient—foreclosure sale, no matter how low the selling price might be.194 As noted above, the federal securities laws do little useful work here. Nor can the Bankruptcy Code, if no bankruptcy case has been commenced. In short, as with regulating issues of identity and motive, the current system prevents us from understanding the real time horizons of shadow bankruptcy players, which creates costs and reduces recoveries.

This, in turn, may explain the fear of reorganization noted in the introduction. For example, as I have argued elsewhere, on inspection, it may be that Bear Stearns—and the entire financial system—would have been better off if that firm had gone through Chapter 11 rather than receive a government-funded bailout.195 If it worked, Chapter 11 should have produced at least the possibility of a competitive bidding process. It should have resulted in an examination of what caused the failure, and the creation or preservation of causes of action against those who harmed the firm, which might increase creditor (and shareholder) recoveries. It should have resulted in a plan that would give all stakeholders—not just shareholders and the Federal Reserve—a say in the firm’s future. While this may only have a been controlled liquidation, it would have created the

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192 According to one private investor with whom I spoke “the real problem isn’t that these guys manipulate the bankruptcy process. Hell, that’s gone on for years. It’s that they’re keeping companies out of bankruptcy when they should go in.” “Telephonic interview with JP. Jan. 14, 2009. See also Dykema Survey, supra note 16, at 1 (unpaginated original) (“44 percent of hedge fund managers who plan to lend money to a financially troubled company in 2009 intend to use their loan to acquire control of the borrower if it files for bankruptcy.”). See also Erika Lovley, How Troubled Firms Skip Bankruptcy Court, WALL ST. J., Feb. 7, 2007, at B5B (describing roles of hedge funds, but also noting that out-of-court restructurings may be the last chance to avoid bankruptcy).

193 Depending on which fraudulent transfer regime is used, the look-back period can be as little as one year, and as long as six. See Jonathan C. Lipson, Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?, 11 J. BANKR. L. & PRAC. 101 (2002) (describing fraudulent transfer provisions).


possibility of greater stakeholder control, perhaps increased recoveries for stakeholders, and rooted out and punished any misconduct that caused the firm’s failure.

Today, however, we can have no confidence that Chapter 11 will do any of these things if it can be co-opted by sophisticated shadow players. Of course, there are probably other reasons why the federal government has stepped in to save firms such as Bear Stearns, AIG and the automakers which have nothing to do with shadow bankruptcy. But, sophisticated observers of Chapter 11 should understand that once a firm enters Chapter 11, all bets on an orderly and welfare-enhancing reorganization are off. Smart observers in the federal government may understand this. They may have concluded that reorganization was simply too risky. Shadow players not only created the disease, but have apparently tainted the cure.

To be sure, some may argue that shadow bankruptcy brings liquidity and expertise to the system—both of which might otherwise be in disturbingly short supply. Thus, as discussed in the next Part, we should be wary of substantive re-regulation that discourages active participation of these players. There is, some would say, nothing inherently problematic about private investors who exploit regulatory gaps to make money. That is a fundamental feature of our system. But, the gaps are now too big, and some re-regulation is in order. The important questions will involve the nature and extent of that regulation.

3.0 Shedding Light

Articulating the contours and costs of shadow bankruptcy is easier than developing a cure. Like most problems of private ordering, regulating the shadow bankruptcy system presents two basic options: Substantive control and forced disclosure. A major overhaul of the financial regulatory apparatus appears virtually inevitable in the near term, which will doubtless feature both. The important questions are whether any of the likely reformulations will account for the shadow bankruptcy system and, if so, how they will work?

This part addresses these questions in two ways. First, it proposes to take seriously the proposition that Chapter 11 is, as described above, an information system. Thus, it proposes to move Chapter 11 into the modern era, offering some early thoughts

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196 Among other things, there is some reason to think that AIG’s liability on credit default swaps would render Chapter 11 a nullity. See The Loophole that became a wormhole: Why the Fed had to bail out AIG, Concurring Opinions, Sep. 19, 2008 (available at http://www.concurringopinions.com/archives/2008/09/the_loophole_th.html) (last visited Feb 26, 2009). Unlike ordinary debts, liabilities on credit default swaps are largely outside the reach of bankruptcy. See 11 U.S.C. § 561. Among other things, this means that counterparties collect despite the issuer’s bankruptcy—to the detriment of other stakeholders in the issuing debtor who in effect unwittingly subsidize the payments on the swap.

197 See, e.g., Goldschmid, supra note 15, at 259 (“The arrival of distressed debt investors can add new, positive energy to the reorganization process.”).

198 Even before the full magnitude of the crisis became apparent (assuming that it has as of this writing), the U.S. Department of Treasury was busy developing a regulatory overhaul scheme. See DEPARTMENT OF THE TREASURY, THE DEPARTMENT OF TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (Mar. 2008), available at http://www.treas.gov/press/releases/reports/Blueprint.pdf [hereinafter TREASURY BLUEPRINT].
on how information technology and uniform disclosure might address problems with the shadow system. But, as William O. Douglas observed, disclosure alone may not be enough. Thus, the second half of this part offers specific suggestions on how we should assess the reorganization system to determine if more control is appropriate.

3.1 Disclosure

The first, and perhaps best, solution to the shadow bankruptcy problem is disclosure. Addressing disclosure is, as discussed in this sub-part, a complex proposition. Nevertheless, properly harnessing developing information technologies to better understandings of the role that disclosure can play might well restore Chapter 11 to its proper function.

3.1.1 Current Proposals—Shadows and Light

The various problems identified in this Article have not, of course, gone unnoticed. Rather, the problem with current proposals is that they are piecemeal and partial. They would tinker with particular, existing mechanisms, such as amending Bankruptcy Rules 2019 or 3001(e) or Securities Exchange Act Rule 13d-1. But none consider the system more broadly, and so none can fully shed light on the shadow system.

Judge Gerber, for example, would expand Rule 2019 in substance, but would eliminate the requirement that purchase price be disclosed. He would require disclosure of short or economically similar positions, as well as “any position or interest that would result in a financial gain upon the failure or delay of the chapter 11 case, or upon decreased recoveries by any other constituency.” Similarly, others have advocated amending Rule 3001(e) to require disclosure of the purchase and sale price of claims or to impose an ownership disclosure rule akin to Rule 13d-1 in bankruptcy that would try to reach the real motives of the players, rather than their simple, stated claims.

These are all laudable proposals. At least as currently articulated, however, they each have their limitations. In the case of Judge Gerber’s proposal, the stopping point is not clear. Almost every position in a case could—and likely would—enjoy “financial gain” “upon decreased recoveries by any other constituency.” Bankruptcy is a zero-sum game—indeed, a negative-sum game—and so it will also be intensely distributive. If the bankruptcy pie is not big enough to feed all creditors, it will be very tempting to eat off someone else’s plate.

Other proposals fail to account for the fact, discussed above, that shadow players may take positions in distressed firms—and influence the outcomes of those firms—well

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201 See Coco, supra note 13, at 651 (“The proposed rule mandating ownership disclosure when a party acquires one half in number or one third in amount of claims or interests would occur toward the end of the Chapter 11 case, when the confirmation plan separates the parties into classes.”).

202 Nor is it clear whether these changes would apply to all stakeholders, or only those who, as under current law, apply only to those stakeholders who represent other stakeholders.
before bankruptcy. To the extent bankruptcy jurisdiction does not attach, it is not clear how its rules or remedies will address the sorts of problems we have seen. It is, as discussed below, possible that the federal securities regime may be a more effective means for address these problems. But the future of securities regulation is, like all financial regulation, up for grabs.

The important point here is go beyond tinkering, and to recognize that Chapter 11 creates and involves an information system. The regulation of this system should reflect modern information technologies as well as the role that reorganization plays in the larger financial system. Failing this, the shadows will persist.

3.1.2 Reorganization as Information Technology

If it is true that Chapter 11 creates a (largely) one-way information system, then perhaps the solution to shadow bankruptcy is to make disclosure comprehensive and mandatory. This sub-part proposes the creation of an electronic registry of positions in or affecting distressed firms—that is claims, interests, derivative positions, and so forth—and considers some of the issues such a system would raise.

Ideally, an electronic registry would piggyback on existing information technologies. Websites such as Creditex and Markit already provide some trading and settlement information about bankruptcy claims and credit default swaps. Similarly, as one hedge fund manager explained to me, private providers like Standard & Poors already have subscription services that perform some of these functions, but on a limited and proprietary basis. Another approach might involve the SEC’s electronic document filing system (EDGAR) system—soon to be replaced by the more user-friendly IDEA system—and its many private conduits.

These systems or others like them could be adapted to provide a range of informational services about positions affecting distressed firms. The systems would not involve registration or regulation of the investors themselves, and so would be distinct from the traditional methods used to regulate commercial banks and mutual funds. But having a central location to assess the array of positions affecting a debtor, who holds

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205 According to its website, Creditex “is a global market leader and innovator in execution and processing of credit derivatives. The company operates a hybrid model of voice and electronic execution, and was the first to successfully launch electronic trading for CDS in 2004. In addition to its core execution business, Creditex has two operating subsidiaries.” Creditex, http://www.creditex.com/overview.html (last visited Feb. 14, 2009).
those positions, and how they are trading, could bring enormous efficiency and transparency to a system that is currently fragmented, obscure and potentially destructive.

A new system would create a single location for aggregating the economic stakes of investors in distressed firms, thereby leveling the negotiating playing field and minimizing the perverse incentive effects of the current system.

Interviews with system participants and an evaluation of literature to date suggest that the most important information will involve stakeholders’ incentives: What do they want and when do they want it? We cannot, however, create a registry of incentives, any more than prosecutors can readily find direct evidence of intent. Rather, the best we can do is to require disclosure of all material aspects of a stakeholder’s set of positions vis-à-vis a debtor, even if they may be derivative positions, short positions, or not otherwise technically covered by the existing, outmoded regulatory structure. Thus, a modern registry would require stakeholders to register not simply the acquisition of debt or shares of a company in Chapter 11, but also of instruments that may not directly involve the debtor, but which would nevertheless tend to influence the incentives of the stakeholder. Thus, credit default swaps, other credit derivatives and short positions should all—if material—be registered in a single place, and in a way that is fairly easy for other system participants to identify.

Simply proposing an electronic registry hardly answers all the many difficult questions presented by a disclosure-based solution to shadow bankruptcy. Fully answering such questions is beyond the scope of this paper. But it is possible to flesh out some of the most important and basic issues at this point, in particular scope, logistics and enforcement.

**Scope.** A basic, and difficult, question facing anyone who wants to require greater disclosure in the reorganization system will involve the scope of disclosure: Who must disclose what, and when? For example, a central registry for the trading of claims against corporate debtors could force purchasers to reveal their identities in real time. But do we want to force all such purchases to be registered? Presumably, if we think disclosure of this sort is appropriate at all—and I do—there should be a materiality threshold below which registration would not be required.

Under the federal securities regulation framework, “materiality” is central to any claim of fraud. Plaintiffs seeking to recover for fraud must prove by a substantial likelihood that a questionable statement or omission involves “material” facts.²¹⁰ A statement or omission is material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”²¹¹ Materiality

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²¹¹ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976) (adopting rule for 14a-9 proxy actions); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) ("expressly adopt[ing] the TSC Industries standard of materiality for the 10(b) and Rule 10b-5 context").
“depends on the significance the reasonable investor would place on the withheld or misrepresented information.”

This definition of materiality exists as a check on securities fraud suits. Its particulars may or may not be responsive to problems presented by the shadow bankruptcy system. Whether, or to what extent, the federal securities law understanding of materiality should inform a disclosure system in corporate reorganization is a question for further study. At this point, it is sufficient to note that some such definition would be appropriate.

Moreover, there would seem to be a continuum of disclosures that are more and less sensitive from the perspective of the discloser (e.g., the hedge fund) which may or may not be coincident with the legitimate systemic needs of other participants. Thus, it is not clear whether the price paid for claims is especially important, although that is currently required by applicable bankruptcy rules. As discussed above, the trade associations for the shadow bankruptcy players want to protect their proprietary trading strategies. It seems to me there is clearly some merit in this. How to balance the need to protect legitimate trading strategies against the larger informational needs of the system will be a difficult question that warrants serious study.

Another important question of scope involves positions taken prior to commencement of a Chapter 11 case. One of the problems with the current regulatory scheme, as noted above, is that it has little effect prior to bankruptcy. But shadow bankruptcy players and tactics can clearly affect a company in financial distress even if it is not in bankruptcy. The shadow system may, for example, lead to a premature liquidations or other transactions that harms the debtor’s long-term viability.

As discussed above, prepackaged bankruptcies for public companies have generally subsisted on the view that disclosure sufficient under the federal securities laws would be good enough for bankruptcy. Yet, Congress recognized in enacting the current Bankruptcy Code that the reporting rules applicable to a solvent and going concern may not be entirely relevant to one that is in distress. In 1997, the National Bankruptcy Review Commission suggested that the Bankruptcy Code be changed to recognize this distinction, to alleviate companies soliciting votes for a prepackaged plan of the cost and burden associated with securities law disclosure compliance. This suggestion did not

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213 Judge Gerber’s thoughtful letter regarding Rule 2019 suggests that disclosure of price may not be especially important. Gerber Letter, supra note 108, at 7 (“And in most cases, what they paid for their claims (and how much profit they will make as a consequence of intercreditor negotiations, or various case outcomes) will be a matter of indifference to the Court, and will not require disclosure.”).

214 S. REP. No. 95-989, at 120 (1978), H.R. REP. No. 95-595, at 408 (1977) (“Reporting and audit standards devised for solvent and continuing businesses do not necessarily fit a debtor in reorganization. Subsection (a)(1) expressly incorporates consideration of the nature and history of the debtor and the condition of its books and records into the determination of what is reasonably practicable to supply.”).

become law, but something like it might be appropriate if properly tailored to the realities of modern investing in distressed companies.

The problem here, as with materiality, is line drawing. When is a firm in such distress that some prebankruptcy form of the disclosure architecture described above should kick in? How would it work? We may, for example, require disclosure only with respect to publicly-traded companies with assets above a certain amount, as reported on the most recent 10K. Disclosure might be triggered by asset/liability ratios, again as reported on another, existing form.

More difficult still will be privately held companies. For these companies, there will be no quarterly (or other) public report with financial information. So, while private investors may learn that a firm is in trouble, and seek to acquire control by buying up claims, it is simply not clear when they would be required to register their positions, or how they would know ex ante that the firm was in such distress that they were supposed to do so.

Finally, questions of scope imply questions about the ultimate policy goal of disclosure. To the extent that federal securities law supplies the model, the question is whether disclosure is an end in itself, or is instead a means to some other end. While there are legitimate debates about the extent to which securities law should force market participants to disclose information, the “primary policy” of U.S. securities law has been “the remediation of information asymmetries” through a mandatory disclosure system that “compels business corporations and other securities issuers to disseminate detailed, generally issuer-specific information when selling new securities to the public and requires specified issuers to file annual and other periodic reports containing similar information.”

The standards and requirements provided in the Bankruptcy Code for postpetition solicitation should be applicable to solicitation for a plan of reorganization within 120 days prior to filing a Chapter 11 petition by an entity that is subject to and in compliance with the public periodic reporting requirements of the Securities Exchange Act of 1934. Notice of such prepetition solicitation should be served on the Securities and Exchange Commission. If an entity solicits for a plan of reorganization but does not file for bankruptcy, the bankruptcy requirements and standards should be applicable if an entity does not complete an exchange offer or any other transaction on the basis of such solicitation.

216 See Joel Seligman, No one can Serve Two Masters: Corporate and Securities Law After Enron, 80 WASH U. L.Q. 449, 450 (2002). See also Troy A. Paredes, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 81 WASH. U.L.Q. 417, 422 (2003) (explaining that “as a regulatory matter, the mandatory disclosure debate has been settled for seventy years, since the Securities Act of 1933 was adopted. Our federal securities laws are designed to protect investors and the integrity of capital markets by mandating disclosure that enables informed investor decision making, boosts investor confidence, and reduces agency costs”). See generally 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 226-77 (3d ed. 1989).

Some—including Douglas—believed that disclosure was an end in itself, meant to deter market misconduct. The information was, in his eyes, less important than the fact that it had to be disclosed. Others have offered a more nuanced view, focusing on the demand-side for information. Troy Paredes, for example, has argued that “[i]nvestors, analysts, and others need to use the disclosed information effectively for the disclosures to be useful. In other words, for our mandatory disclosure system to work, securities market participants must not only have access to information, but must be able to search and process in an effective manner the information that is disclosed.”\(^{218}\) Given the sophisticated nature of shadow bankruptcy players, it seems more appropriate to focus on the real ways in which they are likely to use information, rather than bluntly require them to make massive, but potentially meaningless, disclosures. In any case, any choice to expand the disclosure system in reorganization implicates difficult policy choices subsumed in the scope of the disclosures required.

**Logistics.** Another important question will involve the logistics of creating, maintaining and enforcing such a system. Prior to the revolution in information technology, imposing disclosure obligations involving shadow bankruptcy players would have been a serious logistical problem. Today, however, information technologies could neutralize a number of these problems. There is no obvious logistical reason why systems such as EDGAR, IDEA or the private providers discussed above could not embrace the sorts of transactions that compose the shadow bankruptcy system.

A more difficult logistical question will involve cost. As noted, firms like Creditex, Markit and S&P offer proprietary and limited coverage of certain aspects of the shadow system. But these are not charities. Who will pay to expand these systems, and how should their services be metered? In the case of a securities issuance, the issuer generally bears the costs of registration or becoming a reporting company. But, companies in financial distress are, by definition, not likely to be in a position to pay to participate in the sort of information system described here. Moreover, it would not necessarily benefit the debtor directly: such a system would exist chiefly to level the playing field among the debtor’s stakeholders, in order to prevent the costly, value-destroying gamesmanship we increasingly see. But, it is hardly realistic to expect shadow players to want to pay to disclose their holdings. They do not want to make disclosure at all at this point. Why would they pay to do so?

Thus, either the government will have to pay to establish and maintain such a system, or participants will have to be taxed. How either would work should be the subject of further study.

**Enforcement.** Yet another question will involve enforcement. Violations of certain securities laws may result in private civil liability. In reorganization, it is not clear whether this form of liability would be desirable or politically viable. Our tendency since the mid-1990s has been to reduce the likelihood of private liability for securities disclosure failures. The Sarbanes-Oxley Act, for example, creates no private causes of action.

\(^{218}\) Paredes, *supra* note 216, at 432.
The key to enforcement will be to link compliance to certain other benefits. For example, we might say that any participation in a Chapter 11 case will require participation in an electronic disclosure registry. There is no guarantee that pre-bankruptcy actors will comply, but the threat of no participation or distribution might affect their incentives. Moreover, one could create affirmative causes of action in bankruptcy to remedy pre-bankruptcy disclosure failures. Perhaps these would be disclosure based, as in Rule 10b-5 under the Securities Exchange Act. In any case, if a shadow player wanted to opt out of the disclosure system, it would bear the burden if there were a bankruptcy of showing that its undisclosed participation caused no harm to the estate.

And that should be the ultimate standard, the polestar for any regulation of the shadow bankruptcy system: What is good for the estate, meaning the debtor and its other direct and indirect stakeholders? This is obviously a rather mushy standard. Yet, it is a standard with a robust history under the Bankruptcy Code, where variations of it can be found in determinations on awarding compensation, granting case financing, and confirming reorganization plans, among others. The fiduciary standards associated with both bankruptcy, and prebankruptcy insolvency, strongly suggest that this sort of collective welfare standard is probably the right one.

The important and difficult work will be figuring out how it translates into real disclosure-based regulation.

3.2 Control & Further Study

Disclosure may cure all ills caused by the shadow system. Certainly, it seems intuitively to be a strong first—and perhaps best—step in the right direction. But we also know from studies like Douglas’s that disclosure alone may be necessary but not sufficient to correct systemic abuses. New substantive controls may also be required.

This was certainly Douglas’ view in the 1930s. Disclosure alone would be inadequate, he reasoned, because disorganized investors faced what was essentially a coercive tender offer. Thus, Douglas proposed two sets of modifications to the reorganization system.

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223 See id. at 905 (“[They] are faced with a ‘Hobson’s choice’ of not depositing . . . 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.”).

Mere disclosure in these situations is hardly sufficient for the protection of investors. 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. Disclosure of the facts regarding these protectors is of little practical utility to investors. Prospective purchasers of securities have, by and large, a real choice—to buy or not as their judgment dictates. To them disclosure of the pertinent facts surrounding the offering is of great value. But in case of these default situations the case is quite different. An investor with an investment in an insolvent company holds the securities; his investment has already been made;
In the first place, methods must be designed to bring within a system of regulation and control committees presently exempt and immune from any supervision. In the second place, the basis for regulation must be broadened so as to require not only the disclosure of relevant facts but also to eliminate material conflicts of interest and unconscionable practices which may persist in spite of full disclosure.\textsuperscript{224}

Today, however, it is less obvious that individual investors are gulled by the shadow bankruptcy system. To be sure, it creates plenty of social costs in the form of lost jobs, depressed asset values, and needless litigation. But shadow bankruptcy does not appear to prey on individual investors. In any case, if it does, that has not yet come to light.

Nevertheless increased control may be appropriate. But the only way to make that decision in a sensible way is to study the system. Indeed, the architecture of the current financial and securities system grew out of a series of landmark reports from the late 1920s through the 1930s on the banking, securities and bankruptcy systems.\textsuperscript{225} That

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\textsuperscript{224} Id. at 905. Douglas went on to recommend “[t]hat standards of full disclosure, such as those set forth in the Securities Act of 1933 in regard to the issuance of securities, be imposed upon the solicitation of all deposits and proxies in connection with reorganizations and that present exemptions from such control be restricted.” Id. at 907.


\end{footnote}
architecture served the needs of the U.S. capital markets remarkably well for several generations. Yet, part of the larger point of this paper is that transactional technologies have now outrun that system. In order to determine how to restructure the regulatory framework, we would first do well to know what that framework is supposed to be regulating.

In the case of corporate reorganization, there have been a half-dozen major system studies over the years, the most recent of which was published by the National Bankruptcy Review Commission in 1997. While that report made significant contributions to our understanding of the system as it existed then, it could not have anticipated the profound changes that have occurred since then. It is thus no surprise that that report did not address the many threats to transparency created by the shadow bankruptcy system. At that time, the shadows were only starting to gather.

To learn how to study the system effectively, we should look to the lessons of Douglas’s report on the reorganization system in the 1930s. Douglas’s analysis did not merely provide a strong case for reforming the reorganization system as it existed in the 1930s. It also provided a template for how we might approach studying the shadow bankruptcy system today.

Douglas’s bankruptcy work has three important lessons for anyone studying the shadow system today. First, his analysis was intensely empirical. Being a legal realist, Douglas believed that the best way to make policy was to understand what was going on in the real world. Thus, he developed questionnaires and interviewed system participants about the dynamics of the reorganization process. The data Douglas gathered led him to conclude that the reorganization system was deeply flawed, existing

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228 See Skeel, Countryman, supra note 61, at 1088 (Douglas “developed an extensive questionnaire to give to the bankers and lawyers involved in every significant restructuring case in the country. [Abe] Fortas [Douglas’ assistant and protégé] and other members of the SEC staff, and occasionally Douglas himself, then crisscrossed the country conducting interviews.”).
chiefly for the benefit of managers, bankers and lawyers, most of whom were feeble, faithless, or both.\textsuperscript{229}

Bankruptcy scholarship since Douglas’s time has become a fountainhead of empiricism, producing an enormous body of high quality research.\textsuperscript{230} In the famous words of Professors Warren and Westbrook, “a debate without data is a useless excursion, a trip from nowhere to nowhere.”\textsuperscript{231} Although there have been plenty of articles assessing the merits of various pieces of the shadow bankruptcy system, none have recognized its larger contours, and none have attempted to dig into the real practices.\textsuperscript{232} Being quantitative, however, this work can largely reach only “revealed preferences” by, for example, surveying system participants, or counting certain types of entries on court dockets. This methodology makes inferences about the world based on observed behaviors.\textsuperscript{233} This is, of course, tremendously useful—when there is behavior to observe.

The problem with shadow bankruptcy is that the whole point is to remain out of sight, unobserved. Thus, conventional quantitative empirical analysis—counting cases or pleadings in dockets—may not be useful. Dockets do not show the instances where informal committees have failed to file adequate notice under Rule 2109, even though they should have done so. Dockets will tell us nothing about claims trading that occurs before bankruptcy or the setting of a claims bar date, although we have good reason to believe that much important trading occurs at those times. There is no place to reliably observe and tabulate short or derivative positions affecting debtors. There is no registry of motives or incentives, although we know they are both important and increasingly

\textsuperscript{229} Concerning bankers and managers, the Douglas Report complained:

Managements and bankers seek perpetuation of [their] control for the business patronage it commands, which they may take for themselves or allot to others, as they will. They seek, also, to perpetuate that control in order to stifle careful scrutiny of the past history of the corporation. Thereby, claims based on fraud or mismanagement are stilled ....

\textit{Douglas Report, supra} note 63, pt. 1, at 863. Concerning lawyers, Douglas had this to say:

[C]ounsel fees frequently constitute the largest single item on the list of reorganization fees.... The vice is that the bar has been charging all that the traffic will bear. It has forsaken the tradition that its members are officers of the court and should request and expect only modest fees.

\textit{Id.} at 867.


\textsuperscript{232} One exception, which gets at part of the problem (claims trading) is Harner, \textit{supra} note 15.

difficult to predict. In short, as noted above, we do not know what we do not know, and so conventional mechanisms of inference may not provide the sort of insight we would want.

Thus, something closer to Douglas’ methodology may be appropriate. Questionnaires are likely to be helpful, but more important still will be interviews and perhaps testimony of system participants. It is possible many of these participants may demand anonymity—to remain in the shadows, so to speak. Asking shadow system players to reveal their preferences is a bit like asking for defection: They are more likely to do so if they are assured of anonymity.234 Thus, any study of the shadow system should be sensitive to the reality that learning about real practice will be especially challenging where practitioners appear to go to great lengths to conceal their activities.235 Judgments may have to be made about how to ferret out the facts.

Second, Douglas concluded that the chief evil of the equity receivership was collusion by insiders which harmed individual investors.236 Thus, the key to reform was controlling the players in a way that would prevent this collusion. So far as Douglas was concerned, the managers, lawyers and bankers who worked with a large company before it went into bankruptcy could not be trusted, and had to be removed.237 As discussed above, these constraints ultimately became part of the Bankruptcy Act of 1938,238 including the distinction between Chapter X, where managers of large public companies would be displaced by trustees and Chapter XI, where managers of ostensibly smaller companies would remain in control of the reorganizing debtor.

234 As one participant explained to me: “The only way you can get anything on this by way of deep background. No one will want to talk to you otherwise.” Telephonic interview with RG Jan. 8, 2009.
235 We should also remember that Douglas did not exactly approach his work in a scientific manner. Having practiced in the corporate reorganization field, at the Cravath firm, he believed he knew what was wrong, and set out to prove it. His investigations may have been in the real world, but he was looking for something that he already believed existed. Thus, even he acknowledged that the SEC reports that arose from these investigations were more advocacy pieces than impartial discussions. See, David A. Skeel, Jr., An Evolutionary Theory of Corporate Law and Corporate Bankruptcy, 51 Vand. L. Rev. 1325, 1369, n. 166 (1998) (“Douglas himself noted that the report was as much a brief supporting the SEC proposals as an objective report.”) (citing Hearing Before the Comm. on the Judiciary, House of Representatives, on H.R. 6439, 75th Cong. 164, 199 (1937)).
236 As the Douglas Report observed—

Those who by tradition have over the years come to possess a monopoly over the conduct of reorganizations have their own objectives, not always compatible with those of investors. The systems of reorganization, the legal techniques, the protective committee system, have all been shaped to conform with the requirements of reorganizers. But self-serving objectives and mechanisms incompatible with the needs and requirements of investors have too often caused perversion of the functions of reorganization.

Douglas Report, supra note 63, pt. 1, at 863.

237 As David Skeel later observed “Only by displacing a debtor’s managers with an independent trustee, and wresting control of reorganization away from Wall Street, could investors’ interests be truly protected.” See Skeel, Countryman, supra note 61, at 1091 (discussing Douglas’ approach to bankruptcy reform).
While this might have eliminated conflicts of interest, it also created other problems. Among other things, it appears to have deterred many large, troubled companies from seeking bankruptcy protection, since it would ask managers to commit professional suicide. Moreover, Douglas’s opinion in *General Stores Corp. v. Shlensky* stunned many by holding that even publicly held companies could file for relief under Chapter XI, thereby leaving management in possession. Ultimately, the costs of this framework outweighed its benefits. Thus, a central feature of the 1978 Bankruptcy Code—the current law—was relaxing concerns about these conflicts. Management would stay in possession and control of the debtor unless good cause was shown to oust them, with the appointment of a trustee. As discussed above, this will be a rare event in a Chapter 11 case under current law.

Today, we do not know the extent to which shadow players collude with one another or with management. The discussions of the *Polaroid* and *Steve & Barry’s* cases, above, suggest that some collusion may well occur, and have costs in the form of depressed asset values. But by their very nature, the presence of shadow players suggests that they will have an interest in challenging collusion, at least under certain circumstances. For every hedge fund that conspires with management to rig the bid process in an asset sale, there may well be other private investors whose positions will suffer accordingly. Those on the losing end of the bid will doubtless attack collusive behavior, if they believe it has occurred. While these sorts of challenges may impose systemic costs—in particular on the judiciary—they would also suggest that collusion may not be the problem today that it was in the 1930s. Thus, we should not assume collusion exists. But, like Douglas, we should be sensitive to its presence. To the extent we find it, and find that existing mechanisms fail to manage it in a cost-effective way, we should consider whether substantive controls are appropriate.

Third, and perhaps most important, Douglas had a uniquely a broad understanding of how reorganization fit into the larger financial system of his time. It is thus not surprising that he believed the SEC should be the administrator of choice for bankruptcy reorganization, and that disclosure rules should model those of the federal securities laws. This is doubtless because even before joining the SEC, Douglas had written extensively about the securities system. He understood how the parts fit together, and approached the problems presented by corporate reorganization with that holistic sensibility in mind. His concern for protecting small investors crossed regulatory boundaries—he

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239 350 U.S. 462, 266 (1956) (“A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company. And there is no reason we can see why c. XI may not serve that end. The essential difference is not between the small company and the large company but between the needs to be served.”).


241 For example, Douglas was part of a group of Yale law professors who introduced a “functional” approach to studying business law, replacing traditional doctrinal categories with “units” that looked holistically at the way firms operate. A review of Douglas’ case book on reorganization, which adopted this approach, praised it for its breadth:

The book is an admirable collection of cases covering the field of corporate reorganization from the formation of the protective committee for security holders to the consummation of the Plan
knew that investors needed to be protected from sharp practices at underwriting, just as they needed to be protected from the self-serving antics found in equity receiverships.

If ever there was a time for a broad, system-wide understanding of how reorganization actually works, that time is now. The actors and transactions that comprise shadow bankruptcy, like shadow banking, have thrived in the interstices of many regulatory systems. Hedge funds are not mutual funds, and so escape meaningful SEC oversight. Claims trading is clearly a kind of securities market, but one largely outside the regular scrutiny of the SEC or any regulatory body. Credit default swaps are neither securities nor insurance, and so have been regulated by neither the SEC, the CFTC or state insurance regulators.\footnote{242}

Fragmentation has long been a key feature of the U.S. regulatory structure, both vertically and horizontally. Thus, since the New Deal, an alphabet soup of agencies has overseen distinct features of the financial system, in part, no doubt, to maintain a diffusion of market and regulatory power. The SEC, the CFTC, the OCC and the FDIC may all have important roles to play in the regulation of a large Wall Street financial firm.\footnote{243} A number of theories have been advanced to explain this fragmentation, including that it may be in the interests of those subject to regulation to keep the regulators divided, that federalism is a deeply held value, and that it prevents concentrations of excessive power.\footnote{244} The Treasury Department’s 2008 “blueprint” to

\begin{itemize}
\item and Agreement of Reorganization with the foreclosure sale and the issuance and distribution of the securities of the “New Company;” and, in between, the many and vexatious problems of equity receiverships, receiver’s certificates, hold-out and hold-up minorities, the upset price, the necessity of a judicial sale and the fairness of the Plan.
\end{itemize}

\textit{See} Joseph V. Kline, Book Review, 41 YALE L.J. 1255, 1255 (1932) (reviewing WILLIAM O. DOUGLAS & CARROL M. SHANKS, CASES AND MATERIALS ON CORPORATE REORGANIZATION (West Publishing Co. 1931)).


remake the regulatory system is intended in part to address and rationalize this atomized approach to managing the financial system.245

While fragmentation of regulation may make sense, fragmentation of understanding does not. To study the causes of the credit crisis without understanding the role that the reorganization system plays in it is to look only at one side of the animal. Yet, so far, that has been the approach. Thus, no academic article to date has called for studies of the scope and orientation of those undertaken in the 1930s. Rather, they tend to focus on specific instruments or events—the role of credit default swaps; the interconnectedness of banks; the breakdown in investor monitoring, and so. All of these are important subjects to study. But whatever is found to be good or bad in those studies is likely to be relevant to reorganization. Yet none address it.

Similarly, the United States’ Treasury’s March 2008 “blueprint” to overhaul the financial system says next to nothing about business reorganization. This 212 page tome covers virtually every aspect of the financial system, from banking, to securities to insurance. It offers many interesting insights into what might be considered an “optimal” regulatory scheme.246 Yet, the word “bankruptcy” appears only three times, and never with the thought that it would be part of the “major” overhaul envisioned.247

It is possible that study of the shadow system will reveal extensive conflicts of interest comparable to those Douglas found, and which warrant direct regulation. It may, for example, turn out that managers and private investors collude frequently to depress asset sale prices in ways that ultimately hurt both public investors and other company stakeholders, such as employees who may be laid off following a liquidation value sale of an otherwise going division. Similarly, it may turn out that those on official committees have far greater conflicts than are currently known, or can realistically be managed by the existing framework of “fire walls” described above. It may, for example, be the case that committees are dominated by private investors who have purchased claims largely to obtain inside information about a debtor’s reorganization, on which they can then trade in the unregulated securities market for distressed debt.

But it may also turn out that these concerns are exaggerated, and that private investor action is not nearly as rife with conflicts as was the system that infuriated Douglas. Existing constraints may in fact work. Or study may conclude that existing constraints do permit conflicts which, viewed in isolation, are troubling. But, we may also conclude that the benefits of private investment outweigh the costs of substantive

245 See TREASURY BLUEPRINT, supra note 198.
246 Id. at 13-14, 137-182.
247 See id. It does mention “business reorganization”—once—in the rather odd context of discussing general attributes of bank regulation:

For instance, some of the most important regulatory principles serving the goal of an efficient and competitive banking system include limitations on banks’ insider lending practices, oversight of business reorganizations and changes in control of banks, restrictions on banks’ ability to “tie” their services to non-banking products, and nationwide deposit caps. These provisions aim at ensuring wide availability of credit by preventing banks from abusing their substantial economic power.

Id. at 42.
control. Or that enhanced disclosure, as described above, is sufficient. We may not want to exclude private investors from reorganization, but only to figure out how to channel their actions in ways that produce greater value for debtors’ estates at lower systemic costs. In short, while we may need to supplement disclosure with control, we should have a good idea of what we want to control, and how.

Conclusion—A Lighter Shade of Grey

This article has been a polemic against an admittedly uncertain problem. It has been hyperbolic in order to emphasize what I believe to be the serious challenges facing the Chapter 11 reorganization system. I recognize that there are objections one could make to my claims, and some of those objections might even be reasonable. The problem may not be very serious, some may argue. Indeed, they may say there is no problem at all—this is just the working of the marketplace. Thus, as has been the style for the last thirty years or so, some may argue that we should have less—rather than more—regulation.

I am sympathetic to concerns about promoting and protecting markets. Indeed, a theme of this article—that technology has outpaced regulation—assumes as its predicate that re-synchronizing the two would produce greater wealth through more fair and efficient private ordering. The problem is not with markets, but the ability that some rich and sophisticated actors have to manipulate them, to the detriment of others. Shadow bankruptcy is, in some sense, really about a very complex form of externality. Even the most ardent supporters of markets usually recognize that those who create costs should bear them.

It is equally true that private investors—those I disparage as shadow players—are here to stay, and may be far more benign than I have suggested. It is, I hope, the rare hedge fund or private equity firm that engages in some of the more egregious conduct discussed here. Moreover, these investors have at least the capacity to bring capital and expertise to the reorganization process that is unlikely to be equalled by the public sector. Moreover, these are big boys,\(^{248}\) who can take care of themselves.

The ultimate problem, as discussed above, is that we don’t know what we don’t know. But the foregoing has shown there is serious reason for concern. Absent correspondingly serious study, we run the risk of a system amok. At minimum, we should want to level the informational playing field. While this certainly brings it own problems of scope, logistics and enforcement, it strikes me as a promising first step.

The current credit crisis can been seen as a massive failure of trust. It is hard for system participants to trust one another when they know that some may lurk in the shadows. The same shadow that has been cast over the larger economy also darkens the system designed by Congress to solve these sorts of problems, Chapter 11 of the Bankruptcy Code. We have been in the shadows long enough. It is time to turn the lights on.

\(^{248}\) And, so far as I can tell, most are “boys”--I have yet to encounter a woman hedge fund or private equity manager in the distress context.