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## **FAILURE'S FUTURES: CONTROLLING THE MARKET FOR INFORMATION IN CORPORATE REORGANIZATION**

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*This Article identifies and explores an important gap in bankruptcy theory and policy, with significant implications for the coming wave of major business failures: How to manage information about financially distressed businesses? The paper makes three claims. First, Chapter 11 of the United States Bankruptcy Code plays a unique informational role, as it creates mechanisms to explain a debtor's failure and to promote reinvestment. Second, the information functions performed by this system face internal and external threats. Internally, bankruptcy reorganization increasingly resembles an unregulated securities market, dominated by sophisticated, wealthy investors whose motives and strategies are often highly opaque. Their ability to arbitrage information will have profound effects on business failure. Externally, growing transactional complexity, and a reluctance to subject very large failed businesses—e.g., Bear Stearns—to bankruptcy, threaten to undermine bankruptcy's ability to expose complex and questionable financial practices. Third, these threats to bankruptcy's information-forcing functions will have systemic costs. The Article concludes with several recommendations about how to approach information policy in business failure.*

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## FAILURE'S FUTURES: CONTROLLING THE MARKET FOR INFORMATION IN CORPORATE REORGANIZATION

*In today's environment, we see little need for judicial doctrines designed to promote investor welfare.<sup>2</sup>*

*Managers have a tremendous incentive to distort information as they attempt to achieve consensus on a reorganization plan. . . . Because it is unlikely that an effective market for corporate control will exist to keep management in check, the case for mandatory disclosure rules is, if anything, even stronger in the bankruptcy context.<sup>3</sup>*

*People who are forced to undress in public will presumably pay some attention to their figures.<sup>4</sup>*

We typically think that bankruptcy reorganization is about fights over money: Who can grab the largest slice of an economic pie that is too small to feed all of a corporate debtor's hungry creditors and shareholders? Increasingly, however, the real fight is about information: Who will control information about the debtor and its stakeholders? Data, not dollars, are rapidly becoming the contested currency in corporate failure.

Why? Because business failure is increasingly a problem markets purport to solve. "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 forum where such sales are

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<sup>2</sup> Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1248 (2006).

<sup>3</sup> See David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 542 (1994).

<sup>4</sup> LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 33 (1ST ED. 1983).

conducted.”<sup>5</sup> Reorganization under Chapter 11 of the Bankruptcy Code<sup>6</sup> “has morphed into a branch of the law governing mergers and acquisitions.”<sup>7</sup>

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<sup>5</sup> See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 71 (2004) [Baird, *New Face*]. Indeed, Professor Baird (along with Dean Rasmussen) claim that the success of market forces has resulted in the “death” of “traditional forms of reorganization.” See Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) [hereinafter, Baird & Rasmussen, *Twilight*]; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) [hereinafter, Baird & Rasmussen, *End of Bankruptcy*] The Supreme Court would appear to concur with the aspiration, if not the empirical claim. “The best way to determine [a reorganizing debtor’s] value is exposure to a market.” See *Bank of Am Nat’l Trust & Sav.Ass’n v. N. LaSalle St. P’ship*, 526 U.S. 434, 457 (1999).

Others are not so sanguine, and argue that bankruptcy reorganization is not, and cannot be, managed effectively by market forces alone. As discussed further below, Professors LoPucki and Doherty argue that asset sales were, at least for a time, increasing in frequency, although producing lower valuations than a traditional reorganization. See, e.g. Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007) [hereinafter, LoPucki & Doherty, *Fire Sales*]. Professor James J. White then challenged the LoPucki and Doherty methodology, which brought a swift and scathing response from LoPucki and Doherty. See James J. White, *Bankruptcy Noir*, 106 MICH. L. REV. 691 (2007); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Verite*, 106 MICH. L. REV. 721 (2008).

<sup>6</sup> The current version of the Bankruptcy Code was originally enacted in 1978 (Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549) and has been amended several times, including in 2005 in ways that indirectly affecting the appointment of examiners. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005(BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (to be codified as amended in scattered sections of 11, 18, 28 U.S.C.).

<sup>7</sup> Baird, *New Face*, *supra* note 5, at 75. See also, David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918 (2003); (“The endless negotiations and

The marketization of bankruptcy has been driven largely by two phenomena: (1) The growth of secondary markets for claims against distressed firms,<sup>8</sup> and (2) the growth of large, private pools of capital that purchase these claims, or other interests in, or assets

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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.”).

<sup>8</sup> For discussions of the development of this market see Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 576 (2002) (describing the market for distressed debt, particularly trade debt, but noting the liquidity of debentures and bonds); Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990); Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 193 n.6 (noting that the term “distressed-debt investors... refers to a class of investors who purchase the assets or claims of firms once their debt or operations become ‘distressed’”); Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors’ Objectives*, 16 AM. BANKR. INST. L. REV. 69 (2008); Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83 (2007); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 101-04 (1995); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. UNIV. L. REV. 1684 (1996); Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 181 (2004) (“distressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act”); Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy: Part 2 ABI Committee on Public Companies and Trading Claims*, 11 AM. BANKR. INST. L. REV. 177, 177 (2003) (“Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims. . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader . . .”).

of, failed companies. Although we have come to call these “hedge funds”<sup>9</sup> or “private equity funds,” in earlier days these distressed investors went by the less charitable name “vulture funds.”<sup>10</sup> Today, while amounts are difficult to determine, it appears that hedge funds play an increasingly important role in bankruptcy reorganization because of their

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<sup>9</sup> 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 with Change the Dynamics o Future Bankruptcies*, 191 N.J.L.J. 102 (Jan. 14, 2008)(unpaginated original); Note, James M. Shea, *Who Is at the Table: Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors under Federal Rule of Bankruptcy Procedure 2019*, 76 FORDHAM L. REV. 2561, 2589 (2008) (“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, 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”)

<sup>10</sup> Richard Lieb, *Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor*, 48 BUS. LAW. 915, 915-19 (1993) (discussing nature and behavior of “vulture” funds); *The Vultures Take Wing: Investing in Distress*, THE ECONOMIST, Mar. 31, 2007, at 77-78; also Rich Pickings, *FUND STRATEGY*, Apr. 3, 2006, at 20 (“Vultures are basically value investors, trying to buy an asset for a price well below its intrinsic or fair value).

access to capital, nimbleness and expertise. Their investments in distressed firms are said to run to the billions of dollars.<sup>11</sup>

To function, markets require at least two things: capital and information.<sup>12</sup> Conventional legal theory approaches problems of information asymmetry from one of three general perspectives, none of which fit bankruptcy reorganization very well. One, a “transactional” model, views information production and verification as the centerpiece of rational market behavior in capital asset transactions.<sup>13</sup> Thus, in negotiated transactions, reasonable parties will (or should) recognize that information sharing is in their interest, as this will lead to the “right” price for the deal in question.

A second model is adversarial, and recognizes that in litigation, parties may have no common interest in sharing information.<sup>14</sup> Thus, nonwaivable rules of discovery and

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<sup>11</sup> See, e.g., Jay Krasoff & John O’Niell, *The Role of Distressed Investing and Hedge Funds in Turnarounds and Buyouts and How This Affects Middle-Market Companies*, TMA Paper [ ].

<sup>12</sup> See Ronald J. Gilson and Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 555 (1984) (discussing “focus on the distribution of information as a determinant of capital market efficiency.”). “Despite certain anomalies, numerous studies demonstrate that the capital market responds efficiently to an extraordinary variety of information.” *Id.* at 551.

<sup>13</sup> Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale. L.J. 239, 274-77 (1984). This is generally referred to as “due diligence,” and is rooted in federal securities law practice. “[D]ue diligence connotes the absence of negligence in the preparation of disclosure; in turn, lack of due diligence is often considered negligence.” See Donald C. Langevoort, *The Statutory Basis for Due Diligence Under the Federal Securities Laws* 11 (PLI Corp. L. and Prac. Course Handbook Series No. B0-00A4, 1999) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1975)).

<sup>14</sup> See generally Judith Resnik, *Uncovering, Disclosing, and Discovering How the Public Dimensions of Court-Based Processes Are at Risk*, 81 CHI.-KENT L. REV. 521, 538, (2006) (“in the 1930s, the drafters of

evidence force parties to share information, even if it is against their perceived self-interest.<sup>15</sup> The civil litigation system “often allow[s] extensive intrusion into the affairs of both litigants and third parties” the Supreme Court explained in *Seattle Times Co. v. Rhinehart*.<sup>16</sup>

A third model comes from the federal securities laws. 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”<sup>17</sup> through a mandatory disclosure system that “compels business corporations and other securities issuers to disseminate detailed, 

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the Federal Rules of Civil Procedure invented an obligation--called “discovery,” entailing the exchange of information (orally and in writing) and the production of records--that not only multiplied the information available to the parties but created the possibility for others to learn more details, in advance of trial, through the disputants' filings.”).

<sup>15</sup> A recent study found that discovery disputes were the second most common type of dispute in civil litigations conducted U.S. District Courts, at least as measured by number of orders entered by those courts. See David A. Hoffman, Alan J. Izenman, Jeffrey R. Lidicker, *Docketology: District Courts, and Doctrine*, 85 WASH U. L. REV. 681 714 (2007).

<sup>16</sup> 467 U.S. 20, 30 (1984).

<sup>17</sup> 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 “[a]s 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).

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.”<sup>18</sup> While no one is required to engage in market transactions involving securities, if they do, they will probably have significant disclosure obligations, at least so long as the issuer is not in bankruptcy.

Bankruptcy reorganization fits none of these models comfortably because it is not exactly (or exclusively) a “deal,” a “litigation” or a securities transaction. On the one hand, Congress intended—and lawyers seem to believe—that reorganization will largely be a negotiated process.<sup>19</sup> The goal of reorganization is conventionally thought to be the

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<sup>18</sup> Seligman, *supra* note 17, at 451. The federal securities laws include The Securities Act of 1933, 15 U.S.C. §77a (2000); the Securities Exchange Act of 1934, 15 U.S.C. §78a (2000); the Public Utility Holding Company Act of 1935, 15 U.S.C. §79 (2000); the Trust Indenture Act of 1939, 15 U.S.C. §77aaa (2000); the Investment Company Act of 1940, 15 U.S.C. §80a-1 (2000); the Investment Advisers Act of 1940, 15 U.S.C. §80b-1 (2000); and the Securities Investor Protection Act of 1970, 15 U.S.C. §78aaa (2000).

<sup>19</sup> *See, e.g.*, Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship, 526 U.S. 434, 457 n.28 (1999) (holding that “the Chapter 11 process relies on creditors and equity holders to engage in negotiations toward resolution of their interests” (quoting G. Eric Brunstad, Jr., Mike Sigal & William H. Schorling, *Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part I*, 53 BUS. LAW. 1381, 1405–06 n.136 (1998))); Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 126 (1990) (“Current law provides a complex legal environment in which representatives of thousands of creditors and shareholders bargain over the disposition of billions of dollars in assets. Adjudication of cases within that environment is thought to be virtually impossible.”).



confirmation of a plan of reorganization, which is possible only if a sufficient number and amount of stakeholders agree to the plan.<sup>20</sup>

On the other hand, reorganization can become adversarial at almost any point.<sup>21</sup> Bankruptcy courts are empowered to hear and decide a wide range of contests within a bankruptcy case that are governed largely by the federal rules of civil procedure and evidence.<sup>22</sup> Even reorganization plans—which are generally viewed as a kind of a contract—can be “crammed down” over significant dissent.<sup>23</sup>

In any case, while reorganization may involve the issuance of new securities—or, more important, trading in the distressed securities of the troubled business—federal securities laws generally do not apply when company is in bankruptcy.<sup>24</sup> Although claims

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<sup>20</sup> See 11 U.S.C. §§ 1129(a)(10) & 1126 & 1126(c) (2000).

<sup>21</sup> That reorganization could become adversarial does not mean that it often does. Baird and Morrison show that litigation in bankruptcy is quite rare. See Douglas G. Baird & Edward R. Morrison, *Adversary Proceedings in Bankruptcy: A Sideshow*, 79 AM. BANKR. L.J. 951, 952 (2005) (“adversary proceedings are rare in both business and consumer cases and, apart from taking less time, have changed little in recent years.”)

<sup>22</sup> Although the federal rules of evidence apply, the rules of civil procedure are modified somewhat and appear generally in Part VII of the federal rules of bankruptcy procedure.

<sup>23</sup> See 11 U.S.C. §1129(b).

<sup>24</sup> For example, securities issued under a confirmed plan of reorganization are generally exempt from the registration process under Bankruptcy Code § 1145. See 11 U.S.C. § 1145. See also H.R. Rep. No. 595, 95th Cong. 1st Sess. 228 (1977) (noting that § 1145 “permits the disclosure statement to be approved without the necessity for compliance with the very strict rules of Section 5 of the Securities Act of 1933 [because the cost of registration is often] prohibitive in a bankruptcy reorganization.”); 8 COLLIER ON BANKRUPTCY, 1145.01[1] (15th Ed. Revised) (“The justification for a relaxation of securities law registration requirements in connection with chapter 11 stems in part from the protections of chapter 11

against a debtor might be traded like securities, the consensus view is that these are not “securities” for purposes of the federal securities laws.<sup>25</sup> The market for claims against debtors in bankruptcy thus increasingly resembles an unregulated securities market.<sup>26</sup>

While bankruptcy reorganization is neither fish nor fowl, informationally speaking, forcing information about a debtor into the public has long been an important, if underappreciated, aspiration of the process. Bankruptcy reorganization has often been characterized as a “fishbowl”<sup>27</sup> with an “acid test” chaser.<sup>28</sup> The “fishbowl” means that

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itself, as well as the perceived unfairness of fettering participants in the chapter 11 process... with the added burdens of complying with the securities law requirements.”).

<sup>25</sup> See Drain & Schwartz, *supra* note 8, at 574 (observing that “the securities laws probably should not apply to bankruptcy claims.”); Stephen H. Case, Trading in Claims, 826 PRAC. L. INST. COMM. 75, 95 (2001) (“It is now fairly clear that trade claims are not [securities].”).

<sup>26</sup> See Drain & Schwartz, *supra* note 8, at 572 (“perhaps the most salient point about the securities laws and bankruptcy claim trading, which often is stated with some pride, is that there is an active, functioning, and enormous (in terms of dollar amount) market in distressed claims that is *not actively regulated*.”) (emphasis in original).

<sup>27</sup> See, e.g., James P.S. Leshaw, *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.”).

<sup>28</sup>The term “acid test” in this context is generally applied to challenges to liens under the so-called “strong arm” provisions of the Bankruptcy Code. See, e.g., Lawrence Ponoroff, *Understanding the Law of Bankruptcy—A Primer on Basic Bankruptcy Rules, Concepts and Policies*, ALI-ABA Course of Study, at 8 (Mar. 26-28, 2003) (“because of [bankruptcy’s] avoidance powers, bankruptcy often becomes the acid test of whether the secured creditor followed all of the applicable state law requirements for acquiring and perfecting a security interest in the debtor's property.”); Hon. John H. Minahan, *Rents and Profits in*

the debtor's management's actions are subject to judicial—and thus public—scrutiny. This results from, among other things, the requirement that the debtor file schedules of assets and liabilities,<sup>29</sup> that the official committee of creditors or a trustee or examiner may conduct extensive investigations,<sup>30</sup> and that the debtor's reorganization plan comes with a disclosure statement that contains "adequate information."<sup>31</sup> The "acid test" means that creditors (or a bankruptcy trustee acting for creditors) have the incentive and the legal ability to press a debtor's contractual commitments to the utmost, assuring that only the most robust rights will survive. Both features of bankruptcy have assured that important information about a debtor and its deals has made its way into the right hands, which is often the public.

Yet, the information functions of bankruptcy are subject to increasing pressure, both internal and external to the system, which will likely grow with the coming wave of large company insolvencies.<sup>32</sup> Internally, the private investment that has exposed bankruptcy to market conditions is likely to lead to fights over who controls information

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*Bankruptcy*, 27 CREIGHT L. REV. 158, 168 (1993) ("The acid test for a security interest, lien, or mortgage is whether it can withstand challenge and avoidance in bankruptcy proceedings.").

<sup>29</sup> See 11 U.S.C. § 521 (2000).

<sup>30</sup> See *id.* §§ 1102, 1103, 1104 & 1106.

<sup>31</sup> See *id.* § 1125.

<sup>32</sup> See *Big Bankruptcies--Long Expected--Are Slowly Emerging*, AMLAW DAILY (available at <http://amlawdaily.typepad.com/amlawdaily/2008/07/steve-barrys-hi.html>) (visited July 14, 2008); Niraj Chokshi, *Courts Post Sharp Rise in Bankruptcies*, LAW.COM available at <http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=900005561405> (visited July 16, 2008) (quoting Peter Gilhuly, a bankruptcy partner in Latham & Watkins' Los Angeles office: "I think we'll be in a full insolvency cycle six months from now, and it will continue for some time.").

about both debtors and their stakeholders. The same securities market that trades in claims against debtors has also created more complex instruments—in particular credit default swaps<sup>33</sup>--that enable investors to mask their true incentives. Holding these derivative rights, creditors may *want* debtors to fail, in order to collect from solvent third parties. Moreover, debtors are apparently entering bankruptcy with fewer unencumbered assets. This means they may have less cash-flow to devote to investigating and explaining how and why the company ran into trouble in the first place. Information may be at a premium, but it is less clear than ever who will pay for it.

Bankruptcy's information function will also experience external challenges. Debtors are increasingly parties to—or otherwise affected by—highly complex transactions, such as credit default swaps. While bankruptcy may not cause growing transactional complexity, cases like *Enron* show that it is nevertheless the place where complexity has often been sorted out. Moreover, as larger institutions fail, regulators may be tempted—as they were with Bear Stearns—to “protect” the system by keeping

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<sup>33</sup> See, e.g., Stephen J. Lubben, *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”).” (citing *Nomura Int'l plc v. Credit Suisse First Boston Int'l*, 2 All E.R. (Comm) 56 (Q.B. 2003)). Credit default swaps apparently played an important role in the *Enron* and *Worldcom* cases. See *In re Enron Corp.*, 328 B.R. 58 (Bankr. S.D.N.Y. 2005); *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 651-52 (S.D.N.Y. 2004). See also Henry T.C. Hu & Bernard Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUROPEAN FIN. MGMT [] (draft of June 1, 2008) (available at <http://ssrn.com/abstract=1084075>).

companies out of bankruptcy, even at the expense of taxpayer dollars and—more important, for our purposes—information about how and why the company failed.

But all of this begs a question: Why does information matter? Information plays an unusually important role in bankruptcy for both “private” and “public” reasons. The private rationales have traditionally been that information forcing has a deterrent effect that prevents remedies pre-failure misconduct (e.g., the creation of secret liens) and that it promotes reinvestment by enabling existing (or potential) stakeholders to make informed decisions about the debtor, especially as to matters of valuation and governance. Creditors will want this information to decide, e.g., whether to sell their claims, or to vote for or against a reorganization plan. In theory, at least, robust information about a debtor will maximize its value, and thus creditors’ recoveries.

The public rationale tends to get short shrift. Here, bankruptcy forces information into the public view to enable the larger investing community to learn why a company failed.<sup>34</sup> The hope seems to be that knowledge reduces the likelihood of similar future

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<sup>34</sup> As discussed below, an especially pure example of the public information-forcing function of Chapter 11 appears to be the creation of the bankruptcy examiner. Under Bankruptcy Code § 1104(c), an examiner may be appointed to examine the mal- or misfeasance that led to bankruptcy. In arguing for creation of the position, Senator DeConcini argued that an examiner would provide “special protection for the large cases having great public interest. There will be automatically appointed an examiner in those cases, but not a trustee as in the Senate passed bill” 124 Cong. Rec. S17403-34 daily ed, Oct 6, 1978 (quoted in Collier on Bankruptcy App. 14.4(f)(iii) (15th ed. Rev 2002)

In order to insure that adequate investigation of the debtor is conducted to determine fraud or wrong doing on the part of present management, an examiner is required to be appointed in all cases in which the debtor’s fixed, liquidated, and unsecured debts, other than for goods, services, or taxes, or owing to any insider, exceed \$5 million. This should adequately represent the needs of the public security holders in most cases.

Id.

failures. Altering the flow of information thus affects not only the parties involved in any given reorganization, but also those who construct financial transactions more generally.

This latter, public information function is likely to be especially important in the near future. Although bankruptcy reorganization is not the only way to produce information about financial failure, it has historically been an important one. Our knowledge about Enron, for example, would likely be far more limited had the company not gone through bankruptcy. Today, the bankruptcy reorganization of companies such as New Century will help to reveal the complex transactions that made possible the subprime mortgage debacle.<sup>35</sup> If, instead, this information remains concealed, we will reduce our chances of learning from our mistakes. It is unlikely that JPMorgan Chase, which purchased Bear Stearns, will produce any report about the Bear Stearns' failure, much less one that is as robust as were the examiners' reports in *Enron* or *New Century*.

Thus, the future of business reorganization—the future of failure—depends on how we set the rules on the production and use of information in this context. Despite a vast literature on the propriety and growth of market forces in bankruptcy reorganization, scholars and practitioners have paid scant attention to bankruptcy's information functions.<sup>36</sup> Rather, they assume with little analysis that the information needed to make

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<sup>35</sup> When it went into bankruptcy in February 2007, New Century was the second largest originator of subprime residential mortgage loans in the nation. See *Final Report of Michael J. Missal Bankruptcy Court Examiner*, In re New Century TRS Holdings, Inc., et al. Case no. 07-10416 (KJC) (Bankr. D. Del., Feb. 29, 2008) [hereinafter "*New Century Report*"].

<sup>36</sup> An important, if limited, exception is Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1949 (2006) ("Because of the private information the existing investors possess and because a prudent lender, even with full information,

intelligent market and social decisions in the bankruptcy tournament will miraculously work its way into the right hands. But they are wrong. If information is a commodity, it will be hoarded as surely as oil or gold.

This Article fills that gap, and has one basic goal: To focus attention on the information functions of the corporate reorganization system. It draws on, among other things, original empirical work, including quantitative data and interviews with system participants.<sup>37</sup> In doing so, it makes three novel claims and several related recommendations:

*First*, and as set forth in Part I, bankruptcy reorganization has historically approached information asymmetry in a way that is unique in our legal system, chiefly by forcing into public view ex post information about failed companies and their stakeholders.

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will lend against an asset only a fraction of the value of the business (determined without the benefit of private information), the junior investor typically cannot borrow against the business lender funds sufficient to pay off the senior investor.”).

While my own work on commercial finance law has focused on the information functions of commercial law, it is has not recognized the essential fact that bankruptcy creates an information system. *See, e.g.*, Jonathan C. Lipson, *Secrets and Liens, The End of Notice in Commercial Finance Law*, 21 Emory Bankr. Dev. J. 421 (2005) [hereinafter, Lipson, *Secrets and Liens*]; Jonathan C. Lipson, *Financing Information Technologies: Fairness and Function*, 2001 WIS. L. REV. 1067, 1104-22 [hereinafter Lipson, *Information Technologies*]; Jonathan C. Lipson, *Remote Control: Revised Article 9 and the Negotiability of Information*, 63 OHIO ST. L.J 1327 (2002) [hereinafter Lipson, *Remote Control*].

<sup>37</sup> Information about these interviews and data appears in Jonathan C. Lipson, *Understanding Failure: Chapter 11 Examiners and the Bankruptcy Reorganization of Large Public Companies*, unpublished manuscript on file with author [hereinafter, Lipson, “*Understanding Failure*”].

*Second*, and as set forth in Part II, this information-forcing model is increasingly threatened from within and without the bankruptcy system.

*Third*, and as set forth in Part III, challenges to bankruptcy's information model will have costs that include the undervaluation of firms, which in turn reduces creditor recoveries.

Part IV provides some observations about how courts, regulators and commentators should respond to growing threats to the market for information in bankruptcy.

#### I. *Bankruptcy Reorganization as Information System*

Bankruptcy reorganization is viewed chiefly as a way to address financial distress. It balances two competing policy goals: maximizing creditor recoveries, on the one hand, versus rehabilitating the debtor, on the other.<sup>38</sup> Yet, bankruptcy reorganization also has a third, related goal: It creates an information system. Many important features of Chapter 11 are designed not merely to address the economic interests of debtors and their stakeholders, but to create a transparent medium to force information into the open, to enable the debtor's stakeholders—and, arguably, the “world”—to better understand the debtor, its failure, and its possible redemption.<sup>39</sup> Although scholars frequently mention

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<sup>38</sup> See Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 607, 617-622 (2008).

<sup>39</sup> See *Asbestos Litigation in the 21st Century, The Future Claims Representative in Prepackaged Asbestos Bankruptcies: Conflicts of Interest, Strange Alliances, and Unfamiliar Duties For Burdened Bankruptcy Courts*, ALI-ABA Continuing Legal Education, November 30-December 1 2006 (“The Chapter 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.”)



this feature of the system in passing, they rarely focus on it.<sup>40</sup> This part does, and explains how the information system it creates differs from the dominant legal models that exist to address information asymmetries in private ordering.

A. *Bankruptcy Information*

Bankruptcy's informational function is largely a byproduct of its judicial orientation. Most important matters in bankruptcy reorganization can only be accomplished with court approval. And, matters that require court approval are presumptively open to public scrutiny<sup>41</sup> This subpart describes some of the major information-forcing features of the system, and the roles they play.

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<sup>40</sup> Professor David Skeel provides one of the more robust early explanations of the informational functions of bankruptcy reorganization:

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

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

<sup>41</sup> 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 \*9 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. As one bankruptcy court explained, it would be inconsistent with the presumption of public access in § 107(a) to treat such allegations as defamatory

1. *Case Commencement*

In theory, the commencement of a case should result in the public production of a large amount of information about a debtor. The case itself can be commenced only with the filing of a publicly available document known as a bankruptcy petition that sets forth the debtor's name, address, authorized agents, etc.<sup>42</sup> A schedule of assets and liabilities will accompany the petition, or be filed early in the case, revealing financial and economic information that might not otherwise be available.<sup>43</sup> 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

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within the meaning of § 107(b)(2)."); *see also* In re Bell & Beckwith, 44 B.R. 661, 664 (Bankr.N.D.Ohio 1984) ("Public scrutiny is the means by which the persons for whom the system is to benefit are able to insure its integrity and protect their rights. This policy of open inspection, established in the Bankruptcy Code itself, is fundamental to the operation of the bankruptcy system and is the best means of avoiding any suggestion of impropriety that might or could be raised."). It is thus fitting that the coverage of § 107(a) is "sweeping" (see William T. Bodoh and Michelle M. Morgan, *Protective Orders in the Bankruptcy Court: The Congressional Mandate of Bankruptcy Code Section 107 and Its Constitutional Implications*, 24 HASTINGS CONST. L.Q. 67, 82 (1996)), extending to "all papers filed in a bankruptcy case," H.R.Rep. No. 95-595, at 317 (1977), U.S.Code Cong. & Admins.News 1977, 5963, 6274; S.Rep. No. 95-989, at 30 (1978), U.S.Code Cong. & Admin.News 1978, 5787, 5816.

<sup>42</sup> 11 U.S.C. § 301(a).

<sup>43</sup> *See* Tung, *supra* note 8, 1733 & n. 242 (citing 11 U.S.C. s 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).

statement of financial affairs, among other things.<sup>44</sup> An examination of the debtor must occur early in the case under Bankruptcy Code section 341.<sup>45</sup>

Although these procedural mechanisms are designed to produce information about the debtor, the reality is that in themselves they are likely to be of limited value to the market for information about a debtor, including existing or potential stakeholders. Scheduled values, for example, can often be wildly inaccurate.<sup>46</sup> Because the section 341 meeting is run by the Office of the United States Trustee, the parties themselves may not have the opportunity to develop useful valuation and related information about the debtor.

More important information about a debtor is likely to emerge in certain types of pleadings frequently filed early in the case, such as a request that the court approve

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<sup>44</sup> Fed. R. Bankr. P. 1007(c).

<sup>45</sup> 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.” Brad B. Erens & Kelly M. Neff, *Confidentiality in Chapter 11*, 22 EMORY BANKR. DEV. J. 47, 54 (2005). Changes in the law have also decreased the necessity for section 341 meetings in many cases. “A section 341 meeting of creditors is now no longer required if the debtor has filed a plan as to which it solicited acceptances prior to the filing of the bankruptcy petition.” Joseph Samet & Ira A. Reid, *Business and International Law Amendments to the United States Bankruptcy Code—2005*, 905 PLI/Comm 65, 71 (2008); Ronald W. Goss, *Meetings of Creditors Under Section 341 of the Bankruptcy Code: A Primer*, 17 J. CONTEMP. L. 1, 9 (1991).

<sup>46</sup> Worldcom, for example, scheduled assets in excess of \$100 billion. See *In re Worldcom, Inc., et al* Case no. 02-13533 (AJG) (Bankr. S.D.N.Y.)

financing during the case.<sup>47</sup> Any such request is likely to contain significant amounts of financial and other important information about a debtor.<sup>48</sup> Because a lender is making a new loan to a troubled company, information supporting the request for financing may well be more accurate than information in the debtor's schedules. Real money hinges on the accuracy of the financial and economic information that leads a lender to finance a bankrupt reorganization. Objections to the financing may require an early valuation of the debtor.<sup>49</sup>

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<sup>47</sup> 11 U.S.C. § 364.

<sup>48</sup> Recent changes in the law require more disclosure in DIP financing agreements. *See* Mark Douglas, *The Year in Bankruptcy: 2007 – Part I*, MONDAQ BUS. BRIEFING, March 12, 2008 (“Among other things, the amended rule requires more detail to be disclosed concerning the terms and conditions of cash collateral and DIP financing agreements in any motion seeking court approval.”).

<sup>49</sup> Valuation information in DIP financing is sought, and received, in many different forms. “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.” Robert F. Reilly, *Measuring Economic Obsolescence in the Valuation of Special-Purpose Properties*, 26-SEP AM. Bankr. Inst. J. 36, (2007). “Intangible-asset valuation (and related economic analysis) reports are often prepared within a corporate bankruptcy. Intangible-asset valuations are often relevant to controversies involving (1) the solvency or insolvency of the debtor corporation; (2) the identification of license, spinoff or joint venture opportunities; (3) the assessment of DIP financing collateral; (4) the value of secured creditors' interests; and (5) the analysis of proposed reorganization plans, among others.” Robert F. Reilly, *Attributes of an Effective Intangible-Asset Valuation Report*, 25-SEP AM. BANKR. INST. J. 48 (2006). An appraisal

Similarly, creditors or shareholders who are not represented by the statutory committee of unsecured creditors appointed at the outset may ask for additional committees, which may be appointed under Bankruptcy Code section 1102(a)(1)<sup>50</sup>. These movants may do so because they genuinely believe they are not adequately represented by the existing official committee. But they may also do so simply because it is a calculated move to produce information. For example, the debtor or committee may oppose the appointment of an equity holders committee on the grounds that the debtor is deeply insolvent. This objection may be supported by some valuation information about the debtor. That information may be in the public domain already, e.g., through the debtor's schedules. But it may not. So, the request for an additional committee may ultimately be incidental to the movant's real goal: to obtain current valuation information about the debtor.

## 2. *Case Management*

Even though a corporate debtor may be under the protection and supervision of a bankruptcy court, courts—and thus public disclosure—generally come into play only when a debtor wants to engage in non-ordinary course transactions. For example, a debtor may seek to assume or reject a lease or executory contract under section 365.<sup>51</sup> Although the decision to do so is reserved to the trustee's (management's) business judgment, the request must come with some information to justify the request. Moreover,

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firm will also be used in some cases. See Leslie H. Miles Jr., *The Role of the Appraiser in a Bankruptcy Case*, 19 AM. BANKR. INST. J. 26 (2000).

<sup>50</sup> 11 U.S.C. § 1102(a)(1) (“the United States trustee . . . may appoint additional committees of creditors or of equity holders as the United States trustee deems fit”)

<sup>51</sup> 11 U.S.C. § 365(a).

if the debtor seeks to assume a contract, it will have to show that it has the economic ability to cure defaults and make payments going forward. Those in the market for information about a debtor are likely to find this information useful.

More important 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.<sup>52</sup> 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 plan process.<sup>53</sup> The real issue in an asset sale will be informational—what is the asset worth? Professors Baird and Morrison believe that auctions are likely to produce more and better information about asset valuation. They write—

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. Less traumatic checks on the bankruptcy judge's

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<sup>52</sup> Compare Baird & Rasmussen, *End of Bankruptcy*, supra note 5, at 751-52 (“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.”) & Baird & Rasmussen, *Chapter 11 at Twilight*, supra note 5, at 679 (“The large Chapter 11s of 2002 confirm our claim in *The End of Bankruptcy* that going-concern sales and implementation of prenegotiated deals now dominate the scene.”) with LoPucki & Doherty, *Fire Sales*, supra note 5, at 43, n. 189 (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”). At least some of the cases cited by Professors LoPucki & Doherty were then pending, so it possible some may have had 363 sales.

<sup>53</sup> *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (1983).

ability to exercise the shutdown option bring similar costs and benefits on a smaller scale.<sup>54</sup>

As discussed further below, there may be reason to question the effectiveness of the information production process in asset sales. If, as some claim, asset sales frequently produce depressed prices,<sup>55</sup> this may be due in part to the fact that the “market” lacks adequate information about the assets being sold. Yet, even if asset sales are infected by distorted or imperfect information, they nevertheless require the public disclosure of some basic information about the transaction.

### 3. *Litigations—The Acid Test*

Although bankruptcy is not a traditional lawsuit, bankruptcy litigation can be seen as performing at least three informational functions. First, litigations to avoid unperfected liens under Bankruptcy Code section 544(a) are in large part about information failures.<sup>56</sup> Under this “strong-arm” power, the bankruptcy trustee may avoid unperfected liens, which as a general matter means liens that are not readily discoverable from the public record.<sup>57</sup> The threat of losing a lien is a device that has, in turn, forced secured creditors

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<sup>54</sup> Douglas G. Baird, Edward R. Morrison, *Bankruptcy Decision Making*, 17 J. L., ECON. & ORG. 356, 369 (2001).

<sup>55</sup> See LoPucki & Doherty, *supra* note, 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”).

<sup>56</sup> 11 U.S.C. § 544(a).

<sup>57</sup> See Lipson, *Secrets and Liens*, *supra* note 36.

to disclose the existence of their interests in a debtor's property. The avoidance power can thus be seen as an ex ante informational device.

Second, and more generally, bankruptcy has historically created a context in which the trustee (management) or a creditors committee has an incentive to scrutinize questionable transactions. The incentive stems in large part from the fact that if the contract is not enforceable, the debtor may be relieved of its obligations under it. That, in turn, may leave a larger pie for creditors. Or, scrutiny may lead to the conclusion that the debtor's estate is owed money or property, which would also improve recoveries. In either case, the prospect of improved economic outcomes creates the incentive to generate and analyze information about a debtor's deals, generally.<sup>58</sup>

Third, bankruptcy creates a unique information-gathering mechanism, the Rule 2004 examination. This rule provides that any party in interest the opportunity may, on motion, examine the debtor or "any entity" at any time and any place, subject to terms imposed by the court and conditions set forth in Rule 2004(c).<sup>59</sup> Although a rule 2004 examination may not be a "fishing expedition,"<sup>60</sup> it is nevertheless quite broad.<sup>61</sup> Of

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<sup>58</sup> To facilitate this analysis, the Bankruptcy Code gives the trustee an extension of time to commence or defend against a variety of prepetition litigations. *See* 11 U.S.C. § 108.

<sup>59</sup> FED. R. BANKR. P. 2004(c) (providing that examination and document production may be compelled under Rule 9016).

<sup>60</sup> *See* *In re Vantage Petroleum Corp.*, 34 B.R. 650, 651 (Bankr. E.D.N.Y. 1983) (stating that scope of examination pursuant to Rule 2004 "can be in the nature of a fishing expedition"). *See also* *In re Mitco Inc.*, 44 B.R. 35, 36 (Bankr. E.D. Wis. 1984) (asserting that Rule 2004 examination cannot be used for "purpose of abuse or harassment").



course, this kind of discovery does not immediately or necessarily result in the production of information that might be relevant to a debtor's reorganization. But it will be an important step in generating this information if negotiations about information fail.

#### 4. *Committees and Trustees*

Perhaps the most obvious means by which Chapter 11 has the unique capacity to generate information is structural, through the entities it creates. Creditors Committees—which are ubiquitous in large reorganizations—may “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 . . . .”<sup>62</sup> Other committees may be appointed if approved by the court.<sup>63</sup> In either case, official committees may retain

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<sup>61</sup> See FED. R. BANKR. P. 2004(b) (describing nature and scope of examination). *See also* In re Table Talk Inc., 51 B.R. 143, 145 (Bankr. D. Mass. 1985) (discussing breadth of Rule 2004 examination).

<sup>62</sup> 11 U.S.C. § 1103(b)(2). *See, e.g.,* In re Cumberland Farms, Inc., 154 B.R. 9, 12 (Bankr. D. Mass. 1993) (noting that one of three basic functions of creditor's committee is to closely monitor debtor's operations); 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). As discussed below, an important new front in informational disputes in bankruptcy will involve the obligation on the part of the committee, added in 2005, to “provide access to information for creditors.” *Id.* at 1103(b)(3).

<sup>63</sup> “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)

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.<sup>64</sup>

If management runs into serious problems, the court may appoint a Chapter 11 trustee, who is likely to 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 . . . .”<sup>65</sup>

#### 5. *Examiners*

If a trustee is not appointed, but the parties are concerned about informational (or similar) failings, they may ask the court to appoint an examiner under section 1104(c) “to conduct such an investigation of the debtor as is appropriate.”<sup>66</sup> 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.”<sup>67</sup> Examiners have played important, often controversial, roles in many of our most recent, high-profile bankruptcy reorganizations, including *Enron*<sup>68</sup>, *Worldcom*,<sup>69</sup> *Refco*,<sup>70</sup> *Mirant*<sup>71</sup> and *New Century*.<sup>72</sup>

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<sup>64</sup> See 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).

<sup>65</sup> 11 U.S.C. § 1106(a)(3).

<sup>66</sup> 11 U.S.C. § 1104(c). *See also* Lipson, *Understanding Failure*, *supra* not e37 .

<sup>67</sup> 11 U.S.C. § 1104(c)(2).

<sup>68</sup> *In re Enron Corp.*, no. 01-16034 (Bankr. S.D.N.Y. 2001).

<sup>69</sup> *In re Worldcom*, no. 02-13533 (Bankr. S.D.N.Y. 2002).

Their investigations have on occasion cost millions of dollars<sup>73</sup> and resulted in major lawsuits or settlements.

Examiners may be the purest form of information-forcing for its own sake that bankruptcy reorganization has to offer. Congress created the role of examiner to provide “special protection for the large cases having great public interest . . . to determine fraud or wrong doing on the part of present management.”<sup>74</sup> The examiner thus exists not solely to determine whether stakeholders have actionable claims—which is really something the stakeholders could do themselves, in a traditional litigation—but also for some larger public purpose, to protect the investing public when companies fail.

#### 6. *Reorganization Plans and Disclosure Statements*

The ultimate information-forcing device in bankruptcy is likely to be the disclosure statement that must accompany a plan of reorganization. Under Bankruptcy Code section 1125, the bankruptcy court may only approve a disclosure statement if it contains “adequate information.”<sup>75</sup> 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

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<sup>70</sup> In re Refco, Inc., no. 05-60006 (Bankr. S.D.N.Y. 2005).

<sup>71</sup> In re Mirant Corporation, no. 03-46591 (Bankr. N.D. Tex. 2003).

<sup>72</sup> In re New Century TRS Holdings, Inc, no. 07-10416 (Bankr. D. Del. 2007)

<sup>73</sup>The examiners in *Enron* charged the estate approximately \$100 million for their services. Anthony Lin, *Enron Examiner Billed Estate for \$100 Million: Batson Seeks End of Appointment for Inquiry*, N.Y.L.J. (Dec. 5, 2003) at 1.

<sup>74</sup> 124 Cong. Rec. S17403-34 daily ed, Oct 6, 1978 (quoted in Collier on Bankruptcy App. 14.4(f)(iii) (15th ed. Rev 2002) (statement of Senator DeConcini).

<sup>75</sup> 11 U.S.C. § 1125(b).

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."<sup>76</sup> Although the disclosure statement need not include a valuation of the debtor or an appraisal of the debtor's assets,<sup>77</sup> financial information is often an important part of the story. There is generally no obligation that the disclosure statement reflect the kind of information or detail that would be found in securities law disclosures,<sup>78</sup> although federal securities laws may provide an analogy in certain circumstances.<sup>79</sup>

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<sup>76</sup> Id. at 1125(a) See §§ 1125(a)(1), (2); *In re Stanley Hotel, Inc.*, 13 B.R. 926, 933 (Bankr. D. Colo. 1981). See also *In re Ferretti*, 128 B.R. 16, 19 (Bankr. D.N.H. 1991) ("disclosure statements should not contain overly technical language that the average creditor cannot readily understand"); House Report at 408 ("the adequacy of disclosure is measured against the typical investor, not an extraordinary one"); *In re Monroe Well Service, Inc.*, 80 B.R. 324 (Bankr. E.D. Pa. 1987); *In re Jeppson*, 66 B.R. 269 (Bankr. D. Utah 1986)., See generally Note, *Disclosure in Chapter 11 Reorganizations: The Pursuit of Consistency and Clarity*, 70 Cornell L. Rev. 733 (1985).

<sup>77</sup> Id. at 1125(b).

<sup>78</sup> 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); *In re Crowthers 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).

I put to one side the treatment of disclosure statements in prepackaged reorganization plans, which involve the solicitation of votes before bankruptcy. Under Bankruptcy Code section 1125(g), prebankruptcy solicitations may be effective in bankruptcy, provided that they complied with "applicable nonbankruptcy law." See 11 U.S.C. §1125(g). In general, it is believed that complying with federal securities laws will satisfy section 1125(g). See Kurt A. Mayr, *Unlocking the Lockup, :The Revival of Plan Support Agreements Under New § 1125(g) of the Bankruptcy Code*, 15 J. BANKR. L. & PRACT. 6, [] (2006) ( Moreover, it appears that section 1125 will not immunize the proponent of a disclosure statement from

B. *Neither Fish Nor Fowl*

Bankruptcy reorganization may force information into the open, but what distinguishes this process from other approaches the law takes to information? In part, the answer is reflected in the fact that reorganization borrows from—but does not fully emulate—the three major models of information production in private law, the negotiated, the adversarial, and the mandatory. In part, the answer lies in the complex interplay between information-forcing rules and unregulated securities market that has arisen around the system.

1. *Negotiated Model*

One way the law deals with information asymmetry is through contract. Many believe that rational market actors will have the proper incentives to produce information needed to get a deal done. Professor Gilson, for example, has argued that the real value of business lawyers is informational: They are “transaction cost engineers” who, in a variety of ways, reduce the difference between the value that capital assets would obtain

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liability for fraud that occurred outside the disclosure statement process. *See* *Jacobson v. AEG Capital Corp.*, 50 F.3d 1493, 1496 (9th Cir. 1995) (stating “[I]f the securities fraud alleged came from some other source or procedure than disclosure and solicitation, then section 1125(e) would not provide immunity.”)

<sup>79</sup> The foregoing is merely a summary of certain information-forcing aspects of Chapter 11. There are many other informational rules that can have other, important consequences, perhaps the most important of which are those involving the protection of personally identifiable information. Bankruptcy Code section 332 creates a “consumer privacy ombudsman” to address these matters. 11 U.S.C. § 332. Other aspects of personal privacy in bankruptcy are discussed in Edward R. Janger, *Muddy Property: Generating and Protecting Information Privacy Norms in Bankruptcy*, 44 WM. & MARY L. REV. 1801, 1865 (2003) (discussing bankruptcy’s ability to protect consumer’s private information).

in a perfect market (i.e., on the capital-asset pricing model) and the price actually agreed-to in the imperfect world that clients occupy.<sup>80</sup>

Much of transaction design occurs because, Gilson suggests, parties will (in a non-strategic environment) want to produce information to induce the other side to contract. Thus, in an asset sale, the seller will want to comply with the seller's requests for information because if she doesn't the buyer will walk away.

The negotiated model is certainly relevant to bankruptcy reorganization. For example, non-ordinary course asset sales are an important tool in the reorganization kit that often require voluntary information-sharing between the debtor and potential asset purchasers. Yet, this model alone cannot be trusted in bankruptcy because bankruptcy is a highly strategic environment, and the potential for agency costs is high.<sup>81</sup> Gamesmanship in bankruptcy asset sales is expected. A debtor may find a stalking horse with whom management is comfortable (or who has leverage over management because of their

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80. *Id.* at 255. The “capital asset pricing” theory posits, in part, that markets will, over time, correctly price assets. *Id.* at 251. If the theory held, “business lawyers cannot *increase* the value of a transaction. Absent regulatory-based explanations, the fees charged by business lawyers would decrease the net value of the transaction.” *Id.* As Gilson acknowledges, the CAPM is not without its critics, who question many of its assumptions, including that its two parameters—risk and return—are the only ones of significance. *Id.* at 251 n.31 (collecting citations of criticisms of the CAPM). Nevertheless, Gilson argues, the value of the CAPM is “normative: It describes why the factors it specifies [i.e., risk and return] should count.” *Id.*

<sup>81</sup> For a decidedly (if inexplicably) contrary view on the nature of agency costs in bankruptcy, see M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543 (2007). If Professor Henderson were correct that bankruptcy is free of agency costs, we might wonder why, as discussed further below, managers ask for—and receive—permission to seal the motions that govern their own compensation packages. See discussion at [CROSS REFERENCE], *infra*.

stakes in the debtor). The debtor may propose to sell assets to the stalking horse, subject to a bidding procedure blessed by the court which permits the debtor to sell the assets to a bidder who makes a higher and better offer. It may also give the stalking horse access to confidential information and an exclusive investigation period.<sup>82</sup>

The creditors committee will, if it is doing its job, make sure the bid procedures maximize the debtor's obligation to produce information to competing bidders, at least to the extent they expect the information will drive up the sales price. But, left to their own devices, it is unlikely the debtor and the stalking horse would agree to share much information at all. Indeed, the fact that this must go through a court is fair evidence that "rational" information sharing is unlikely to occur.

So, too, with reorganization plans. They may be contracts in the general sense that they embody an "agreement" of sorts among the debtor and its constituents. But it is also true that whoever proposes the plan is likely to cast it in the light most likely to get sufficient support from stakeholders.<sup>83</sup> Since plan proponents will often be management—who presumptively control information about the debtor—it is highly unlikely they will voluntarily produce information that does not advance their cause. The

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<sup>82</sup> See Ronald L. Leibow, et al., *Distressed Assets Sales: Selling and Acquiring Assets from the Debtor Estate*, 877 PLI/Comm 71, 82-83 (Mar.-Apr. 2005) ("Upon identifying a potential stalking horse, the prospective buyer and the debtor typically enter into a confidentiality agreement to enable the buyer to conduct due diligence. Additionally, a buyer also may seek an exclusive period during which the debtor will not shop the sale to other potential candidates. During this period, the stalking horse seeks to avoid any competition from other potential bidders seeking stalking horse protection.").

<sup>83</sup> See Skeel, *supra* note 3, at 542 ("Managers have a tremendous incentive to distort information as they attempt to achieve consensus on a reorganization plan . . .").

strategized environment of the plan confirmation process—where the deal could turn adversarial at any moment—puts a premium on careful control of information.<sup>84</sup>

## 2. *Litigated Model*

Just because much of bankruptcy occurs in a strategic environment against a judicial backdrop does not mean that it is a traditional litigation. As with the negotiated model, some aspects of the litigation model apply, but only incompletely. Yet, because

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<sup>84</sup> Some evidence of the strategic nature of the plan process comes from our study of the use of examiners in large Chapter 11 cases. See Lipson, *Understanding Failure*, *supra* note 37. Parties frequently seek the appointment of examiners during the plan confirmation process not because they genuinely care about the information an investigation might produce, but instead because they believe—perhaps correctly—that it will give them leverage with the plan proponent. If the proponent fails to accede to the demands of the party that requests an examiner, there is a good chance the court will have to appoint one, which may derail or at least delay the plan confirmation process. See, e.g., *In re Loral Space & Communications Ltd.*, 313 B.R. 577 (Bankr. S.D.N.Y. 2004). The Bankruptcy Court in *Loral* denied the request as having been made for essentially strategic reasons. The bankruptcy court's decision was reversed on appeal, however. See Order, signed on 12/17/2004, by the Honorable R.P. Patterson, Jr., U.S. District Court Judge Reversing and Remanding the Bankruptcy Court's Denial of the Loral Stockholders Protective Committee's ("LSPC") Motion to Appoint an Examiner (related document(s)1411). (Gist, Marion) (Entered: 12/22/2004) (docket no. 1663) & Opinion and Order of U.S. District Court Judge Robert P. Patterson signed on 12/29/2004. Re: 1389 appeal. (Text of entry: "The Bankruptcy Court's denial of the LSPC's motion to appoint an examiner is reversed and remanded to the Bankruptcy Court to appoint a qualified independent examiner. In this Court's view, the examiner should have an adequate budget and expertise to review whether appropriate procedures were followed in valuing Loral's assets, particularly the space-based assets. That appointment should take place within 10 days of this Order. (Cheng, Ka Kin) (Entered: 12/29/2004)") (docket no. 1670).



bankruptcy reorganization occurs in courts, many of the concerns about the continued availability of court-generated information apply here.

There has long been a tension between making litigated information public, on the one hand, while protecting legitimate private interests on the other. There is, the Supreme Court held in *Richmond Newspapers v. Virginia*, a First Amendment interest in preserving “the stock of information from which members of the public may draw.”<sup>85</sup> Yet, litigants may have privacy and proprietary rights in certain of the information produced during the discovery process.<sup>86</sup>

Courts have generally treated litigation and its results (judicial orders and opinions) as presumptively public, while discovery not revealed in pleadings is generally treated as private.<sup>87</sup> As to judicial orders and presumptively public pleadings, parties may ask the court to seal matter that is confidential or protected under trade secret or know-how doctrines. Courts will generally seal the record as to nondispositive matters only if there is “good cause” to overcome the presumption that such matters should be public.<sup>88</sup> If the information goes to the merits of the case, an order to seal will generally be granted only if there is a compelling need to preserve privacy.<sup>89</sup>

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<sup>85</sup> *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 576(1980).

<sup>86</sup> *Seattle Times v. Rhinehart*, 467 U.S. 20 (1984).

<sup>87</sup> *Baxter International v. Abbott Labs*, 297 F. 3d 544 (7th Cir. 2002). The public will have access when (1) a judicial proceeding has historically been open and (2) public access plays a significant role in the proper functioning of the process. *Press-Enterprise Co. v. Superior Court*, 478 U.S. 1, 8 (1986); *Globe Newspaper Co. v. Superior Court*, 457 U.S. 596, 605-06 (1982).

<sup>88</sup> *Chicago Tribune Company v. Bridgestone/Firestone, Inc.*, 263 F.3d 1304 (11th Cir. 2001).

<sup>89</sup> *Leucadia, Inc. v. Applied Extrusion Technologies, Inc.*, 998 F. 2d 157 (3d Cir. 1993).

As discussed above, the bankruptcy system has special rules that require debtors and stakeholders to reveal large amounts of information about themselves. Arguably, bankruptcy involves even more information forcing than does traditional litigation because there need be no showing of “relevance” before information is produced, and it is produced not just to the other parties, but to the “world.” Bankruptcy has special informational tools, such as the Rule 2004 exam and the possibility that an examiner will be appointed.

Yet, precisely because so much information about a debtor—and its stakeholders—may be used for competitive advantage, courts may be expected to be more solicitous of requests for confidentiality. As noted above, Bankruptcy Code section 107(b) creates a special rule in bankruptcy that would appear to give judges greater discretion to seal records than would be the case in other courts.

### 3. *Information Policy under Federal Securities Laws*

Instinctively, we might think that bankruptcy reorganization’s nearest informational relative is the disclosure system created by federal securities laws. After all, both sets of laws have roots in the New Deal legislation spawned by the massive market failures of the Great Depression. Both bear the imprint of Professor (later Supreme Court Justice) William O. Douglas. And, while both deal in information, they do so in very different ways, perhaps reflecting the different contexts they address and the policies they seek to implement.

As a general matter, to sell securities in interstate commerce requires that an effective registration statement be on file with the Securities and Exchange Commission

under the Securities Act of 1933.<sup>90</sup> If a corporate issuer wants to permit secondary trading in its securities, it must be a reporting company under the Securities Exchange Act of 1934.<sup>91</sup> The “recurrent theme” of federal securities law, Loss & Seligman’s leading treatise explains, is “disclosure, and still more disclosure. Substantive regulation has its limits. But ‘the truth shall make you free.’”<sup>92</sup> The Sarbanes-Oxley Act of 2002, enacted in the wake of the most recent string of major bankruptcies, only upped the informational ante.<sup>93</sup>

At the risk of oversimplification, there are three different views of the policy we could have regarding securities law disclosure. One would be the mandatory regime we have adopted. The goal here is disclosure for its own sake, in a belief that the requirement to tell the truth and the whole truth will in fact result in better behavior by those forced to make the disclosure. It is, in a sense, a supply-side, deterrence-based theory of the regulatory power of information.<sup>94</sup> We care less about the audience for the information than the fact that the information must be produced.

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<sup>90</sup> See Securities Act of 1933, ch. 38, tit. I, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77 a-bbbb (1988)).

<sup>91</sup> Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78 a-kk (1988)).

<sup>92</sup> 1 Louis Loss & Joel Seligman, *Securities Regulation* 29 (3d ed. rev. 1998).

<sup>93</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

<sup>94</sup> ) As William O. Douglas wrote “the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity. . . .” William O. Douglas, *Protecting the Investor*, 23 YALE REV. 522, 523-24 (1934).

A second, and essentially opposite, approach would mimic the contractual nature of information exchange in private transactions: Voluntary disclosure. Capital market participants can be trusted to ask for—and receive—full and accurate information. If companies don't supply this information, they would have to “forego access to the capital markets.”<sup>95</sup> This is conventional economic theory applied to the distribution of information about securities transactions. The state has no meaningful role in resolving information asymmetries because none should exist. If they do, it will be because investors are lazy or gullible, but in any case not deserving of protection.

A third, and in some respects, more challenging approach would look not exclusively at the supply side (as in the current model) or ignore the problem entirely (as in the pure market approach), but instead ask about the demand side. “[D]isclosure of information is not enough for a disclosure-based regulatory system to succeed,” Troy Paredes has argued.<sup>96</sup> “Investors, 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

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<sup>95</sup> HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 119 (1979) (““A disclosure will be supplied voluntarily by issuers interested in the capital markets when there is a consensus among suppliers of capital or other transactors in the capital market that this information is necessary to them for lending and investment decisions.”). See also HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) (arguing against prohibitions on insider trading); Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 *ACCT. REV.* 515 (1969); Stigler, *Public Regulation of the Securities Markets*, 37 *J. BUS.* 117 (1964) (same).

<sup>96</sup> Paredes, *supra* note 17, at 432.

information that is disclosed.”<sup>97</sup> The supply side of the information equation clearly matters on this view, but is not the only—or necessarily the most important—focus of information policy. Indeed, at some fundamental level, this approach treats disclosure as if it really were an information policy, rather than a means to some other end, such as deterring fraud.

Bankruptcy has chosen bits and pieces of each of these possible policies. It thus cannot be said to model the federal securities law approach any more than it models the purely contractual or purely litigated model. Many information forcing rules in bankruptcy seem designed—or to be used in practice—not with information production as an end, but rather as a means to some other end.<sup>98</sup> The strong-arm power that permits the avoidance of unperfected security interests, for example, may exist today to redistribute property from (rich) secured creditors to (poor) unsecured creditors.<sup>99</sup> That it forces secured parties to produce information about their liens is, today, only a happy and vestigial byproduct. Similar observations can be made about the instrumental uses of the investigative powers of committees or examiners, fights over the adequacy of information in a disclosure statement, or whether private investors have complied with obscure and technical notice requirements. Yet, much information in bankruptcy may be produced voluntarily, and sometimes even with sensitivity to the needs of the expected reader. Bankruptcy’s information policy is not one policy, but many.

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<sup>97</sup> Id.

<sup>98</sup> Cf. Paredes, *supra* note 17, at 431 (“The goal of the federal mandatory disclosure system is not disclosure. Disclosure is merely the chosen means to the end of informed investor decision making.”).

<sup>99</sup> See Lipson, *Secrets & Liens*, *supra* note [] (discussing political economy of avoidance powers).

Both Chapter 11 of the Bankruptcy Code and the federal securities laws are in the business of requiring companies to produce and verify information. Yet, the systems differ in fundamental ways. The securities law disclosure system generally deals with financially healthy companies, and seeks to protect individual investors (as well as the integrity of the markets in general) with mandatory disclosure. It contemplates long-term investors, and is concerned only indirectly with problems of collective action.<sup>100</sup> It addresses a robust and enormously complex system of contract and property rights that often fluctuates rapidly and unpredictably. It is run largely by administrators in the executive branch (i.e., the SEC) and self-regulatory bodies, such as NASDAQ. Perhaps most important, it has selected a policy goal—mandatory disclosure—even if many question the merits of that policy.

Virtually none of these things can be said of bankruptcy. Unlike securities law, bankruptcy law deals with financially ailing companies, and seeks to address problems of collective action. It is, one hopes, a finite and speedy process. While bankruptcy outcomes are increasingly influenced by the growing, unregulated secondary market in bankruptcy claims, that remains a far smaller and more opaque market than the securities market as a whole. It is run not by the executive branch or approved self-regulatory bodies, but instead Article I judges and the parties themselves.

In short, Chapter 11 of the Bankruptcy Code creates a unique informational medium. The Second Circuit Court of Appeals probably captured bankruptcy's informational aspirations best in the *Lionel* opinion, which relied heavily on both the

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<sup>100</sup> The rules on proxy contests, for example, can be seen as affecting governance, and thus collective action by shareholders seeking to influence corporate policy.

legislative history of the Bankruptcy Code and the ways that the Code distinguished itself from prior law:

A fair analysis of the House bill reveals that reorganization under the 1938 Chandler Act, though designed to protect creditors had, over the years, often worked to their detriment and to the detriment of shareholders as well. The primary reason reorganization under the Act had not served well was that disclosure was minimal and reorganization under the Act was designed to deal with trade debt, not secured or public debt or equity. The [current Bankruptcy Code], it was believed, provides some form of investor protection to make it a “fairer reorganization vehicle.” The key to the reorganization Chapter, therefore, is disclosure. To make disclosure effective, a provision was included that there be a disclosure statement and a hearing on the adequacy of the information it contains. The essential purpose served by disclosure is to ensure that public investors are not left entirely at the mercy of the debtor and its creditors.<sup>101</sup>

## II. *Clouding the Fishbowl--Challenges to Information-Forcing in Bankruptcy and Beyond*

Bankruptcy reorganization may create a unique informational medium in which to understand failure. But its informational architecture is increasingly vulnerable. Forces within and without the bankruptcy system threaten the flow and quality of information about failure. This Part discusses examples of both.

### A. *Internal Threats*

Some threats to the flow of information about failure come from within the system. Managers are highly reluctant to disclose any more than they have to about a firm—or their interests in it. Private investors may want as much information as possible about reorganizing firms. But they may not want the world at large—and in particular other existing or potential investors—to know what they know. Nor are they likely to want to reveal their own positions or motives. More basically, reorganizing firms increasingly enter bankruptcy laden with large amounts of secured debt. As such, they

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<sup>101</sup> In re Lionel Corp. 722 F.2d 1063, 1070 (2d Cir.1983) (internal citations omitted).

may lack the cash flow to conduct the information-forcing investigations and analyses that have historically been central to bankruptcy reorganization.

1. *Management*

The bankruptcy system may be designed to force information into the open, but that does not mean managers happily reveal their company's—or their own--secrets. In some cases, the desire to conceal information reflects a logical, if disturbing, desire to conceal acts or omissions that may have harmed the debtor. Our study of examiners in large Chapter 11 cases, for example, revealed that management was by far the most likely party to oppose appointment of an examiner, registering 55% of all objections to examiners in the large cases we studied.<sup>102</sup>

In the recent, high profile *New Century* case, for example, the United States Trustee sought the appointment of a Chapter 11 trustee or, in the alternative an examiner, shortly after the case was commenced. The bankruptcy court declined to appoint a trustee—which would have displaced management—but did appoint an examiner, to determine, among other things, how and why this major subprime lender had mistated its financial statements so seriously.<sup>103</sup>

According to the examiner's report, management was not interested in complying with his investigation. "The Examiner's investigation was made much more challenging, lengthy, inefficient and expensive due to some troubling failures of New Century and

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<sup>102</sup> See *Understanding Failure*, *supra* note 37.

<sup>103</sup> See *New Century Report*, *supra* note [], at 11 (providing that examiner would "investigate any and all accounting and financial statement irregularities, errors or misstatements . . .").



others to cooperate,” the examiner’s report explained.<sup>104</sup> The company “unreasonably withheld for many months the production to the Examiner of hundreds of thousands of important documents.”<sup>105</sup> This may not be surprising, given that the examiner’s investigation determined that the debtor’s estates had causes of action against executives to recover bonuses and other compensation paid based on alleged misstatements of financial performance.<sup>106</sup>

Even in the absence of allegations of securities fraud or similar wrong-doing, managers may resist disclosure. In several recent cases, for example, managers have obtained orders sealing the pleadings used to establish retention bonus programs, even over the objections of creditors.<sup>107</sup> In *In re Georgetown Steel Co., LLC*, for example, the court held that the Chapter 11 debtor could seal, among other things, the names of key employees as well as information on benefits and salary that would be paid under U.S.C.A. § 107(b).<sup>108</sup> The debtor was attempting to implement a “key employee retention program” to ensure the employ of fourteen individuals that would be vital to the

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<sup>104</sup> Id. at 18.

<sup>105</sup> Id.

<sup>106</sup> Id. at 513-541.

<sup>107</sup> *In re Allied Holdings, Inc.*, 337 B.R. 716, 717, n. 1 (Bankr. N.D.Ga.2005) (overruling objection of Teamsters Union and permitting debtor to file identities of employees that were parties to key employee retention agreements under seal); *In re Georgetown Steel Co.*, 306 B.R. 542 (Bankr. D. S.C. 2004) (names of key employees under a KERP would be sealed as in the nature of “confidential commercial information”) [ADD?]

<sup>108</sup> *In re Georgetown Steel Co., LLC*, 306 B.R. 542 (2004).

reorganization plan.<sup>109</sup> The debtor moved to seal the records of the program, yet certain entities, i.e. the United States Trustee for the District of South Carolina, objected to the debtor's motion.<sup>110</sup> However, the court held that certain information, including the names of the employees and benefits received under the plan, is protected as "commercial information" under 107(b).<sup>111</sup> This information, the court believed, could provide competitors with a recruiting advantage with the key employees, or disrupt the internal morale of the company.<sup>112</sup>

## 2. *Statutory Committees*

Fights over information are also increasingly common on official committees, in particular creditors' committees. Because they will often have access to confidential information about the debtor, official committees will have special informational

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<sup>109</sup> Id at 543-544.

<sup>110</sup> Id at 544.

<sup>111</sup> Id at 546.

<sup>112</sup> Id. In *In re Nellson Neutraceutical Inc.*, management persuaded a Delaware bankruptcy judge to let it pay more than \$1 million to nine top employees without disclosing the identities of the recipients or the amounts in question. See Peg Brickley, *Delaware Blockes Ch. 11 Bonus Debates from Public View*, DOW JONES NEWSWIRE, available at [CITE]. Similar results apparently obtained in the Werner Co. and Pliant Corp. bankruptcies, where courts allegedly agreed to close courtrooms and seal pleadings involving management retention bonuses out of concern that "employees would be demoralized should they learn details of the bonuses for top insiders." Id. "What's new in Delaware," a news report indicated, "is that such agreements are being used on a regular basis to justify the extreme remedy of closed courtrooms and sealed evidentiary records." Id.

challenges. Their members might be tempted to trade on this information.<sup>113</sup> This would be problematic because, among other things, it would violate the fiduciary duties committee members are said to owe to their constituencies. The solution proposed by the court in the *Federated* case, and generally adopted elsewhere, was “trading walls”—informational screens between those who might sit on a committee (and thus obtain confidential information) and other employees of the creditor who might be engaged in claims trading.<sup>114</sup>

The problem here is akin to insider trading, which is generally prohibited by federal securities laws—when they apply.<sup>115</sup> Insiders—committee members—may use

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<sup>113</sup> See Robert P. Enayati, *Undermining the Trading Wall: The BAPCPA’s Affront on the Creditors’ Committee’s Duty 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.”)

<sup>114</sup> See *In re Federated Dep’t Stores*, No. 1-90-00130, 1991 Bankr. LEXIS 288 (Bankr. S.D. Ohio Mar. 7, 1991). According to the *Federated* court, “the trading wall must be “reasonably designed to prevent [creditor’s] trading personnel from receiving any nonpublic committee information through [creditor’s] committee personnel and to prevent [creditor’s] committee personnel from receiving information regarding [creditor’s] trading in securities of the Debtors ... in advance of such trades.” *In re Federated Dep’t Stores, Inc.*, 1991 Bankr. LEXIS 288, at 2. Trading walls were also in issue in the more recent, and controversial, *Fibermark* case. See Order Approving Specified Information Blocking Procedures and Permitting Trading in Securities Of the Debtors Upon Establishment Of a Screening Wall, *In re FiberMark, Inc.*, No. 04-10463 (Bankr. D. Vt. Aug. 16, 2005).

<sup>115</sup> See Drain & Schwartz *supra* note 8, at 622 (“It is not likely that there will be an opportunity, moreover, 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 with the

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.<sup>116</sup>

A recent, awkwardly-designed response to this problem, appeared in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).<sup>117</sup> BAPCPA requires 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.”<sup>118</sup> The problem is that this provision makes no distinction for confidential or sensitive information that might affect the market for claims against a debtor.<sup>119</sup> Thus, it

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amendment to Rule 3001(e) 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 least would be able to develop means to track claim trades and discern potential insider trading situations.”).

<sup>116</sup> See Fortgang & Myers, *supra* note 8, 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”)

<sup>117</sup> Bankruptcy Abuse and Consumer Protection Act of 2005, Pub L. No. 109-8, 119 Stat. 23, (codified as amended in scattered sections of 11 U.S.C).

<sup>118</sup> 11 U.S.C. § 1102(b)(3).

<sup>119</sup> See Enayati, *supra* note 113.

simply expands the pool of those who might trade on insider information. The court in the recent *Refco* decision, however, provided that creditors committees may require those who request information to sign confidentiality agreements, thus managing to some extent the insider-trading problem.<sup>120</sup>

These problems would be easier to address if we had some idea what informational policy we were trying to advance. If, for example, we believe that a contractual solution to information asymmetry is appropriate, then both the trading walls proposed by the *Federated* court, and the confidentiality agreements permitted by the *Refco* court, may be inappropriate restraints on the use of information. Information should be put to its highest and best use. The government—in the form of informational rules—should not protect those too slow or guileless to take advantage of the information asymmetries created by bankruptcy.

If, instead, we believe that any information system that requires disclosure must consider both the supply and demand sides of the information curve, we might be more comfortable with the status quo. Looking at the demand side, we might say that using inside information creates the potential for harm to those who lack access to the confidential information. Having access to this information is a competitive advantage conferred not by contract but by the state, and the bankruptcy system it has created. There is, on this view, no particular reason to believe that some creditors should benefit from inside status, while others do not.

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<sup>120</sup> In re *Refco, Inc.*, 336 B.R. 187, 190-91 (Bankr. S.D.N.Y. 2006). The *Refco* court also required the creditors' committee to set up a web site to provide access to non-proprietary information and allowed creditors to challenge a denial for proprietary information by the committee in court by showing that the need for the information outweighs the need to protect the proprietary information. *Id.* at 198.

The important point here is not to choose among these or other policy goals. Rather, it is to acknowledge that skirmishes in bankruptcy appear increasingly to affect the flow of information—and not necessarily for the better.

3. *Private Investors (Hedge Funds & Private Equity Investors)*

Managers and committees are not the only parties who fight over information in bankruptcy. Indeed, the leading combatants in information-related bankruptcy fights appear to be private investors, whose strategies also increasingly appear to be about the control of information.

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.<sup>121</sup> The economic goal may be to reach the “fulcrum” position, the point in the capital structure that achieves maximum control for minimum investment.<sup>122</sup> The strategic key for these private investors will be information arbitrage: They want to obtain as much information as possible about the debtor—and the debtor’s other stakeholders—but to reveal as little information about themselves as possible. Two sets of rules—those regarding collective representation and those regarding claims trading—impede private stakeholders’ ability to arbitrage information, and will thus form another informational battleground in bankruptcy reorganization.

a. *Unofficial Committees*

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<sup>121</sup> See, e.g., sources cited in note 9.

<sup>122</sup> See, e.g., Lichtenstein & Cheney, *supra* note 9 (unpaginated original).

Consider first the question of ad hoc committee representation. In two recent and controversial opinions from the *Northwest Airlines* reorganization, Judge Gropper held that an ad hoc committee of equity security holders would have to reveal a fair amount of information about its members and their stakes in the debtors.<sup>123</sup>

In the first case, Judge Gropper held that the committee would have to comply with Federal Rule of Bankruptcy Procedure 2019, which 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.”<sup>124</sup> As Judge Gropper observed, this rule grew out of important reforms of the bankruptcy system dating back to the 1930s aimed at stemming abuses by representatives of creditors.<sup>125</sup>

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<sup>123</sup> 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 Federal Rule of Bankruptcy Procedure 2019) [*Northwest I*]; *In re Northwest Airlines Corp.*, 363 B.R. 704 (Bankr. S.D.N.Y. 2007) (denying request by ad hoc committee to file Rule 2019 disclosures under seal).

<sup>124</sup> Fed. R. Bankr. P. 2019.

<sup>125</sup> As Judge Gropper explained—

Unofficial committees have long been active in reorganization cases, and the influential study in the 1930's by Professor (later Justice) William O. Douglas for the Securities and Exchange Commission centered on perceived abuses by unofficial committees in equity receiverships and other corporate reorganizations. See Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937). The four-volume SEC 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

Having lost this motion, the committee then sought to comply with the rule by filing its statement under seal under Bankruptcy Code section 107(b) and Federal Rule of Bankruptcy Procedure 9018.<sup>126</sup> The committee initially argued that sealing the filings was appropriate to protect its members' "trading strategies."<sup>127</sup> The court rejected this "improbable contention," however, and it appears that counsel conceded in argument that this was not the real issue.<sup>128</sup> Rather, it appears that the real concern of the committee members would have been for 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."<sup>129</sup> "Just as car dealers do not disclose to customers their actual acquisition cost of their cars," one committee member explained "and builders do not disclose to potential home buyers their actual cost to build homes, we do not disclose to potential counterparties our basis in our investments."<sup>130</sup>

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equitable plans free from deception and overreaching. 13A King et al., *Collier on Bankruptcy*, 10-211.04 (14th ed.1976).

*Northwest Airlines I*, 363 B.R., at 704.

<sup>126</sup> *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...."

<sup>127</sup> *Northwest Airlines II*, 363 B.R. at 707.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.* at 708 (quoting Decl. of Daniel Krueger, p. 3).

<sup>130</sup> *Id.*



Judge Gropper was, however, unmoved. “The Committee members do not advance their position when they compare themselves to car or real estate salesman,” he wrote.

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. . . . In any event, any interest that individual Committee members may have in keeping this information confidential is overridden by the interests that Rule 2019 seeks to protect. 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. . . .* Rule 2019 is based on the premise that the other shareholders have a right to information as to Committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own. 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.<sup>131</sup>

Not surprisingly, the trade associations that represent claims traders, the Securities Industry and Financial Markets Association (SIFMA) and the Loan Syndications and Trading Association (LSTA), have sought to rewrite Rule 2019 to prevent a repeat of Judge Gropper’s interpretation.<sup>132</sup> These associations have argued that Rule 2019 should be abandoned in favor of traditional discovery—the adversarial model—for “important public policy reasons.<sup>133</sup> Among other things, they claim, the rule “has very little actual utility to the sound administration of chapter 11 cases” because the disclosures it requires

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<sup>131</sup> Id. at 708-709.

<sup>132</sup> See Letter from Loan Syndications & Trading Ass'n and the Sec. Indus. & Fin. Mkts. Ass'n to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conference of the United States 6 (Nov. 30, 2007) [hereinafter LSTA/SIFMA Comment Letter], available at <http://www.sifma.org/regulatory/pdf/BankruptcyRule2019Letter.pdf>. [hereinafter, “SIFMA/LSTA Letter”]

<sup>133</sup> Id. at 6.

“are unlikely to provide information that could assist the court or any other party in applying bankruptcy law properly or in reaching a disposition of the case.”<sup>134</sup>

The big problem for the associations was the requirement that the ad hoc committee members disclose the price at which they acquired their claims against or interests in the debtor. This information will, according to SIFMA and LSTA, “rarely add relevant information to the bankruptcy reorganization process” because information about the amount paid for a claim “has no legal relevance to the claim holder’s rights under the Code or non-bankruptcy law.”<sup>135</sup> Revealing this information, they argued, “can have a potentially counterproductive effect” because “distressed investors such as hedge funds employ aggressive and complex investment strategies.”<sup>136</sup> This would put the ad hoc committee members at a competitive disadvantage with other funds, who could easily obtain Rule 2019 statements through the electronic case filing system. These “competitors will be better able to reconstruct the unique trading systems developed by the fund that was forced to disclose.”<sup>137</sup> The disclosure may also give the competitor “knowledge of a particular long or short position” that would allow the competitor to “move the market in a direction adverse the fund that was forced to disclose.”<sup>138</sup> This

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<sup>134</sup> Id.

<sup>135</sup> Id. at 7. The information was legally irrelevant, they claimed, because the price paid for a claim has no bearing on how it will be treated under a reorganization plan. *See id* (citing *In re* Fairfield Executive Associates, 161 B.R. 595, 602-03 (D.N.J. 1993).

<sup>136</sup> Id. at 22-23.

<sup>137</sup> Id. at 23-24.

<sup>138</sup> Id.at 24.

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.”<sup>139</sup>

The reality is that it is difficult to muster much sympathy for either Judge Gropper’s or the hedge funds’ views of Rule 2019. On the one hand, it is hard to see how the information forced out of stakeholders by the rule protects the parties who ostensibly benefit from the information. A principal motive behind rules such as 2019 was elimination of the “opprobrious” “bankruptcy ring” and the cronyism that Congress decried in the legislative history of the Bankruptcy Reform Act of 1978.<sup>140</sup> The term “bankruptcy ring” referred chiefly to the bankruptcy lawyers, trustees, receivers and other professionals who allegedly perverted the bankruptcy system in New York in the early part of the 20<sup>th</sup> century.<sup>141</sup> A series of investigations was undertaken, the findings of which, according to Professor Skeel, “were dramatic and shocking and suggested a wide-ranging conspiracy to control bankruptcy administration.”<sup>142</sup>

It is possible that hedge funds will seek to re-animate the bankruptcy rings of a century ago. But that is improbable. While they would doubtless want “control”, it is

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<sup>139</sup> Id.

<sup>140</sup> H.R. Rep. No. 95-595, at 6011 (Sept. 8, 1977). *See also* In re Sonicblue Inc., 2007 WL 926871 (Bankr.N.D.Cal.2007). (discussing bankruptcy ring in light of counsel’s failure to disclose potential conflicts of interest in order to protect referral sources).

<sup>141</sup> *See* David A. Skeel, *Debt’s Dominion* 77-80 (Princeton, 2001). *See also* *Strengthening of Procedure in the Judicial System: The Report of the Attorney General on Bankruptcy Law and Practice*, Senate Doc. No. 72-65 (1932) (“Thacher Report”); *Report on the Administration of Bankruptcy Estates*, 71<sup>st</sup> Cong. (Committee Print 1931) (“Donovan Report”)

<sup>142</sup> Skeel, *Debt’s Dominion*, *supra* note [], at 77.

likely not over bankruptcy administration, but instead over information that will enrich them in the bankruptcy process. In the first instance, this means they will seek as much data about the debtor and other stakeholders as possible, while revealing as little about themselves as possible. This form of information arbitrage may create other problems for the reorganization system, but it is not likely one that will be solved by forcing disclosure of the purchase price of securities. *Northwest's* information forcing solved a problem that does not appear to exist today.

On the other hand, SIFMA/LSTA position seems overstated. They do not want their members to have to reveal pricing information, but they say such disclosures are irrelevant because “that information is readily obtainable from numerous sources every trading day.”<sup>143</sup> If that’s true, then how could their trading strategies be so vulnerable? What does this added disclosure really cost them, informationally?<sup>144</sup>

b. *Claims Trading*

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<sup>143</sup> See *SIFMA/LSTA Letter*, *supra* note 132, at 11.

<sup>144</sup> Not surprisingly, at least one court has ruled the other way, although the ruling lacks precedential value. In *In re Scotia Pacific Company, 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*, Case 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.* Case No. 03-46590 (Bankr. N.D. Tx. May 16, 2007); *Mirant to Complete Settlement with Pepco*, *Mirant Corp.* Press Release, Aug. 7, 2007 ([www.mirant.com](http://www.mirant.com)).

Rules on revealing the identities of claims purchasers appear to function in a similar way. At least in theory, those who purchase claims against a debtor in bankruptcy must 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.”<sup>145</sup> Before it was added, in 1991, bankruptcy courts had far greater control over claims trading, as they had to approve any such transfer.<sup>146</sup> This change, however, permits transfers 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.<sup>147</sup>

Although bankruptcy courts have essentially left the transfer process—and its informational functions—to the clerk’s office, they retain the power to police the

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<sup>145</sup> Fed. R. Bankr. P. 3001(e).

<sup>146</sup> The pre-1991 amendment version of Bankruptcy Rule 3001(e) provided, in relevant part:

Transferred Claim.

(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.

<sup>147</sup> See Drain & Schwartz, *supra* note 8, at 579 (“, amended Rule 3001(e) dispenses with notice (other than notice to the transferor), and the court should not become involved unless the transferor objects to its own purported trade. Moreover, the parties to the trade are not required by the amended rule to disclose any terms of transfer.”).

activities of claims purchasers for “inequitable” conduct.<sup>148</sup> Those who purchase large amounts of interests in a debtor may be treated as “insiders” and held to owe a fiduciary to the debtor that might preclude strategic behavior.<sup>149</sup> Misconduct may be inferred from the failure to disclose the purchase of claims.<sup>150</sup> The mere fact that a creditor acquires

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<sup>148</sup> The bankruptcy court's power to regulate claims trading has been predicated on *American United Mutual Life Ins. Co. v. City of Avon Park*, 311 U.S. 138, 61 S.Ct. 157, 85 L.Ed. 91 (1940). In the *City of Avon Park* case, the Supreme Court refused to confirm the city's Chapter IX plan because the city's fiscal agent had solicited votes from bondholders without disclosing that its previous purchases of bonds at 50 percent of their value gave the agent a financial interest in the success of the city's plan.

I put to one side the related question of whether purchasers of claims acquire them subject to defenses a debtor may have had against the original creditor. *See Levitin, supra* note 23 (discussing subordination of purchaser's claim based on seller's conduct).

<sup>149</sup> *See Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*, 323 F.3d 228 (3d Cir. 2003). Here, Citicorp Venture Capital had purchased at a discount, without disclosure, while an insider, claims against debtor Papercraft constituted breaches of CVC's fiduciary duty to Papercraft and its creditors. *In re Papercraft Corp.*, 187 B.R. 486, 498-99 (Bankr.W.D.Pa.1995). The Bankruptcy Court limited CVC's allowed claim to the \$10,553,541.88 price, and held that further subordination of CVC's claims pursuant to the principles of equitable subordination codified at 11 U.S.C. § 510(c) was not appropriate because the Bankruptcy Court was already limiting CVC's allowed claim to the amount it paid for such claim (upheld)

<sup>150</sup> *In re Revere Copper and Brass, Inc.*, 58 B.R. 1 (Bankr.S.D.N.Y.1985), Judge Abram concluded that Phoenix Capital's failure to disclose the terms of an announced or filed plan to the prospective sellers of claims permitted the bankruptcy court to withhold approval of the transfers until the selling creditors were provided with such notice, together with 30 days in which to revoke their assignment of claims to Phoenix Capital.

claims to obtain an economic advantage in a bankruptcy case is not, of itself, sufficient to punish the purchaser.<sup>151</sup>

As with fights over compliance with Rule 2019, there is a sense in litigation over rule 3001(e) that information is not the real issue. In *In re Burnett*, for example, the Bankruptcy Appellate Panel for the Ninth Circuit held that a transferee's failure to disclose the consideration paid for its claim was not grounds to disallow it.<sup>152</sup> Here, investors purchased multiple claims against the debtor.<sup>153</sup> The debtors objected to the investors' proofs on the grounds that the investors had failed to disclose the consideration paid for the claims.<sup>154</sup> The court analyzed the legislative history of the applicable Rule 3001(e) and determined "the consideration supporting a transfer of a claim is not...pertinent to the validity and allowance of the claim."<sup>155</sup>

The decision in *Burnett* is obviously correct, but begs an informational question: why would we want members of an informal committee to disclose the price they paid for their stake in the debtor, but not individual claims purchasers? The answer is probably purely a matter of political economy: Rule 3001(e) was amended in 1991, as the claims trading market was developing. Rule 2019 was not.

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<sup>151</sup> *In re Pleasant Hill Partners, L.P.*, Bankr. N.D. Ga. 388, 396 (Bankr. N.D. Ga. 1994) (although had purchased a majority of the debtor's unsecured debt, the "creditor's conduct in furtherance of its own interest [] should not result in unfair disadvantage to other creditors or the debtor . . .").

<sup>152</sup> *In re Burnett*, 306 B.R. 313 (Bankr. 9<sup>th</sup> Cir. 2004).

<sup>153</sup> *Id.* at 314.

<sup>154</sup> *Id.* at 314-315.

<sup>155</sup> *Id.* at 319.

The likely reality is that these fights over stakeholder disclosures under Rules 2019 and 3001(e) are not chiefly about information at all. The “roaring controversy over [their] disclosure obligations”<sup>156</sup> may not, in fact, be about information at all. Instead, these fights are probably about the use of informational rules for strategic advantage. They are fights that purport to be about data, to gain dollars.

But this is not to say that these rules perform no important informational function. They do, but it is not quite the one Judge Gropper identifies in his *Northwest* opinions. He justified application of the Rule to the hedge funds because “other shareholders” should know about the activities of committee members so that they can “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.”<sup>157</sup>

This may or may not be realistic. If the shareholders are widely dispersed, it is unlikely they will pay close attention to these filings. After all, the company is in bankruptcy. Given the way priority works, shareholders likely expect to receive little if any return on their investment. Tracking the docket to find these pleadings is probably

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<sup>156</sup> See Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1375 n.193 (2007). See also *The Vultures Take Wing*, ECONOMIST, Mar. 31, 2007, at 77, 77 (noting the role that banks and hedge funds plan to play in what many predict to be an active distressed and bankruptcy market); cf. Erika Lovley, *How Troubled Firms Skip Bankruptcy Court*, WALL ST. J., Feb. 7, 2007, at B5B (describing the increasing role of hedge funds and distressed investors in out-of-court restructurings, but noting that these out-of-court restructurings are the last chance to avoid bankruptcy court); See D. Tyler Nurnberg & Heath D. Rosenblat, *Disclosure Rules Alter Chapter 11 Hedge Fund Strategies?*, N.Y. L.J., Apr. 30, 2007.

<sup>157</sup> *Id.* at 708-709.



not worth the effort. If, instead, the shareholders are concentrated, they are more likely already to have taken an active position. Moreover, the rules on classification of claims and interests makes it unlikely that an “inside” group of shareholders could cut a better deal for themselves. Absent fairly good reason, holders of like rights—e.g., common stock—should be grouped together, and treated the same.<sup>158</sup>

Rather, the important informational function here will likely be the effect these disclosures have *other*, non-similarly situated stakeholders. If a group of shareholders (or creditors, or what have you) have gone to the trouble of forming an ad hoc committee, the odds are good they are seeking to improve their treatment. Given the dynamics of reorganization, this likely means they will want to cut a better deal, which may mean that they may want to capture value that would otherwise flow some other tranche of rightsholders. For example, preferred stockholders may want capture some portion of new common stock to be issued under plan that, but for aggressive negotiation, would go to creditors, who are senior in order of priority. So, the important audience for this

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<sup>158</sup> The Bankruptcy Code provides for equality of treatment by, among other things, plan of reorganization provide similar treatment to similarly situated claims. Several sections of the Code are designed to ensure equality of distribution from the time the bankruptcy petition is filed. Section 1122(a) provides that only “substantially similar” claims may be classified together under a plan of reorganization. Section 1123(a)(4) requires that a plan of reorganization “provide the same treatment for each claim or interest of a particular class.” And § 524(g) states that “present claims and future demands that involve similar claims” must be paid “in substantially the same manner.” *See generally* In re Combustion Engineering, Inc., 391 F.3d 190, 239 (3<sup>rd</sup> Cir.2005) (describing equality of treatment standards).

information will not necessarily be similarly situated stakeholders, but instead other types of stakeholders, who can expect either to negotiate or compete with the ad hoc group.<sup>159</sup>

#### 4. *Opaque Incentives-Credit Default Swaps and Control-Decoupling*

Until recently, the skirmishing seen in cases like *Northwest* and *Burnett* would have been nothing but transparent gamesmanship. Knowing a debtor's stakeholder's position—stock, claim, etc—would not seem to have required a rule of any sort. So, litigation over those rules must have been about something else (e.g., money). If creditors or shareholders wanted any hope of recovering anything, they had to file proofs of claim or interest, thereby revealing the nature and amount of their rights against the debtor.<sup>160</sup>

In doing so, they would reveal not only their positions, but by inference something about their incentives. More likely still, the debtor and other major stakeholders (e.g., the creditors committee) probably had a fairly good handle on the nature and amount of these claims and interests, if only because they would be negotiating with the larger and more aggressive holders of these interests. However, recent market developments—in particular credit default swaps and the phenomenon of decoupled control rights (or “empty voting”)—make it increasingly difficult to know what those positions are. If we do not know—or have the opportunity to learn in a timely fashion—the real positions of stakeholders, we may not know their real motives in the

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<sup>159</sup> Judge Gropper alludes to this when he says that the rule “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.” *Id.* at 708-709. Credibility is important, of course, but it is not clear how this filing would establish (or refute) that. What is important is simply the presence of a reasonably well organized group of otherwise unrepresented stakeholders.

<sup>160</sup> 11 U.S.C. §§ 501 & 1111 (2000) (setting forth rules on proofs of claim and interest)

case. These developments have made incentives opaque, which in turn creates a variety of system costs.

a. *Credit Default Swaps*

Consider first the problem of credit default swaps. 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 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.<sup>161</sup>

The problem with swaps of this sort is not so much moral hazard as it is one of information. We do not generally say that beneficiaries of guarantees are subject to moral hazard when they exercise their rights so as to maximize their rights against a guarantor, even if that might harm the debtor whose obligation is guaranteed. These

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<sup>161</sup> See Lubben, *supra* note 33, 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”).

swaps are not exactly guarantees, but if we believe in contract, we should expect maximizing behavior. Rather, the problem is that we will simply not know whether a creditor is party to one of these swaps, because debtors themselves are not generally parties to them. These transactions can remain entirely out of public view, yet can significantly influence how a stakeholder might behave.<sup>162</sup>

For example, in the absence of a swap of this sort, a creditor might be expected to support proposals that would maximize estate values. Thus, an unsecured or undersecured creditor would likely want a debtor to sell assets or propose a reorganization plan that produces the greatest recovery possible. If, however, the swap is triggered only if recoveries are *below* a certain amount, then the creditor that has purchased this protection will not support, and may actually oppose, value-maximizing transactions. The creditor that holds a credit default swap has effectively shorted the debtor's reorganization, and can be expected to behave accordingly.

There are ways to deal with strategic behavior of this sort. But in the first instance, the debtor and other stakeholders would have to know which creditors hold CDS rights and what triggers those rights. Nothing currently requires creditors to disclose these positions. Commentators not surprisingly believe that disclosure might be a cure here.<sup>163</sup>

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<sup>162</sup> See Hu & Black, *supra* note 33, 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.”).

<sup>163</sup> See Lubben, *supra* note 33, at 427 (“It may be that petitioning creditors should be required to disclose their swap positions as part of the involuntary petition, a change that would require an amendment to either

*b. Decoupled Control Rights*

The phenomenon of empty voting presents the potential for similar problems. 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.<sup>164</sup> They argue that control rights can increasingly be separated from economic or other rights. “Voting rights 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.’ . . . .”<sup>165</sup> 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.”<sup>166</sup>

They have argued that this problem infects not only equity, but debt. Debtors can purchase bonds and vote (or threaten to vote) to waive covenants, they argue.<sup>167</sup> Loan participations may give the lead bank voting rights far in excess of their economic stake in the debtor. These and similar market mechanisms that separate control rights from economic interests create problems of moral hazard and informational integrity. Not only

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the Code or the Federal Rules of Bankruptcy Procedure, so that courts considering petitions have some awareness if the creditors had incentives to “jump the gun” with the petition.”).

<sup>164</sup> See Hu & Black, *supra* note 33. Hu & Black have made a cottage industry of developing this insight. See, e.g., Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. \_ (2008) (collecting citations to Hu & Black on empty voting)..

<sup>165</sup> See Hu & Black, *supra* note 33, at 1.

<sup>166</sup> *Id.*

<sup>167</sup> See Hu & Black, *supra* note 33, at 17-18.

will incentives be opaque, but we might expect that creditor monitoring will decline. If creditors do not care about getting paid from the debtor, they may not engage in the sort of informational management of their borrowers that the market has come to expect.

In the case of both swaps and the more general problem of control decoupling, the critical problem is informational. And, unlike management attempts to mask self-dealing or stakeholder attempts to conceal their holdings, these are not problems that bankruptcy law is yet capable of addressing. Only a contract theory of information production applies here. Nothing in bankruptcy or other applicable law forces disclosure of these interests. Yet, knowing whether they exist and what they are can have important consequences in business failure.

#### 5. *Multi-tiered Encumbrance*

A fifth threat to information forcing within the bankruptcy system comes from the growth of multi-tiered encumbrances. There has, in the past several years, apparently been a significant increase in the amount of second- and third-lien financing, much of which is placed or held by hedge funds and other private investors.<sup>168</sup> According to one

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<sup>168</sup> See *Structured Complacency*, *Grant's Interest Rate Observer*, June 2, 2006 and Cantrell, Amanda, How hedge funds make money now, Cnn/Money, (August 4, 2006) <http://money.cnn.com/2005/08/04/markets/fastmoney/index.htm>. See also See Baird & Rasmussen, *Missing Lever*, *supra* note [], [154 U Pa. L. Rev. 1209,] 1247 (2006) (“The exclusive buyers of these [subordinated liens] are hedge funds, private finance companies, and wealthy individuals. Sophisticated professional investors are thus willing to acquire these "silent second liens" and bind themselves to the wishes of the senior lender, even though they know that the senior creditor's interests do not correspond to their own.”).

10 D’Souza, Mary, Second Lien Bank Loan Report, Bank Loan Report, February 6, 2006.

source, second lien lending increased from approximately \$430 million in 2002 to \$17.6 billion in 2005.<sup>169</sup> While this may well have been a phenomenon associated with a low interest environment, companies whose assets are so encumbered are nevertheless likely candidates for bankruptcy in the coming years.

Companies that enter bankruptcy with multiple-tiered encumbrance structures present two basic informational problems. The first, and systemically milder, problem is in understanding the relative rights of the several secured creditors. Neither the Bankruptcy Code nor the Uniform Commercial Code contains rules aimed at managing the contractual relationship between a senior and junior lien holder. The Bankruptcy Code generally respects properly perfected security interests and the priorities created at state law (assuming no preference or other avoidance problems). While the UCC sets forth elaborate default rules on the priority of security interests in personal property, it says virtually nothing about contractual arrangements among the holders of multiple liens that provide for, e.g., the subordination of one lien to the other.<sup>170</sup>

These contractual relationships can, however, be exceedingly complex.<sup>171</sup> Among other things, they may provide that the junior agrees to “stand still” during the bankruptcy case, that the senior has some (or all) right to control the claim of the junior,

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<sup>169</sup> Rob Graver, *The Benefits of Second Lien Loans*, CAPITAL EYES (Bank of America), Nov./Dec. 2006, [http://corp.bankofamerica.com/public/public.portal?\\_pd\\_page\\_label=products/abf/capeyes/archive\\_index&dcCapEyes=indCE&id=339](http://corp.bankofamerica.com/public/public.portal?_pd_page_label=products/abf/capeyes/archive_index&dcCapEyes=indCE&id=339).

<sup>170</sup> The UCC simply provides that “[t]his article does not preclude subordination by agreement by a person entitled top priority.” UCC § 9-339.

<sup>171</sup> See Jo Ann J. Brighton & Mark N. Berman, *Second-Lien Financings: Enforcement of Intercreditor Agreements in Bankruptcy*, 25 AM. BANKR. INST. J. 38 (2006).

and that the senior may collect any distributions that would otherwise be provided to the junior, until the senior has been paid in full. The problem here is not substantive: we know that these provisions will generally be enforced. Rather, the problem is informational. How can other current or potential stakeholders make judgments about the likely direction of the case if they do not understand who among the secured creditors is likely to call the shots? Subordination agreements are not generally public documents, especially if the debtor is not a party to the agreement.

Second, and more important, may be the effect that multiple encumbrances have on cash flow. In theory, pre-petition security interests do not reach assets acquired by a debtor post-petition.<sup>172</sup> The reality, however may be that if the debtor's assets are fully encumbered when it goes into bankruptcy, it may not be able to generate cash flow sufficient to fund operations.<sup>173</sup> It may seek a debtor-in-possession loan, but pre-bankruptcy secured claims are, to some extent, protected from being primed by a loan made during bankruptcy.<sup>174</sup> The economic claims of second (or third) lien holders—often the very same hedge funds that may have other claims against the debtor—may constrain the economic capacity to investigate the debtor's failure. Information, like law, is not free. If the debtor has limited cash-flow, it is not clear who will pay for this investigation.

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<sup>172</sup> 11 U.S.C. § 552(a).

<sup>173</sup> See Lichtenstein & Cheney, *supra* note 9 (unpaginated original) (“Debtors, too, may fight requests for current payments or replacement liens for second liens, which could result in decreased liquidity in bankruptcy cases.”).

<sup>174</sup> See *id.* (“Strategic DIP financing terms, such as pricing, cross-collateralization and the priority of post-petition liens, will be vigorously contested.”); 11 U.S.C. § 364.



## B. *External Threats*

These are not the only threats to bankruptcy's information-forcing function, and bankruptcy is not the only context for reorganizing troubled businesses. But if bankruptcy itself is becoming less transparent, it at least creates a system which in significant part seeks to produce information for a variety of purposes. Larger challenges to our ability to understanding financial failure may thus come not from bankruptcy, but from forces and systems outside bankruptcy.

### 1. *Complexity and the Three C's of Failure*

Major financial failures don't just happen. They require real effort. This effort often takes the form of increasing transactional complexity. Complexity is not a problem created by bankruptcy, and is thus in some respects external to the informational challenges discussed above, which are endogenous (and perhaps unique) to the bankruptcy system. Nor is complexity a problem—if it we believe it is a problem—to which bankruptcy alone can respond. Nevertheless, the growing density, fragmentation and inter-relatedness of rights and relations appears to play an increasingly important role in failure's cause and failure's cure. Yet, transactional complexity presents unique, daunting challenges to the legal system. These are challenges that bankruptcy's information forcing mechanism would seem at partially suited to address, at least ex-post.

Historically, financial failures were typically attributed to either or both of two causes: conflicts of interest among agents (a/k/a "fraud") and/or complacency. Many famous business failures have been little more than Ponzi schemes, which is to say very

pronounced conflicts of interest.<sup>175</sup> Other, more common cases, involve economic forces beyond the control of debtors and creditors—*e.g.*, interest rate or commodities shocks—who can be seen as victims of a kind of complacency. In all (or most) cases, failure could have been averted with sufficient foresight, insurance, or a more efficient distribution of rights (*e.g.*, investors would have fared better had they taken collateral to secured their loan).

Today, however, we must add a third cause of failure: Transactional complexity. Thus, the three C's of failure: Conflict, complacency and complexity.<sup>176</sup> Important financial transactions no longer merely involve buyers and sellers, or lenders and borrowers, but often many different parties subdividing rights into increasingly slender and unstable fragments. The sales of cash flows in securitizations, or structured financings, have been central to this, but are certainly not the only mechanism by which we see growing transactional complexity. Credit default swaps, collateralized debt

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<sup>175</sup> GEOFFREY C. HAZARD, JR., ET AL., *THE LAW AND ETHICS OF LAWYERING* 304-08 (3d ed. 1999) (discussing *Report of the Trustee Concerning Fraud and Other Misconduct in the Management of the Affairs of the Debtor, In re O.P.M. Leasing Servs., Inc.*, No. 81 B 10553 (Bankr. S.D.N.Y. Apr. 25, 1983)).

<sup>176</sup> See Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. (forthcoming in issue no. 2, 2008-09) [hereinafter, Schwarcz, *Meltdown*]. I had suggested this alliterative way to describe failure's causes in commenting on Professor Schwarcz's paper. See *id.* I am grateful to Professor Schwarcz for acknowledging and developing this observation. See Steven L. Schwarcz, *Complexity as a Catalyst of Market Failure: A Regulatory Inquiry* (draft of 8/05/08 on file with author) [hereinafter, Schwarcz, *Complexity*].

obligations, credit derivatives and other market developments are all examples of exceedingly complex transactions.<sup>177</sup>

Transactional complexity appears to be a growth industry, suggesting a kind of “transactional entropy”.<sup>178</sup> Transactional entropy means that transactions will tend over time to greater complexity. Because complexity breeds opacity, we face a systemic problem: people with conflicts of interest—agents—will tend to arbitrage complexity to gain at the expense of complacent investors and regulators.

This was, in many respects, the story with *Enron*—doubtless the most complex bankruptcy case filed in the modern era.<sup>179</sup> And, it would appear to be an important part

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<sup>177</sup> See Schwarcz, *Complexity*, *id.*

<sup>178</sup> “Entropy” is a term with special meaning in the information sciences. “Informational” (or “Shannon”) entropy is a measure of uncertainty associated with a random variable. See C. E. Shannon, *A Mathematical Theory of Communication*, BELL SYSTEM TECHNICAL JOURNAL, v. 27, pp. 379-423, 623-656, July, October, 1948.. According to Wikipedia, Shannon entropy “quantifies the information contained in a message, usually in bits or bits/symbol. It is the minimum message length necessary to communicate information.” See *Information Entropy*, [http://en.wikipedia.org/wiki/Information\\_entropy](http://en.wikipedia.org/wiki/Information_entropy) (visited July 9, 2008). Entropy is also associated with the second law of thermodynamics which, in simple terms, holds that closed systems will tend to disorder in an effort to find equilibrium. For our purposes, the more prosaic, non-technical meanings of “entropy” are helpful: “A measure of the disorder or randomness in a closed system. . . . A measure of the loss of information in a transmitted message. See <http://www.thefreedictionary.com/entropy> (visited July 9, 2008).

<sup>179</sup> See Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 UNIV. ILL. L.REV. 1, 5 (“the better explanation is that Enron’s structured transactions were so complex that disclosure either would have had to oversimplify the transactions or else provide detail and sophistication beyond the level of both ordinary and otherwise savvy institutional investors in Enron securities.”).

of the story in the credit crisis that began in 2007 and, as of this writing, shows no signs of abating. As William Buiter explains in a recent paper:

The financial engineering that went into some of the complex securitised structures issued in the last few years before the ABS markets blew up on August 9, 2007, at times became ludicrously complex. Simple securitisation involves the pooling of reasonably homogeneous assets, say, residential mortgages issued during a given period with a given risk profile (e.g. sub-prime, alt-A or prime). These were pooled and securities issued against them were tranced. However, second-tier and higher-tier-securitisation then took place, with tranches of securitised mortgages being pooled with securitised credit-card receivables, car loan receivables etc. and tranced securities being issued against this new, heterogeneous pool of securitised assets. Myriad credit enhancements were added. In the end, it is doubtful that even the designers and sellers of these compounded, multi-tiered securitised assets knew what they were selling, knew its risk properties or knew how to price it. Certainly the buyers did not.<sup>180</sup>

Complexity is, in some sense, a much greater problem than conflicts or complacency. This is because it is simply not clear how, if at all, the legal system could regulate it. Increasingly slender filaments of rights present an “anti-commons” problem—too many rights held by too many people.<sup>181</sup> It is tempting to think that disclosure is the answer. But it may really be the problem. More information generally increases—not

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<sup>180</sup>William H. Buiter, *Lessons from the North Atlantic Financial Crisis*, <http://www.newyorkfed.org/research/conference/2008/rmm/buiter.pdf> (draft of May 28, 2008) at 7.

<sup>181</sup> Frank I. Michelman, *Ethics, Economics and the Law of Property*, in 24 NOMOS 3, 6 (1982). Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 633–40 (1998). In an anticommons, Michael Heller has argued, multiple rights bearers are each endowed with the right to exclude others from a scarce resource, with the result that no one has an effective privilege of use. In an anticommons, “tragedy” results when “multiple owners each have a right to exclude others from a scarce resource and no one has an effective privilege of use.” Heller, *supra* at 624. I have developed the anticommons problem in the context of secured credit. See Lipson, *Remote Control*, *supra* note [], at 1409-1410.

reduces—complexity, which may not be such a good thing.<sup>182</sup> Not surprisingly, the legal response to complexity remains in its infancy.<sup>183</sup>

In part, this may be because complexity is not normatively troubling in the same ways as conflicts and complacency. Complexity, we seem to assume, is simply a feature of modern life, and financial transactions are no exception. Indeed, it is a point of pride. Smart people do complex deals; a fortiori, simple deals are only for dimwits. Our fate is transactional entropy—deals of ever growing convolution, understandable only by the smallest coterie of participants, the lawyers and bankers who may have created them.

One way to manage transactional complexity might be through bankruptcy. Bankruptcy's many information-forcing features—the “fishbowl” and “acid test,” discussed above—create mechanisms and incentives to scrutinize and test the rights ostensibly created in complex pre-bankruptcy transactions. They force parties who want to make any important decisions with respect to the debtor—from reorganizing it to liquidating it—to spell out their reasons for wanting to do so, mostly in public pleadings. The informational functions of bankruptcy, in other words, can provide ex post exposure to complex transactions which might over time promote a better understanding of them, and perhaps create incentives to structure simpler deals.

## 2. *Non-bankruptcy Reorganization*

Yet, there is no guarantee that failing businesses will be subject to bankruptcy's revelatory process at all. A second form of external threat to bankruptcy's information

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<sup>182</sup> See Barry Schwartz, *The Tyranny of Choice*, SCIENTIFIC AMERICAN, Apr., 2004, 71-75 (available at <http://www.swarthmore.edu/SocSci/bschwar1/Sci.Amer.pdf>).

<sup>183</sup> See Schwarcz, *Complexity*, *supra* note 176

function is that some business failures—sometimes very important ones—will not be addressed in bankruptcy at all.

For example, some entities are already so heavily regulated that bankruptcy as such would add little in the event of financial failure. Thus, banks and insurance companies may not be debtors under Chapter 11 of the Bankruptcy Code, even though they most assuredly may fail.<sup>184</sup> More complicated are cases involving companies that could be debtors in bankruptcy, but which, for reasons of “systemic” concern, are subjected to some alternative procedure.

The major current example involves Bear Stearns.<sup>185</sup> In Bear Stearns, the principal articulated concern was about the collapse of certain overnight capital markets. If Bear Stearns actually went into bankruptcy, institutions holding funds at Bear would withdraw those funds, leading Bear to collapse completely. This is certainly possible, and may well have been good reason to avoid a traditional chapter 11 bankruptcy.

The full story of Bear’s failure will have to wait to be told—if it is ever told. A recent paper by Markus Brunnermeier provides some insight into why the stakes might have been so high. It appears that Bear’s demise may have been precipitated in part by the Fed’s decision to create a \$200 billion term securities lending facility that would enable investment banks—including Bear Stearns—to swap mortgage-related bonds (which may have been defaulting at higher-than expected rates) for safer Treasury bonds,

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<sup>184</sup> 11 U.S.C. §109 (who may be a debtor).

<sup>185</sup> Until the Bear Stearns episode, the most famous example involved Long Term Capital Management. *See* Hedge Fund Operations: Hearing Before the House Comm. on Banking and Financial Services, 105th Cong. 22-24 (1998) (testimony of Alan Greenspan, Chairman of the Federal Reserve Board, explaining and defending the bail-out).

for up to 28 days.<sup>186</sup> According to one observer, “Some market participants might have mistakenly interpreted this move as a sign that the Fed knew that some investment bank might be in difficulty. Naturally, they pointed to the smallest, most leveraged investment bank with large mortgage exposure, Bear Stearns.”<sup>187</sup>

An email message from one of Goldman Sach’s derivatives groups on March 11 appears to have been the final straw. Apparently, Goldman informed hedge fund Hayman Capital that “it would no longer step in for clients on Bear Stearns’s derivatives deals.”<sup>188</sup> Among other things, this was interpreted to mean that Goldman would not allow nettings that would create exposure to Bear Stearns. “That news caused unease among Bear Stearns hedge fund clients, and many of them fled,”<sup>189</sup> Bear Stearns thus faced the equivalent of a bank run.

With about 150 million trades spread across various counterparties on the books, the firm’s potential bankruptcy also posed a significant systemic risk. On Thursday, March 13, Bear Stearns’s management contacted officials from the Federal Reserve Bank of New York. By early morning on Friday, March 14, the New York Fed had agreed to provide emergency financing to Bear Stearns via JPMorgan Chase for up to 28 days. JPMorgan Chase was used as a conduit, since as a commercial bank it is under the Fed’s

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<sup>186</sup> See Markus K. Brunnermeier, *Deciphering the 2007-08 Liquidity and Credit Crunch*, \_\_J. ECON PERSP. \_\_ (forthcoming 2008) (draft available at <http://www.newyorkfed.org/research/conference/2008/rmm/Brunnermeier.pdf>) (at p. 17 of draft).

<sup>187</sup> Id.

<sup>188</sup> Id.

<sup>189</sup> Id.

supervisory authority. It also has access to the Fed's discount window and, as Bear Stearns's clearing bank, has good knowledge about Bear Stearns's repo transactions.

The idea was to keep Bear Stearns going through the weekend in order to have enough time to organize a takeover before the markets opened in Asia on Sunday evening. New York Fed officials and bankers from JPMorgan Chase worked over the weekend to evaluate Bear Stearns's positions. Initially, market rumors mentioned J.C. Flowers, a private equity fund, as a second bidder, but as time passed it became clear that a takeover by JPMorgan Chase would be the preferred option to minimize the systemic risk. Bear Stearns was simply too interconnected to be allowed to suddenly fail. A big party had to step in to minimize counterparty credit risk. At that point, Bear Stearns had little bargaining power left and it was agreed that J.P.Morgan Chase would acquire Bear Stearns for US\$ 236 million, or US\$ 2 per share.<sup>190</sup>

But what no one stopped to consider was what was lost by keeping Bear out of bankruptcy. At least one thing lost was transparency: We have very little idea today why Bear collapsed, whether the Fed-financed JP Morgan bailout was cost justified, or whether Bear might have had causes of action against managers or counterparties (e.g., hedge funds).

A bankruptcy case, by contrast, would likely have produced an enormous amount of information. Since bankruptcy examiners—the ultimate information-forcers—are frequently appointed in high profile cases involving large debtors (e.g., *Enron*, *Refco*), it is reasonable to surmise that one would have been appointed in a Bear Stearns bankruptcy. The examiner would then have done what examiners do—which is to produce a large, detailed report that does exactly what Congress thought examiners should do: explain the failure to the investing public.

This did not happen in Bear Stearns, and we can only speculate why. Perhaps the hedge funds that were involved with Bear paid their managers exorbitant salaries,

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<sup>190</sup> Id. at \_\_ (draft at 18).



regardless of their performance.<sup>191</sup> Perhaps Bear made serious mistakes in creating or maintain markets for securities that really defied economic sense, e.g., the failed market in “auction-rate” securities.” Perhaps Bear simply oversold or undersold its assets or its liabilities.

Today, there are only two ways we can know the answer to these or related questions: First, Bear (via its acquiror, JP MorganChase) may voluntarily agree to disclose these matters. It is, for example, possible that Bear disclosed any such problems to JP MorganChase in the acquisition process. It is, however, equally possible that the forced nature of the marriage may have created opportunities to short-cut disclosure. JP Morgan may not have cared as much about what Bear had really done, knowing that the Federal Reserve had agreed to absorb certain Bear losses.

Second, Bear may be forced to disclose this or similar information in piece-meal litigation. The adversarial model may produce some information. But it will be at a significant economic cost, and may do little to shed light generally—or to the public—on what went wrong in a larger organizational sense. The information produced in litigation will be about the litigation, not the failure generally.

It bears noting that an examination of the sort that might occur in bankruptcy may not be cost-justified. The actual result in Bear may, in fact, be as good as it gets. But we will not know because there are likely to be no independent information-forcing analyses like those that typically accompany a bankruptcy reorganization.

### III. *What's at Stake*

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<sup>191</sup> See James Surowiecki, *Performance-Pay Perplexes*, THE NEW YORKER, Nov. 12, 2007, 34 (“fund managers reap large rewards on the upside without a corresponding punitive downside”)

The goal of processes to address financial distress is ultimately economic. Stakeholders of a failed company want to get paid. Information is always a secondary and instrumental concern. Creditors and shareholders of companies in bankruptcy do not collect gossip—they want money. Yet, bankruptcy under Chapter 11 has made aggressive attempts to force information into the open because it recognizes that information is a necessary intermediate step in resolving financial distress. Stakeholders cannot make the adjustment bankruptcy asks them to make in the dark. The important question therefore is not *whether* the system should produce information, but how, and for whom?

The manipulation of information in bankruptcy has a number of costs. Two fairly obvious ones will be inappropriately depressed asset prices and increased transaction costs that stem from trying to figure out various stakeholders' real motives.

A. *Capital Asset Price Depressions*

Professors LoPucki and Doherty have suggested that asset sales involving large, publicly-traded corporate debtors have been highly depressed.<sup>192</sup> They have argued that conflicts of interest among investment bankers and the absence of competition among courts for large cases may explain this effect.<sup>193</sup> This may well be true. But another

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<sup>192</sup> See LoPucki & Doherty, *supra* note 5, 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”).

<sup>193</sup> *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

possibility is informational: the parties—in particular, creditors or other potential bidders—lack the information to generate greater value.<sup>194</sup>

Those who control the debtor will have a unique capacity to control information about the debtor. This may be management; it may be the investors who owned the company before bankruptcy; it may be senior creditors who have the capacity to change management or shut the company down; it may be the investment bankers who are charged with generating the most important information of all—the value of the assets. In any case, their decisions about how to manage information about the debtor’s value must affect the market for the debtor’s assets. If, as LoPucki and Doherty suggest, there is collusion among management and acquirors, that collusion requires an effective strategy to cloak important information about the transaction.

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.*<sup>195</sup>

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frequently had conflicts of interest. So did the investment bankers who advised the managers and solicited bids.”).

<sup>194</sup> 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.”).

<sup>195</sup> *Id.* at 33-34.

The ability to sell a company like Polaroid depends in the first instance on liquidity, and information alone will not produce cash where there is none. It may be that the company was in such desperate straits that without this transaction, the assets would have been auctioned piecemeal, producing even worse values for creditors.

But the failure to disclose managers' true stake in the deal in a timely fashion suggests that their incentives might have been askew. If so, how reliable would their data about cash flow have been? How would the creditors or judge, who accede to the sale, know? After the fact, of course, there may be some form of accounting that brings the truth to the surface. But by then it may be too late.

What would happen with better informational practices? If we accept the proposition that there is a market for investments in, and the assets of, distressed companies, then the answer is simple: It should improve the efficiency and effectiveness of the market.<sup>196</sup>

#### B. *Unpredictable Incentives*

Perhaps the greatest informational problem we face in bankruptcy is not that private investors want to arbitrage information asymmetries to buy assets at fire sale prices, but that in many cases, their real incentives will be unknown and unpredictable. As discussed above, bankruptcy rules currently require ad hoc committees to report their

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<sup>196</sup> This may not always produce higher values. Indeed, a better informed market may conclude that the company is actually worth less than management, investors and senior stakeholders contend. But if we believe that in the long run market transparency and a level informational playing field produce more robust bidding, then decisions about the control of information will inevitably influence the valuations obtained in reorganization.

collective status (and purchase price positions) publicly; rules on claims trading requires the holder of the claim to show declare its position too, although not its economic basis. These rules have been justified, at least in part, as policing a potentially (and historically) corrupt system.

But the problems presented by credit default swaps and control decoupling are ultimately problems that can be addressed by disclosure. The extent of these problems will be unknown because private investors' positions are not currently required to be disclosed. If they are invested in multiple positions around the fulcrum, management and other stakeholders will have little ability to predict which class of rights the investor will want to promote. In a simpler world, we might expect the investor to promote those actions that maximize firm value, so that if they have an equity stake, it will recover something. If equity recovers then, a fortiori, other senior positions held by the investor will also be worth something.

But the investor may believe that equity is worthless and a senior position will be converted into new equity. If the investor also holds a sufficiently large amount of this senior position, maximizing equity may not be worthwhile; converting the senior position to new equity would produce a better outcome.<sup>197</sup> The investor would thus be willing to sacrifice its equity position to enhance the value of a more senior claim. Other equity holders may not be so diversified, but their stock would be cancelled all the same. Unless

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<sup>197</sup>As two practitioners observe:

Previously, bankruptcy reorganizations were largely influenced by traditional financial institutions, which had a vested interest in their customer's affairs and having them remain in business. The goals of hedge funds, however, diverge from those of conventional lenders. Instead of restructuring or refinancing troubled loans, distressed investors holding senior-lien positions may seek more immediate recoveries through asset sales., unlike traditional bond holders or junior lenders with subordinate lien positions, today's second-lien holders are not necessarily concerned with repayment, but are comfortable converting their debt into equity.

See Lichtenstein & Cheney, *supra* note 9 (unpaginated original).

we know the amount and position of a private investors' stake, it will be difficult to know their real motives. The costs here might be in reduced recoveries, or increased costs, or both.

The point here would be to promote disclosure not for its own sake, but with an understanding of the demand side of the informational equation. Forcing parties to disclose information that promotes meaningful, vigorous bidding is unquestionably appropriate, and managers should not be permitted to mask their relationships and true incentives. Forcing parties to disclose their full and true sets of rights against a debtor can only improve the integrity and quality of the negotiations that bankruptcy reorganization is designed to promote.

#### IV. *Tentative Recommendations*

A casual reader may believe that I think more information will cure all ills. In fact, however, I think that is wrong. The important questions are not about the quantity of information, but the quality of information and—most important of all—figuring out how to set rules to assure that the legitimate informational goals of the system are met. If anything, blind reliance on “more” information got us into the credit crisis of 2007-2008. But information production is always a two-sided equation that requires us to ask about both the supply of and demand for information.<sup>198</sup> Like the regulation of securities law—

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<sup>198</sup> Compare Paredes, *supra* note 17 at 432 (“[D]isclosure of information is not enough for a disclosure-based regulatory system to succeed. Investors, 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”) with David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277, 278,

“disclosure and more disclosure”—the focus of bankruptcy’s information forcing rules has been on the supply side, not the demand side.

But as anyone who has ever tried to read a disclosure statement approved in a major case knows, these documents are likely to be no more reader-friendly than the average Form 10K or registration statement on Form S-1. Which is to say that it is improbable that “average” creditors (or shareholders) will read these documents, or act on proprietary information about hedge funds. Rather, they are likely to rely on the guidance of experts. These experts will overlap with, but not be identical to, the experts who populate the world of securities law disclosures, e.g., securities analysts, money managers, institutional investors, sophisticated individual investors, arbitrageurs, brokers, and other securities market professionals and financial intermediaries.<sup>199</sup> One of the many complicating factors in bankruptcy is that the experts whose actions will often matter most will be unregulated private investors. Being unregulated, however, we have little insight into how they will filter sophisticated bankruptcy reorganization information, or how they manage (or are affected by) compromising agency and moral hazard conflicts.

*First*, we should recognize that the unusual context and contours of reorganization probably demand a different approach to information than legal theory has thus far offered. Bankruptcy is a collective process with a (hopefully) finite duration. Its primary

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287-94 (1986). *See also* Jonathan Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficiency of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329 (2003) (discussing demand for securities-related information).

<sup>199</sup> *See* Paredes, *supra* note 17, at 452-59 (discussing experts and the filtering function they perform in securities markets)

goals are remedial—to maximize creditor recoveries and rehabilitate the debtor. These goals are fundamentally different from those of the private contract system, the adversary system or the mandatory disclosure rules of the federal securities laws.

*Second*, taking seriously the role that information plays in the reorganization of failed firms requires us to take seriously both the supply of information and the demand for it. There is a burgeoning literature on cognitive science and decision-making in the presence of large amounts of complex information. To the extent that bankruptcy law has taken this information into account, it has done so principally to gain insight into debtor and stakeholder behavior. This literature might tell us that more disclosure is better, or that some disclosure is pointless, or that information should be controlled and distributed by courts in ways that we currently cannot imagine.

*Third*, we should bear in mind the costs of information. Information, like law, is not free. In bankruptcy, the cost of information is often born by the debtor. Sometimes those costs can be considerable. In *Enron*, for example, the examiners final fee applications awarded compensation approaching \$100 million.<sup>200</sup> The problem with

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<sup>200</sup> A review of the dockets in *Enron* indicates that the examiners and their professionals billed in excess of \$100 million. The orders granting fees to the examiners and their professionals were entered 2/15/2006 (Docket No. 28924) and 3/6/2006 (Docket No. 29054), respectively. The final fee-granting order (to any professional) was entered 8/10/2006 (Docket No. 30095). Although “examiner’s” fees are not the subject of the final order, it does contain a summary of compensation for all professionals involved. The following figures represent [Professional] [Fee] + [Expenses] = [Total]

|   |   |
|---|---|
| Harrison J. Goldin and Goldin Associates, LLC | 11,627,568.75 + 1,601,621.50 = 13,229,189.50  |
| Neal Batson and Alston & Bird LLP             |   |
| Neal Batson, Esq.                             | 1,809,810.25 + 10,325.95 = 1,820,136.20       |
| Alston & Bird LLP                             | 71,066,038.04 + 14,577,275.89 = 85,643,313.93 |
| Combined                                      | 72,875,848.29 = 14,587,601.84 = 87,463,450.13 |
| Other Professionals Retained by Batson:       |   |
| Plante & Moran PLLC                           | 6,185,693.99 + 476,834.20 = 6,662,528.19      |
| George J. Benston, Ph.D.                      | 420,452.50 + 1,502.00 = 421,954.50            |



information is that, in some very fundamental sense, we do not know whether a rule that requires an investigation or a party to reveal information about itself will be cost-justified.

*Fourth*, we should recognize the public interest in understanding the causes and consequences of failure. Even if bankruptcy is now a more market-driven process than it once was—and even if that is a good thing—bankruptcy is not exclusively a private process. Especially in the case of large businesses, failure has broad social consequences. Usually, if we think about those social consequences at all we focus on those that are more tangible, such as: How many jobs are lost because the company liquidates rather than reorganizes? But merely recognizing the role that information forcing plays in reorganization would be a start. The policy decisions we make about informational rules will affect both private and public interests.

#### *Conclusion*

This paper has presented a problem not a solution, a question not an answer: How should the law of financial failure address a rapidly changing market for information about distressed companies? It has shown that Chapter 11 of the Bankruptcy Code creates an information system that is unique in the sense that it does not fit comfortably within any of the three dominant responses to information asymmetry, viz, contract, adversity and mandatory disclosure, but is also being challenged by market forces, including the power of private investors and the development of an unregulated securities market for claims against corporate debtors.

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Al Hartgraves, Ph.D.  
Combined

$401,340.00 + 88.00 = 401,428.00$   
 $7,007,486.49 + 478424.2 = 7,485,910.69$

While the paper has made some tentative recommendations, the most basic and important is simply to recognize the informational values at stake in reorganization. Only in this recognition will we have a more coherent and productive discussion about what the rules should be, and why. That discussion should, among other things, account for the costs and benefits of the dominant informational models, and make sense of them in bankruptcy. The discussion may suggest we use those models in a more conscious way. It may suggest that bankruptcy reorganization is informationally unique, and warrants an entirely different approach. We are only beginning to recognize the new informational challenges we will face when businesses fail. We should take these challenges seriously. The future of failure depends on it.

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