PASSIVE CLAIMS TRADING, THE UNSOPHISTICATED CREDITOR, AND ONLINE EXCHANGES AS A MARKET REMEDY

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I. Introduction

The years immediately following the financial crisis of 2008 witnessed unparalleled value destruction in global commerce and finance.[1] However, the crisis boosted the market for distressed debt, creating vast opportunities for the few firms with the enviable luxury of liquid capital.[2] The number of public and private companies defaulting on their debt[3] and declaring bankruptcy ballooned in

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[1] Robert Frank, *World's Rich have Lost $10 Trillion in Global Financial Crisis*, WALL ST. J. WEALTH REP. (Apr. 3, 2009, 1:55 PM), http://blogs.wsj.com/wealth/2009/04/03/worlds-rich-have-lost-10-trillion-in-global-financial-crisis/ ("[T]he world's rich have lost $10 trillion, or a quarter of their wealth, in the global financial crisis, according to Oliver Wyman, a consulting firm. That is about equal to the combined economic output of Japan, Germany[,] and China.").

[2] *See, e.g.*, Kelly DePonte, *An Overview of the Private Equity Distressed Debt and Restructuring Markets*, PROBITAS PARTNERS RES. (Probitas Partners, San Francisco, Cal.), 2010, at 10, http://probitaspartners.com/pdfs/Distressed+-+Overview.pdf ("The latest market cycle has been named by some the 'financial bubble', whose bursting has led to the largest global recession since the Great Depression and a potentially huge opportunity for the distressed debt and restructuring sector."); Richard G. Mason et al., *Private Equity, Restructuring and Finance Developments*, HARV. L. SCH. CORP. GOVERNANCE BLOG (Watchel, Lipton, Rosen & Katz, New York, N.Y.), Jan. 20, 2009, at 1, http://blogs.law.harvard.edu/corpgov/files/2009/01/trading-in-distressed-debt.pdf ("[F]or the survivors of 2008's financial hurricane, 2009 also could be a year of unprecedented opportunity. Bank debt and bonds of good-quality companies are trading at historic lows. Hedge funds that have withstood the wave of investor redemptions, and private equity firms that have raised massive amounts of new capital but see few traditional investment outlets, may explore (or, for the veterans, reenter) the distressed debt market.").

[3] DePonte, *supra* note 2, at 7 fig.1.1.

2009.[4] This activity fueled the market for claims against distressed companies, and several entrepreneurial firms utilized online platforms to bring together more buyers and sellers of bankruptcy claims at online exchanges[5]—SecondMarket[6] and One Exchange Street[7] in the United States and IlliquidX[8] in Europe. These firms and their competitors[9] enabled the community of distressed sellers to

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[4] Lynn LoPucki, *Large, public company bankruptcies filed in the United States, by year, 1992 – 2012*, UCLA-LOPUCKI BANKRUPTCY RESEARCH DATABASE, http://lopucki.law.ucla.edu/tables_and_graphs/Filings_by_year.pdf (last visited Mar. 12, 2013).

[5] *See, e.g.*, Press Release, IlliquidX, $1BN of Lehman Debt Traded On IlliquidX Platform Over the Past 18 Months (Mar. 16, 2011), *available at* http://www.illiquidx.com/news/ lehman_claims_trading.php ("IlliquidX . . . reports trading volume of over $1bn of Lehman creditor claims since the beginning of 2010 in more than 120 separate transactions. This confirms the position of IlliquidX as a leading independent player in this asset class in Europe, with an established and growing franchise. In 2011 alone, IlliquidX achieved a 1.3%+ global market share in Lehman claims trading, based on $9bn traded globally, representing circa 3,000 claims, between January and April 2011."); Press Release, SecondMarket, SecondMarket to Trade Lehman Bros. Bankruptcy Claims (Sept. 25, 2008), *available at* https://www.secondmarket.com/education/news/releases/secondmarket-to-trade-lehman-bros-bankruptcy-claims ("SecondMarket, the largest marketplace for illiquid assets, announced today that effective immediately it will begin trading bankruptcy claims created by the Lehman Brothers Holdings Inc. Chapter 11 filing. With $639 billion in assets and more than 100,000 creditors, the Lehman Brothers bankruptcy is the largest in the U.S. to date. . . . SecondMarket expects to trade a variety of unsecured claims resulting from the Lehman Brothers bankruptcy, including structured product, trade, lease and contract rejection, employment and other unsecured claims. Lehman Brothers listed total liabilities of $613 billion in its bankruptcy filing.").

[6] *See Bankruptcy Claims*, SECONDMARKET, https://www.secondmarket.com/bankruptcy-claims (last visited Mar. 12, 2013).

[7] *See Why One Exchange Street?*, ONE EXCHANGE STREET, http://www.oneexchangestreet.com/static/why_one_exchange_street (last visited Mar. 12, 2013) ("The Online Platform for Trading in Bankruptcy Claims.").

[8] *See Bankruptcy Claims*, ILLIQUIDX, http://www.illiquidx.com/bankruptcy_claims.php (last visited Mar. 12, 2013).

[9] *How SecondMarket Helps Stockholders of Startups Like Facebook and Twitter Cash in Their Shares*, PBT CONSULTING (Nov. 6, 2010), http://tommytoy.typepad.com/tommy-toy-pbt-consultin/2010/11/how-secondmarket-helps-stockholders-of-startups-like-facebook-and-twitter-

rapidly and to efficiently unload a variety of financial claims and commitments, ranging from bankruptcy claims to limited partnership interests in private investment funds.[10]

Distressed debt encompasses a broad swath of debt and equity securities of solvent corporations as well as claims against corporations in bankruptcy.[11] When a company enters into bankruptcy protection, creditors with claims against the corporation are allowed to transfer their claims, which distressed investors and other creditors may happily exchange for some consideration.[12] Trading a bankruptcy claim thus enables a creditor to avoid waiting

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cash-in-their-shares.html (identifying the following firms as competitors in the trading of illiquid assets: SecondMarket, SharesPost, Grant and Thornton, IlliquidX, BNY Mellon, and the "thousands of wealth or asset management firms, hedge fund management firms and stock brokerage firms specializing in private placements and trading of illiquid assets").

[10] Press Release, IlliquidX, *supra* note 5 ("Bankruptcy claims-trading enables creditors with claims against bankrupt companies to sell their interests to investors before the conclusion of a bankruptcy case. While this is a mature market in the US, it is still a growing one in Europe, and the Lehman Brothers bankruptcy, as well as the Icelandic banks collapse, has helped this niche market develop on this side of the Atlantic. That said, the appetite for a market in illiquid assets is growing fast with many private equity houses and hedge funds raising significant sums from their clients to invest in the distressed market. They are now meaningful providers of liquidity in a market where traditional market makers and proprietary desks of some investment banks have disappeared. IlliquidX is playing a pivotal and unbiased role by stepping in to fill the void."); Press Release, SecondMarket, s*upra* note 5 ("In addition to bankruptcy claims, SecondMarket trades auction-rate securities, restricted securities in public companies and other illiquid assets. SecondMarket's online trading platform has more than 1,500 members, including global financial institutions, hedge funds, private equity firms, mutual funds, and other institutional and accredited investors that collectively manage over $250 billion in assets available for investment.").

[11] *Distressed Securities*, INVESTOPEDIA, http://www.investopedia.com/terms/d/distressedsecurities.asp (last visited Mar. 22, 2013) ("A financial instrument in a company that is near or is currently going through bankruptcy. This usually results from a company's inability to meet its financial obligations. As a result, these financial instruments have suffered a substantial reduction in value. Distressed securities can include common and preferred shares, bank debt, trade claims (goods owed) and corporate bonds.").

[12] *See infra* Part II (providing an overview of claims trading).

for a distribution when the debtor's plan of reorganization is eventually confirmed.

Legal commentators have tracked the growth of distressed debt investing generally, and bankruptcy claims trading in particular, for the past two decades.[13] Much of this literature brings attention to

[13] *See, e.g.*, Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155 (2011) [hereinafter Harner, *Barbarians*] (examining activist distressed investors and proposing that the Williams Act require disclosure of a material position in a company's debt); Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648 (2010) [hereinafter Baird & Rasmussen, *Antibankruptcy*] (discussing the shift in bankruptcy from coalition building into an anticommons gridlock in which too many owners with disparate interests fail to reach efficient or timely resolution); Jonathan C. Lipson & Christopher M. DiVirgilio, *Controlling the Market for Information in Reorganization*, 18 AM. BANKR. INST. L. REV. 647 (2010) (contending the policy concerns underlying reorganization differ from those motivating general securities regulation and concluding reorganization requires a unique set of laws pertaining to the availability and disclosure of information); Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. FIN. & COM. L. 23 (2009) [hereinafter Baird, *The Bankruptcy Exchange*] (discussing the policies and incentives behind disclosure in markets and applying those lessons to the claims trading in the bankruptcy process); Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67 (2009) (challenging Baird and Rasmussen's anticommons thesis by pointing to the lack of an empirical basis and advancing an alternative theory that claims trading may in fact reduce the number of involved parties and foster negotiation); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1611 (2009) (describing third party involvement in reorganization process); Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008) [hereinafter Harner, *Corporate Governance*] (detailing the ways in which distressed debt investing has changed the reorganization process); Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69 (2008) [hereinafter Harner, *Trends*] (analyzing results from one of the only empirical studies of distressed debt investors); Paul M. Goldschmid, Note, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191 (2005) (arguing that distressed debt investors are the optimal residual actor in the bankruptcy process); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) [hereinafter Baird & Rasmussen, *Twilight*] (arguing traditional

two observations. First, bankruptcy claims trading has fundamentally altered Chapter 11 corporate reorganization.[14] The relationship-based negotiation between a debtor and its primary lender has given way to a dynamic competition between distressed investors.[15] Distressed debt firms build positions in all tranches of the debtor's capital structure and seek to maximize their distribution under the plan of reorganization.[16] These firms apply both activist restructuring

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reorganization is not suited to modern businesses); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003) (discussing corporate governance in context of trading bankruptcy claims); Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?,* 10 AM. BANKR. INST. L. REV. 569 (2002) (cataloguing the overlap and interaction of bankruptcy and federal securities laws); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 778–89 (2002) [hereinafter Baird & Rasmussen, *End of Bankruptcy*] (discussing control rights in reorganization); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684 (1996) (examining claims trading and proposing an equitable injunction on trading prior to plan confirmation); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990) (presenting analysis of the mechanics of claims trading and its potential benefits for the bankruptcy process).

[14] *See* Baird, *The Bankruptcy Exchange*, *supra* note 13, at 37 ("The bankruptcy forum has gone through dramatic evolution since the adoption of the Bankruptcy Code in 1978. It is no longer a sleepy place where traditional lenders and entrenched managers try to come to terms. In implementing the Bankruptcy Code, the modern bankruptcy judge creates a marketplace from scratch every time a large case is filed before her.").

[15] Baird & Rasmussen, *Antibankruptcy*, *supra* note 13, at 670 ("Banks and hedge funds, though owning the same instrument, often have drastically different business models. Banks are repeat players. A bank can have a relationship with a business that lasts for decades. The bank provides a large suite of services beyond simply making the loan. In addition, commercial norms and its reputation constrain its conduct in any particular relationship. While it might, for example, have the legal right to call a loan in default, commercial norms and its concern about its reputation with other borrowers may lead it to waive the covenant. A hedge fund, by contrast, has a limited life, provides no services, and acts under no reputational constraints.").

[16] *Id.* at 651 ("Dozens of constantly changing stakeholders occupy every tranche, each pursuing its own agenda."); Harner, *Trends*, *supra* note 13, at 70 ("These [distressed] investors are purchasing positions in multiple tranches of the debtor's capital structure, obtaining seats on the statutory committee of unsecured creditors and even acting as the debtor's post-

strategies, such as replacement of management, debtor-in-possession financing, and debt for equity swaps to gain control of the debtor and its plan of reorganization, as well as passive strategies, such as arbitrage, short-term trading, and hedging through credit default swaps.[17]

Second, legal commentators have observed that bankruptcy claims trading has largely avoided formal regulatory treatment under the Bankruptcy Code[18] and the federal securities laws.[19] Bankruptcy

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petition lender. The latter role has given rise to a practice known as 'loaning to own,' where the investor extends debtor in possession financing to the debtor in order to facilitate the investor's eventual ownership of the debtor's business, through a debt-for-equity exchange, sale transaction or otherwise.").

[17] Harner, *Trends*, *supra* note 13, at 82–86 (identifying three distressed investment practices as (1) pursuing an exchange of debt for equity, (2) selling debt before maturity or redemption, and (3) pursue payment of debt at maturity or redemption; and identifying three distressed investment strategies as (1) investing in distressed debt to acquire control of the debtor, (2) investing in distressed debt to influence board or management decisions at the company, and (3) investing in distressed debt for a strategy not involving control or influence); Goldschmid, *supra* note 13, at 212 ("Distressed investors commonly purchase relatively low-yielding bank loans and bonds with a high probability of eventually being converted into equity positions that can provide much higher rates of return if the bankruptcy reorganization is successful and if the company emerges from bankruptcy with revitalized earnings power."); *id.* at 264 ("The distressed debt investment is an informed wager that the company is worth more if taken out of the control of widely syndicated debt holders, potentially given new management, and run by operations-minded strategic investors.").

[18] Baird & Rasmussen, *Antibankruptcy*, *supra* note 13, at 659 ("The ability to trade in claims against a Chapter 11 debtor began to take hold in the 1980s. At that time, however, some courts interpreted the Bankruptcy Rules to allow them to review claim trades and ensure that those selling them received full disclosure. In 1991, however, the Rules Committee decided to deregulate claims trading, as existing judicial oversight was perceived to impair the liquidity of claims. This newly deregulated market for claims provided opportunities that the highly regulated market for acquiring control through equity did not.").

[19] *Id.* ("In 1991, however, the Rules Committee decided to deregulate claims trading, as existing judicial oversight was perceived to impair the liquidity of claims."); Drain & Schwartz, *supra* note 13, at 572 ("Indeed, 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

judges exercise little discretion over claims trading, relying on a few Bankruptcy Rules of Procedure[20] and general powers of equity[21] in a bankruptcy case.

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distressed claims that is *not actively regulated*."); Michael H. Whitaker, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL'Y 303, 319 (1994) ("Neither the Securities Act nor the Securities Exchange Act includes a claim arising out of bankruptcy in its definition of a security. Although a claim is not listed in either definition, the definitions are broadly written and have been interpreted broadly by the courts. In fact, the Supreme Court describes the Securities Acts' definitions of securities as 'sufficiently broad to encompass virtually any instrument that might be sold as an investment.' The broad reading given to these definitions has not been extended to claims in bankruptcy. The Securities Act of 1933 comes closest by including 'evidence of indebtedness' in its definition of a security. No court, however, has held that a Chapter 11 claim qualifies as a security under this definition.").

[20] FED. R. BANKR. P. 3001(e) (addressing claims transfers and proof of claim); FED. R. BANKR. P. 2019 (requiring disclosure of an economic interest in the debtor by any creditor participating in a formal or ad hoc creditors' committee). Prior to the 2011 amendment of Rule 2019, the opportunity for an ad hoc committee of distressed investors to purchase claims while privately establishing a net short position against the reorganized debtor exposed a troubling gap in bankruptcy disclosure requirements. Without sufficient disclosure, judges could not fairly evaluate each creditor's intentions when participating in plan confirmation. A net-short creditor, seeking to realize the benefit of a private contract, might vote for a suboptimal plan or reject an efficient and equitable plan while looking to the private contract for ultimate distribution. The amendment of Rule 2019 addressed this problem for groups of creditors but failed to close the gap completely for individual creditors exploiting this strategy. For a critique of amended Rule 2019 and an argument for expanding its reach and disclosure obligation beyond groups of creditors to any individual claim holder who votes for or opposes a plan, see Samuel M. Kidder, Note, *What's Your Position? Amending the Bankruptcy Disclosure Rules to Keep Pace with Financial Innovation*, 58 UCLA L. REV. 803, 804 (2011). *See also* Jennifer Albrecht, Note, *New Bankruptcy Rule 2019: Boon or Bane for Distressed Investors?* 2011 COLUM. BUS. L. REV. 717 (2011).

[21] *See* 11 U.S.C. § 105(a) (2006) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to

Though legislators have allowed claims trading to enjoy unregulated status, some legal commentators have criticized claims trading, pointing to its harmful effects on the bankruptcy process[22] and calling for greater regulation of the practice.[23] Professor Douglas Baird observes that the normative debate over claims trading has reached its zenith, and he concludes that "[w]e should accept that it has become a fundamental feature of bankruptcy."[24] Professor Adam Levitin adds that a broader normative debate about the role of bankruptcy is "of little use in formulating policy on claims trading realities. Instead, by examining claims trading for what it is—a diverse collection of practices and markets—rather than as a meme for normative ideas, we can better understand how claims trading affects bankruptcy and determine which claims trading practices should be encouraged."[25] Heeding Levitin's advice, this Note focuses on a discrete piece of the claims trading universe. It examines claims trading between passive investors and unsophisticated creditors, and explores the relationship between these two groups. From a normative standpoint, then, this Note endorses a favorable view of claims trading between passive investors and creditors for the bankruptcy process, but does not address the broader debate about claims trading generally.

This Note analyzes passive-strategy claims trading and argues that, in the context of the existing rules of bankruptcy procedure, online exchanges lend new justification for a regulation-free environment aimed at passive claims traders. Importantly, this Note does not address the regulatory debate surrounding active-strategy claims trading, which many commentators have already thoughtfully analyzed.[26] Part II provides a brief overview of claims

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enforce or implement court orders or rules, or to prevent an abuse of process.").

[22] *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 13, at 687–698.

[23] Tung, *supra* note 13, at 1748–52 (proposing that after an initial period of unrestricted claims trading, a debtor be entitled to petition the court for an equitable trading injunction); Whitaker, *supra* note 20, at 339–41 (proposing mandatory disclosure of the terms of claims trades including price as well as the identity and interests of the buyers).

[24] Baird, *The Bankruptcy Exchange*, *supra* note 13, at 23.

[25] Levitin, *supra* note 13, at 112.

[26] *See* Harner, *Barbarians*, *supra* note 13, at 196 (proposing disclosure requirements on any investor who establishes a material position in a corporation's debt); *see also* Baird, *The Bankruptcy Exchange*, *supra* note

trading, focusing especially on the years following the financial crisis. Part III asserts that, from a regulatory perspective, bankruptcy claims trading by distressed debt investors can, and should, be classified into two categories: (1) *active*—meaning any strategy whereby an investor seeks to control or influence the debtor or its plan of reorganization—and (2) *passive*, meaning any other strategy.[27] Part IV summarizes the mechanics of claims trading.

Part V introduces the most significant problem raised by claims traders with an exclusively passive strategy, namely, the problem of the unsophisticated creditor. This Part examines this problem in a comparative context by looking at markets and accompanying regulation for securities and derivatives. Finally, this Part concludes that the problem of the unsophisticated creditor is too insignificant to warrant regulatory interference in the private contractual context of claims trading. Part VI argues that online exchanges for bankruptcy claims reduce risk for unsophisticated creditors.[28] This market remedy (1) further justifies a flexible environment for passive claims traders and (2) cuts against

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13, at 35 (discussing the policies rationale for disclosure by market participants).

[27] For an excellent overview of claims trading strategies and examples of each, see Harner, *Trends*, *supra* note 14, at 82–86 (documenting the primary investment strategies based on survey results); *see also* discussion *infra* Part III.

[28] Press Release, Restricted Stock Partners, Restricted Stock Partners Acquires T-REX; Adds Bankruptcy Claims to Online Trading Platform (June 9, 2008), *available at* http://www.reuters.com/article/2008/06/09/idUS124732+09-Jun-2008+PRN20080609 ("Competitive bidding for such claims through the RSTN will enable sellers to receive a fair market price. Potential buyers will benefit from easy online access to a broad range of bankruptcy claims to which they otherwise might not have had access. Bankruptcy claims can be listed for sale on the RSTN at no cost and potential purchasers can become members free of charge. As with all securities traded on the RSTN, the entire documentation and settlement process for claims transactions will be handled by Restricted Stock Partners. A transaction fee is deducted from the proceeds upon completion of a sale . . . . 'By acquiring T-REX, we will improve efficiency and transparency in the trade claims market, similar to our efforts with restricted securities and auction-rate securities,' Silbert said. 'As an independent secondary market, the RSTN will help unsecured creditors obtain liquidity for bankruptcy claims, while providing attractive opportunities for investors seeking to participate in this growing market.'").

commentators' proposals for heightened disclosure by claims traders as a solution to the unsophisticated creditor problem.[29]

Part VII addresses two potential concerns about the accelerated pace of claims transfers through online exchanges. First, will the debtor be able to keep track of claims and claim holders? Narrowly tailored trade orders appear to sufficiently address this problem.[30] Second, will faster turnover of claims hinder the negotiation necessary to confirm a plan of reorganization? Part VIII endorses a simple recommendation from other scholars to revise existing bankruptcy notice requirements. Creditors should be notified of the opportunity to trade claims on an online exchange and the benefits of utilizing an exchange. Part IX concludes that passive claims trading in the context of online exchanges benefits the reorganization proceeding, aligns with bankruptcy policy goals,[31] and

[29] For proposals to amend Federal Rule of Bankruptcy Procedure 3001(e) so as to require additional or complete disclosure, see Whitaker, *supra* note 19, at 339–41 (proposing mandatory disclosure of the terms of claims trades including price as well as the identity and interests of the buyers); W. Andrew P. Logan III, Note, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e) (2)*, 2 AM. BANKR. INST. L. REV. 495, 496 (1994).

[30] *See, e.g.*, Motion for Interim and Final Orders Pursuant to sections 105, 362 and 541 of the Bankruptcy Code and Bankruptcy Rule 3001 Establishing Notification and Hearing Procedures for Trading in Claims and Equity Securities at ¶ 18, 27, *In re* Mesa Air Group, Inc., 449 B.R. 441 (Bankr, S.D.N.Y. 2011) (No. 10-10018 (MG)), 2010 WL 6451040 [hereinafter Motion, *In re* Mesa Air Group, Inc.] (seeking relief to monitor claim transfers that might affect debtor's use of net operating losses ("NOLs") as well as change of control restrictions under the Transportation Code pertaining to the airline industry).

[31] Harner, *Trends supra* note 13, at 107 ("[T]he primary goals of the chapter 11 process are the rehabilitation of the debtor and the maximization of returns to all of the debtor's creditors. These dual goals guide a debtor's restructuring efforts and encourage the debtor to maximize the value of its bankruptcy estate through the financial and perhaps operational reorganization of its business. A debtor cannot always satisfy both goals, and in those instances, a liquidation of the debtor focusing solely on maximizing returns to creditors follows. Nevertheless, a debtor typically does and, under the existing regime, should try to reorganize first. A debtor's attempts to satisfy both goals of the chapter 11 process may or may not further the primary goal of the distressed debt investor.").

brings potential benefits to the players involved that outweigh potential risks.[32]

II. Overview of Claims Trading

In 1978, Congress amended the Bankruptcy Code by creating Chapter 11 corporate reorganization as an alternative to liquidation of an insolvent business.[33] Upon filing a Chapter 11 petition, an insolvent corporation receives an automatic stay upon all collection and enforcement actions by parties with claims against the debtor.[34] While the Code provides this protective haven for the debtor, the Code also allows creditors with claims against the debtor to trade those claims.[35] Federal Rule of Bankruptcy Procedure 3001 generally provides that creditors may transfer their claims without judicial oversight.[36] Rule 3001 limits the court's involvement to the

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[32] *See* Press Release, SecondMarket, *supra* note 5.

[33] Tung, *supra* note 13, at 1686 ("Enacted as part of the Bankruptcy Reform Act of 1978, Chapter 11 creates a reorganization regime premised on collective negotiation among the parties. To a greater degree than the reorganization statutes that preceded it, Chapter 11 distributes leverage to all parties in interest and depends on negotiated outcomes for both the ultimate terms of reorganization and resolution of the debtor's significant operating issues during the case.").

[34] 11 U.S.C. § 362 (2006 & Supp. V 2011) (providing for automatic stay upon filing a petition, subject to certain exceptions not relevant here).

[35] FED. R. BANKR. P. 3001(e) (allowing for transfers of claims).

[36] One commentator provides the following analysis of prior Rule 3001(e) and the purpose of the 1991 amendment:

> Former Bankruptcy Rule 3001(e), which required disclosure of the "terms of the transfer" and "the consideration therefor," was amended in 1991 because it was seen as frustrating the goal of providing a liquid market for the sale of claims because many courts had refused to authorize the transfer of claims until adequate information was provided to the sellers. The delay in transfer resulting from this disclosure requirement arguably discouraged buyers from purchasing claims and affected the liquidity of the claims market. . . .
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> . . . .Today, Rule 3001(e)(2), as amended, simply requires the transferee to provide evidence of the transfer to the court. If the transferor does not object within twenty days of notification by the clerk, the court substitutes the transferee for the transferor. Thus, Rule 3001(e)(2)

adjudication of disputes in which the transferor objects to the transferee's assertion of ownership over a claim.[37] Congress amended Rule 3001 in 1991 to clarify the court's limited role in monitoring claims trading.[38] Professors Baird and Rasmussen note that prior to the 1991 Amendment, "some courts interpreted the Bankruptcy Rules to allow them to review claim trades and ensure that those selling them received full disclosure. . . . [But the] Rules Committee decided to deregulate claims trading, as existing judicial oversight was perceived to impair the liquidity of claims."[39]

As acknowledged in the introduction to this Note, the market for distressed debt has fluid boundaries, including public and privately traded high yield bonds,[40] performing and defaulted loans,[41]

> restricts the court's function with respect to transferred claims to resolving whether a disputed transfer has in fact been made by the transferor, by providing only the transferor with standing to object to the transfer of a claim. Additionally, the Rule eliminates any requirement that the filings with the court reflect either the "terms of the transfer" or "the consideration therefor." The Rule also eliminates the need for court approval of unopposed assignments. The Advisory Committee Note to the 1991 Amendments states that the amendments to the rule were intended to limit the court's role to the adjudication of disputes regarding transfers of claims and *was intended to deprive the court of a governance role over postpetition transfers of claims*.

Logan, *supra* note 29, at 500–02 (emphasis added).

[37] FED. R. BANKR. P. 3001(e)(1)-(4); *see also* Victor G. Milione & Travis J. Norton, *Governing Law Regarding Claims Trading in Bankruptcy*, 15 ANN. N.E. BANKR. CONF. 612, 613 (2008), *available at* http://www.abiworld.org/committees/newsletters/publicComp/vol5num4/Public_Companies_July_2008_Hot_Topics_Governing_Law.pdf (outlining disclosure requirements and acknowledging a limiting role for the judiciary in claims trading).

[38] Baird & Rasmussen, *Antibankruptcy*, *supra* note 13, at 659.

[39] *Id*.

[40] Edward I. Altman, *Global Debt Markets in 2007: New Paradigm or the Great Credit Bubble?* 19 J. OF APPLIED CORP. FIN. 17, 17 (2007), *available at* http://people.stern.nyu.edu/ealtman/2007-Global%20Debt%20Market.pdf ("Distressed debt is a sub-group of the high-yield bond market and is defined as securities yielding at least 10% (1,000 basis points) above the risk-free rate benchmark.").

and unsecured pre-petition as well as post-petition claims on a bankrupt debtor.[42] Distressed investors are willing to pursue liquid securities, such as publicly traded corporate bonds and syndicated loans, as well as illiquid claims, such as unsyndicated bank debt, union claims, executory contract claims, and supplier claims.[43] In the three and a half decades since Congress created Chapter 11 reorganization, an over-the-counter market for illiquid bankruptcy claims has steadily grown, both in volume and in the diversity of purchasers.[44] Investors across the globe are looking to distressed

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[41] *Id.* (defining defaulted debt as "a subset of distressed securities that trade after the issuing firm has missed an interest payment or filed for bankruptcy.").

[42] *See* Levitin, *supra* note 13, at 83–84 ("In the business context, in contrast, bankruptcy claims do not constitute a distinct market from distressed debt, in part because the collection efforts involved do not vary significantly depending on bankruptcy. Historically, there was a distinct "bankruptcy claims" market that was thin and highly specialized. Claims traders bought claims only after a plan was proposed. They assumed only plan vote and feasibility risk, which was *de minimis*. The plan was a public document, and investors looked to pick up claims on the eve of the vote. Over the past two decades, however, investors began buying claims earlier and earlier. Now, investors trade in distressed debt well before bankruptcy. Instead of distinct markets based on whether the obligor is bankrupt or not, there is a general distressed debt market with a variety of investment strategies based on timing. The segmentation that exists in the market is not based on bankruptcy status, but rather on asset class.").

[43] Goldschmid *supra* note 13, at 206 ("Distressed investors offer liquidity, albeit often at a steep discount, for owners of nearly every kind of claim, including publicly traded debt, bank loans, trade claims, tort claims, and rejected executory contract claims."); *see, e.g.*, *AMR Update: Claims Trading Opportunities,* SIDLEY AUSTIN LLP (Aug. 8, 2012), http://www.sidley.com/AMR-Update-Claims-Trading-Opportunities-08-08-2012/ ("As is the case with many Chapter 11 proceedings of this size, and airline bankruptcies in particular, the secondary market for trading claims against AMR is very active. . . . Historically, union claims in airline restructurings have been a significant source of secondary market trading. ").

[44] *Compare* Fortgang & Mayer, *supra* note 13, at 4 (observing that in 1990 bankruptcy claims were not traded on exchanges or over-the-counter), *with* DEBTWIRE, NORTH AMERICAN DISTRESSED DEBT OUTLOOK 2012, at 15 (2012), *available at* http://www.mergermarket.com/pdf/NA_Distressed_Debt_Outlook_2012.pdf (observing that in 2012 over 1,000 bankruptcy claims were traded per month over SecondMarket's online exchange).

debt, and bankruptcy claims in particular, as a potentially high-return investment in their portfolios.[45] The number of institutions pursuing distressed debt as an exclusive or significant investment strategy has grown to nearly 400.[46]

Because the market for distressed debt includes a wide variety of private securities and non-standardized, illiquid claims, researchers have struggled to compile comprehensive market data.[47] A broad metric to measure this market includes distressed and defaulted corporate bonds. Professor Edward Altman estimates that "as of June 30, 2007, the size of the distressed and defaulted debt markets was about $550 billion in face value and $470 billion in

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[45] Altman, *supra* note 40, at 17–18 ("There are today at least 180 investment funds in the U.S., as well as another 40 or 50 in Europe, that specialize in investing in distressed securities (not counting proprietary trading desks at most investment banks). This compares to about 100 in the U.S. in 2000 and about 60 in 1990, and probably just a few in Europe five years ago."); DePonte, *supra* note 2, at 10 tbl.1.2 ("Fundraising [in 2008] for distressed debt and restructuring funds hit a new high of $51.4 billion"); DEBTWIRE, *supra* note 44, at 15 ("From Iceland to Mexico and back to the United States, trading in claims against companies in insolvency proceedings is a meaningful component of strategy for increasing numbers of investors.") (quoting Bill Govier, Of Counsel, Bingham McCutchen LLP).

[46] *See Updated List of Distressed Debt Hedge Funds*, DISTRESSED DEBT INVESTING (Dec. 6, 2010), http://www.distressed-debt-investing.com/2010/12/updated-list-of-distressed-debt-hedge.html (listing 399 institutions pursuing distressed debt investments). Note that this number includes proprietary trading desks of investment banks, which must be spun off or shut down in the near future to comply with the Volcker Rule. *See* 12 U.S.C. § 1851(a) (Supp. V 2011) (prohibiting banks from engaging in proprietary trading directly or indi
rectly through subsidiaries).

[47] Levitin, *supra* note 13, at 77 ("No one has a handle even on the most elementary questions like the size of the bankruptcy claims trading market, either in terms of face value of claims trading hands or the volume of transactions. There is broad consensus that there is a large and growing market in claims. Academic articles place the market at hundreds of billions. One company [SecondMarket, immediately after acquiring the T-REX exchange in 2008] attempting to create an exchange in trade claims estimates this piece of the market to be worth $75 billion. It is not clear what that number is actually measuring-- total par value of claims, total amounts paid for claims, etc. Moreover, it is unclear how anyone could arrive at any number. The data simply does not exist.").

market value."[48] Moody's 2011 Annual Default Study shows that the volume and rate of corporate defaults peaked in 2008 and early 2009 before sharply declining as many companies refinanced their debt.[49] Much of this refinancing—by distressed companies and their over-leveraged lenders—has been classified as an "amend, pretend, and extend" strategy, or in other words, refinance today (rather than trigger default covenants) with the hope that a broad market turnaround will improve borrowers' debt servicing capacity.[50]

Through its growing platform for bankruptcy claims trading, SecondMarket, an online marketplace for bankruptcy claims, private company stock, and other securities, has generated a more focused metric than the broad measurement of distressed and defaulted debt. Since 2008 SecondMarket has collected data on claims trades executed through its platform. SecondMarket reports that "[o]ver the 11-month period through November 2011, monthly bankruptcy claim transfers topped 1,000 during four months, compared to two months during the February through November period in 2010."[51] The company also reports that during the twelve months ending in August 2012, the ten most widely traded bankruptcy cases generated

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[48] Altman, *supra* note 40, at 17.

[49] *Annual Default Study: Corporate Default and Recovery Rates, 1920–2011*, SPECIAL COMMENT (Moody's Investor Services, New York, N.Y.), Feb. 29, 2012, at 1, 4 ("With a great deal of uncertainties surrounding the European sovereign debt crisis, corporate defaults came in quite low in 2011. Only 35 Moody's-rated corporate issuers defaulted on a total of $35.7 billion of debt in 2011, the lowest record in the past four years. This was somewhat below our forecast for the year of 37 defaults. In comparison, there were 57 defaults in 2010 which affected $39.1 billion of debt. The low level of defaults primarily stemmed from ample liquidity and low interest rates. Additionally, most companies' balance sheets have improved after the 2008/2009 crisis and debt maturity profiles were relatively manageable as many issuers have refinanced their debt in recent years.").

[50] DePonte, *supra* note 2, at 13 ("If there is a phrase that describes many debt-holders in this cycle, it is 'amend, extend… and pretend'. Given the massive problems hidden away on many lenders' balance sheets, there has been a much greater predilection to amend debt agreements and extend maturities in the hopes that things will get better in the future instead of moving things formally into default. Though there certainly has been a surge in defaults, they have not reached anywhere near the heights forecasted early in 2009.").

[51] DEBTWIRE, *supra* note 44, at 15.

$44.7 billion of traded claims in over 15,000 discrete trades.[52] Despite the relative decline in large company bankruptcy filings in 2011-12 from a peak in 2008-09,[53] SecondMarket's data shows an active market for distressed debt, fueled particularly by the lengthy mega-bankruptcies of Lehman Brothers and MF Global.[54]

During the 1990s and 2000s the academic community debated the virtues of claims trading in relation to the policy goals of Chapter 11 reorganization.[55] Those in support point out that claims trading enables creditors to liquidate their claims, exit the bankruptcy proceeding, and redeploy capital to solvent borrowers.[56] Creditors, such as lending institutions or a debtor's suppliers, can then turn their attention and capital to their domain of expertise while distressed debt professionals, many of whom have experience in corporate turnarounds and reorganization negotiations, enter into the bankruptcy process.[57] Those who oppose claims trading point out

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[52] *Claims Trading Monthly: August 2012*, SECONDMARKET (Sept. 17, 2012), https://www.secondmarket.com/discover/reports/claims-trading/claims-trading-monthly-august-2012.

[53] Data from Lynn LoPucki's database show the number of large public company bankruptcy filings decreasing from a peak of ninety-one in 2009 to twenty-two in 2011. LoPucki, *supra* note 4. A research query on LoPucki's database indicates that only twenty-one companies with assets greater than $500 million filed for bankruptcy in 2012. Lynnn LoPucki, *BRD Spreadsheet*, UCLA-LOPUCKI BANKRUPTCY RESEARCH DATABASE, http://lopucki.law.ucla.edu/spreadsheet.htm (last visited Mar. 19, 2013).

[54] Jacqueline Palank, *Lehman, MF Global Dominate Distressed Debt Trading*, WALL ST. J. (Jul. 24, 2012, 11:56 AM), http://online.wsj.com/article/SB10000872396390443437504577546881046314296.html.

[55] *See supra* note 13.

[56] *See, e.g.* Fortgang & Mayer, *supra* note 13, at 7 ("Most creditors are in business to collect cash from their debtor—cash back for cash advanced, cash paid for goods sold, or cash received for services rendered. Many of these creditors do not want securities from their debtor under a plan of reorganization unless the securities can immediately be sold for cash, which may not always be the case. Many creditors operate under laws or regulations that restrict them from taking stock under a plan of reorganization. Some creditors—government agencies are a good example—have no idea what to do with illiquid securities.").

[57] Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 429 (1997) ("Vulture investors frequently gain control by purchasing senior securities, and often become board members or managers of the target company. The improvement in post-restructuring performance relative to pre-default levels

that claims trading exposes the reorganizing debtor to the disruptive forces of distressed debt investors.[58] These investors pursue and trade claims for a number of different profit-seeking motives, ranging from passive spread-seeking to corporate takeovers.[59] Many distressed debt investors pursue active strategies, such as influencing the debtor's management, proposing alternative plans of reorganization,

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is higher when vultures are active in management and/or gain control. The returns to bondholders and shareholders associated with vulture claim purchases are negatively related to the priority of the claim purchased, and are greater when vultures are active in the restructured company. The evidence suggests that vulture investors serve to discipline managers of companies in financial distress.").

[58] For a concise but comprehensive overview of commentators' arguments for and against claims trading, see Levitin, *supra* note 13, at 72–75. Levitin catalogues the arguments against bankruptcy as follows:

> 1) Claims trading hinders bankruptcy plan negotiations by raising transaction costs of negotiation because the identity of creditors is churning, which makes it hard to lock in a deal. The delay imposes an externality on creditors who do not trade and reduces the value of the debtor's estate.
> 2) Claims trading enables greenmail, insider trading, and other unfair practices that allow particular creditors to extract surplus rents.
> 3) Claims trading hurts unsecured creditors by making it harder to find creditors willing and able to serve on committees. Many creditors will not serve on committees because they wish to remain unrestricted for trading purposes, while others have purchased claims up and down the capital structure, and therefore, have conflicts of interest that preclude them from serving.
> 4) Claims trading encourages participation of creditors who value short-term returns on trades and quick monetization over the long-term value and viability of the debtor company. This can lead to deadweight loss through the destruction of going concern value and can lead to recidivism among debtors. The loss often has externalities on non-creditor community interests affected by bankruptcies.
> 5) Claims trading destroys the "symbiotic relationship of debtor and creditor" that is the premise of Chapter 11.

Id.

[59] For a brief overview of the types of distressed investors, see Adam Levitin, *Bankruptcy Claims Trading: Part I*, CREDIT SLIPS, (Sept. 20, 2007, 10:18 PM), http://www.creditslips.org/creditslips/2007/09/bankruptcy-clai.html#more. For an exhaustive examination of distressed debt motives, see Harner, *Trends*, *supra* note 13.

and seeking control of the debtor's post-reorganization equity.[60] Such strategies and their effects on the reorganization constitute a headline issue for the field of bankruptcy.[61] But the discussion of these active

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[60] Many distressed corporations reorganize outside of Chapter 11 and file prepackaged plans, and thus many of the negotiating parties do not fall under the disclosure requirements of the Code and the Rules of Procedure. Wulf A. Kaal & Christoph K. Henkel, *Contingent Capital with Sequential Triggers*, 49 SAN DIEGO L. REV. 221, 271 (2012) ("Prepackaged plans and preplan sales are common practice in reorganizations under Chapter 11. . . . The most significant downside of prepackaged plans is the risk that disclosure requirements and other safeguards under the Bankruptcy Code are short circuited, thereby violating creditors' rights.").

Focusing on the market for control of reorganizing debtors, Michelle Harner addresses this lack of disclosure and suggests that Congress expand reporting obligations under Section 13 of the Securities Exchange Act by imposing disclosure obligations onto any purchasers of long-term debt who establish a material position, "fifteen percent (15%) or more of any single long-term debt obligation or twenty percent (20%) or more of the company's aggregate long-term debt obligations." Harner, *Barbarians*, *supra* note 13, at 196. Harner points out that this reporting obligation would cover pre-petition as well as post-petition trading that reached a material level. *Id.* at 194. Furthermore, the information would provide a signal to the market of a potential takeover, empowering other suitors to make bids for control and empowering the debtor's management team during reorganization negotiations. *Id.* at 205. However, Harner's proposed disclosure obligation would not address distressed investors who kept their holdings of long-term debt below the triggering thresholds. The key gap here is similar to the gap left by amended Rule 2019, where an individual distressed investor can assemble a significant position in the debtor, participate in plan formation by way of its negotiating power (rather than through a creditor's committee which would trigger Rule 2019 disclosure), and still enter private contracts that run counter to the goals of other creditors or the debtor.

[61] *Compare* Goldschmid, *supra* note 13, at 273 ("Instead of longing for the days of the past, we should tentatively applaud the way that distressed-debt investors have brought enterprises closer toward an efficient communitarian relationship. Where distressed claims of the 1980s and early 1990s may have traded hands from one inefficient owner to the next, today, these claims are being aggregated in the hands of what often turn out to be long-term residual owners. The bankruptcy code and the courts should generally facilitate such transfers."), *with* Baird & Rasmussen, *Antibankruptcy*, *supra* note 13, at 648 ("[T]he legal system now faces a challenge that is much like assembling a city block that has been broken up into many parcels. There exists an anticommons problem, a world in which ownership interests are

strategies and their effects on the bankruptcy process goes beyond the scope of this Note.[62]

The normative debate often leads to discussions of disclosure obligations. As a distressed investor acquires a bankruptcy claim and becomes a creditor, what information should be available to the court, the debtor, other parties, and the public? Despite the fact that billions of dollars of claims trade each year, the market remains largely unregulated, with distressed investors required to disclose very little.[63] Professor Frederick Tung made two observations in 1996 about the perspective of most distressed debt investors on the function and regulation of their niche industry, and despite the increasing use of exchanges for trading claims, these observations remain largely true today:

> The buying and selling of a bankruptcy claim has traditionally been conceptualized as a private transaction between willing parties in a free market, not subject to outside scrutiny or restriction. . . . [J]udicial intervention is best limited to policing

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fragmented and conflicting. This is quite at odds with the standard account of Chapter 11—that it solves a tragedy of the commons, the collective action problem that exists when general creditors share numerous dispersed, but otherwise similar, interests. This Article draws on the lessons of cooperative game theory to show how, in combination, these recent changes are toxic. They undermine the coalition formation process that is a foundational assumption of Chapter 11.").

[62] *See generally* Harner, *Barbarians*, *supra* note 13.

[63] *See KB Toys: Hobgoblins Return to Haunt Bankruptcy Claims Traders*, JONES DAY (July/August 2012), http://www.jonesday.com/kb-toys-hobgoblins-return-to-haunt-bankruptcy-claims-traders/ ("The market for 'distressed' debt is thriving and largely unregulated. The market has grown so much in size and scope that claims trading has become commonplace in nearly every major chapter 11 case. Sophisticated players in the market are aware of most of the risks associated with acquiring discounted debt but generally focus on the enforceability of the obligation in question and its probable payout or value in terms of bargaining leverage. These risks can often be assessed with reasonable accuracy by examining the underlying documentation, applicable nonbankruptcy law, the obligor's financial condition, and its prospects for satisfying its obligations in whole or in part. Other types of risk may be harder to quantify. For this reason, most claim-transfer agreements include a blanket indemnification clause designed to compensate the transferee if a traded claim proves to be unenforceable in whole or in part.").

> abuses at the fringes of the market. Fundamentally, however, the market should remain unsupervised.[64]

Distressed debt investors are generally not required to disclose their strategies, motives, or the prices paid for claims.[65] In fact, Federal Rule of Bankruptcy Procedure 3001(e) constitutes the only bankruptcy provision directly governing claims trading.[66] Rule 3001 does little more than require that evidence of a transfer be filed with the court.[67] To guard against fraudulent assignment, the court gives the transferor notice and twenty-one days to object to the transfer.[68] One legal practitioner comments that "[g]enerally, the bankruptcy court's, or the claims agent's, involvement in claims trading is ministerial, i.e., maintaining the claims register and recording transfers if the form complies with the rule."[69] And as

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[64] Tung, *supra* note 13, at 1687.

[65] Aaron L. Hammer & Michael A. Brandess, *Claims Trading: The Wild West of Chapter 11S*, AM. BANKR. INST. J., July/Aug. 2010, at 1, 62 ("Fed. R. Bankr. P. 3001(e) currently limits judicial involvement in claims trading to dispute resolution between a transferor and transferee. . . . The decision to reduce judicial intervention has lead [sic] to the current lack of regulation and the increased market activity. Courts are no longer able to examine the terms or consideration received from the transferee. The changes successfully limited judicial activism; however, the absence of market transparency left a considerable legacy.").

[66] *Id.*

[67] Levitin, *supra* note 13, at 77 ("The Rule 3001(e) filing requirement applies only when the actual claim changes hands, however, not when the beneficial interest represented by the claim changes hands. This means that many economic claims trades are not reported with the court.").

[68] FED. R. BANKR. P. 3001(e)(2); Bob Eisenbach, *Selling A Bankruptcy Claim: Opportunity And Risk*, IN THE (RED) (Aug. 11, 2006), http://bankruptcy.cooley.com/2006/08/articles/business-bankruptcy-issues/selling-a-bankruptcy-claim-opportunity-and-risk/ ("If you sell your claim, you will often be required to sign an additional document with a name such as 'Evidence of Transfer of Claim,' which does not mention the price paid and which will be filed with the bankruptcy court. Thereafter, you may receive a notice from the bankruptcy court that the claims buyer has filed the Evidence of Transfer of Claim document and giving you 20 days to object to the transfer. This notice is designed to prevent unscrupulous individuals from fraudulently assigning claims to themselves and is only a formality in a legitimate claims sale.").

[69] Lawrence V. Gelber et al., *Bankruptcy Claims Trading Orders: Who is Watching?*, LAW360 (Aug. 29, 2011), http://www.srz.com/files/News/

noted earlier, the Advisory Committee's comment to amended Rule 3001(e) indicates that the rule is intended "to limit the court's role to the adjudication of disputes regarding transfers of claims. . . . This rule is not intended either to encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under nonbankruptcy law to a transferor or transferee."[70] Even if the Code or Rules of Procedure required such disclosure, it would appear that most bankruptcy judges do not have the time or resources to investigate the motives and fairness surrounding the hundreds or thousands of claims that trade during some of the largest cases.[71]

Professor Baird explains the policy concerns surrounding the issue of disclosure. Requiring investors to fully disclose information about their trades may discourage trading and decrease market liquidity: "[W]e have to be careful about requiring the disclosure of private information that is costly to gather. One of the most sensitive pieces of information for any trader is her reservation price, as it reduces all of her private information to a single number."[72] But the solution for an efficient market may not be as simple as no disclosure, Baird contends, because illiquid markets create an opportunity for sophisticated investors to manipulate the market and extract additional value from unsophisticated sellers:

> A trader known to have private information would appear at an exchange and conspicuously sell. Others would infer that the private information was bad news and would sell as well. The price would fall. At this point, confederates of the insider would begin to amass a huge position at the now artificially low price. When the private information becomes public information, the price rises far above the original level. The informed trader and his

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136cda3d-a782-4acd-9c13-b92847b818bc/Presentation/NewsAttachment/786378f7-c63f-4ea6-a2cf-b9e720871519/Gelber_Karp_Harris_Bankruptcy_Law360_August_2011_Bankruptcy_Claims_Trading_Orders_Who_Is_Watchin.pdf.

[70] FED. R. BANKR. P. 3001(e) advisory committee's note.

[71] *See infra* text accompanying note 75 (quoting bankruptcy judge who is "not troubled by" certain investment strategies and who finds certain types of behavior involved in claims trading a "matter of indifference to the Court.").

[72] Baird, *The Bankruptcy Exchange*, *supra* note 13, at 35.

> confederates enjoy an even larger profit than they would have had if he relied on his information without manipulating the market simultaneously.[73]

This Note addresses the regulatory solution to these policy concerns about disclosure in Parts IV and V. But first, it is necessary to distinguish between different types of claims trading strategies to isolate the strategy addressed by this Note—passive trading.

III. Passive v. Active Trading Strategies

As a threshold matter in a regulatory discussion of claims trading, distressed debt investing should be separated into active and passive strategies. A 2009 letter from Judge Gerber of the U.S. Bankruptcy Court for the Southern District of New York to the Advisory Committee on Bankruptcy Rules illustrates the rationale for such a distinction:

> When distressed debt investors buy into the case and participate in it as passive investors (achieving their returns by their skill in knowing when to invest and for how much, by reason of superior financial analysis), their presence is at least generally benign. But increasingly, we see distressed investors . . . attempting to influence the outcome of the chapter 11 case.[74]

Judge Gerber's distinction between passive and active distressed investing calls into question a regulatory perspective that

[73] *Id.* at 36; *accord id.* at 37 ("In addition to the possibility of market manipulations, we need to worry about the way in which dispersed private information can undermine the liquidity of a market. One can imagine environments in which multiple parties possess private information, but none of them has an incentive to disclose what they [sic] know, even though each would be better off if everyone disclosed what they [sic] knew. Put differently, we face a collective action problem in which the individual benefits of disclosure are small, but the benefits of disclosure to the group as a whole are large.").

[74] Letter from Judge Gerber, U.S. Bankr. Court S. Dist. N.Y., to Advisory Comm. on Bankr. Rules 3 (Jan. 9, 2009), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202008/08-BK-M-Suggestion-Gerber.pdf.

lumps all distressed investors together, regardless of strategy. If different types of behavior produce different outcomes for the bankruptcy process, then the regulatory treatment of these behaviors ought to reflect the differences. Judge Gerber goes on to write:

> [D]istressed debt investors, and the organizations that lobby on their behalf, regard their profit maximization strategies as highly confidential—even sacred. To the extent that such investors do not try to influence the outcome of a bankruptcy case, I am not troubled by that, and think their desires can be accommodated. And in most cases, what they paid for their claims (and how much profit they will make as a consequence of intercreditor negotiations, or various case outcomes) will be a matter of indifference to the Court, and will not require disclosure.[75]

Thus, Judge Gerber proposes a regime of increased disclosure for activist investors only, particularly those acting through official or *ad hoc* creditors' committees.[76] In 2011 the Supreme Court amended Federal Rule of Bankruptcy Procedure 2019, addressing Judge Gerber's concerns.[77] Rule 2019 applies to any official or unofficial group or committee that (1) "consists of or represents . . . multiple creditors or equity security holders" and (2) acts in concert to promote "their common interests."[78] Covered entities must disclose any economic interest affected by the debtor's value.[79] This includes "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest."[80] The resulting disclosure provides the judge and the parties with a complete, accurate picture of the interests actively represented in the case. Rule 2019 achieves this result without requiring covered entities to disclose prices they paid for their claims or the timing of

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[75] *Id.* at 7.
[76] *Id.* at 10–11.
[77] FED. R. BANKR. P. 2019; *see also supra* note 20 and accompanying text.
[78] FED. R. BANKR. P. 2019(b)(1).
[79] *Id.*
[80] *Id.*

acquisition, maintaining the privacy of distressed investors' proprietary information.[81]

Rule 2019 represents a thoughtful and targeted regulatory response to some of the unique problems raised by activist investors—a group that attempts to influence the debtor's plan of reorganization or take control of the debtor.[82] Such actions invariably affect many constituencies involved in the bankruptcy proceeding. A debtor faces the formidable challenge of creating a plan of reorganization that a sufficient number of its creditors will approve.[83] Confirmation requires approval from each class of creditors, with class approval constituting two-thirds in amount and a majority in number of allowed claims on which creditors have voted.[84] Activist investors introduce additional concerns that the debtor's plan must address. Most importantly, activist investors seek to increase their distribution under the plan.[85] Because additional distribution for one class must decrease the distribution available for other classes, plan confirmation requires negotiation among creditor classes. Writing in 1996, Professor Tung commented:

> Reorganization is complex and expensive under the best of circumstances. If in addition to the existing complexity of this multiparty bargaining game, significant creditors or creditor groups sell out, or new participants enter with no prior connection to the debtor or the ongoing negotiation, the complexity of the process is magnified significantly.[86]

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[81] Albrecht, *supra* note 20, at 742–43 ("While New Rule 2019 significantly expands disclosure of the types of interests that each committee member must disclose, it significantly narrows disclosure requirements regarding the price and timing of acquisition. Prior Rule 2019 required covered parties to disclose the date of acquisition and price paid for each claim or interest. By contrast, New Rule 2019 does not require covered parties to disclose the price at which any 'disclosable economic interest' was acquired or sold.").
[82] *See* Harner, *Barbarians*, supra note 13, at 157.
[83] 11 U.S.C. §§ 1121–1123 (2006).
[84] 11 U.S.C. § 1126(c) (2006).
[85] *See* Harner, *Barbarians*, supra note 13, at 191.
[86] Tung, *supra* note 13, at 1720.

Rule 2019, however, ensures that the judge and the parties at least have a complete understanding of economic interests when engaging in negotiations and the plan confirmation process.

Passive-strategy investing raises a narrower set of issues of less significance as compared to active-strategy investing.[87] Rather than participating in the reorganization process, the passive investor merely facilitates claims transfers and waits for an ultimate distribution under the plan.[88] Addressing the active and passive distinction, Paul Goldschmid argues that the presence of passive distressed investors is not only "benign," as Judge Gerber writes, but positive:

> [T]here will always be certain investors, often hedge funds, who come in and buy up relatively small amounts of claims with the hope that a short-term event or a particular kind of leverage will increase the trading value of this claim. . . . There is a significant presence of these trading funds, and they often get the wrath of debtor-oriented literature lamenting that the funds' only interest is to "flip" their investment, capitalizing on a short term gain, at the debtor's expense.
>
> But, these "traders" are really no different than the trade creditors or banks from whom they may buy their claims; they will always favor corporate decisions that will increase the value of their individual claims. . . . In a worst-case scenario, we can expect that their self-motivated actions would mimic the actions of classic claimholders (too risk-averse when holding senior debt, too risk-loving when holding junior positions). In the best-case scenario, we can expect these holders to be far superior to the classic par holders. Even if these investors only want the company to trade well when it emerges, they will still want to make sure that the management team is impressive and the capital structure is sound.[89]

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[87] *Id.* at 1738.
[88] Goldschmid, *supra* note 13, at 269–71.
[89] *Id*.

Other commentators provide typologies of claims trading strategies. Professor Michelle Harner conducted a survey of distressed investors and identifies three broad categories of investment practices: (1) seeking to influence the debtor, (2) seeking to gain control of the debtor, and (3) everything else.[90] Harner calls for revisions of the Williams Act, an amendment to the Securities Acts of the 1930s pertaining to tender offers, to require all investors—distressed or not—to disclose a material position in the debt of a corporation, whether insolvent or not.[91] She argues that the market for control of distressed and bankrupt corporations should be regulated much like the market for control of solvent corporations' equity.[92] Such a disclosure regime would increase transparency and fairness and mitigate the problems created by traders pursuing control strategies.[93] While Harner's proposed disclosure regime could conceivably ensnare a passive distressed investor that built up a significant position in a debtor, most passive investors do not amass such large positions.[94]

In addition to Harner's empirical study, Professor Levitin provides one of the more incisive overviews of the types of claims traders.[95] Levitin broadly identifies (1) "simple passive arbitrageurs" who do not appear in court and seek a return either through a buy-sell spread or by acting as a broker and taking a commission; (2) active arbitrageurs who purchase claims with the intent to influence the reorganization and increase their payout; and (3) active arbitrageurs seeking to take over the company by acquiring the fulcrum security.[96] After identifying these categories, Levitin then explains:

> Claims trading strategies are not exclusive. A claims purchaser could be seeking the fulcrum security, but find itself with a simple dollar for dollar spread or a blocking position. . . . While a basic typology of claims trading is possible, we do not know how neat these categories are in practice. . . .

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[90] Harner, *Trends*, *supra* note 13, at 84.
[91] Harner, *Barbarians*, *supra* note 13, at 196.
[92] *Id.* at 196–97.
[93] *Id.* at 205–06.
[94] Goldschmid, *supra* note 13, at 269–71.
[95] Levitin, *supra* note 13, at 94–98.
[96] *Id.* at 95.

> . . . [C]laims trading is comprised of dynamic, multi-motivational, and overlapping sub-markets, which raise distinct policy concerns.[97]

But focusing in on his first category—"simple passive arbitrageurs"—Levitin concludes that "passive investment types of activity are, by themselves, harmless, except to the extent claims trading volume overall is a problem.[98]

Harner and Levitin appear to agree that activist claims traders generate significant policy concerns for the bankruptcy process while passive claims trading is generally benign. Given this contrast between active and passive claims trading, it is worthwhile to isolate passive claims trading, consider its effects on the bankruptcy process, and determine whether this activity should be left alone or regulated to a greater extent as some commentators have proposed.[99]

IV. Trading Mechanics

An overview of claims trading mechanics illustrates the potentially complex steps involved in claims trading. The process begins with the establishment of a claim. At the outset of a case, the debtor must file a list of creditors and a schedule of its assets and liabilities.[100] A creditor may file a proof of claim[101] along with documentation evidencing the claim.[102] Whereas the debtor must file its creditor list and schedule immediately, the creditor's proof of claim may be submitted at any time until a court-established bar date (and under Rule 3001, the claim may be transferred before the Proof

[97] *Id.* at 97–98.
[98] Levitin, *supra* note 13, at 95. Regarding the extent to which claims trading volume may become a problem, see Part VII.
[99] *See infra* Part V. *See generally*, Kidder, *supra* note 20.
[100] 11 U.S.C. § 521(a) (2006 & Supp. V 2011); *see also* FED. R. BANKR. P. 3003(b)(1) ("The schedule of liabilities filed pursuant to § 521(l) of the Code shall constitute prima facie evidence of the validity and amount of the claims of creditors, unless they are scheduled as disputed, contingent, or unliquidated. It shall not be necessary for a creditor or equity security holder to file a proof of claim or interest except as provided in subdivision (c)(2) of this rule.").
[101] 11 U.S.C. § 501(a) (2006).
[102] FED. R. BANKR. P. 3001.

of Claim is filed).[103] Once filed, a claim is deemed allowed unless a party in interest, which includes the debtor, objects.[104] The court determines the allowed amount of the claim after notice and a hearing.[105] Additionally, the court determines the allowed amount of any contingent or unliquidated claim.[106]

Once an allowed claim has been established (but sometimes even earlier), distressed investors working in an over-the-counter context will use the publicly available creditor list or a creditor's proof of claim to contact the creditor with a preliminary bid for the creditor's claim.[107] The parties will usually negotiate between the creditor's offer and the investor's bid.[108] Once they reach an agreement, the parties enter into a trade confirmation and the investor conducts due diligence on the claim.[109]

Finally, the parties execute a binding purchase and sale agreement to memorialize the transaction.[110] The investor typically seeks representations and warranties from the creditor as well as grants of indemnification in the event the claim is disallowed or impaired.[111] The parties will usually transfer the claim through a sale

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[103] *Id.* 3001(e).
[104] 11 U.S.C. § 502(a).
[105] *Id.* § 502(b).
[106] *Id.* § 502(c)(1).
[107] Joshua Nahas, *Trade Claims Primer*, DISTRESSED DEBT INVESTING (Oct. 26, 2010), http://www.distressed-debt-investing.com/2010/10/trade-claims-primer_26.html ("For a sophisticated trade claims investor it is possible to begin negotiations to purchase a claim utilizing this [list of large creditors' claims filed by debtor].").
[108] *Id.*
[109] *Id.* ("This [due diligence] phase again can take a few days to a few weeks depending on the issues involved. At this stage in the process the buyer will begin examining the documentation supporting the claim. This includes reviewing invoices, purchase orders, or other contracts in order to determine the validity of the claim. It is also necessary to reconcile the amounts on the invoices with what is filed on the POC and the Schedules. . . . The purchaser must also confirm that the entity at which the claim he is purchasing is filed corresponds to the entity listed on the supporting invoices as well as have been filed prior to the Claims Bar Date.").
[110] *Id.*
[111] *Id.* ("The PSA will required [sic] the seller to provide Reps and Warranties on the ownership, validity and lack of any encumbrances on the claim. In addition, the PSA will contain Indemnification provisions, should the claim be impaired or disallowed. This means that if for some reason the purchaser of the claim needs to seek recourse because the seller

rather than an assignment, as the investors seek to avoid the risk of equitable subordination, the doctrine applied in a judicial decision during Enron's bankruptcy.[112]

V. The Unsophisticated Creditor

Commentators accurately point out that the most significant problem raised by claims traders with an exclusively passive strategy is that of the unsophisticated creditor.[113] This Part first presents the problem of the unsophisticated creditor. Second, this problem of the

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misrepresented his claim or it was disallowed as a result of actions taken by the seller, the purchaser must be able to rely on the counter party to indemnify him for his losses. ").

[112] *See In re Enron Corp.*, 379 B.R. 425, 439 (Bankr. S.D.N.Y. 2007) (holding that a transferee's claim could be subject to equitable subordination and claim disallowance based on the transferor's conduct if the claim was transferred by an assignment but not by a sale); Kristopher M. Hansen, Harold A. Olsen & Abigail M. Beal, *Enron Ruling on Claims Transfers Reversed*, STROOCK SPECIAL BULLETIN (Stroock & Lavan LLP, New York, N.Y.), Aug. 29, 2007) at 2, *available at* http://www.stroock.com/SiteFiles/Pub546.pdf ("The Court explained that in an assignment, an assignee takes a claim with all limitations that existed on the claim when it was in the hands of the assignor. In a sale, under certain circumstances, a purchaser can take the claim without the same limitations that the seller had. Also, although certain characteristics of a claim always travel with a claim regardless of whether there is a sale or an assignment, 'personal disabilities' of a claimant do not always travel with the claim. If a claim is assigned, a personal disability of the claimant transfers from the claimant to the assignee. However, if a claim is purchased, the personal disability of the claimant will not be transferred. The District Court determined that the principles of equitable subordination and disallowance are both personal disabilities of claimants, as opposed to attributes of a claim. As such, these principles do not automatically transfer from seller to purchaser through a sale.").

[113] Drain & Schwartz, *supra* note 13, at 572–73 ("[T]here is at least good anecdotal evidence that small unsophisticated sellers — trade creditors sometimes characterized as "involuntary" participants because they did not buy their claims as investments but, rather, were stuck with their obligor's default — already are widely engaged in the distressed debt market and are taken advantage of."); Whitaker, *supra* note 19, at 336 ("[U]nsophisticated creditors [are] at risk of being treated unfairly."). It should be noted that the problem of the unsophisticated creditor is not unique to passive investors but is raised by activist investors as well.

unsophisticated creditor is compared with analogous markets for securities and derivatives to gain perspective on the problem and a potential solution. Third, this Part concludes that the problem of the unsophisticated creditor does not warrant regulatory interference in the arm's length transactional context of claims trading.

A. The Problem

An information asymmetry exists between sophisticated investors and many of a debtor's non-financial creditors.[114] An investor may possess specialized knowledge about the restructuring process, the likelihood of recovery on a claim, and expected delay in distribution under a plan of reorganization.[115] Conversely, a trade creditor—often one of the debtor's suppliers, a lessor, or a union or group of employees—lacks this experience and specialized knowledge.[116] The investor will use its superior information to obtain the claim at a price below its expected value.[117] In addition to this information asymmetry between buyer and seller, the trade creditor's incentive to liquidate the claim increases her susceptibility to selling at an overly discounted price.[118] As discussed earlier in Part II,

[114] Tung, *supra* note 13, at 1699–700.
[115] *Id.* at 1700.
[116] Drain & Schwartz, *supra* note 13, at 572–73. ("Sellers may be trade creditors or small, dispersed bondholders, who may not be sophisticated financial players. They may not be institutionally equipped to follow complex reorganization cases that may take years to resolve. They may simply lack the economic stake in the reorganization to justify the costs of monitoring and actively participating in the case.").
[117] *See* Tung, *supra* note 13, at 1699–700. The investor purchases the claim based upon two discounts. Fortgang & Mayer, *supra* note 13, at 5. First, the investor must calculate the probability of receiving any distribution under the plan of reorganization and discount the claim to the expected payout. *Id.* Second, the investor must estimate the time until a distribution under the plan and discount the claim based upon the time value of money. *Id.* And, as Fortgang & Mayer point out, "[i]t is very possible for postpetition investors to lose one or both of these bets." *Id.* at 6.
[118] Fortgang & Mayer, *supra* note 13, at 7 ("Most creditors are in business to collect cash from their debtor—cash back for cash advanced, cash paid for goods sold, or cash received for services rendered. Many of these creditors do not want securities from their debtor under a plan of reorganization unless the securities can immediately be sold for cash, which may not always be the case."); Tung, *supra* note 13, at 1686 ("Cashing out is an attractive option for these selling claimants."); *id.* at 1726 ("The

purchasers of claims are not required to disclose anything beyond the Rule 3001(e) notice requirements,[119] and bankruptcy judges generally do not intervene in claims trading to protect unsophisticated creditors.[120] Thus, a selling creditor may not have any comparable trades with which to establish an offering price for its claim.

Until recently, claims trading only occurred in private trades and over-the-counter markets.[121] In a 2004 textbook on distressed debt trading strategies, Stephen Moyer observes that this market has "no ticker tapes or electronic screens showing bids, offers, or last trades . . . . [I]n many smaller issues within the distressed debt universe, often there may be absolutely no firm bids or offerings in the market, and there may not even be a recent quote."[122] Moyer

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selling creditor, by selling, has unmistakably evidenced its desire to strike a deal quickly and a willingness to settle at a discount. By contrast, the professional bankruptcy investor has invested new money with the intent of realizing a profit.").

[119] *See supra* notes 65–67 and accompanying text.

[120] Few courts have actively regulated the process of claims trading or intervened to protect unsophisticated creditors. In one rare case, *In re Revere Copper and Brass, Inc.*, the bankruptcy judge refused to approve certain claims transfers and ordered a claims purchaser to provide a disclosure statement to any future assignors. 58 B.R. 1, 3 (Bankr. S.D.N.Y. 1985) (explaining that the court "will not approve the assignments [at issue] until the assignor-creditors have been given [a 30-day period], in which to revoke their assignment" after receiving a disclosure with sufficient information upon which to judge the offer). The judge relied, in part, upon the lack of disclosure by the claims purchaser, the apparent unsophistication of the claim seller, and the seller's susceptibility to abuse. *Id.* at 2–3 (expounding some of "the evils attendant upon a solicitation of assignments of claims" that include a seller's potential ignorance and unsophistication); *see also* Whitaker, *supra* note 19, at 324–25 (summarizing the court's justification for intervening into the claims transfer process). For a case where the court disqualified some of a claims trader's actions based on a finding of bad faith, *see In re Allegheny Int'l, Inc.*, 118 B.R. 282, 289–90 (Bankr. W.D. Pa. 1990) (finding a claims trader acted in "bad faith" under Bankruptcy Code Section 1126(e) when the trader acquired and then wielded a vote-blocking position on the debtor's plan of reorganization, and disallowing the blocking vote); *see also* Whitaker, *supra* note 19, at 326–27 (summarizing the Allegheny court's analysis in greater detail).

[121] *See* STEPHEN G. MOYER, DISTRESSED DEBT ANALYSIS: STRATEGIES FOR SPECULATIVE INVESTORS 300 (2004).

[122] *Id.* at 296, 300.

writes that broker-dealers facilitate most claims trading as intermediaries between buyers and sellers, explaining that "because of the liquidity and transfer of bankruptcy rights issues, the types of electronic trading interfaces that have developed in certain equity and bond markets have not evolved for distressed securities."[123] Moyer explains that, unless the parties request otherwise, broker-dealers will usually notify the market after a trade with the bid-ask spread but will exclude the size of the trade and the parties' identities.[124] Moyer further explains that "[a]lthough every situation has its own dynamics, often when trying to trade very illiquid situations, a key objective is to complete a trade, even of modest size, just to establish a price context."[125] Moreover, "[t]he distressed investor must always bear in mind that, particularly in illiquid situations, there is no assurance that he or she will be able to accumulate the ideal position at the ideal price."[126]

As noted earlier in Part II, Federal Rule of Bankruptcy Procedure 3001(e) imposes negligible disclosure requirements on investors when executing claims transfers.[127] One student note analyzes the 1991 revision to the Federal Rule of Bankruptcy Procedure 3001 and concludes:

> The lack of guidance under the present Bankruptcy Code has created a great deal of uncertainty in the business community as to when a court will involve itself in claims trading. This uncertainty decreases efficiency by limiting market activity, increasing transaction costs, and placing unsophisticated creditors at risk of being treated unfairly.[128]

The founder of One Exchange Street, an online secondary exchange for bankruptcy claims, explains the market interaction as follows: "Buyers of bankruptcy claims are generally sophisticated about the process . . . . If you're a claims seller, however, you're getting all these calls and contacts from buyers, and you have no way

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[123] *Id.* at 298.
[124] *Id.* at 304.
[125] *Id.*
[126] *Id.*
[127] *See supra* notes 65–67 and accompanying text.
[128] Whitaker, *supra* note 19, at 336.

to evaluate whether the price you're being offered is fair and reasonable . . . . This is a big problem for sellers."[129]

Thus, unsophisticated creditors find themselves negotiating with experienced investors without the benefit of price disclosure by claim buyers or the oversight of the court in claims trading. The information asymmetry raises the opportunity for sellers to leverage superior information and extract a majority of trade surplus. In the words of Moyer:

> [T]he buyer is trying to present the picture that he or she is "the only sucker on the planet dumb enough to buy these things; if you miss this bid, the next buyer will pay less." And the buyer may, in fact, drop his or her bid for a day or two and then increase it to reinforce the reality that he or she is the only buyer in the market.[130]

But a claims purchaser's exploitation of superior information to obtain this surplus is not illegal. Indeed, such an outcome may not necessarily be inequitable or inefficient, as one student note indicates.[131] More important than the argument of the fairness of these transactions is the following observation: the problem of the unsophisticated creditor is largely one of equity, *not* fraud. The following section compares the unsophisticated creditor problem with certain securities and derivatives markets to demonstrate that the absence of a risk of fraud in claims trading between unsophisticated creditors and passive investors justifies the freedom of this market from regulation-imposed disclosure requirements.

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[129] Lynne Meyer, *One Exchange Street Appears Set to Reshape Bankruptcy Marketplace*, HIVELOCITY (May 31, 2012), http://www.hivelocitymedia.com/innovationnews/oneexchangestreet052412.aspx (internal quotation marks omitted).

[130] MOYER, *supra* note 121, at 298.

[131] Whitaker, *supra* note 19, at 338 ("Simple regulations regarding disclosure by parties involved [in claims trading] would go a long way towards creating efficient and equitable markets for claims trading.").

B. Comparative Context

The prior section demonstrates that, in the context of claims trading between passive investors and creditors, it is generally the seller who is unsophisticated. But a selling creditor still possesses an underlying claim and knows a good deal about its characteristics. This selling creditor simply lacks an understanding of the market for the claim, and hence an ability to value the claim. While this transaction favors a sophisticated claim purchaser, it does not raise the greater problem of fraud in the marketplace.

In her analysis of the secondary market for private company stock, Professor Elizabeth Pollman frames a regulatory question that applies directly to claims trading between unsophisticated creditors and passive investors:

> Imperfect or asymmetric information is, of course, a common issue in contracting. In some cases the law intervenes, and in some it does not. Public securities laws provide an example of regulatory intervention. In many contexts, though, parties can address information issues on their own through contract, or they can agree to a price that reflects the uncertainty surrounding their contract. Thus, the decision of whether to regulate requires an analysis of the information issues that exist in the private secondary markets and a determination whether the markets and parties are equipped to respond well to these issues without regulatory intervention.[132]

The following sections briefly examine the markets in and regulatory treatment of certain securities and derivatives, giving particular attention to secondary exchanges of private company stock and over-the-counter derivative exchanges.

1. Securities Acts of 1933 & 1934

The justification underpinning securities regulation provides a helpful contrast for claims trading. Under the Securities Acts of 1933 and 1934, it is the *potential* for fraud, deceit, or misrepresenta-

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[132] Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 206–07 (2012).

tion that justifies the regime of disclosure, *not* inequitable trading outcomes that arise solely from differing levels of sophistication between buyers and sellers.[133] Reflecting on the New Deal response to the Great Depression, the Supreme Court wrote:

> Congress enacted two landmark statutes regulating securities. The 1933 Act was described as an Act "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." The Securities Exchange Act of 1934 was described as an Act "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."[134]

Jumping from the enactment of the Securities Acts to the modern era of online trading, the Securities and Exchange Commission remains especially focused on protecting purchasers of securities from fraud or misrepresentation by issuers and sellers.[135]

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[133] *See, e.g.*, *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml (last updated Aug. 30, 2012) ("[T]he Securities Act of 1933 has two basic objectives: require that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities."). The 1933 Act is codified as amended at 15 U.S.C. §§ 77a-77aa (2006 & Supp. V 2011), and the 1934 Act is codified as amended at 15 U.S.C. §§ 78a-77pp (2006 & Supp. V 2011); *see also* Securities Exchange Act of 1934 § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) (2006) (proclaiming that fair and orderly markets require that information is made available to brokers, dealers, and investors).

[134] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727–28 (1975) (citation omitted).

[135] Robert B. Robbins & Brad M. Dashoff, *Regulation of Online Securities Transactions* (ALI-ABA Continuing Legal Education, June 21–22, 2007), *available at* WL SM052 ALI-ABA 473, 475 ("In general, the Securities and Exchange Commission (the "Commission") has welcomed the Internet as a positive development that enables the Commission to better achieve its

Comparing the market for claims trading with the market for securities (in its broadest sense) shows two markedly different contexts. Congress recognized the potential for an issuer of securities to misinform and defraud the buyer about the securities being sold. The Securities Acts therefore place disclosure obligations on issuers of securities so that buyers, armed with information about the issuer, the security, and potential risks of the investment, can make informed investment decisions.[136] But in the context of claims trading, the less sophisticated party is the seller, who does not face a risk of being defrauded by the claims purchaser.

2. Secondary Market for Private Company Stock

While this Note only examines online exchanges for claims trading, most online exchange companies also host platforms for secondary trading in private company stock. This group of companies includes SecondMarket, NYPPEX, SharesPost, Portal Alliance, Financial OS, and Xpert Financial.[137] Two commentators note the diversity of trading platforms these companies make available:

> Some of these intermediaries are licensed broker-dealers that charge a commission on the sale, paid by the seller. Others operate bulletin boards where sellers post the terms of their sale and qualified buyers can select from available opportunities, where a fee is charged for use of the bulletin board. Some of these bulletin board operators are registered

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goals of increasing market transparency and increasing investor access to information. However, the Commission has expressed concern that the tremendous proliferation of information and increased participation in the securities markets increases the opportunity for securities fraud. To this end, the Commission has issued several rules that apply the existing federal securities laws to this new medium, and has devised new regulations to protect investors who engage in securities transactions using the Internet.").

[136] *See supra* notes 133–134 and accompanying text (providing the basis for concluding that disclosure requirements reduce information asymmetry between buyers and issuers).

[137] Thomas M. Devaney & Paul "Chip" Lion, *Secondary Markets for Restricted Securities in Private Companies*, ASPATORE, Mar. 2012, at *6, *available at* 2012 WL 4751795.

> broker-dealers, governed by FINRA, while others are not.[138]

Most legal commentary on online exchanges focuses on secondary trading in private company stock.[139] Professor Elizabeth Pollman notes that SecondMarket's exchange has succeeded in centralizing transactions and enabling investors to overcome information and regulatory obstacles to the sale of private company stock.[140] But Pollman looks beyond these benefits to the potential problems with Secondmarket, observing as follows:

> [C]oncern has been rising about the lack of information and the information asymmetry between buyers and sellers in the secondary markets. This apprehension relates to both the quality and amount of information being disclosed. Underlying these concerns is the larger worry that without an adequate amount of accurate information, private company stock cannot be properly valued."[141]

Comparing this pricing problem for private company stock with the pricing problem for bankruptcy claims, there are two clear differences. The vulnerable party in the stock context is the buyer,

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[138] *Id.*

[139] *See, e.g.*, Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 557 (2012) ("While it is tempting to picture these platforms as places where private shares are fluidly bought and sold . . . this is not the case. In reality, these platforms contain hallmarks of illiquidity. . . . The author [of a 2011 Wall Street Journal article] observed that the 'numbers of buyers and sellers remain fitfully small' and that on SharesPost 'real trades remain rare, with listings showing trades that grew stale months ago.' Echoing this sentiment, another article noted that on these markets 'days or weeks can go by without shares of even big private-company stocks changing hands.' Moreover, when trades do happen, they are mired in transaction costs. On the public markets, trades happen instantaneously. But on these private platforms, buying and selling is 'time-consuming and bureaucratic.' For example, while Facebook was trading privately, buying a share would take a week to accomplish. Overall, as the above description illustrates, despite appearances to the contrary, these markets are quite illiquid.").

[140] Pollman, *supra* note 132, at 203.

[141] *Id.* at 206.

whereas the vulnerable party in the claims context is the seller. And the stock buyer's pricing problem arises from lack of knowledge about the security and its issuer, whereas the claims seller's pricing problem arises from lack of knowledge about the market.

Professor Jeff Schwartz, also analyzing secondary exchanges for private company stock, notes that some securities professionals and commentators advise that regulators "stand back and allow private markets to evolve and meet investor liquidity demands."[142] Schwartz then comments as follows:

> A proponent of this approach could point to SecondMarket and SharesPost as examples of the potential for entrepreneurial ventures to fill market gaps as they emerge. While these venues may be relatively unappealing today, perhaps they or their competitors could evolve into suitable platforms if given time to develop.
>
> This line of thought also has intuitive pull, but there is reason to be skeptical that it would be a better approach. . . . [I]t is fanciful to expect that those allowed entry [into this secondary market] will make sound decisions and police themselves on the grounds that they are sophisticated parties. The financial collapse stemmed in part from poor decisions made by sophisticated investors in private securities markets; the original securities laws were put in place because self-regulation was failing."[143]

Schwartz's critique of regulatory restraint in secondary markets of private company stock may be sound in light of the dangers to investors that arise from a lack of information. But this very approach of regulatory restraint *is* sound when applied to the market for bankruptcy claims. Indeed, this market is evolving to meet liquidity needs, albeit of selling creditors rather than investors.

3. Derivatives Exchanges

Whereas the securities markets analyzed in the previous sections contrast with the claims market, the market for over-the-

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[142] Schwartz, *supra* note 139, at 603.
[143] *Id.* at 603–04.

counter derivatives shares similar features with the claims market. One scholar contrasts the exchange-traded derivative market with the over-the-counter derivative market as follows:

> The advantage of the OTC market compared to the exchange market is that instead of being limited to the finite set of standardized exchange-traded contracts, OTC counterparties can customize and narrowly tailor their derivatives contract to meet their needs and desires. Compared with agreements executed on an exchange, however, transaction costs may be higher, especially when a contract is heavily negotiated.[144]

As noted in Part II, there is a wide variety of claims that exists both within and between bankruptcy cases. A single, unique trade claim may require negotiation of a variety of terms. In contrast, a case involving a debtor's subordinated notes may generate many comparable trades by the holders of those notes, similar to exchange traded derivatives whose characteristics differ only in price.[145]

Another group of scholars comments on the challenge of standardizing over-the-counter derivative documentation, observing that "the appeal of OTC derivatives is the ability to customize the product to meet the risk management needs of both parties involved in the transaction. OTC derivatives are often created precisely because there is no standardized derivative product available for the risk management needs of the parties involved. Hence, because of the customization involved, it may be very difficult to impose standardization requirements on OTC derivatives. Moreover, any such standardized language and terms will be difficult to fashion because of the complexity and variety of derivatives."[146]

Bankruptcy claims trading, similar to derivative trading, occurs on a continuum, from highly standardized exchange-traded instruments to highly customized and bargained for over-the counter instruments. The flexibility of both the instrument and the trading

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[144] Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. U. CHI. L.J. 1, 32–33 (2011).
[145] *See id.* at 30–31.
[146] Frank D'Souza et al., *Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market*, 12 U. PA. J. BUS. L. 473, 504 (2010).

environment reflects the varying degrees of uncertainty and risk associated with unique claims. Additionally, a regulatory environment that allows for flexibility and freedom in claims transactions, both in private and on exchanges, fosters greater trade activity.

C. The Solution

The foregoing sections demonstrate that unsophisticated creditors are not at risk of being defrauded by passive investors. Creditors are selling claims, and their lack of information pertains to the market for claims rather than the claim itself. Whether creditors and passive claims investors engage in privately negotiated transactions or standardized, exchange-facilitated transactions, they should be free to deal with one another at arm's length without any forced disclosure requirements.

VI. Online Exchange as a Remedy for the Unsophisticated Creditor

Professor Levitin writes that:

> [t]he most immediate improvement that can be made of claims trading is improved price disclosure. Because bankruptcy claims trade on the OTC market, there is limited pricing information; a creditor cannot easily gauge what the market price for its claim is. There might not be comparables, and even if there are, there is no central source to see pricing. At best, a creditor might receive several solicitations around the same time and be able to compare them. Absent the ability to easily cross-check against comparables, it is difficult for a creditor to evaluate an offer to purchase its claim.[147]

Levitin then calls for central clearing and pricing bulletin boards as mechanisms for increasing disclosure by investors and improving the regulation of claims trading.[148] But beyond Levitin's suggestions and commentators' general calls for increased disclosure

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[147] Levitin, *supra* note 13, at 110–11.
[148] *Id.*

and transparency,[149] no robust treatment has been given to the topic of online exchanges for bankruptcy claims.[150] This Note argues that online exchanges can fulfill the function Levitin envisions—increasing information dissemination between buyers and sellers of claims and reducing risk for unsophisticated creditors. This market innovation remains in its infancy, but it appears it could improve transparency and centralization without burdening this market with forced disclosure.

SecondMarket and IlliquidX each claim to fulfill a centralizing function for claims trading. On its website, SecondMarket offers creditors in the "highest-profile" bankruptcy cases the opportunity to "transact on a simple, centralized platform," which delivers the "most competitive pricing" through periodic auctions or privately arraigned transactions.[151] Investors seeking to the use the platform must confirm that they satisfy the accredited investor standard.[152] Selling creditors do not.[153] IlliquidX's founder says "[b]efore we came along, the market for illiquid securities was opaque and inefficient, but we have created an independent, transparent and regulated market place where buyers and sellers can enter into transactions at realistic prices."[154] IlliquidX indicates that it

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[149] *See, e.g.*, Drain & Schwartz, *supra* note 13, at 572 ("Effective entry into the market is difficult and generally limited to sophisticated institutions. Reliable information about debtors and chapter 11 cases is not regularly available and large creditors have frequent opportunities to access inside information. Might the market be improved for all participants by making it more transparent?").

[150] One restructuring professional, Jonathan O. Mottahedeh, has briefly considered the online exchange as a vehicle for increased transparency and efficiency in the claims trading market. *See generally* Jonathan O. Mottahedeh, *A New Exchange on the Street: Discovering Prices for Unsecured Trade Debt*, AM. BANKR. INST. J., June 2012, at 54, 54.

[151] SecondMarket, *Bankruptcy Claims*, SECONDMARKET (last visited Sept. 25, 2012), https://www.secondmarket.com/bankruptcy-claims.

[152] *Id.* The accredited investor standard is defined at 17 C.F.R. § 230.501 (2012).

[153] Press Release, SecondMarket, *supra* note 5.

[154] Kathleen Brooks, *Cleaning Up after the Crisis*, CITY A.M. (Mar. 26, 2010), http://stage.cityam.com/article/cleaning-after-crisis [hereinafter City A.M.] ("As its name suggests, Illiquidix provides liquidity solutions for assets that are traditionally illiquid, such as distressed debt, bankruptcy claims, illiquid high yield bonds and also mortgage-backed securities. 'There are so many of these assets around especially since the collapse of Lehman Brothers,' says Amore. 'Before we came along, the market for

"acts as either auction organiser [sic] or bidder in competitive contexts together with other traditional players (investment banks and traditional brokers)."[155]

There is little research or reporting to verify the extent to which these online exchanges have lived up to their assertions. But the foregoing analysis in Part V, examining the unsophisticated creditor problem, suggests that these creditors are in no danger of being defrauded with or without online exchanges. Facing no more than a problem of asymmetric information and an inferior bargaining position, selling creditors stand to potentially benefit in several ways when trading through one of these online exchanges.

First, creditors can avoid the administrative hassle of fielding individual solicitations from distressed debt investors.[156] The creditor can redirect investors to the exchange, allow the exchange operator to receive bids, and provide the creditor with a bid summary. This centralized process could generate efficiency gains for creditors, especially those with a large or steady supply of claims arising from their relationships with more than one debtor. Second, the selling creditor can gain relatively cheap access to a larger pool of prospective buyers. The creditor avoids hiring a broker to market the claim (though still pays a commission to the exchange operator per transaction). The exchange operator will notify buy-side members about the upcoming auction and provide details about the size and characteristics of the claim, and will then solicit bids from interested investors. SecondMarket has more than 1,500 institutional investors

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illiquid securities was opaque and inefficient, but we have created an independent, transparent and regulated market place where buyers and sellers can enter into transactions at realistic prices.' Amore believes that now, in the aftermath of the financial crisis, is the right environment for boutique financial firms like his to flourish: 'Smaller players have been able to come into this market because the trust in large financial organisations has been lost.' . . . By providing a transparent platform for distressed assets it is helping to cleanse the financial system: 'These assets need to be valued at a market price and then sold on to get the economy going again, without that we can't recover from the crisis.'").

[155] *IllliquidX We Add Value*, ILLLIQUIDX, http://www.illiquidx.com/buyers_for_lehman_bonds_and_claims.php (last visited Mar. 15, 2013).

[156] *See* Meyer, *supra* note 129.

registered as exchange members,[157] while IlliquidX has more than 650.[158]

A third potential benefit is the auction process, which could enable the creditor to obtain a higher price for a claim than a privately negotiated transaction. Without an auction, the selling creditor is forced to price its claim. And, as noted previously, selling creditors often lack the information needed to assess the probability of repayment, the expected delay in distribution, and the risks inherent in the particular claim. After struggling to determine a price, the selling creditor must field individual solicitations from distressed investors. Each investor not only offers a different price but will also want to negotiate over particular terms of the purchase and sale agreement. The price an investor offers may be contingent upon the creditor retaining certain risks or offering indemnification. The exchange-run auction, however, may standardize the terms of the transfer agreement and force bidders to bid on a single deal structure.

While SecondMarket and IlliquidX both claim to bring standardization to the process, their realization of this goal remains unproven.[159] One restructuring professional analyzes the need for standardization as follows:

> Although the legal environment for trading claims is conducive for a centralized exchange to operate in a liquid and transparent environment, the fundamental issue is how the exchange can manage the due-diligence process and provide a standardized claims-transfer agreement for unsecured trade claims. In order for the exchange to sustain high trading volume, there must be a solution that minimizes or eliminates bilateral negotiations and the costs associated therewith.[160]

Despite the administrative and efficiency gains these platforms bring to selling creditors, it also appears that neither has

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[157] Press Release, SecondMarket, s*upra* note 5.
[158] Brooks, *supra* note 154.
[159] Mottahedeh, *supra* note 150, at 54 ("Although T-Rex Auctions (later acquired by SecondMarket) provided a glimpse of hope, little progress was made toward a transparent marketplace.").
[160] *Id*. at 55.

fully embraced price transparency.[161] However, the newest of these platforms—One Exchange Street—contends that it will encourage price transparency.[162] The founder explains that "[c]laims sellers can list their claims and see recent transaction amounts for similar claims."[163] One Exchange Street will provide creditors "access to relevant information in order to help them, and their advisors, value their bankruptcy claim prior to setting their asking price."[164] One Exchange Street's voluntary approach to price disclosure is certainly novel in an industry that has long repelled legally required disclosure. In addition to price transparency, One Exchange Street explains: "[A]ll members on our exchange agree to transact using a standardized claim transfer agreement. This enables real-time execution of transactions. These two things differentiate us from our competitors."[165]

One Exchange Street began operations in 2012 after closing a seed-financing round in April.[166] Thus, their ability to bring transparency and standardization to the secondary claims market has also yet to be tested like SecondMarket and IlliquidX. The founders are both experienced restructuring professionals who "identified critical transparency and efficiency issues inherent in the bankruptcy market in February 2011 while advising the ad hoc group of Lehman Brothers Holdings Inc. creditors."[167]

Online exchanges for bankruptcy claims offer potential benefits to unsophisticated creditors without raising further risks. Unsophisticated creditors seeking to sell their claims to passive investors already participate in transactions relatively free of the risk of fraud present in securities markets. With the status quo for the unsophisticated creditor cutting against the rationale for imposing additional disclosure by claims traders, online exchanges appear to

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[161] *Id.* ("Current trading practices do not provide the support necessary to enhance trading volume because of the lack of price discovery . . . .").

[162] *One Exchange Street Launches Platform for Online Trading in Bankruptcy Claims*, PR NEWSWIRE (Jun. 5, 2012), http://www.prnewswire.com/news-releases/one-exchange-street-launches-platform-for-online-trading-in-bankruptcy-claims-157192805.html [hereinafter *One Exchange Street Launches Platform*].

[163] Meyer, *supra* note 129.

[164] *One Exchange Street Launches Platform*, *supra* note 162.

[165] Meyer, *supra* note 129.

[166] *One Exchange Street Launches Platform*, *supra* note 162

[167] *Id.*

introduce a market remedy that will enhance the position of the vulnerable party in these transactions.[168]

Three final critiques of forced disclosure lend additional support to the approach of regulatory restraint. First, Judge Gerber indicates that bankruptcy judges would be unlikely to utilize disclosed price information in case administration.[169] Second, many unsophisticated creditors lack the expertise or resources to conduct any research when establishing an offering price or negotiating a purchase and sale agreement. It is not clear that these creditors would be able to effectively determine a claim price by analyzing the prices and disparate terms of other claims, at least not easily. Third, voluntarily disclosed information dissemination through an exchange provides a more efficient system for all exchange participants than court filed disclosures; rather than forcing traders to disclose their proprietary "reservation price," investors should have the freedom to trade through over-the-counter markets or online secondary exchanges.[170] In light of this market innovation, proposals for mandatory disclosure by claims traders of price, entity information, and purchasing motives appear misguided.

VII. Cocnerns about "Run-Away" Trading

The online exchange for claims provides a market remedy to protect the unsophisticated creditor. But how else might these exchanges affect a reorganizing debtor? Given the ease of trading claims through an online exchange, it is conceivable that more claims will change hands during a case, perhaps at a faster rate. To the extent that trading volume and trading speed accelerate during a case, the debtor's increased administrative burden of tracking claims should not be overbearing.

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[168] *See* Whitaker, *supra* note 19, at 339 ("[T]his Note proposes requiring disclosure of the parties in interest and the consideration paid for a claim").
[169] *See* Gerber, *supra* note 74.
[170] *See* Gelber et al., *supra* note 69. *Contra* Baird, *The Bankruptcy Exchange*, supra note 13, at 35.

A. Narrowly Tailored Trade Orders as a Brake

Large public company debtors often need to keep track of the identity of claim holders and the size of claim holdings.[171] Reasons for such tracking often reach beyond the Code. Tax concerns and industry-specific regulations[172] often hinge on equity control, and a change in control could create restrictions on the debtor.[173] Because unsecured claims are often converted into equity in the reorganized entity (in lieu of a cash distribution), claims are integral to concerns about control.[174] The most widespread control concern arises under the Internal Revenue Code, which allows a corporation to carry forward Net Operating Losses ("NOLs") to deduct against future income.[175] A corporation in Chapter 11 will often have NOLs because rising costs, reduced revenue, or a

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[171] *See* Gelber et al., *supra* note 69, at 3 ("[Trade] orders are increasingly common in large bankruptcy cases and may restrict trading in the debtors' debt and equity securities and claims.").

[172] *See infra* note 190 and accompanying text.

[173] James L. Bromley, Kristopher Hess & Joseph Lamport, *Protecting Trading Markets and NOLs in Chapter 11*, AM. BANKR. INST. J., Feb. 2005, at 1, 1 ("The [model order] project was motivated by the disruptions to the debt-trading markets that have been increasingly caused by restrictive NOL orders entered by bankruptcy courts at the request of debtor corporations in large chapter 11 cases. Recent examples of large cases where such orders have been entered are *UAL, US Airways, Mirant, Conseco* and *WorldCom*. These orders are intended to protect the debtors' ability to utilize NOL carryovers to offset future tax liability. In many instances, however, the effect of the orders has been to halt or seriously restrict trading in the corporations' debt and to require investors to expend significant time in an effort to understand and negotiate the scope of the restrictions.").

[174] Jean Morris, *Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor's Chapter 11 Case to Preserve the Debtor's Net Operating Loss Carryforward: Examining the Emerging Trend*, 77 AM. BANKR. L.J. 285, 287 (2003) ("[A]n "ownership change" may occur if a debtor's confirmed chapter 11 plan of reorganization provides for creditors to receive stock in the reorganized debtor. However, under the "bankruptcy exception" embodied in the Internal Revenue Code [Section 382(*l*)(5)(A)], the NOL is nonetheless preserved if the debtor's existing shareholders and/or "Qualified Creditors"[10] own at least 50% of the value and voting power of the debtor's stock after reorganization.").

[175] 26 U.S.C. § 172(b) (2006 & Supp. V 2011) ("[A] net operating loss for any tax year . . . shall be a net operating loss carrying over to each of the 20 taxable years following the taxable year of the loss").

combination of the two force the corporation to seek bankruptcy protection. The NOLs, which can be deducted against future profits, have great value for the corporation when it emerges from bankruptcy as a reorganized entity.[176] However, the Code restricts the deduction of NOLs in the event of certain change of control scenarios.[177]

As discussed earlier, bankruptcy judges rarely exercise oversight over claims trading. However, bankruptcy courts do become involved in the mechanics of claims transfers via trade orders.[178] Though lacking specific authority, bankruptcy judges issue trade orders pursuant to their equitable power under Section 105(a) of the Code.[179] A debtor will move the court to enter a trade order,[180]

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[176] Morris, *supra* note 174, at 287 ("Accordingly, in cases where a debtor corporation concludes that its ability to carry over an existing NOL to offset future profits following reorganization will provide additional value to the reorganization case and to creditors generally, that debtor corporation must inevitably consider the potential impact on its NOL of transfers of its debt and equity securities, either privately or in the public markets. This fear of lost value, through restrictions on the ability of the debtor to carry forward existing NOLs to future profitable years, has motivated debtors to attempt to obtain orders from the bankruptcy court restraining trading in debt and equity interests that could, even unintentionally, adversely affect this potential value.").

[177] For a comprehensive analysis of Internal Revenue Code restrictions on NOLs in bankruptcy and change of control scenarios, see *id.* at 286–87. *See generally* H. Jeffrey Schwartz, Brian E. Greer & Iva Uroic, *Protection of Net Operating Losses Through Trading Injunctions and Forbearance Agreements*, 17 J. BANKR. L. & PRAC. 935.

[178] Gelber et al., *supra* note 69, at 1.

[179] 11 U.S.C.A. § 105(a) (West 2012) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

[180] *See generally* Schwartz, Greer & Uroic, *supra* note 178. ("Accordingly, a corporation in Chapter 11 may seek injunctive relief from the U.S. bankruptcy court presiding over the Chapter 11 case to prevent an ownership change from occurring under section 382 and thus protect its NOLs. Specifically, the debtor corporation may seek to enjoin the purchase and sale of equity interests in the debtor that would effect [sic] an ownership change under section 382 and the trading of claims against the debtor that would cause the reorganized corporation not to qualify for the bankruptcy exception under section 382(l)(5). While such injunctions serve to benefit the corporation by preserving a potentially significant asset of the estate—the NOLs—it is not without a cost to the corporation's creditors and equity

which one bankruptcy practitioner describes as follows: "Typically, such orders contain a 'notice and hearing' provision whereby the restrained party is required to give a designated notice to the debtor of a proposed transfer and is permitted to complete the transfer if the debtor does not object within the prescribed notice period."[181] However, the party "is restrained from proceeding with the transfer and must obtain court approval for the transfer if the debtor objects."[182] Thus, "[f]rom the debtor's perspective, one of the main objectives of a trading order is to allow the debtor to monitor the ownership of the claims so that it can protect itself from triggering a change in control that could jeopardize . . . tax advantages such as net operating losses ('NOL') carryforwards."[183]

The trade order alone cannot indefinitely restrict claims transfers. Rather, the court must determine that the NOL carryforward is property of the bankruptcy estate pursuant to Code Section 541, which many courts have been willing to do.[184] Having made that conclusion, the court may then reason that an exercise of control over property of the estate violates the automatic stay.[185] Finally, the court may enjoin the trading of the debtor's equity or claims that would result in loss of NOLs.[186] Courts often tailor such injunctions to either

> (a) require substantial claimholders (those who are estimated to receive about 5% of equity in the reorganized corporation on account of their claims) to identify themselves and require approval before any additional claims can be acquired by such

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holders who want to trade out of their positions in the corporation or accelerate their losses for estimated tax purposes.").

[181] Morris, *supra* note 174, at 285 n.1.

[182] *Id.*

[183] Gelber et al., *supra* note 69, at 3.

[184] Morris, *supra* note 174, at 290; *see also, e.g.*, Official Comm. of Unsecured Creditors v. PSS S.S. Co., Inc. (*In re* Prudential Lines, Inc.), 928 F.2d 565 (2d Cir. 1991) (finding that a parent company, which took a worthless stock deduction on its debtor subsidiary and thus restricted the debtor's NOL deduction, violated the automatic stay by exercising control over property of the estate). *But see In re* Cumberland Farms, Inc., 162 B.R. 62 (Bankr. D. Mass. 1993) (determining that a speculative NOL was not property of the estate).

[185] Morris, *supra* note 174, at 290.

[186] *See generally* Schwartz, Greer & Uroic, *supra* note 178.

> substantial claimholders, or (b) permit the debtor to seek a "sell-down order" at the end of the Chapter 11 case to cause substantial claimholders to sell any claims that would result the claimholder receiving in an excess of 5% of the stock of the reorganized corporation.[187]

Holders of debt and equity claims have pushed back on restrictive trade orders, arguing that the automatic stay cannot apply to claims transfers[188] and that, at the least, such holders are owed compensation for loss of liquidity as relief from the automatic stay when applied to claims transfers.[189]

In *In re Mesa Air Group, Inc.*, the bankruptcy judge issued a trade order requiring any claim transferee to file a Claim Acquisition Notice in addition to the Rule 3001 Evidence of Transfer if, after such transfer, the transferee would become the holder of more than

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[187] *Id.*; *see also* NAT'L BANKRUPTCY CONFERENCE, REPORT TO THE 2006 ANNUAL MEETING, COMMITTEE ON TAXES 3 (2006), *available at* www.nationalbankruptcyconference.org/pubs/CLI_1454986_1_NBC_Tax Report 2006.DOC ("This trend is at least partly in response to a model order drafted in 2004 by the Bond Market Association and the Loan Syndication and Trading Association, which had as its objective the preservation of debtor tax attributes while minimizing disruption to the full functioning of the debt and equity markets.").

[188] *In re* Dana Corp., 358 B.R. 567, (Bankr. S.D.N.Y. 2006); Morris, *supra* note 174, at 293–298.

[189] NAT'L BANKRUPTCY CONFERENCE, *supra* note 187, at 4 ("Those opposing claims trading orders have also been emboldened by the Seventh Circuit's recent statement in *dictum* [*In re UAL Corp*., 412 F.3d 775 (7th Cir. 2005)] that injunctions against stock trading to preserve the value of a debtor's NOLs should not be imposed unless the debtor provides a funded mechanism (such as a cash bond or an adequate protection order) for compensating those who might be hurt by the injunction."); Morris, *supra* note 174, at 297 ("Additionally, § 362 provides that the nondebtor party may move for relief from the automatic stay. If relief is requested, any continuance of the stay is conditioned upon the debtor proving that the nondebtor party's interest in the affected property is adequately protected. Therefore, if a claimholder or equity holder is determined to be enjoined from transferring its claim or stock pursuant to § 362(a), any benefit to the debtor could be short-lived, should the debtor be required to give the nondebtor party protection from the loss of value of its claim or interest through market fluctuation.").

$25 million in claims.[190] When creditor BF Holdings objected to confirmation of the debtor's plan of reorganization, the debtor responded that BF Holdings, which failed to file a Claim Acquisition Notice despite acquiring over $25 million in claims, lacked standing for failure to comply with the trade order.[191] The debtor operated a private airline and sought to avoid a change of control that might restrict its use of NOLs or trigger noncompliance with the Transportation Code, which requires that at least 75% of the debtor's voting interest be held by U.S. citizens.[192] The court overruled BF Holdings objection to plan confirmation for lack of standing,[193] as well as on the merits.[194]

As seen from the forgoing analysis and the example of *In re Mesa*, most equitable trade orders place a slight delay on claim

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[190] Gelber et al., *supra* note 69, at 2; *Motion, In re* Mesa Air Group, Inc., *supra* note 30, at ¶ 18, 27 ("[I]n order to preserve to the fullest extent possible the flexibility to craft a plan of reorganization which maximizes the use of their NOL carryforwards, the Debtors seek limited relief (consistent with their rights under the automatic stay) that will enable them to closely monitor certain transfers of claims and equity securities and be in a position to act expeditiously to prevent such transfers if necessary to preserve their NOL carryforwards. Further, as discussed above, such transfers may potentially affect the value and continued viability of the Codeshare Agreements. By establishing procedures for continuously monitoring claims-trading and equity-securities-trading, the Debtors can preserve their ability to seek relief at the appropriate time if it appears that additional trading may jeopardize the use of their NOL carryforwards or affect the Codeshare Agreements. . . . The Debtors are not seeking to bar the trading of all claims and stock trading. Rather, the relief requested herein is narrowly tailored to permit certain claim and stock trading to continue, subject only to Fed. R. Bankr. P. 3001(e) and applicable securities, corporate and other laws. Furthermore, the Debtors are only seeking to enforce the provisions of the automatic stay with respect to certain types of claims and stock trading which pose serious risk under the ownership change tests, and to monitor other types of unsecured claims trading which could pose serious risk so they can preserve their ability to seek relief at the appropriate time if it appears that the proposed trade will jeopardize the unrestricted use of the NOL carryforwards.").

[191] *In re* Mesa Air Group, Inc., No. 10-10018 (MG), 2011 WL 320466, at *1 (Bankr. S.D.N.Y. 2011).

[192] *Id.* at *2.

[193] *Id.* at *4–5.

[194] *Id.* at *5–12.

transfers that meet a threshold size.[195] Thus, if the debtor has a legitimate concern about tracking claims and claimholders, the debtor can seek effective, short-term relief via a trade order. The order may not permanently enjoin trading, but it will generally provide the debtor at least an opportunity to object to a control-changing transfer.

Returning to the distinction between passive and active claims traders, passive traders will rarely purchase enough claims to trigger a change-of-control threshold.[196] Professor Levitin, commenting on different categories of traders, notes that "simple passive arbitrageurs . . . are also often eager to purchase very small claims because these claims will likely be classified as convenience claims, which are frequently paid in full."[197] Thus, equitable trade orders protect a debtor's interest in tracking claims and claimholders, even if those claims trade at a faster rate and in a greater volume.

B. Passive Claims Trading Does Not Hinder Coalition Forming

Professors Baird and Rasmussen argue that claims trading and financial innovation have created an empty core in bankruptcy.[198] They observe that bankruptcy has become "a world in which everyone brings special expertise to the bargaining table and negotiates in an environment that is virtually frictionless."[199] Without shared expectations and leadership of either a secured lender or an official creditors' committee, the parties fail to reach efficient outcomes.[200] "When there is a zero-sum game, there are an infinite number of possible deals. The parties must form a coalition around one of many possible agreements. Bargaining works best when there are focal points that provide a basic understanding of the contours of an acceptable deal."[201]

Professor Levitin challenges the empty core thesis. He writes that while Baird and Rasmussen's conclusion is "compelling, it relies on two questionable assumptions: [f]irst, that claimholdings are

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[195] *See* discussion *supra* notes 190–194 and accompanying text.
[196] Goldschmid, *supra* note 13, at 269–271.
[197] Levitin, *supra* note 13, at 95.
[198] Baird & Rasmussen, *Antibankruptcy*, *supra* note 13, at 68.
[199] *Id.*
[200] *Id.*
[201] *Id.*

actually more fragmented than in the past, and second, that this is causing more problems in forming coalitions, resulting in suboptimal outcomes."[202] Levitin continues:

> It is not unreasonable to theorize that claims trading reduces the number of parties involved and thereby *facilitates* negotiation . . . . Rather than financial innovation creating a collective action problem that undermines the procedural goal of bankruptcy, namely resolving a different collective action of the race to the courthouse, financial innovation is creating a solution to a collective action problem that is endemic to the multiparty nature of bankruptcy. Claims trading might help resolve the anticommons problem, rather than exacerbate it.

How do the different types of claims traders fit into this debate about bankruptcy negotiation? It appears that activist investors create the controversy. These investors amass enough claims to exert blocking votes on plan confirmation. They often extend debtor-in-possession financing with restrictive debt covenants to exert control over the debtor's operations. They pursue the fulcrum security to obtain control of the reorganized entity.[203] Thus, these investors raise the most questions for facilitating or hindering bankruptcy negotiation.

Because passive investors generally build smaller claim positions than active investors and do not actively participate in the reorganization process, they are more likely than active investors to fulfill Levitin's assertion that claims trading will resolve the anticommons problem rather than exacerbate it.[204] A creditor with a small claims position probably cannot exert a blocking vote in its creditor class. The passive investor rarely enters the proceeding to litigate its claims or influence the plan. In fact, passive investors replace disgruntled, unsecured creditors and decrease the likelihood that this class will reject the plan due to an insufficient distribution.

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[202] Levitin, *supra* note 13, at 100–01.

[203] *See generally* Harner, *Barbarians supra* note 13.

[204] Levitin, *supra* note 13, at 106 (advancing an alternative theory to Baird and Rasmussen's anticommons thesis by arguing that claims trading may in fact reduce the number of involved parties and foster negotiation).

Thus, an online exchange that accelerates the claims transfer process or results in individual claims changing hands multiple times during a case will not hinder coalition formation.

VIII. Notice to Creditors of an Opportunity to Trade on an Online Exchange

As a modest addition to existing bankruptcy regulations, notice to creditors that the debtor has filed a petition should include an additional notice—the existence of online exchanges for bankruptcy claims and the benefits to creditors of trading their claims through such an exchange. The idea of giving creditors notice of the existence of a secondary market for claims is not new. One student note proposes "a notice to all creditors that a secondary market in claims may be created."[205] Levitin also suggests that claims trading regulation should "improve market efficiency by increasing unsophisticated creditors' awareness of their claims trading options and by enhancing price disclosure to market participants through mechanisms like electronic quotation bulletin boards."[206] If online exchanges continue to bring participants the kinds of efficiency, administrative, and price benefits that they assert, then selling creditors should be apprised of this opportunity.

IX. Conclusion

This Note has analyzed passive-strategy claims trading and argued that, in the context of existing rules of bankruptcy procedure, online exchanges for bankruptcy claims mitigate the risk facing unsophisticated creditors and further support a regulatory environment free from forced disclosure by passive claims traders. Given adequate time, these exchanges may alleviate information asymmetries and the inferior bargaining position faced by unsophisticated creditors, ushering in administrative and efficiency gains, standardization of transaction terms, centralization of the market, and price optimization. Even if these exchanges fail to accomplish these objectives, the status quo for selling creditors—an over-the-counter market for claims—is a transacting environment relatively free of the risk of fraud, and thus needs no additional disclosure by passive investors.

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[205] Whitaker, *supra* note 19, at 340.
[206] Levitin, *supra* note 13, at 67.

While online secondary exchanges mitigate the risk posed to unsophisticated creditors by passive claims traders, amended Rule 2019, which targets disclosure for activist investors, serves as a sufficient regulatory response to activist investors. Forcing additional, mandatory disclosure under Rule 3001 would lead to an overinclusive outcome as activist investors would have to disclose under both Rules. As Professor Harner argues in several of her papers, the market populated by activist distressed investors may require additional regulatory remedies. Nevertheless, efforts to regulate activist investing and the issues relating to the control of a debtor or the formation of a plan of reorganization should be narrowly tailored enough to exclude passive distressed debt investing.