[Brooklyn Journal of Corporate, Financial & Commercial Law](https://brooklynworks.brooklaw.edu/bjcfcl)

Volume 4 | Issue 1 Article 2

2009

The Bankruptcy Exchange

Douglas G. Baird

THE BANKRUPTCY EXCHANGE

Douglas G. Baird[*]

The bankruptcy forum has become a marketplace for claims.[1] Those who made the loans are far removed from the players that sit at the negotiating table in the modern corporate reorganization. Instead of stock being traded on the floor of an exchange, claims are traded in bankruptcy court. Investors become residual owners of firms outside of bankruptcy by buying stock. Inside of bankruptcy they do it by buying debt. In both cases, it is a world of professional traders, arbitrageurs, and corporate raiders.[2]

Long passed is the time when we could usefully debate whether claims trading in bankruptcy was a good or a bad thing. We should accept that it has become a fundamental feature of bankruptcy. But it is naive to think that this new market, the bankruptcy exchange, should be unregulated. All markets are regulated. Whether one is a merchant who seeks to sell wool in the twelfth century or a farmer who wants to sell grain in the nineteenth, being subject to regulation is inevitable.[3] One cannot set up a market

---

* Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School. This paper was presented at a symposium on securities regulation and claims trading organized by the *Brooklyn Journal of Corporate, Financial & Commercial Law* on February 27, 2009. The ideas grow out of my long and continuing work with Robert Rasmussen. I am most grateful to Michael McMahon for assistance and the Sarah Scaife Foundation, the Lynde and Harry Bradley Fund, and the John M. Olin Foundation for support.

1. *See* Stuart C. Gilson, *Investing in Distressed Situations: A Market Survey*, FIN. ANALYSTS J., Nov.–Dec. 1995, at 8; Adam J. Levitin, Jr., *Finding* Nemo: *Rediscovering the Virtues of Negotiability in the Wake of* Enron, 2007 COLUM. BUS. L. REV. 83, 86 (2007) ("Although the exact size of the corporate bankruptcy claims trading market is unknown, it was estimated to be in the hundreds of billions of dollars about a decade ago and has seen a prodigious growth in recent years.").

2. *See* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 703 (2008) ("Activist institutional investors traditionally have invested in a company's equity to try to influence change at the company. Some of these investors, however, are now purchasing a company's debt for this same purpose."); *see also* Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 70 (2008) ("[P]rofessional distressed debt 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-petition lender.").

The market for claims against a distressed business also flourishes well in advance of a bankruptcy filing. In the recent Chrysler bankruptcy, for example, the Indiana pension funds that sought to block Chrysler's sale had bought their secured debt for forty-three cents on the dollar nine months before the bankruptcy filing. Michael J. de la Merced, *U.S. Court of Appeals Upholds Chrysler Sale to Fiat*, N.Y. TIMES, June 6, 2009, at B2 (discussing *In re* Chrysler L.L.C., 576 F.3d 108 (2d Cir. 2009)).

3. *See*, *e.g.*, Munn v. Illinois (*In re* Munn), 94 U.S. 113, 135–36 (1877) (upholding state regulation of the storage and sale of grain); *see also* Richard O. Zerbe, Jr., *The Origin and Effect of Grain Trade Regulations in the Late Nineteenth Century*, 56 AGRIC. HIST. 172, 172 (1982) ("Business transactions of every sort take place within a regulatory context in the sense that there is a framework of law, custom, or culture which provides rules and structure to transactions.").

without regulating it. Simply providing that it is open on Wednesdays, but not Saturdays, is a form of regulation that works to the advantage of some and to the disadvantage of others. The Chicago Board of Trade is the paradigm of a free market, but it is also among the world's most heavily regulated. Elaborate rules establish who can trade, what can be sold, when trading can occur, and under what terms.[4]

Regulation of the bankruptcy exchange is similarly inescapable. Every decision in a bankruptcy case affects the bankruptcy exchange, for better or worse. Scheduling a date for a cramdown hearing has the effect of putting an exercise date on an option contract. Whether intended or not, every decision a bankruptcy judge makes affects trading on the bankruptcy exchange. The question is not whether there should be regulation, but what form it should take.

In this Article, I review the first principles that should be at work in regulating the bankruptcy exchange. Part I examines the features and the virtues of a well-functioning market and connects them to the trading of claims in bankruptcy. Parts II and III look more narrowly at the role the disclosure rules play. Disclosure rules are a crucial feature of the playing field in this market as in any other. At the medieval fair, goods for sale had to be on public display.[5] On the Chicago Board of Trade, traders must, under some circumstances, disclose their trading positions (though only to the exchange, not to their contracting opposites).[6] All markets have disclosure rules, and the bankruptcy exchange should not be an exception. Part II focuses on the disclosures needed for the rest of the bankruptcy process to work effectively, independent of the exchange itself. Part III focuses on the role that disclosure plays in ensuring a well-functioning market in bankruptcy claims. This part of the Article is the most tentative, because while one can set out basic principles, it is too soon to provide many clear lessons about the costs and benefits of maintaining transparency in the trading of bankruptcy claims.

I. THE WELL-FUNCTIONING EXCHANGE

Those who establish an exchange, whether medieval prince, Chicago merchant or bankruptcy judge, try to ensure that the market works while advancing their own agendas, whether it is raising taxes, promoting business, or rehabilitating firms. The rules that govern well-functioning markets share three features worth underscoring. First, they allow those who want to sell to do so at low cost and at a price that reflects the value of

---

4. *See generally* CHI. BD. OF TRADE, CHICAGO BOARD OF TRADE RULEBOOK, *available at* http://www.cmegroup.com/rulebook/cbot-rulebook-listing.html (last visited June 9, 2009).

5. *See* ELLEN WEDEMEYER MOORE, THE FAIRS OF MEDIEVAL ENGLAND: AN INTRODUCTORY STUDY 115 (Pontifical Inst. of Mediaeval Studies 1985).

6. *See* CHICAGO BOARD OF TRADE RULEBOOK, R. 561.

the assets that are being traded. Second, they ensure that assets will move to those who value them the most. Third (and less noted), they try to take best advantage of the information that a well-functioning market aggregates.[7] The price generated in such a market contains more reliable information than what you can find in the report of any expert.[8] Even those who do not themselves trade can benefit from this information.[9]

When a market is liquid, that is, when many are able to trade at low cost, the price at which assets are sold is likely to reflect its true value. This in turn attracts trade and lowers costs.[10] Quite apart from transaction costs, someone who is confident that a market is working can worry less about strategic behavior. Moreover, the average trader can sell at the current price without doing elaborate research. The research is unnecessary as the information it would uncover is already embedded in the market price. Trading done by those who already have the information in a liquid market has this effect.[11]

The ordinary, uninformed outsider can invest in the stock market by acquiring a diversified portfolio and be confident that, at least over the long run, she will enjoy a market return on her investment.[12] A well-functioning bankruptcy exchange serves a similar function. Unsophisticated small creditors, whether they are suppliers, tort victims, or small investors, can opt out of the bankruptcy process early and liquidate their claims.

One must, of course, make an important caveat: To say that a well-functioning bankruptcy exchange has these virtues is not to say that claims trading in any particular bankruptcy works well. When the market for claims is thin, inaccessible, or laden with transaction costs, the prices at which claims trade may have no relationship to their true value. While a well-functioning market brings an enormous benefit to tort victims, one that works poorly can be worse than none at all. The unsophisticated creditors who trade, receive far less for their claims than they are worth. They are not knowledgeable enough to know that they should hold on to their claims.[13]

---

7. *See*, *e.g.*, Justin Wolfers & Eric Zitzewitz, *Prediction Markets*, 18 J. ECON. PERSP. 107, 113 (2004) (evidence illustrates that the Hollywood Stock Exchange has been almost as accurate as experts in picking Oscar winners).

8. *Id.*

9. *See id.*

10. *See* Fischer Black, *Noise*, 41 J. FIN. 529, 532 (1986).

11. *See generally* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

12. *See generally* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (1973) (advocating a passive, indexing strategy toward investing); HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959) (providing the mathematical foundation for portfolio selection).

13. For the classic analysis of claims trading, see Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990). For an early and forceful exposition of the virtues of disclosure, see Joy Flowers Conti,

Of course, one cannot expect prices to track true values precisely, even in the most well-functioning market.[14] As a matter of theory, it is simply not possible for the two to match. The prices on an exchange can reflect information only if those who possess it are able to profit by trading on it. They have to believe there is a gap between the true value and the market price or they will not have an incentive to trade. Quite apart from theory, experience has taught us that prices are inevitably noisy.[15] Fischer Black's test for whether a market was working well was whether an asset trades at a price that is within fifty percent of its true value.[16]

In short, while searching to improve its regulation, one should not expect too much of the bankruptcy exchange. Even under the best of circumstances, prices on the exchange will be volatile. The best we can do is minimize the volatility and try to ensure that the price at which a claim is sold is an unbiased estimate of its actual value, where the price is as likely to be too high as too low.

A well-functioning market is one of the best ways to aggregate information. The best estimate of the price at which grain will sell next October is the price generated on the futures exchange today. Such knowledge is valuable not simply to the people who buy and sell on the exchange, but also to the farmer who must decide whether to plant wheat and to the bakery that must decide whether to expand. Indeed, markets are so effective at aggregating information that sometimes we create information markets solely for this purpose. For example, prediction markets do far better than any expert in predicting the outcome of the presidential election or the next winner of an Academy award.[17]

It might seem that this feature of well-functioning markets could be harnessed in the bankruptcy process. Assume, for example, that a firm has creditors owed a total of $100 and all of it is unsecured. Let us also assume that the plan of reorganization will give one share of equity for each dollar of claim. The price at which each claim trades today multiplied by one hundred tells us how much the firm is worth.

Raymond F. Kozlowski, Jr. & Leonard S. Ferleger, *Claims Trafficking In Chapter 11—Has The Pendulum Swung Too Far?*, 9 BANKR. DEV. J. 281, 349 (1992). For an incisive look at claims trading in bankruptcy, see Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1701–03 (1996).

14. *See* Black, *supra* note 10, at 531 (noise trading is necessary for the market to function). Indeed, Black showed that without such valuation uncertainty, securities markets could not even exist. *Id.* For him, a market was efficient if the price at which a security traded is somewhere between half and twice its true value. *Id.* at 533 (factor of two arbitrary values Black uses to define an efficient market).

15. *See*, *e.g.*, G. William Schwert, *Stock Market Volatility*, FIN. ANALYSTS J., May–June 1990, at 23, 23.

16. Black, *supra* note 10, at 533.

17. Wolfers & Zitzewitz, *supra* note 7, at 112–13.

One should, however, be quick to note the limitations of our ability to use or extract information from this market, even when it functions well. A judge cannot, for example, use the price at which claims trade to put a value on the firm. When the judge is putting a value on the firm, the price at which claims trade is not an estimate of the value of the firm, but rather a best estimate of the value the judge will place on it. If the judge follows the market price at the same time those who trade in the market are following the judge, they will simply be chasing each other's tails.

Nevertheless, the bankruptcy exchange can still provide information. The bankruptcy judge and other players can usefully extract information from the prices at which claims trade. Among other things, they provide warning signals. Consider, for example, the case in which there is a hard cash offer for the firm and a plan of reorganization that the debtor has put forward. The judge must pick between the two. If the value of the firm derived from the bankruptcy exchange is less than the cash offer, one must at least ask whether the market is reflecting the possibility that the judge will accept that plan and that the plan is worth less than the hard cash offer. Of course, one must be confident both that the market is thick enough for prices to capture information and that the hard cash offer is indeed hard, but such information can be a useful signal.

The general features of a well-functioning market are understood. The basic idea is to encourage trade. The more fragmented the market and the more diverse the underlying assets that are bought and sold, the less likely the market will work effectively. The perennial challenge facing the Chicago Board of Trade is defining the underlying contract for the commodities that are bought and sold.[18] If the definition of "corn" is too broad and allows for too much variation in the type of corn, sellers can act strategically and deliver corn of the low quality and still meet the contract. High-quality corn will become debased or disappear from the market altogether. But if "corn" is defined too narrowly, there will be too little trading. The price will not capture information as effectively and the contract itself can become subject to manipulation, such as the risk of a corner.[19]

The bankruptcy exchange also requires that claims be defined in a way that allows trading at low cost. The basic way in which the Bankruptcy Code treats claims does exactly this. The Bankruptcy Code converts all unsecured debts into a general claim against the firm, regardless of the

18. *See* WILLIAM CRONON, NATURE'S METROPOLIS: CHICAGO AND THE GREAT WEST 132 (1992) (standard grades eliminated worries about the quality of grain in futures, but created the possibility of corners).

19. *See id.* at 127–32 (discussing corners on the Chicago Board of Trade in the nineteenth century).

debt's duration and interest rate.[20] Debentures with different interest rates, different covenants and different maturity dates outside of bankruptcy trade become homogenized in bankruptcy, while many of their non-bankruptcy attributes are washed away.[21] As any commodity becomes more fungible, it becomes easier to trade. Hence, facilitating claims trading ought to be counted among the justifications for this homogenization of disparate claims.

For the same reason, the widespread understanding that all claims with the same legal attributes must be put in the same class also facilitates trade.[22] Some, including me, have criticized the rule on the ground that a supplier owed money and a bank might have radically different perspectives on a plan of reorganization.[23] Hence, lumping them together might neglect the rights of some of the affected groups. But whatever benefit might arise from having multiple classes must be weighed against the cost to the bankruptcy exchange. The greater the diversity among the voting rights attached to claims, the thinner the market for them will be.

The need to ensure a well-functioning market in claims provides an additional justification for Justice Holmes's opinion in *Sexton v. Dreyfuss*.[24] In that case, Justice Holmes held that the attributes of every claim against the debtor are fixed at the time of the filing of the petition.[25] The filing of the bankruptcy petition is a day of reckoning that "collapses all future probabilities to present values."[26] We take a snapshot of every claim on that day and the characteristics of the claim on that date remain throughout the case.[27] No one can be made the holder in due course of a negotiable instrument after a bankruptcy petition is filed.[28] A claim subject to

---

20. *See* 11 U.S.C. § 101(5) (2006) (defining "claim" for purposes of the Bankruptcy Code as generally any "right to payment").

21. *See* 11 U.S.C. § 502(b)(2) (2006) (disallowing claims for unmatured interest).

22. 11 U.S.C. § 1122(a) (2006).

23. *See* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 259–60 (4th ed. 2006).

24. 219 U.S. 339 (1911).

25. *Id.* at 345. The principle has been reaffirmed many times over the decades. *See*, *e.g.*, United States v. Marxen, 307 U.S. 200, 207 (1939) ("[T]he rights of creditors are fixed by the Bankruptcy Act as of the filing of the petition in bankruptcy."); *In re* Groenleer-Vance Furniture Co., 23 F. Supp. 713, 715 (W.D. Mich. 1938) ("[T]he rights of creditors become fixed at the moment of bankruptcy and . . . they then acquire a right in rem against the assets."); Swarts v. Siegel, 117 F. 13, 15 (8th Cir. 1902) ("The rights of creditors are fixed by the status of their claims when the petition in bankruptcy is filed.").

26. Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 936 (2001).

27. A conspicuous exception arises if a creditor holding a claim engages in bad conduct during the bankruptcy case and thus subjects the claim to subordination. *See* 11 U.S.C. § 510(c)(1) (2006) (giving the bankruptcy court power to subordinate claims "under principles of equitable subordination"); *see also* Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 699–700 (5th Cir. 1977) (explaining the required conditions for equitable subordination).

28. A bankruptcy petition constitutes notice of the debtor's default. Hence, "[o]nce the issuer of a negotiable instrument files a bankruptcy petition, no buyer of the instrument can be a holder

subordination at the moment the bankruptcy petition is filed should, by this logic, similarly remain subject to subordination no matter how many times it is transferred subsequently.[29] The character of a claim should not change no matter who is holding it.

But while these longstanding bankruptcy rules facilitate the creation of the bankruptcy exchange, a number of new developments threaten to undermine it. As I have pointed out elsewhere, novel capital structures create an anti-commons problem.[30] Instead of a firm with a dispersed group of holders of homogenous general claims against the firm, we increasingly see more complicated structures.[31] There may be second liens and subordinated creditors in addition to general creditors.[32] In a large case, secured creditors of a parent company may be structurally subordinated to the general creditors of the operating company subsidiary. A single bank is the record holder of a particular claim, but many individuals may hold the economic interest through total return swaps and other devices.[33]

The fragmentation we see today may make it hard for a market in claims to come into being, even if everyone knows exactly who holds which claim. Forming a plan of reorganization is analogous to the problem facing the developer who wants to assemble a city block and build a skyscraper on it: The more dispersed and convoluted the various freehold and leasehold interests, the harder it is for the city block to be used effectively or a value to be placed on any of them.[34] Bankruptcy is no different over this dimension.

---

in due course because the buyer will be on notice that the instrument is overdue." LAWRENCE P. KING ET AL., 6 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 94.03[2][a][i] (Chaim J. Fortgang & Thomas Moers Mayer eds., 15th ed. rev. 2005).

29. This was vigorously and inconclusively contested in the *Enron* litigation. Enron Corp. v. Ave. Special Situations Fund II, L.P. (*In re* Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005), *vacated and remanded*, 379 B.R. 425 (S.D.N.Y. 2007). The opposing argument is likewise premised upon the need to promote the trading of claims. One can argue that to promote the bankruptcy exchange, negotiability primes other considerations. Hence, doctrines such as equitable subordination should attach only to the party that engages in bad conduct, not to subsequent good faith purchasers. See Levitin, *supra* note 1, for a lucid discussion.

30. *See* Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. (forthcoming 2009) (manuscript at 6), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1396827.

31. *Id.* (manuscript at 3–4).

32. *See id.* (manuscript at 25–28) (discussing second lien loans).

33. *See id.* (manuscript at 39).

34. *See generally* Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998); *see also* Lee Anne Fennell, *Commons, Anticommons, Semicommons*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF PROPERTY LAW (Kenneth M. Ayotte & Henry E. Smith eds., forthcoming 2009), *available at* http://ssrn.com/abstract=1348267; MICHAEL HELLER, THE GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES (2008).

II. DISCLOSURE AND THE BANKRUPTCY PROCESS

Before we reach the question of how much transparency is desirable or necessary to create a well-functioning exchange, we first need to recognize that there is some need for disclosure in order to ensure the smooth functioning of the bankruptcy process as a whole. The bankruptcy judge needs information about claims and those who hold them to administer the case effectively. A judge must make her decisions on the basis of what interested parties tell her. Advocates cannot engage in any misrepresentations, but they do not have to make the other side's argument for them. To decide sensibly, the judge must take into account that she is listening to advocates and draw inferences from what they do and do not say.

In theory, the judge should be able to do this when multiple advocates are before her, as long as at least one of them has the incentive to disclose the relevant information.[35] In contrast to many judicial forums, however, the bankruptcy judge is often forced to decide questions when only some of the interested parties are before her. Sometimes only the moving party is in court. Motions are filed and no one files an objection. "GNO" is the marginal note most often scribbled on the bankruptcy judge's motion calendar—grant if no objection.

Deciding matters effectively in such an environment requires drawing inferences from what is being said and who is saying it. The bankruptcy judge is likely to look much differently at a motion to provide adequate protection blessed by a large general creditor, from the way she looks at it when the same creditor says nothing. She draws the reasonable inference that the order makes sense when someone who ultimately bears its costs supports it. She assumes that this party has reviewed the risks, even those that might not be readily apparent.

But drawing inferences from self-interested advocates may require knowing where the advocates are coming from, especially when only a limited number of them appear. When an investor who holds a general claim against the estate also holds an even larger slice of the secured debt, her willingness to bless the adequate protection order means much less. Hence, independent of what disclosures are needed to promote the bankruptcy exchange, it may make sense to require anyone who appears in front of the bankruptcy judge to disclose their position, regardless of whether they serve on a committee.[36]

---

35. For an analysis of decision making in such contexts, see Paul Milgrom & John Roberts, *Relying on the Information of Interested Parties*, 17 RAND J. ECON. 18, 19 (1986).

36. Bankruptcy Rule 2019 requires certain disclosures from creditors serving on a committee other than the official creditors committee, but there is no general disclosure rule. FED. R. BANKR. P. 2019.

Disclosure, at least of a limited kind, may also be necessary because of the plan formation process. When the firm can be sold as a going concern, the plan of reorganization may involve little more than dividing the cash. But a going-concern sale does not always serve the interests of the stakeholders. Precisely because there is a liquid market in claims, those who are now participating in the bankruptcy process are already those who value the firm most highly. They prefer a reorganization in which they emerge as the owners of the business. They will receive less value from outsiders if they seek to sell the firm because they possess insider information. If they try to sell the firm, outsiders will infer that the private information they possess is bad. There is a standard "lemons" problem.[37] They are better off negotiating among themselves rather than trying to sell it.

In such cases, negotiations are the lifeblood of the bankruptcy process, and the plan formation process is often complicated. The governing rules should make these negotiations easier. This may require disclosure, at least as to who owns what. It is hard to forge a consensual plan if you do not know with whom you should be bargaining. The general principle here is clear: The easier it is to find the stakeholders, the more likely a sensible plan of reorganization can emerge. The core idea here is a familiar one seen in many other environments. The better defined the property rights, the more valuable they are. Land becomes more valuable when its owner and its boundaries are easy to identify from public records.[38] Quite apart from whether I want to buy or sell land, I can use my own land more effectively if it is easy for me to learn who my neighbors are. Put simply, knowing the identity of the holders of property rights is a key assumption of Coasean bargaining.[39]

III. DISCLOSURE AND THE BANKRUPTCY EXCHANGE

Certain types of disclosure are necessary so that the market for claims functions effectively. The amount of disclosure needed to ensure a well-

---

37. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489–90 (1970). Akerlof suggests that used cars are sold for unusually low prices because buyers fear that their sellers are selling only because the car is a "lemon." *Id.* Given that those with good cars cannot sell them for their true value, they are inclined not to sell them. *Id.* Therefore, the pool of cars put up for sale falls in quality, depressing the price even more. At the limit, the market can collapse completely. *Id.*

38. *See* Gary D. Libecap & Dean Lueck, *The Demarcation of Land and the Role of Coordinating Institutions* (Int'l Ctr. for Econ. Research, Working Paper No. 14, 2009), *available at* SSRN: http://ssrn.com/abstract=1436986.

39. Potential distortions of the plan formation process lie at the heart of most critiques of Hu and Black, as well as Lubben, and the need they see for additional disclosure. *See* Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 734 (2008) ("We believe that disclosure of coupled assets should become a routine part of bankruptcy proceedings."); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 430 (2007).

functioning market is not obvious. All exchanges must have some mechanism for enforcing contracts and preventing fraud. Rules designed to ensure the solvency of those who trade on the exchange are also commonplace.[40] By contrast, rules governing disclosure are far from self-evident and vary widely. Trade-offs are inevitable. Put in place too few disclosure obligations, and those who trade are forced into endless games of twenty questions. There is much information in possession of the seller that sophisticated buyers insist on knowing before they are willing to trade. But sellers will not answer every question and sophisticated buyers will not insist on it.[41] Too many disclosure obligations discourage traders from gathering valuable information in the first place.[42] Everyone else suffers because the prices do not take account of the information and thus do not reflect the underlying value of the asset. Perhaps because of this tension, clear benchmarks have not emerged.[43]

Consider the following case:[44] The geologists for a mining company discover a vast mineral deposit on farmland in Canada. After the discovery, the company decides to repurchase a large amount of its own stock. Two disclosure issues present themselves. First, does the mining company have to disclose the existence of the mineral deposits to the Canadian farmers when they seek to acquire the mineral rights? Second, does it have to disclose the existence of the mineral deposits to the Wall Street investors when it tries to repurchase the stock? The answer to both questions under existing law is plain. The firm is free to hire intermediaries and buy up the mineral rights from the naïve farmers without disclosure as long as it does not engage in lies or misrepresentations,[45] but it must disclose the existence

40. *See*, *e.g.*, CHI. BD. OF TRADE, CHICAGO BOARD OF TRADE RULEBOOK, R. 820, 824, *available at* http://www.cmegroup.com/rulebook/cbot-rulebook-listing.html (last visited June 9, 2009) (providing the Clearing House with the power to adjust terms of performance bonds as conditions change).

41. The proliferation of "big boy letters" evidences that sophisticated parties do not insist on complete disclosure, even when they know that their contracting opposites possess material, nonpublic information. *See* Daniel Sullivan, Comment, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533, 537 (2008).

42. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 159, 165–66 (1966) (arguing that insider trading laws reduce incentives for investing in information about firm value); *see also* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEG. STUD. 1 (1978) (explaining common law disclosure duties with this idea).

43. For illustrations of competing views on disclosure rules, see Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) and John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

44. The facts in this illustration are based on *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

45. *See* Laidlaw v. Organ, 15 U.S. 178, 195 (1817) (holding that contracting party had no duty to disclose material fact – in this case, the end of the War of 1812 to a stranger on the other end of the bargain); Harris v. Tyson, 24 Pa. 347, 359 (1855) ("A person who knows that there is a mine on the land of another may nevertheless buy it.").

of the deposits to the sophisticated investors before it proceeds with its plan to repurchase the stock.[46] Whether either disclosure rule makes sense or whether there is a sensible way to justify the different duties has long been a source of controversy with respect to commercial transactions generally and the trading of securities.[47] But the example itself shows both the range of approaches and an absence of obvious overarching principles.

Other things being equal, disclosure of information is good. One wants the price to reflect underlying values, but only if the information about the underlying value is known can it be incorporated into the market price. Yet, the issue is more complicated than it first seems. The need for disclosure in a liquid market is far less than it appears. Indeed, when the markets are thick enough, information can remain private and still be reflected in the market price. The trading activity of those with knowledge drives the price. It is enough that those with knowledge trade (and are known to trade). In equilibrium, the information that only knowledgeable insiders possess becomes embedded (with some noise) in the market price.[48]

Consider the simplest case, in which outsiders can observe the trading behavior of someone who is known to possess inside information and can see the price at which this trader is indifferent between buying and selling, but nothing else. Imagine ten black boxes with an identical, but undisclosed amount of cash inside. One person in the room is allowed to look inside each box before it is sealed. The boxes are then offered for sale. The person who has looked inside the box will buy any box that is offered for less than twenty dollars and willingly sells to anyone who offers more than twenty dollars. What happens next? Even those who have never looked inside the box will be willing to buy them, and they will be able to sell them to others who have never looked inside. And in all cases the price will be about twenty dollars. Everyone will buy and trade at a price that reflects the inside information that only one person possesses. Someone who entered the room and bought a box would buy it at a price that reflected its true value. When the market is otherwise sufficiently liquid, disclosure requirements are not merely unnecessary, but are affirmatively harmful. We need to give the one person the incentive to look inside the box and then be in a position to profit when the price rises just above or falls just below twenty dollars. Disclosure mandates reduces the incentive to gather information in the first place and also reduces the incentive to trade on it.[49]

---

46. *See Texas Gulf Sulphur Co.*, 401 F.2d at 847–49, 851–52. The different treatment arises by virtue of Rule 10b-5 of the Securities Exchange Act of 1934. 17 C.F.R. § 240.10b-5 (2008).

47. *See* Kronman, *supra* note 42.

48. *See* Fama, *supra* note 11; Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 565–79 (1984).

49. *See*, *e.g.*, MANNE, *supra* note 42, at 159, 165–66.

Returning to the example of the mining company, if the legal regime forced the company to disclose what it knew about the mineral deposits before acquiring the mineral rights, it might never have spent the money hiring geologists to look for the deposits in the first place. Consequently, the minerals might never have been discovered. Rules aimed at ensuring transparency can actually create a less efficient market, one that is less liquid and in which prices fail to reflect underlying values. Both those with and without information are left worse off.

For the trading of claims in bankruptcy, the lesson is a subtle one. On its face, there does not seem to be anyone in the position of the mining company and its team of geologists. Nor does it seem that the disclosures that are sometimes required—such as the price at which a hedge fund acquired a claim—have much to do with the underlying business.[50] Regardless of whether such disclosures do any affirmative good, they do not seem to do any harm. Indeed, attaching importance to the price at which someone bought a claim (which vulture investors routinely do) seems to be an example of the sunk-cost fallacy.[51] If two investors have the same information about an asset, both should be willing to sell it at the same price, regardless of how much they paid for it. Both should maximize the value of whatever they hold today.

The amount originally invested in an asset is a sunk cost. It should not be part of the decision calculus. In deciding how much to bet in a poker game, the number of chips in the pot that once were yours is irrelevant; once the money is in the middle of the table, it no longer belongs to you.[52] Good poker players (including many vulture investors who assert that the amount they paid for their claims matters enormously) know that you must ignore what you have bet and instead calculate the cost for you to continue playing against the value of the entire pot.[53] A bankruptcy claim seems to be the same. You make the decision that promises to give you the most for your claim, regardless of whether you bought at twenty or at forty. You

---

50. *See*, *e.g.*, *In re* Northwest Airlines Corp., 363 B.R. 701, 702 (Bankr. S.D.N.Y. 2007) (requiring disclosure of purchase price for members of nonofficial committee under Rule 2019 of the Federal Rules of Bankruptcy Procedure).

51. For a discussion of the sunk cost fallacy, see Thomas Kelly, *Sunk Costs, Rationality, and Acting for the Sake of the Past*, 38 NOÛS 60, 61 (2004) ("[I]t is widely agreed that honoring sunk costs is obviously and clearly irrational, and that doing so is, without exception, to be avoided. In economics and business textbooks, the tendency to honor sunk costs is treated as an elementary fallacy.").

52. Annie Duke, *The Sunk Costs of Trading*, FIN. SPREAD BETTING – A TRADER'S GUIDE, http://www.financial-spread-betting.com/Sunk-cost.html (last visited Nov. 1, 2009). In poker lingo, the ratio of how much a bet is relative to the pot size is known as a player's "pot odds." *See id.*

53. *Id.* For further discussion on pot-odds, see MASON MALMUTH, ED MILLER & DAVID SKLANSKY, SMALL STAKES HOLD'EM: WINNING BIG WITH EXPERT PLAY 27–31 (Two Plus Two Publishing L.L.C. 4th prtg. 2009).

want the highest possible price, regardless of how much you paid for it. But appearances may be deceiving. Investors do not share the same information, and, as noted, we 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. One of my best clues about how much you value an asset is the information that you, a sophisticated seller, bought the asset a minute ago for twenty dollars and are willing to sell it now for twenty-one dollars. I do not need to ask you anything about your private information as long as I can find out the price at which you are willing to buy and the price at which you are willing to sell. Claims in bankruptcy are no different from any other asset. Requiring a vulture investor to disclose the price at which she buys and sells a claim reveals her own estimate of its underlying value. At the limit, such a disclosure duty might have the same effect as a general duty to disclose.

Disclosure brings with it a second cost as well. As mentioned earlier, firms in financial distress, especially today, possess capital structures that are badly fragmented. The bankruptcy exchange provides a mechanism that allows those who trade to consolidate the different pieces and make the ownership claims simpler and more coherent. Disclosure obligations can make this harder. The challenge is analogous to the one facing the real estate developer mentioned in Part I of this Article.[54] Suppose the developer wants to reassemble an entire city block.[55] Disclosing the plan in advance invites hold-outs who will refuse to sell simply to capture some of the benefits the developer hopes to earn by reunited fragmented pieces of land.[56] One can argue that those who try to acquire substantial positions in the fulcrum security of a firm in Chapter 11 should be able to do so free of disclosure obligations.[57] We should allow investors to build positions, just as we allow those who try to assemble city blocks not to reveal what they are doing. All standard critiques of the Williams Act apply with full force in the bankruptcy context.[58]

---

54. *See* discussion *supra* p. 29 and note 34.

55. *See* sources cited *supra* note 34.

56. *Id.*

57. Exactly what disclosure obligations exist under current law are not clear. Unanswered are even such basic questions as whether bankruptcy claims are "securities" within the meaning of securities laws. *See* Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569 (2002). Also unclear is the equitable power to fashion regulations inside of bankruptcy analogous to Rule 10b-5. *See* 17 C.F.R. § 240.10b-5 (2008).

58. 15 U.S.C. §§ 78m(d)–(e), 78n(d)–(f) (2006) (relevant sections of the Williams Act). For a critique of the Williams Act, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 165 (1991).

These objections to disclosure obligations, however, rest on the assumption that the underlying market is liquid. When the amount of trading that takes place in a given market is small, all bets are off. Distortions are possible. Prices may not reflect underlying values. For example, prices can rise or fall, not because of any underlying change in the true value of the firm, but because of an information mirage.[59] A single trader mistakenly believes that another is trading on the basis of private information. She believes that the other has looked inside the black box when she has not. A third trader observes the first two trades, assumes that the second is not making a mistake, and draws an even stronger inference. An information cascade develops from just a small misstep.

When markets are illiquid, one must also worry about manipulation. 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 confederates enjoy an even larger profit than they would have had if he relied on his information without manipulating the market simultaneously.

In the case of commodities contracts in the nineteenth century, the manipulation of most concern was the corner.[60] A trader would secretly amass a huge portion of a particular contract (such as No. 2 soft red winter wheat for March delivery).[61] At the same time, the trader would go long on the same commodity with short sellers.[62] When the time came to deliver the wheat, the short sellers would not be able to acquire it because the trader would keep it off the market.[63] The short sellers as a group would battle each other over the small amount that was actually available and the price would sky rocket.[64]

The crucial, and largely unexplored, question is whether manipulations are possible on the bankruptcy exchange. Manipulation does not arise merely because a trader who knows an asset is undervalued tries to amass a large position at a low price. A trader who does this will, by virtue of her trading activity, raise the price. The trading activity pushes the price in the right direction. The price is never distorted in the sense that the trading

59. *See* Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 QUART. J. ECON. 797 (1992); Colin Camerer & Keith Weigelt, *Information Mirages in Experimental Asset Markets*, 64 J. BUS. 463 (1991).

60. *See* CRONON, *supra* note 18, at 127–32.

61. *Id.* at 127.

62. *Id.*

63. *Id.*

64. *Id.*

brings the market price closer to its true value. While the bankruptcy judge might need disclosure to do her job effectively or distort the plan formation process, disclosure is not necessary to ensure that the market functions effectively merely because someone is trading on the basis of inside information. But one can imagine investors acquiring different positions in different tranches with a view to misleading others and turning things to their advantage.

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 know, even though each would be better off if everyone disclosed what they 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. We face a trade-off between discouraging those with information from trading on it and ensuring that the market is sufficiently transparent that people will be willing to trade on it. It is axiomatic that the fewer the players, and the less active the trading, the less confident we can be that this will happen.

Existing theories of market design do not offer many lessons about the liquidity/transparency trade-off.[65] It may be that for the moment the best we can do is focus on the concrete. It may be possible to be more pointed in asking what information the judge needs to decide the questions before her and what information the parties need to know to be able to negotiate with each other, while at the same time being aware of the costs of disclosure, even of things that seem both irrelevant and innocuous. Making this balance and exercising discretion wisely is yet another burden we must place on the modern bankruptcy judge.

IV. CONCLUSION

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. Especially in a world of illiquidity, parties will assert—with greater or lesser degrees of credibility—that the judge's decision to impose one set of rules or another will destroy either the firm or the marketplace for its securities. Insisting on coherent rules can make life hard for those who

---

65. *See* RUBEN LEE, WHAT IS AN EXCHANGE: THE AUTOMATION, MANAGEMENT, AND REGULATION OF FINANCIAL MARKETS 247 (1998) ("In sum, . . . it is . . . still difficult to draw robust conclusions from the literature concerning the effects or the merits of transparency.").

make the most noise. In this world, the judge must resist the temptation to gravitate towards the decision that provides the easiest way to end the case. The smoothest path is not necessarily the one that promotes either the bankruptcy forum or the bankruptcy exchange. Until coherent norms emerge, the bankruptcy judge must seek out, as best she can, the most sensible set of regulations—including disclosure rules. Discovering these will bring the greatest rewards over the long run.