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BANKRUPTCY MARKETS: MAKING SENSE OF CLAIMS TRADING

*Adam J. Levitin**

The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code's enactment in 1978. Claims trading has revolutionized bankruptcy by making it a much more market-driven process. The limited scholarly literature on claims trading, however, while recognizing its radical impact, has either focused on doctrinal issues or used claims trading as a touchstone for the "Great Normative Bankruptcy Debate" about whether bankruptcy should be a market process or a safe-harbor from the market. The result is that scholarly treatments of claims trading have operated with a high level of generality and scant evidentiary basis.

This Article argues that a more productive approach to claims trading must begin with a better understanding of its nuances. It shows that claims trading is a complex, multi-dimensional, and dynamic market with tremendous variation by timing, asset class, and trading motivation, and with different impacts on the bankruptcy reorganization process. Accordingly, the Article challenges the claim of Professors Douglas G. Baird and Robert K. Rasmussen that claims trading, along with other financial innovations, is detrimental to the bankruptcy process by creating an anticommons problem. The Article questions key assumptions underlying Baird and Rasmussen's argument and suggests that rather than wreaking havoc on the bankruptcy process, claims trading might facilitate more efficient bankruptcy negotiations and help reorganizations.

In the abstract, however, claims trading's net social welfare impact is indeterminate, and empirical examination is not possible because of the incomplete nature of claims trading disclosure requirements, which expose only changes in legal title, not economic interest. Given the complexity of the claims trading market and our limited knowledge of its operations and impact, regulatory approaches to claims trading should be narrowly targeted and noninvasive. A start would be to 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.

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INTRODUCTION

The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code's enactment in 1978.¹ Claims trading has revolutionized bankruptcy by making it a much more market-driven process.² Instead of serving as a forum for creditors to negotiate a restructuring of the debtor's finances with the goal of limiting their losses, bankruptcy is now a general investment opportunity. The development of a robust market for all types of claims against debtors has changed the cast of characters involved in bankruptcies. In addition to long-standing relational creditors, like trade creditors or a single senior secured bank or bank group, bankruptcy cases now involve professional distressed debt investors, whose interests and behavior are often quite different than traditional relational counterparty creditors.

The changes wrought by claims trading have placed tremendous pressure on the bankruptcy reorganization structure set forth in Chapter 11 of the Bankruptcy Code, which was drafted with a relational creditor world in mind.³ Because of the changes that claims trading has unleashed on the bankruptcy process, it arouses passions unlike any other issue in the bankruptcy world. Yet, in spite of this, claims trading remains a poorly understood and little studied area of bankruptcy. Although there are a fair number of legal decisions that touch on aspects of claims trading, only a few squarely address the key policy issues involved.⁴ Exacerbating this problem, only a limited number of scholarly articles that discuss bankruptcy

1. Cf. Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy: ABI Committee on Public Companies and Trading Claims* (pt. 2), 11 AM. BANKR. INST. L. REV. 177, 177 (2003) [hereinafter Siegel, *Part 2*] ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims.").

2. Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 104 (1995) (claims trading "epitomizes the development of markets in connection with bankruptcy").

3. 11 U.S.C. §§ 1-1532 (2006).

4. See, e.g., *Enron Corp. v. Ave. Special Situations Fund II, L.P.* (*In re Enron Corp.*), 340 B.R. 180 (Bankr. S.D.N.Y. 2006), *vacated*, *Enron Corp. v. Springfield Assocs., L.L.C.* (*In re Enron Corp.*), 379 B.R. 425 (S.D.N.Y. 2007); *Enron Corp. v. Ave. Special Situations Fund II, L.P.* (*In re Enron Corp.*), 333 B.R. 205, 211 (Bankr. S.D.N.Y. 2005); *Viking Assocs., L.L.C. v. Drewes* (*In re Olson*), 120 F.3d 98, 102 (8th Cir. 1997) (under FED. R. BANKR. P. 3001(e), a court may not reduce the allowed amount of a claim to the amount paid by a claims buyer unless objected to by the transferor); *Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am.* (*In re Figter*), 118 F.3d 635 (9th Cir. 1997); *In re First Humanics Corp.*, 124 B.R. 87, 92 (Bankr. W.D. Mo. 1991) (claims purchase by debtor's former management company to gain standing to file a plan to protect interest of the debtor was in good faith); *In re Applegate Prop. Ltd.*, 133 B.R. 827, 836 (Bankr. W.D. Tex. 1991) (designating votes of an affiliate of the debtor that purchased a blocking position to thwart a creditor's plan because it was done in bad faith); *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 289-90 (Bankr. W.D. Pa. 1990) (because of bad faith activities, the court designated votes of a claims purchaser who purchased to get a blocking position on a plan).

claims trading.⁵ The existing literature tends to focus on doctrinal issues created by claims trading, contains no discussion of the market mechanisms for claims trading and rarely delves into the differences among the varied trading practices that fall under the rubric of “claims trading.” Put another way, the limited literature on claims trading generally does not engage with claims trading’s realities.

Instead, claims trading is often used as a totem for a larger normative debate about bankruptcy: What interests should be served by bankruptcy policy? What relative weight should be placed on concerns of efficiency

5. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. (forthcoming 2009) (manuscript), available at <http://ssrn.com/abstract=1396827>; Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610 (2008) (discussing problems of claims trading and empty voting); Joy Flowers Conti, Raymond F. Kozlowski, Jr., & Leonard S. Ferleger, *Claims Trafficking in Chapter 11—Has the Pendulum Swung Too Far?*, 9 BANKR. DEV. J. 281 (1992); Thomas Donegan, Note, *Covering the “Security Blanket”: Regulating Bankruptcy Claims and Claim-Participations Trading Under the Federal Securities Laws*, 14 EMORY BANKR. DEV. J. 381 (1998); Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569 (2002); Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991–92); Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733 (1993) (exploring the problems created by “participation” interests in claims trading); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990–91) [hereinafter Fortgang & Mayer, *Trading Claims*]; 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 for the positive role of distressed debt investors in reorganizations); Geoffrey Groshong, *Trading Claims in Bankruptcy: Debtor Issues*, 10 AM. BANKR. INST. L. REV. 625 (2002); Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008); Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 89 (2007) [hereinafter Levitin, *Finding Nemo*]; Adam J. Levitin, *The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading*, 15 J. BANKR. L. & PRAC. 389 (2006) [hereinafter Levitin, *The Limits of Enron*]; 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 (1994); Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987 (2002); Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153 (2004) [hereinafter Miller & Waisman, *Twenty-First Century*]; Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129 (2005) [hereinafter Miller & Waisman, *Is Chapter 11 Bankrupt?*] (criticizing the effects of distressed debt investors on the Chapter 11 process); Guy B. Moss, *The Risks of Purchasing and Collecting Consumer Debt*, 10 AM. BANKR. INST. L. REV. 643 (2002); Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy: ABI Committee on Public Companies and Trading Claims* (pt. 1), 10 AM. BANKR. INST. L. REV. 567 (2002) [hereinafter Siegel, *Part 1*]; Siegel, *Part 2*, *supra* note 1; Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684 (1996) (considering the benefits and problems of claims trading in the plan confirmation context); Michael H. Whitaker, Note, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL’Y 303 (1994).

and distributional fairness?⁶ Should bankruptcy merely be a procedural extension of the market or is it a safe-harbor from the market in which other values and interests are expressed? This Great Normative Bankruptcy Debate has focused on claims trading because it has been the leading factor in the marketization of bankruptcy.

This Article argues that it is unproductive to understand claims trading through the lens of the Great Normative Bankruptcy Debate. Burdening consideration of claims trading with the weight of this overarching policy debate has prevented a serious engagement with actual practice of claims trading. Instead, claims trading is frequently treated as a generic and stylized phenomenon, divorced from its more nuanced operation in practice.

This Article disaggregates the wide variety of investment practices that fall under the rubric of claims trading. It argues that claims trading is actually comprised of several overlapping and evolving markets that vary on dimensions of timing and asset class. These different markets have distinct mechanisms and distinct risks for buyers and sellers who are moved by a variety of motivations.

An examination of these markets shows that claims trading has cross-cutting impacts on the bankruptcy process with a net impact that is indeterminate on the available evidence. Accordingly, claims trading is not well-suited for broad policy reforms. Instead, at this point, we can merely identify several modest features of the claims trading market that can be improved.

Part I of this Article connects the bankruptcy claims trading debate to the Great Normative Bankruptcy Debate and observes two problems that plague discussions of bankruptcy claims trading: a scant evidentiary basis and a high level of generality. Part II shows how claims trading is a multidimensional and dynamic market with tremendous variation by timing, asset class, and trading motivation. It demonstrates how some claims trading may be beneficial or neutral, while other trading activities are more problematic. This suggests that any regulatory approaches to claims trading should be narrowly targeted so as not to throw out the proverbial baby with the bathwater.

Part III considers an argument recently articulated by Douglas G. Baird and Robert K. Rasmussen (Baird and Rasmussen) that implicates claims trading, *in general*, along with other financial innovations, as detrimental to

6. It is also possible to add in concerns of administrability. In the bankruptcy context, however, administrability is ultimately a question of efficiency and distribution. A case that is hard to administer takes longer and is more expensive, and the costs from the delay are borne by the residual claimant(s). For a discussion on the difficulty in identifying residual claimants, see Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341, 1342 (2004).

the bankruptcy process.⁷ Baird and Rasmussen point to claims trading as contributing to an anticommons problem that reduces the effectiveness of bankruptcy as a procedural tool for resolving the collective action problem of the race to the courthouse. Part III questions key assumptions underlying Baird and Rasmussen's argument and suggests that rather than wreaking havoc on the bankruptcy process, claims trading may actually facilitate more efficient bankruptcy negotiations and help reorganizations. Part IV concludes with some suggestions for improving the claims trading market.

I. CLAIMS TRADING AND THE GREAT NORMATIVE BANKRUPTCY DEBATE

A. A TAXONOMY OF NORMATIVE VIEWS OF BANKRUPTCY

Over a decade ago, Douglas Baird mapped the world of bankruptcy scholarship as roughly divided into two loose camps: Traditionalists and Proceduralists.⁸ As Baird explained:

The [T]raditionalists believe that bankruptcy law serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise, if the protections that bankruptcy law provides were unavailable. By contrast, the [P]roceduralists deny that bankruptcy can work any special magic. Firms must live or die in the market. All bankruptcy can do is ensure that fights among creditors and other investors of capital do not accelerate a firm's liquidation. For them, one does more harm than good by doing anything more to protect a firm from the forces of the market.⁹

The division that Baird finds in the scholarship is also a different view of what bankruptcy's relationship to the market process should be. Should bankruptcy be a part of or apart from the market? Is bankruptcy merely an extension of the market or a safe haven from it?

Ultimately, the camps diverge on the question of whether markets can be relied upon to produce optimal outcomes. Are markets always the answer? Traditionalists are more skeptical of markets than Proceduralists.¹⁰ Part of this skepticism is both expressed in and a function of how optimal outcomes are defined. Traditionalists, who often work on consumer bankruptcy issues, look at net social outcomes, while Proceduralists, who tend to focus on corporate reorganizations, focus on the firm, in keeping

7. Baird & Rasmussen, *supra* note 5 (manuscript at 6, 33).

8. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576 (1998).

9. *Id.* at 577-78.

10. There is a strange tension between the Proceduralist view of bankruptcy as a solution to a market failure due to a collective action problem and Proceduralists' willingness to generally rely on a market they recognize as fallible.

with a long tradition of exclusively firm-focused corporate law scholarship.¹¹ While many variations exist in these camps, it still remains a remarkably accurate intellectual cartography of the bankruptcy world.

B. NORMATIVE VIEWS OF BANKRUPTCY AND THE CLAIMS TRADING DEBATE

Baird's taxonomy has remarkable explanatory power for understanding the debate about claims trading. Arguments being made against claims trading are very much Traditionalist arguments, while arguments being made for claims trading are Proceduralist arguments. For example, Harvey Miller, perhaps the leading practitioner advocate of the rehabilitation view of business bankruptcy, has argued that:

Distressed debt trading and changes in bankruptcy relationships have destroyed the symbiotic relationship of debtor and creditor Because Chapter 11 is premised upon a symbiotic relationship between debtor and creditor, it is becoming less effective in the context of distressed debt trading.¹²

Miller contends that the failure rate of large Chapter 11 cases is due in part to claims trading, as “distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments.”¹³ Similarly, Fredrick Tung has argued that claims trading upsets the community of interests involved in bankruptcy.¹⁴

Others have maintained that claims trading merely provides a mechanism for creditors to move in or out of this community.¹⁵ They argue that “distressed-debt investors generally have a salutary impact on the residual actor problem of bankruptcy by expediting business reorganizations and protecting going-concern enterprise values”¹⁶ or that “courts should encourage, rather than interfere with, the market in order to facilitate the significant benefits claims trading offers in bankruptcy.”¹⁷

In this light, it is worth considering the standard arguments about claims trading. These arguments in favor of claims trading are about efficiency and markets:

11. See Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 92 S. CAL. L. REV. 1075, 1122–23 (2009).

12. Miller, *supra* note 5, at 2014–15.

13. *Id.* at 2016.

14. Tung, *supra* note 5, at 1718.

15. See, e.g., Levitin, *Finding Nemo*, *supra* note 5, at 87 (“The ability to sell bankruptcy claims provides an exit opportunity for creditors who do not wish to incur the hassle and expense of the reorganization process.”).

16. Goldschmid, *supra* note 5, at 193.

17. Rasmussen & Skeel, *supra* note 2, at 104.

- 1) Claims trading allows an exit for those creditors who want to cut loose from the bankruptcy process because of liquidity constraints,¹⁸ administrative hassle and expense,¹⁹ regulatory risk,²⁰ to avoid an adversarial relationship with the debtor,²¹ or to establish a tax loss.²² There are significant risks, costs, and delays inherent in bankruptcies. Payouts are speculative and can take years to receive.²³ Selling a claim allows a creditor to “cash out” at a certain price.
- 2) Claims trading permits an entrance to the bankruptcy process for those investors who want to take the time and effort to monitor the debtor and contribute expertise to the reorganization process.²⁴
- 3) Claims trading increases liquidity overall in capital markets and lowers the cost of credit as the option of avoiding the uncertainty of being a creditor in bankruptcy increases the risk tolerance of originating lenders.²⁵
- 4) Claims trading reduces transaction costs in the plan negotiation process by consolidating dispersed claimholders into a few large claimholders.²⁶
- 5) Claims trading reduces the administrative costs of bankruptcies by speeding up the reorganization negotiation process through consolidation of claimholders.²⁷
- 6) Claims trading creates a market for control in bankruptcy that might not exist absent a cramdown plan or a § 363 sale.²⁸

18. *In re Kreisler*, 546 F.3d 863, 864 (7th Cir. 2008) (“Claims trading allows creditors to opt out of the bankruptcy system, trading an uncertain future payment for an immediate one, so long as they can find a purchaser.”).

19. Goldschmid, *supra* note 5, at 206.

20. See Drain & Schwartz, *supra* note 5, at 575.

21. *Id.*

22. *Id.*; see also Goldschmid, *supra* note 5, at 206.

23. Baird & Rasmussen, *supra* note 5 (manuscript at 13).

24. *Id.* at 40; see also Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 401 (1997) (finding that “vulture investors add value by disciplining managers of distressed firms”); Wei Jiang et al., *Hedge Funds in Chapter 11* 32 (Nov. 1, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1493966 (“The prevalence of hedge funds contributes to the trend toward a more management-neutral restructuring process, and is viewed by the market as enhancing the overall value of bankrupt firms.”).

25. See, e.g., Levitin, *Finding Nemo*, *supra* note 5, at 89; Drain & Schwartz, *supra* note 5, at 575.

26. See, e.g., Drain & Schwartz, *supra* note 5, at 575–76.

27. William Beranek & Steven L. Jones, *The Emerging Market for Trade Claims of Bankrupt Firms*, 23 FIN. MGMT. 76, 76, 79 (1994).

28. David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 921 (2003) (noting that “claims trading sometimes simulated a market for corporate control”).

- 7) Claims trading can result in a higher and/or quicker return for creditors because it imposes market discipline on debtors.²⁹ If a reorganization is being run poorly, creditors will sell their claims, and the buyers will either push for a liquidation or attempt to take control of the reorganization.³⁰

Three more arguments not found in the literature might be added to the arguments above. First, claims trading ensures more efficient allocations of capital in the market by permitting entry and exit, which lets parties express their idiosyncratic valuations. Second, claims trading can facilitate reorganizations by bringing in parties who are willing and able to contribute the fresh capital needed to fund the reorganization process (Debtor in Possession (DIP) financing) and the newly reorganized company (exit financing). And third, claims trading may facilitate more sustainable reorganizations by enabling firms to emerge with lower leverage ratios.

Banks are generally prohibited from holding equity in non-financial operating companies.³¹ Therefore, bank creditors want their claims paid either in cash or in debt of the reorganized company. This either makes reorganization harder by requiring more cash on hand or adds to the debt burden of the reorganized firm, making the reorganization less sustainable and (all else being equal) increasing the likelihood of a refiling (a so-called Chapter 22).

Claims trading enables the replacement of bank creditors with hedge funds and private equity funds,³² which are able, and often eager, to take equity in the reorganized company.³³ Thus, claims trading facilitates a shift in the composition of creditors that allows more flexibility in reorganizing and promotes more sustainable reorganizations.³⁴

These arguments emphasize efficiency gains both in bankruptcy and in the capital markets from claims trading. This contrasts with the arguments against claims trading, which raise countervailing efficiency concerns, as

29. Drain & Schwartz, *supra* note 5, at 575–76.

30. Thus, claims trading could result in a positive externality on creditors who do not trade but instead free-ride on the market discipline of the traders.

31. Bank holding companies are unable to hold equity in firms whose activities are not “so closely related to banking as to be a proper incident thereto.” 12 U.S.C. § 1843(c)(8) (2006); *cf.* 12 C.F.R. § 5.34(d)(2) (2009) (providing limitations on national banks’ operating subsidiaries).

32. Banks are more likely than hedge funds and private equity funds to have relationships with operating firms and originate loans.

33. For example, a hedge fund that purchases a claim at thirty cents on the dollar and gets paid out forty-five cents on the dollar in cash and new debt will likely be happy to take an equity piece as well and capture the potential upside of the firm (which is greater if the firm has manageable debt service).

34. Banks also prefer payouts in debt rather than equity in order to protect themselves in the event of a refiling and because debt would boost their earnings per share (EPS). EPS is not a relevant performance metric for hedge funds and private equity funds, so they are less driven by earnings.

well as concerns about procedural and distributional fairness, not just within the bankruptcy, but also to a larger community of interests:

- 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.³⁵ The delay imposes an externality on creditors who do not trade and reduces the value of the debtor's estate.³⁶
- 2) Claims trading enables greenmail, insider trading, and other unfair practices that allow particular creditors to extract surplus rents.³⁷
- 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.³⁸
- 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.³⁹ This can lead to deadweight loss through the destruction of going concern value and can lead to recidivism among debtors.⁴⁰ The loss often has externalities on non-creditor community interests affected by bankruptcies.⁴¹
- 5) Claims trading destroys the "symbiotic relationship of debtor and creditor" that is the premise of Chapter 11.⁴²

The arguments about claims trading roughly track the normative bankruptcy scholarship divide identified by Baird.⁴³ Arguments in support of claims trading favor letting the market guide reorganizations, while the arguments

35. Baird & Rasmussen, *supra* note 5 (manuscript at 50).

36. The externality can include the loss of valuable net operating losses (NOLs) if the turnover in ownership is too high. *See* 26 U.S.C. § 382(l)(5) (2006).

37. Baird & Rasmussen, *supra* note 5 (manuscript at 50).

38. *See, e.g.*, Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, AM. BANKR. INST. J., Dec.–Jan. 2007, at 24, 87.

39. *See, e.g.*, Miller & Waisman, *Twenty-First Century*, *supra* note 5, at 181; Miller, *supra* note 5, at 2016 ("distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments"); Harner, *supra* note 5.

40. Miller & Waisman, *Twenty-First Century*, *supra* note 5, at 182; Miller & Waisman, *Is Chapter 11 Bankrupt?*, *supra* note 5, at 153.

41. *See, e.g.*, Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 336–42 (1993) (suggesting various distributional goals besides economic efficiency).

42. Miller, *supra* note 5, at 2014.

43. Baird, *supra* note 8.

against are skeptical of the market producing either efficient or fair results for the community of interests involved in a bankruptcy.

All of these arguments operate on a very high level of generality. The standard arguments about claims trading focus on whether claims trading should or should not be allowed. They are not arguments for regulating claims trading, but are instead arguments about it being either a positive or negative phenomenon.

This binary divide makes little sense, however. Are critics of claims trading really calling for an end to all claims trading or merely for some regulation of it? Are advocates of claims trading arguing for it to remain a virtually unregulated market, or simply arguing for claims trading to continue in some form? To date, no one seems to have called for an outright ban on claims trading. When pressed, proponents of claims trading will usually concede the need for some reforms in the market to curb such abuses as claims laundering, greenmail, insider trading, or to protect unsophisticated trade creditors.⁴⁴

When confronted with claims trading as an actuality, rather than as a way for expressing normative views on bankruptcy policy, the binary arguments collapse into a spectrum of more regulation to less regulation. This spectrum, however, contains relatively few regulatory proposals. To the extent that arguments about claims trading are really about claims trading, rather than a normative vision of bankruptcy, it has a thin evidentiary basis which forces claims trading to be addressed in a highly generalized manner.⁴⁵ These features limit the debate to being little more than an imperfect battleground for the Great Normative Bankruptcy Debate.

C. THE THIN EVIDENTIARY BASIS FOR THE CLAIMS TRADING DEBATE

The debate over claims trading operates on a limited evidentiary base. Arguments about claims trading are based on theory, common sense, and anecdote, but not data. Empirically, we know relatively little about claims trading. What is the volume of claims trades in number? In amount? What percentage of claims change hands? How frequently do claims trade? Who buys and who sells? How many discrete buyers are there? How many are prepetition creditors? Does trading result in a consolidation or dispersal of holdings and to what degree? How much variation is there by case? By asset class? By timing within a case? By type of debtor? How does the pricing change over time? How accurate of a predictor of plan payouts is

44. See generally Conti, Kozlowski & Ferleger, *supra* note 5, at 287, 296, 299 (discussing specific claims trading abuses and the need for reform through proper disclosure).

45. Notable exceptions are: Baird & Rasmussen; *supra* note 5; Drain & Schwartz, *supra* note 5; Goldschmid, *supra* note 5; Levitin, *Finding Nemo*, *supra* note 5; and Levitin, *The Limits of Enron*, *supra* note 5.

the claims market? And how does this all compare to distressed debt trading on the doorstep of bankruptcy?

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.⁴⁶ One company attempting to create an exchange in trade claims estimates this piece of the market to be worth \$75 billion.⁴⁷ 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.

The reason that we do not know the extent of the claims trading market is because it is largely invisible in court records. Claims trading is an over-the-counter (OTC) market,⁴⁸ so there is no exchange that can provide information. The sole specific regulation of claims trading, Federal Rule of Bankruptcy Procedure 3001(e) (Rule 3001(e)), states that notice of claims trades be filed with the court, although no particular timeliness is required.⁴⁹ 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.⁵⁰ This means that many economic claims trades are not reported with the court.

In particular, two major categories of claims—bank debt and bond claims—do not show up in Rule 3001(e) filings. Bank debt is often syndicated; only the administrative agent for the syndicate (typically the lead bank) will file a claim in the bankruptcy.⁵¹ The syndicated interests (assignments or participations) might change hands, but it will not be reflected in a Rule 3001(e) filing.

46. See, e.g., Drain & Schwartz, *supra* note 5, at 569–70 (noting the “formation of numerous distressed debt funds with assets in excess of \$1 billion” in 2002); Rasmussen & Skeel, *supra* note 2, at 101 n.71 (providing financial figures on claims trading); Tung, *supra* note 5, at 1685 (noting an estimate of the claims trading market “as high as \$300 billion” in 1996).

47. See Press Release, Restricted Stock Partners, *Restricted Stock Partners Acquires T-REX; Adds Bankruptcy Claims to Online Trading Platform* (June 9, 2008), [http://express-press-release.net/50/Restricted Stock Partners Acquires T-REX; Adds Bankruptcy Claims To Online Trading Platform.php](http://express-press-release.net/50/Restricted%20Stock%20Partners%20Acquires%20T-REX;%20Adds%20Bankruptcy%20Claims%20To%20Online%20Trading%20Platform.php).

48. There is a nascent attempt to create a claims trading exchange in the so-called Trade Receivables Exchange (T-REX), now part of Second Market. See Second Market, Bankruptcy Claims, <http://www.secondmarket.com/markets/bankruptcy-claims.html>.

49. Generally applicable laws on fraud and contract apply to claims trades, of course. See generally Drain & Schwartz, *supra* note 5. For certain types of claims, federal and/or state securities laws may apply as well.

50. See Groshong, *supra* note 5, at 642.

51. Anne Marrs Huber & Thomas H. Young, *The Trading of Bank Debt In and Out of Chapter 11*, 15 J. BANKR. L. & PRAC. 1, 1, 3 (2006).

Trades in bank loans are also unlikely to be visible in Rule 3001(e) filings because the economic interest in the loan could be separated from legal title to the loan due to a total return swap (TRS). A bank loan TRS is an OTC derivative product in which a bank (the funding bank) agrees to swap the total return (all interest and fees) on a loan it funds (or has purchased) in exchange for periodic payments by the swap counterparty (typically a hedge fund) of LIBOR plus a spread.⁵² The bank thus ends its exposure on the loan for the duration of the swap (typically one year), but makes a profit on the difference between its own cost of funding the loan and the payments it receives from its swap counterparty.⁵³

In a TRS, the funding bank retains legal title to the loan and performs all ministerial acts, including filing of bankruptcy claims, but the economic interest in the loan is transferred to the swap counterparty. There are three potential TRS-related transactions that would not be visible. First, a TRS could expire postpetition. This would have the effect of transferring the economic interest in the loan back to the funding bank. Second, a TRS could be entered into postpetition on an existing loan (unlike a credit default swap). And third, the funding bank's swap counterparty could assign its interest to another party postpetition. None of these transactions would be observable in Rule 3001(e) filings because legal title for the loan remains with the funding bank, even as the economic interest in the loan shifts.

For bonds, there will be only one claim filed per indenture, and it will be filed by the indenture trustee. Thus, there will be no Rule 3001(e) filings evident for trades in the debtor's bond debt. Trades in claims for two large slices of the capital structure of bankrupt companies are simply invisible.

52. Philip Nisbet & Mark Herzinger, *Bank Loan Total Return Swap Primer*, in THE HANDBOOK OF LOAN SYNDICATIONS & TRADING 680, 684, 693 (Allison Taylor & Alicia Sansone eds., 2007). The size of the TRS market for North American bank loans is estimated to be \$75 billion. *Id.* at 681, 693. Banks require their TRS counterparties to post collateral to cover counterparty payment risk, but the collateral is usually a fraction (a "haircut") of the amount of the reference loan(s) for the swap. *Id.* at 681, 692–93. This means that TRS are actually a device for leveraged investing. In recent years, up to 10x leverage has been available. *Id.* at 698. To illustrate, consider a TRS on a \$10 million bank loan. If the bank's swap counterparty wanted to fund the loan itself, directly, it would need to tie up \$10 million in the loan. The bank, however, might only require \$1 million in collateral for a TRS. Thus, the counterparty will be able to achieve the return on a \$10 million loan (minus LIBOR plus the spread) while only tying up \$1 million. *See id.* at 697 (providing additional sample calculations). Of course, the swap counterparty is responsible for its payments regardless of the total return on the bank loan, so such leverage carries significant risks.

53. *Id.* at 684. Bank capital requirements do not require banks to hold specific risk-based capital for perfectly hedged assets in their trading books and counterparty risk can be covered by posting of sufficient collateral, which is part of the TRS transaction. O.C.C. Interpretive Letter No. 893 (Nov. 23, 1999), available at <http://www.occ.treas.gov/interp/oct00/int893.pdf>. Therefore, banks have extremely low costs of funding for loans hedged by TRS (which are perfectly matched hedges, so the difference between the swap counterparty's period payments and the bank's cost of funding—the bank's profit of the TRS—is substantial).

The trades that are visible are primarily trades in unsecured trade debt. In large Chapter 11 cases (Mega-Cases), there is clearly an active market in such claims, as their case dockets are peppered with Rule 3001(e) filings. These trades will range from claims as small as a \$40 claim by a locksmith (such a trade occurred in Footstar's bankruptcy⁵⁴) to multi-million dollar claims,⁵⁵ but many are relatively small, under \$1,000.⁵⁶ While it would be possible to undertake an empirical study of claims trading based on Rule 3001(e) filings, it would necessarily be incomplete, and there is good reason to believe that the market in unsecured trade and vendor claims looks different from the market in bond claims or bank debt.

To the extent that claims trading has received scholarly attention, it is in the context of Mega-Cases,⁵⁷ yet there are many smaller business bankruptcy cases, ranging from small businesses that file under Chapter 13 to small cap, middle market, and even sizeable Chapter 11's with publicly traded debt securities that are not Mega-Cases. We know almost nothing about claims trading dynamics in the medium and small business cases. For those small businesses in Chapter 13, the dynamics presumably resemble those of Chapter 13 consumer debtor cases. But for the smaller Chapter 11 cases, it is not clear how much claims trading there is or what its purpose is. Not surprisingly, given the epistemological limitations on any discussion of bankruptcy claims trading, the debate usually operates at a high level of generality, lumping all claims trading together.

The claims trading debate is hindered by this level of generality. At best, with a high level of generality, all we can say is that the net impact of claims trading is indeterminate.⁵⁸ Unpacking the various practices that fall under the claims trading rubric is a necessary first step in advancing a more productive discussion about claims trading's impact on bankruptcy. The following section considers some of the key variations in the claims trading market and their likely impacts on the bankruptcy process.

54. See Notice to transfer of Claim pursuant to rule 3001 (e)(1) from A & Z Lock & Key to Revenue Management, *In re* Footstar, No. 04-22350 (Bankr. S.D.N.Y. June 22, 2004).

55. Burbage & Weddell, Barzel Industries Bankruptcy – Trade Debt Picture, Largest Unsecured Creditors (Sept. 16, 2009), <http://www.burbageweddell.com/2009/09/16/barzel-industries-bankruptcy-trade-debt-picture-largest-unsecured-creditors/>.

56. Posting of Adam J. Levitin to Credit Slips: A Discussion on Bankruptcy, <http://www.creditslips.org/creditslips/2007/10/bankruptcy-clai.html> (Sept. 20, 2007, 22:18 EST).

57. See, e.g., Levitin, *Finding Nemo*, *supra* note 5, at 89 (discussing *Enron*'s effect on bankruptcy claims trading); see generally Levitin, *The Limits of Enron*, *supra* note 5 (discussing the subordination that buyers of bankruptcy claims will be subjected to post-*Enron*); Kenneth M. Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?* 15 (March 2009) (Univ. of Penn. Inst. for Law & Econ. Research, Paper No. 09-05, Nw. Law & Econ. Research Paper No. 09-05, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639 (discussing Lehman Brother's decision to file for bankruptcy and the effects on government intervention).

58. Levitin, *Finding Nemo*, *supra* note 5, at 89.

II. THREE-DIMENSIONAL CLAIMS TRADING

Claims trading is a multi-dimensional and dynamic market that encompasses trades in claims based on a variety of types of debts and trading motivations. The market varies on three dimensions: temporally, regarding when claims trading takes place; qualitatively, regarding what is traded; and motivationally, regarding trading strategies. As an initial matter, however, it is necessary to define claims trading. We often speak of “bankruptcy claims trading,” but what is it about a bankruptcy claim that distinguishes it from a regular debt claim? Answering this requires us to first consider the temporal dimension of claims trading.

A. THE TEMPORAL DIMENSION: ARE BANKRUPTCY CLAIMS A DISTINCT MARKET?

From a legal perspective, there are many possible distinctions between a bankruptcy claim and a regular debt. In an earlier work, I noted that the Bankruptcy Code’s definition of “claim”⁵⁹ was arguably broader than what might be commonly thought of as a debt because it included disputed, contingent, and unliquidated payment obligations.⁶⁰ I also noted that not all debts were enforceable in bankruptcy, that a bankruptcy claim carries rights with it that are distinct from those that are part of a debt, and that bankruptcy endows a claim with a relational aspect that does not exist in a debt.⁶¹ Filing for bankruptcy can also accelerate debts that have not yet become due outside of bankruptcy.

Although there is a legal distinction between a bankruptcy claim and a regular debt, they are both rights to use the legal system to collect value from another. The value of those rights depends on legal distinctions, such as whether the collection takes place through state law or federal bankruptcy law, whether or not a claim is ultimately allowable, and, if so, in what amount, with what priority, and with what voting rights. Buying or selling either a bankruptcy claim or a regular debt is a gamble on this constellation of risks, but the market is concerned about these distinctions

59. 11 U.S.C. § 101(5)(A), (B) (2006) defines a “claim” as:

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

Id.

60. Levitin, *Finding Nemo*, *supra* note 5, at 169–70. The Bankruptcy Code’s definition of “debt” is simply “liability on a claim.” 11 U.S.C. § 101(12) (2006).

61. Levitin, *Finding Nemo*, *supra* note 5, at 170.

only to the extent that they are meaningful markers of risk and value. Yet, the market import of legal distinction between bankruptcy claims and distressed debt depends on whether it is in a consumer or a business context.

1. Consumer Debt

Within consumer claims, there are a few submarkets, temporally. First, there is a market involving the resale of consumer debt as part of routine securitization transactions.⁶²

Second, there is a market for delinquent debt of non-bankrupt consumers.⁶³ Third, there is a market for consumer bankruptcy claims, many of which were previously delinquent.⁶⁴ And fourth, there is a market in “zombie” debt that has been discharged in bankruptcy.⁶⁵ These temporal submarkets are further divided by asset type. Although many claims buyers will deal in all types of consumer debt, there are some that specialize in credit card debt, mortgages, auto loans, student loans or medical debt.⁶⁶

The key temporal distinction, however, in consumer cases is the bankruptcy status of the obligor. There is a distinct market for bankruptcy debt from delinquent or regulatorily “charged-off” debt.⁶⁷ This is due to the

62. See Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 189 (2009).

63. Victoria J. Haneman, *The Ethical Exploitation of the Unrepresented Consumer*, 73 MO. L. REV. 707, 715 (2006).

64. Moss, *supra* note 5, at 646.

65. This discharged debt is called “zombie” debt because there are still attempts to collect it even though it is legally unenforceable, making it a financial “undead.” Liz Pulliam Weston, “Zombie” Debt Is Hard to Kill, <http://articles.moneycentral.msn.com/SavingandDebt/ManageDebt/ZombieDebtCollectorsDigUpYourOldMistakes.aspx>. Debtors will sometimes pay discharged “zombie” debt because they do not know that the debt is no longer enforceable; because they do not want to deal with the harassment of (illegal) debt collection; because of a sense of moral obligation to repay debts, regardless of their legal status; because they hope it will help their credit rating; or because repayment of the debt is a precondition for receiving new financing or other consideration. Some courts have held that the purchase or sale of discharged debt, leading to subsequent collection activity, can be a violation of the discharge injunction. See, e.g., *In re Nassoko*, 405 B.R. 515, 520–21 (Bankr. S.D.N.Y. 2009) (sale of discharged debt could provide basis for violation of discharge injunction); *Gunter v. Kevin O’Brien & Assocs. Co.* (*In re Gunter*), 389 B.R. 67, 73 (Bankr. S.D. Ohio 2008) (failure to inform the purchaser of the discharge is itself a violation of the discharge injunction); *In re Lafferty*, 229 B.R. 707, 714 (Bankr. N.D. Ohio 1998) (“The selling of accounts is a deliberate act to collect on a discharged debt.”); *Walker v. M&M Dodge, Inc.* (*In re Walker*), 180 B.R. 834, 844 (Bankr. W.D. La. 1995); *In re Roush*, 88 B.R. 163, 165 (Bankr. S.D. Ohio 1988) (“[T]he burden of establishing procedures adequate to minimize or eliminate this problem was upon the creditor.”); *In re Conti*, 50 B.R. 142, 146 (Bankr. E.D. Va. 1985) (“The IRS is not privileged to ignore the dischargeability of certain taxes because of the burden or inconvenience which it may cause.”). *But see* *Finnie v. First Union Nat’l Bank*, 275 B.R. 743, 746 (E.D. Va. 2002) (sale alone of discharged debt is not a collection action in violation of the discharge injunction).

66. Levitin, *supra* note 62, at 192–93.

67. Generally accepted accounting principles prohibit non-performing assets from remaining on a balance sheet but do not specify specific dates for which they must be “charged-off.”

differences in collecting bankruptcy claims and merely delinquent debt. A creditor in a consumer bankruptcy case only has to file a proof of claim or be listed on a debtor's schedule, and, unless the claim is challenged or the creditor objects to the plan, the creditor will receive its allocated payment from the bankruptcy trustee.⁶⁸ Generally, it is a passive investment process.

This contrasts with investing in delinquent, but non-bankrupt consumer debt, which will usually payout only if there are active collection efforts, such as dunning calls and letters. This is a much more labor-intensive business model that results in very different pricing for bankruptcy and non-bankruptcy consumer claims most clearly visible in the pricing of unsecured debt in Chapter 13.

Because 93–96% of Chapter 7 cases are “no-asset” cases,⁶⁹ most of the consumer bankruptcy claims market is in Chapter 13 claims.⁷⁰ \$72.35 billion in consumer claims were sold in 2008.⁷¹ Around three-quarters of the total market (\$55.527 billion) was credit card debt,⁷² and Chapter 13 claims accounted for around a quarter of face value of the consumer debt resale market.⁷³ Whereas a dollar of credit card debt sells on average for 10–11 cents in a Chapter 13 case, it will only sell for 2–3 cents outside of bankruptcy.⁷⁴ Thus for consumer claims, there is a distinct bankruptcy claims market based on different collection models.

The temporal pricing variations for different types of consumer debt also inform an important debate issue in consumer finance about the effect of bankruptcy recovery rates on the cost and availability of consumer credit, especially to the riskiest consumers. In theory, if limits on dischargeability resulted in greater returns for creditors, they would result in lower costs for borrowers and/or greater credit availability, assuming perfectly efficient, complete markets. The assumption of perfect or complete markets is

Banking regulation, however, requires that financial institutions “charge-off” non-performing debt after a specified lapse of time: 180 days for open-end credit and 120 days for closed-end credit. Uniform Retail Credit Classification and Account Management Policy, 64 Fed. Reg. 6655, 6657 (Feb. 10, 1999).

68. See 11 U.S.C. § 502(a) (2006). This provision applies to business bankruptcies as well. *Id.*

69. W. Clarkson McDow, Jr., *Protecting the Integrity of the Bankruptcy System in Chapter 7 No-Asset Cases*, http://www.usdoj.gov/ust/eo/public_affairs/articles/docs/nabtalkfall2001.htm (last visited Sept. 15, 2009) (ninety-six percent of Chapter 7s in 2000 were no-asset cases); Dalié Jiménez, *The Distribution of Assets in Consumer Chapter 7 Bankruptcy Cases*, 85 AM. BANKR. L.J. (forthcoming Dec. 2009) (manuscript at 3), available at <http://ssrn.com/abstract=1471603> (ninety-three percent of consumer Chapter 7s were no-asset cases).

70. See *Credit Card Debt Sales in 2008*, THE NILSON REPORT, Mar. 2009, at 10, 10 [hereinafter NILSON REPORT].

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

generally problematic,⁷⁵ and there is mixed evidence on whether greater dischargeability actually affects the cost or availability of consumer credit.⁷⁶

Given that the price of unsecured Chapter 13 debt is so much higher than the price of equivalent debt outside of bankruptcy, it raises the question of whether changes in bankruptcy law that would broaden the scope of the discharge and enhance the debtor's fresh start in life would have adverse consequences on consumer finance markets. As long as the bankruptcy return (and hence the price of bankruptcy claims) is still greater than that of the equivalent debt outside of bankruptcy, policies that make bankruptcy more attractive to defaulted consumers should not affect consumer credit pricing. When faced with a defaulted debt, the relevant consideration for a creditor is the trade-off between state law and bankruptcy as collection methods (or restructuring the debt). In many cases, bankruptcy may be a more attractive option for creditors.⁷⁷ State law collection, especially of unsecured debts, is ineffective because of limitations on garnishment and asset exemptions.⁷⁸ Bankruptcy, on the other hand, requires payments to be made if there are nonexempt assets or disposable income.⁷⁹

2. Business Debt

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.⁸⁰ Claims traders bought claims only after a plan was proposed.⁸¹ They assumed only plan vote and feasibility risk, which was *de minimis*.⁸² The plan was a public document, and investors looked to pick up claims on the eve of the vote.⁸³

Over the past two decades, however, investors began buying claims earlier and earlier.⁸⁴ Now, investors trade in distressed debt well before

75. See JOSEPH E. STIGLITZ, *WHITHER SOCIALISM?* 33 (1994) (explaining how markets are always incomplete).

76. Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. 565, 586–99 (reviewing literature).

77. See *id.* at 602 (suggesting that Chapter 13 cramdown would result in smaller losses than state law foreclosure for mortgages).

78. See *id.* at 644.

79. See *id.* at 579; see also 11 U.S.C. § 1325(b) (2006).

80. Levitin, *Finding Nemo*, *supra* note 5, at 92.

81. Interview with Thomas Janover, Partner, Kramer, Levin, Naftalis & Frankel L.L.P. (July 29, 2009) (on file with author).

82. *Id.*

83. *Id.*

84. *Id.*

bankruptcy.⁸⁵ 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.⁸⁶ The segmentation that exists in the market is not based on bankruptcy status, but rather on asset class.⁸⁷

The lack of temporal distinction between bankruptcy and non-bankruptcy claims trading in the business claims context is important because it suggests that regulatory cost spillovers would be much more severe in the business claims context.⁸⁸ Because business bankruptcy claims are part of a broader market in business debt obligations, regulation of bankruptcy claims trading would also affect activity elsewhere in the broader market. While there might be good *bankruptcy* policy reasons to regulate bankruptcy claims trading in particular ways, the policy analysis has to consider the impact on *non-bankruptcy* claims trades in a way that it might not in the consumer claims context.

B. THE QUALITATIVE DIMENSION: MARKET SEGMENTATION BY ASSET CLASS

1. Consumer Debt

The consumer claims market is entirely distinct from the business claims market. It has also been largely overlooked by the academic literature, other than in context of the Fair Debt Collection Practices Act, even though claims buyers represent an important class of consumer bankruptcy creditors, especially for credit card debt.⁸⁹

Most of the claims traded in consumer bankruptcy cases are in unsecured claims, especially credit card debt claims.⁹⁰ Consumer claims trading also occurs primarily in Chapter 13 debt because almost all Chapter 7s are no-asset cases.⁹¹ As Guy B. Moss has noted regarding consumer Chapter 7s:

If the aim of the buyer is to realize on the upside potential of the claim based solely on the ultimate dividend payable from the estate, the prospects appear marginal. If, instead, the buyer's aim is to realize on all or a significant part of the entire claim by attacking the debtor's discharge or the dischargeability of the claim purchased by taking advantage of the debt reaffirmation provisions of the Bankruptcy Code, or by inducing voluntary payments after the discharge enters, the prospects are at best

85. *Id.*

86. *Id.*

87. *Id.*; see also Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 71 (2008).

88. Levitin, *Finding Nemo*, *supra* note 5, at 151–60.

89. For a major exception, see Moss, *supra* note 5.

90. See NILSON REPORT, *supra* note 70, at 10.

91. McDow, *supra* note 69.

uncertain, in many respects fraught with risk, and, of course, subject to the potential costs of litigation.⁹²

Accordingly, the Chapter 7 consumer claims market is much more limited than the Chapter 13 market.

Consumer claims trading is a fairly concentrated industry, with ten firms holding over 80% of resold consumer debt (excluding sales that occur as part of securitization transactions) and a similar percentage for credit card debt.⁹³ Apparently, concentration is much higher for bankruptcy claims, as executives at eCast Settlement Corporation (formerly a Bear Stearns affiliate, now a JPMorgan Chase affiliate) estimate that eCast and two other major consumer debt buyers hold 70% of consumer credit card debt in Chapter 13 bankruptcies.⁹⁴ eCast and the other buyers purchase the credit card debt and occasionally other types of unsecured debt, such as auto loan deficiencies in bankruptcy cases, at 10–15 cents on the dollar depending on a variety of actuarial factors, including the judicial district, the judge and trustee, and account features.⁹⁵

Typically, in consumer cases there is only one trading moment in bankruptcy for any particular claim—a debt buyer purchases a claim and holds it through the case. In consumer cases, claims trading operates on a single basic strategy—buy low and get a higher payout. The risk of a lower than anticipated yield is mitigated through diversified investment in thousands of cases.⁹⁶

Because there is no voting in Chapter 7, 12, or 13 cases, the value of a claim is its payout value, but that payout value can be manipulated because a claim gives the claim holder standing to make motions as a party in interest. A motivated professional Chapter 13 creditor, like a claims buyer, might also strategically bring frivolous litigation to boost its payouts. Frivolous or not, on a one-off basis, it is simply not worthwhile to bring much litigation over a \$3,000 or \$8,000 claim. Consumer debtors, however, can rarely afford to litigate such matters. Thus, the threat of litigation, enhanced by the occasional noisy example, can result in greater payouts.

Consumer claims trading raises two key policy concerns. First, can the claims purchaser actually prove title to the claim and the requisite facts to support the claim?⁹⁷ And second, might claims trading be used to “launder” the claim?⁹⁸ The consumer debtor might have a claim against the lender that

92. Moss, *supra* note 5, at 643 (internal citations omitted).

93. NILSON REPORT, *supra* note 70, at 10.

94. Telephone Interview with Mark Jackwicz, Executive Vice President & Kwang Thomas Choi, Executive Vice President, eCast Settlement Corp. (Sept. 11, 2008) (on file with author).

95. *Id.*

96. Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. & FIN. L. 23 (2010) (discussing the benefits of a diversified portfolio over the long run).

97. See, e.g., *In re Wingerter*, 376 B.R. 221 (Bankr. N.D. Ohio 2007).

98. See Levitin, *Finding Nemo*, *supra* note 5, at 141.

could result in the claim being disallowed, equitably subordinated, or subject to setoff.⁹⁹ The sale of the claim by the lender to a third party would prevent the consumer from prosecuting its action against the lender in the bankruptcy forum, preventing the consumer from having the debt disallowed, subordinated, or setoff, in the hands of the purchaser. The lender can thus “launder” the claim and monetize it based on its untainted value, while the buyer remains impervious to the consumer’s claims.¹⁰⁰

2. Business Debt

Business debt claims fall into roughly four asset classes: bond debt, bank debt, trade debt, and tort debt. Some investors will purchase claims in any and all classes, while others limit themselves to particular classes. These types of debt differ not only based on where they are in the capital structure, but also based on the risks that a purchaser assumes.

a. Bond Debt

Claims based on bond debt are by far the most liquid type because bond debt is a commodity with relatively fewer risks attached to it than other asset classes.¹⁰¹ There is little risk about whether bond debt will be disallowed, subordinated, or subject to clawback actions.¹⁰² The validity and amount of the bonds are not in question and the bondholder and indenture trustee have no dealings with the debtor that would create equitable subordination grounds. Most bonds are unsecured, so there is no strong-arm risk.¹⁰³ Moreover, because bond debt trades publicly, there is little counterparty risk involved in the trades because of the use of large financial institutions as broker-dealers; there is no question whether the party that is selling the claim actually owns it. There is minimal diligence involved in a bond debt trade, and the identity of counterparties is typically not known, making more serious diligence impossible.

There is also typically a rough symmetry of sophistication between parties in bond debt trades. Most corporate bonds are owned by financial

99. 11 U.S.C. §§ 502(b) (disallowance), 510(c) (equitable subordination) (2006).

100. For a discussion of claims washing in the business bankruptcy context, see Levitin, *Finding Nemo*, *supra* note 5, at 145 and Levitin, *The Limits of Enron*, *supra* note 5, at 404. The consumer context may raise different equities and policy concerns than the corporate context even though there is but “one Code to rule them all.” See J.R.R. TOLKEIN, *THE LORD OF THE RINGS, PART ONE: THE FELLOWSHIP OF THE RING* 55 (Ballentine Books 1965) (“One ring to rule them all . . .”).

101. Edward J. Janger, *The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration and Coordination Problems*, 4 BROOK. J. CORP. FIN. COM. L. 39 (discussing the fear of harming the liquidity of corporate debt).

102. 11 U.S.C. §§ 502(b), (d), 510(c) (2006).

103. The so-called “strong-arm” provision of the Bankruptcy Code, 11 U.S.C. § 544(a) (2006), permits the trustee to avoid most liens that are unperfected at the time of a bankruptcy filing.

institutions, not by individual investors.¹⁰⁴ Accordingly, bond debt trades do not raise concerns of sophisticated investors fleecing naïve mom-and-pops.

b. Bank Debt

Bank debt is commonly syndicated, participated, or both and, trades in slices, rather than whole loans.¹⁰⁵ The syndications now are written with an eye to trading, a contrast from past practice, when bank loan syndications were often restricted to banks, out of concerns about the different accounting rules and non-banks' ability to make further advances to the debtor.¹⁰⁶

Bank debt bears more risks for a claims purchaser than bond debt because it might be subject to disallowance due to clawback actions.¹⁰⁷ Bank debt is almost always secured, but a lien might turn out to be unperfected and subject to avoidance.¹⁰⁸ There is also risk of equitable subordination for misbehavior by the bank.¹⁰⁹

On the other hand, bank claims provide a purchaser with information and leverage that is not available to a bondholder. Bank loans typically have various reporting covenants beyond what exist in bond indentures.¹¹⁰ The access to the information is hugely valuable to an investor. Thus, bank debt is particularly attractive, especially to purchasers pre-bankruptcy, who will end up with a large informational advantage on the market.¹¹¹

Bank debt also provides a claims purchaser with far more leverage over the debtor, especially before bankruptcy. There are many more covenants in bank loans, which make defaults more likely, but which offer the purchaser of bank debt the possibility of forbearance fees, additional security, or

104. Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U.L. REV. 565, 583–86 (1995).

105. Harner, *supra* note 5, at 712 (reporting that banks are “increasingly syndicating commercial loans or selling their loans once a company experiences financial distress”); *see also* Marc Bennett, *Buying and Selling Bank Debt*, HEDGE FUND NEWS, May 2003, http://hedgefundnews.com/news_n_info/article_detail.php?id=287 (describing how banks trade “pieces” of troubled loans, and how participation may be used as an alternative to, or a step toward, the full assignment of bank debt).

106. Harner, *supra* note 5, at 712–13.

107. 11 U.S.C. §§ 502(d), 547, 548 (2006).

108. 11 U.S.C. § 544 (2006).

109. 11 U.S.C. § 510(c) (2006).

110. BUSINESS WORKOUTS MANUAL §16:50 (2d ed. 2002) (“[A] bondholder may find itself without access to important information. The reporting requirements imposed by most indentures are substantially less comprehensive than those required under a typical bank loan agreement. . . .”); *see also* Henry S. Miller, *Emerging Issues in Workouts & Bankruptcies 2004 – PowerPoint Slides*, in EMERGING ISSUES IN WORKOUTS & BANKRUPTCIES 2004 WHAT YOU NEED TO KNOW!, at 99, 108 (PLI Comm. L. & Practice, Course Handbook Series No. A0-00KZ, 2004) (“Covenants [are] generally less restrictive than first lien or bank loans.”).

111. *See* Harner, *supra* note 5.

forcing the debtor into bankruptcy by denying forbearance.¹¹² Thus, the holder of bank debt, even if it is participated or syndicated, has greater influence over the relationship with the debtor than does a single bondholder. Additionally, because bank debt is usually sold in large denominations, if a seller breaches its sale warranties to the buyer, a lawsuit is economically viable and can likely cover the damages. Like bond debt, bank debt is almost always held by a financial institution and trades between sophisticated investors on both sides of the transaction.

c. Trade Debt

Trade debt offers even more challenges to a claims purchaser than bank debt. The counterparty risks, and therefore, the diligence requirements, are much higher.¹¹³ The defenses that a debtor might raise against a bank loan are fairly limited: There might be counterclaims against the bank or equitable subordination issues, but the validity of the loan itself is relatively easy to ascertain.¹¹⁴ This is not the case with trade debt.

For example, a vendor might have breached its contract with the debtor in any number of ways. The vendor might have delivered the debtor an insufficient quality or quantity of merchandise, failed to deliver it on time or failed to perform the services promised. Any of these breaches could provide the debtor with defenses to the enforcement of the contract, but would be quite difficult for a claims purchaser, with no right to inspect the debtor's books and records, to diligence. There might also be setoff rights based on other dealings between the vendor and the debtor, including other discrete contracts.¹¹⁵ A purchaser of trade claims has much greater uncertainty about how much, if any, of the claim will be allowed, and every trade claim presents distinct risks.

While the purchaser can protect itself via representations and warranties from the seller, many trade debt claims are in denominations that make litigation over misrepresentations on the sale uneconomic.¹¹⁶ This depresses the market for smaller trade claims, which is already limited because of the higher ratio of transaction costs to value, and because small claims are of little interest to buyers who are looking to gain influence over a plan. The market in smaller trade claims attracts buyers primarily looking to capture a

112. This might be done to trigger a loan credit default swap or total return swap on the loan. It might also be done as part of a loan-to-own strategy.

113. Levitin, *Finding Nemo*, *supra* note 5, at 152–53.

114. *Id.* at 175.

115. Levitin, *The Limits of Enron*, *supra* note 5, at 414 (explaining, post-*Enron*, the higher relative value of loan participation claims to trade claims resulting from their lower relative risk).

116. There are methods of mitigating this risk. For example, a cautious purchaser might purchase small claims only after the debtor schedules them and bases the purchase price on the scheduled amount of the claim, rather than on the amount listed on the proof of claim filed by the seller.

spread, since small trade claims will probably be classified as convenience claims and likely paid in full.¹¹⁷ This means small claims are unlikely to have a vote on a plan,¹¹⁸ which makes them unattractive to buyers looking to gain control over a plan.

While trade debt offers investors many more diligence challenges than bond or bank debt, it also offers some advantages. Bondholders and bank lenders must lay out 100 cents to get a \$1 allowed claim.¹¹⁹ Therefore, their “cost” of a claim is 100%. To the extent that the claim is sold for less than 100 cents on the dollar, there is an economic loss to the bondholder or bank lender.

A trade claimant, in contrast, likely has a much lower “cost” for its claim. If the trade claimant’s markup on the goods it sold to the debtor was 50%, then the trade claimant will come out ahead economically (but not necessarily in accounting), by selling at 54 cents on the dollar. Additionally, trade creditors are more likely to place a premium on liquidity than bank lenders or bondholders, all of which means they are likely more willing to sell at lower prices.¹²⁰ For a vulture fund looking to purchase unsecured debt in a bankruptcy, an allowed trade claim is just as good as an allowed bond claim, but the likely price spread produces an attractive arbitrage opportunity.¹²¹

Trades in trade claims raise concerns about sophisticated traders taking advantage of ingénue vendors. It is important to remember that trade creditors include both incredibly sophisticated parties with extensive bankruptcy experience (e.g., Fortune 500 companies like OEM auto manufacturers) as well as sole proprietorship small businesses with no prior bankruptcy experience.

d. Tort Debt

Finally, there is a much smaller market for tort claims.¹²² Most investors are not interested in tort claims, in part because of the issues of

117. See Levitin, *The Limits of Enron*, *supra* note 5.

118. See 11 U.S.C. §§ 1122(b) (permitting creation of convenience class), 1126(f) (unimpaired classes are deemed to have accepted a plan) (2006).

119. Many bonds have an original issue discount (OID), meaning the purchase price at issue is less than the face value that the issuer will have to pay to redeem the bond upon maturity. OID is generally treated as a form of unmatured interest in bankruptcy. See, e.g., *Chateaugay Corp. v. Valley Fid. Bank & Trust Co. (In re Chateaugay)*, 961 F.2d 378, 380–81 (2d Cir. 1992) (unaccrued OID on unsecured debt treated as unmatured interest); *In re Solutia Inc.*, 379 B.R. 473, 486 (Bankr. S.D.N.Y. 2007) (unaccrued OID on secured debt treated as unmatured interest).

120. See Andrew Africk, Comment, *Trading Claims in Chapter 11: How Much Influence Can be Purchased in Good Faith Under Section 1126?*, 139 U. PA. L. REV. 1393, 1399–1400 (1991).

121. Harner, *supra* note 5, at 716.

122. Janover, *supra* note 81.

proof involved in disputed claims and because champerty issues are particularly salient in the personal injury context.¹²³

3. Deal Mechanics and Documentation

Deal documentation and deal mechanics vary for claims depending on asset class. Bond debt and equity trade in bankruptcy just as it did outside of it (although exchange-traded equity will be delisted and trade OTC on the Pink Sheets), and with the same documentation.¹²⁴ The same securities laws will apply in bankruptcy as outside, which presents another variation in asset class.¹²⁵

A claim's status under securities laws affects its attractiveness to investors.¹²⁶ Federal securities laws will apply to bond claims and certificated equity interests, which sometimes trade as penny stocks.¹²⁷ State securities laws might, in some cases, extend to bank or trade claims, as state law definitions of securities can be broader than federal law.¹²⁸ Some investors are happy to comply with securities regulation regimes, while others do not want to be subject to it.¹²⁹ This is another factor encouraging buyers toward bank and trade debt and away from bonds.

Bank debt trades OTC using standardized documentation from the Loan Syndication and Trading Association (LSTA), a trade association of syndicated loan broker-dealers.¹³⁰ Large investment banks serve as the broker-dealers in this market, but a number of smaller firms such as Imperial Capital, Cantor Fitzgerald, The Seaport Group, and Pressprich & Co. also compete. Because bank loans are not treated as securities for federal law, the broker-dealers are not subject to federal broker-dealer regulation, including the duty of fair dealing and the 10b-10 trade confirmation rule.¹³¹

Broker-dealer pricing depends on the size of the transactions and the liquidity in the claim type, but is typically in the range of a couple basis

123. See Peter Charles Choharis, *A Comprehensive Market Strategy for Tort Reform*, 12 YALE J. ON REG. 435, 461 (1995); see also *In re Brown*, 354 B.R. 100, 105 (Bankr. N.D. W. Va. 2006).

124. See Drain & Schwartz, *supra* note 5, at 570 (although exchange-traded equity will be delisted and trade OTC on the Pink Sheets).

125. *Id.* at 606, 609.

126. Anthony Michael Sabino, *No Security in Bankruptcy: The Argument Against Applying the Federal Securities Laws to the Trading of Claims in Bankruptcy*, 24 PAC. L.J. 109, 128 (1992).

127. See Drain & Schwartz, *supra* note 5, at 606, 609.

128. See, e.g., OHIO REV. CODE ANN. § 1707.01(B) (LexisNexis 2009) (defining security as including "interim receipts, interim certificates, promissory notes, all forms of commercial paper, evidences of indebtedness . . . any instrument evidencing a promise or an agreement to pay money. . .").

129. See Drain & Schwartz, *supra* note 5, at 571–73.

130. Huber & Young, *supra* note 51; Siegel, *Part I*, *supra* note 5, at 567–68.

131. Drain & Schwartz, *supra* note 5, at 571–72.

points on each trade.¹³² There is no direct contact between the buyer and the seller, and they receive separate trade confirmations.¹³³ Thus, it is impossible to know if the broker-dealer is acting as a dealer engaged in a price arbitrage itself (trading for its own account and pocketing the spread between the buyer's offer and the seller's price) rather than as a broker (a fiduciary agent with compensation limited by contract).¹³⁴

Trade debt can also go through a broker-dealer, but its initial sale often involves direct contacts between the buyer and seller. As soon as schedules of claimholders or proofs of claims are filed, firms that specialize in buying trade claims rush to send offers to claimholders.¹³⁵ As the website of Argo Partners, a firm that specializes in trade claims, explains:

If you have received a letter from Argo Partners offering to purchase your claim, you are listed in papers filed in the bankruptcy court as a creditor in a bankruptcy proceeding. The letter you received extends an offer to buy your claim in exchange for the amount stated.

To accept our offer, simply complete the Assignment Agreement and return it via mail, email or fax. Payment for your claim will be made pursuant to the terms of the offer letter you received. Argo Partners will file the necessary documents to effectuate the transfer with the U.S. Bankruptcy Court.¹³⁶

Documentation for trade claims is far from standardized, although there have been moves made in that direction. In 2002, a number of specialists in trade claims formed a Trade Claims Buyers Association (TCBA) with the goal of standardizing "the assignment, transfer and payment for such claims. This would not only clarify procedures among competitors in the trade claims market but, most importantly, would also act to bring additional confidence to creditors wishing to sell their claims."¹³⁷

It is unclear how much progress has been made in adoption of standardized procedures and documentation for trade claims. Trade claims can be subject to a range of contract defenses. Therefore, contracts for the purchase of trade claims typically have mechanisms to adjust for a disallowance, reduction or offset.¹³⁸ Sellers often want to negotiate these terms carefully, which precludes standardization.

132. Beranek & Jones, *supra* note 27, at 78.

133. Only equity securities are subject to Securities Exchange Commission Rule 10b-10's mark-up disclosure requirement. *See* 17 C.F.R. 240.10b-10 (2005).

134. Janover, *supra* note 81.

135. These specialists are often looking to later resell to other distressed debt investors who do not want to engage in the direct-to-vendor contact.

136. Argo Partners, Bankruptcy, <http://www.argopartners.net/bankruptcy.html> (last visited Sept. 10, 2009).

137. Argo Partners, TCBA, <http://www.argopartners.net/tcba.html> (last visited Sept. 10, 2009).

138. *See* Carianne Basler & Michelle Campbell, *Savvy Claims Purchasers Must Avoid Pitfalls*, 25-5 AM. BANKR. INST. J. 26, 27 (2006).

The differences in the asset classes of bankruptcy claims suggest that different types of regulation are necessary. Trade claims, for example, might require regulation with a greater eye to protecting sellers because of differences in sophistication. The differences in the asset classes also suggest that there should be different rules about transient liability with claims.

For example, consider the sorely confused district court ruling in *Enron*, the most important claims trading case to have emerged in recent years.¹³⁹ The issue before the district court was whether a claim could be equitably subordinated or disallowed in the hands of a purchaser for malfeasance done by the seller unrelated to the claim.¹⁴⁰ The district court held that the answer depended on whether the claim was “sold” or “assigned,”¹⁴¹ a novel distinction that flew against the long-standing interchangeability of these terms in legal practice.¹⁴²

A rule that equitable subordination or disallowance follows a claim might make sense if there was a highly negotiated transfer, such as a trade claim with opportunities for the buyer to conduct diligence on the seller or negotiate warranties. It makes little sense, however, for a claim based on a bond, where counterparty diligence is impossible, as is the ability to negotiate separate warranties absent knowledge of the counterparty’s finances. While it is true that *Enron* involved bank debt, which has a more complicated situation because it trades on standardized forms, there is a greater ability to negotiate terms and conduct diligence of the immediate seller (but not of upstream transferors) of bank debt.¹⁴³ A rule that makes sense for one asset class of claim might not for another.

139. *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007).

140. *Id.* at 427–28.

141. *Id.* at 448–49.

142. *See, e.g., In re Kreisler*, 546 F.3d 863 (7th Cir. 2008) (using “assignment,” “purchase,” and “sale” interchangeably). *See also* Richard L. Ferrell, *Court Says ‘No Harm, No Foul’ in Claims Trading Case Standards for Distressed Debt Claims Trading Continue to Evolve*, J. CORP. RENEWAL, Mar. 10, 2009, <https://www.turnaround.org/Publications/Articles.aspx?objectID=10736>; Ken Coleman & Hugh McDonald, *District Court Enron Opinion: A Pyrrhic Victory for Traders*, ASSET SALES COMMITTEE NEWSLETTER (AM. BANKR. INST., Alexandria, Va.), Oct. 2007, <http://www.abiworld.org/committees/newsletters/assetsales/vol4num3/Southern.html> (noting that “a great deal of debt is traded using documents somewhat indiscriminately labeled ‘purchase and sale’ and ‘assignment and acceptance’ or ‘assignment and assumption,’ or is simply not documented by more than a trade confirmation. This potential problem is compounded by the fact that most loan and credit agreements contain appendices, often labeled as ‘assignment,’ which lenders are required to use in order to transfer their debt to a downstream purchaser/assignee.”); Bingham, *Ruling in Enron Claims Trading Case Cheers Distressed Debt Traders*, Sept. 11, 2007, <http://www.bingham.com/Media.aspx?MediaID=5678> (“Typically in commercial law a sale is a form of assignment. . . .”); U.C.C. § 2-106(1) (2003) (defining “sale” as “the passing of title from the seller to the buyer for a price”).

143. *See* Levitin, *Finding Nemo*, *supra* note 5, at 93.

C. THE MOTIVATIONAL DIMENSION: TRADING STRATEGIES

1. Sellers

A claims trade requires both a seller and a buyer, of course, but it is important to recognize the differences in their respective motivations, as well as the impact of their activity. Claims sellers have a variety of motivations. Parties want to get out of bankruptcy cases for a variety of reasons including liquidity constraints, administrative hassle, conflicts of interest with current customers (including the debtor), and expense or regulatory risk. Others wish to sell their claims to lock in a profit, limit a loss, or benefit from a tax advantage.¹⁴⁴

Additionally, there might be some creditors who want to get out of the bankruptcy case because they have done something nefarious that would cause the claim to be disallowed or subordinated in their hands and are looking to “launder” their claim through the sale.¹⁴⁵ Unless there are grounds for an independent action against them for their conduct, once they cease to be a creditor in the bankruptcy, they have little to lose.¹⁴⁶ Despite the celebrated *Enron* case,¹⁴⁷ there is no evidence that this practice is widespread. Most likely, the vast majority of claims sellers are simply looking to disengage from the bankruptcy with no bad faith motivation.

Preserving exit opportunities for creditors is important because it affects the availability and cost of capital to all businesses, especially riskier ones. To the extent that creditors are worried about being trapped into a bankruptcy, it will reduce their willingness to lend, resulting in less credit availability and/or higher costs. This, in turn, might force marginal borrowers into bankruptcy.¹⁴⁸

Bankruptcy claims are the residual capital market, and as such are intimately linked with upstream markets. While the workings of this relationship depend on the ease of non-bankruptcy debt collection, there are

144. In some cases, a party will be both a buyer and a seller in sequence. This might be simply because the party wishes to monetize on its trading gains. But it can also be a loss mitigation strategy. The ability to sell gives claims purchasers a fallback in case their investment strategy does not go as planned. This fallback option is only available, however, in cases where there is sufficient liquidity in claims that an investor will not fear being locked into its position.

145. *Enron Corp. v. Ave. Special Situations Fund II, L.P. (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006), *vacated*, *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007); *Enron Corp. v. Ave. Special Situations Fund II, L.P. (In re Enron Corp.)*, 333 B.R. 205, 211 (Bankr. S.D.N.Y. 2005). *Enron* was largely a fluke case in this regard, as the alleged wrong-doing was by the seller, not the purchasers. *In re Enron*, 340 B.R. at 184–85; *In re Enron*, 333 B.R. at 212–13. The issue in the case was whether the purchasers were liable for the seller’s wrong-doing unrelated to the claim. *In re Enron*, 340 B.R. at 183; *In re Enron*, 333 B.R. at 210.

146. In the business context, unlike the consumer context, there may well be funding for such an independent action.

147. *In re Enron Corp.*, 340 B.R. 180; *In re Enron Corp.*, 333 B.R. 205.

148. See Levitin, *Finding Nemo*, *supra* note 5, at 89.

indelible connections between bankruptcy markets and non-bankruptcy markets; with business debt, they are largely seamless.

From a policy perspective, however, it is very easy to view bankruptcy as a world in and of itself. The problem is that bankruptcy is not an end in and of itself, but a part of the market regulation system. It is an easy trap for those who work solely in the bankruptcy realm to focus only on the bankruptcy effects of claims trading (and often only through the prism of the case at hand); it is harder for them to see the indirect effects of claims trading on capital markets, much less the causal links. Nonetheless, evaluations of claims trading must account for the larger net social welfare impacts including liquidity.

To the extent that we believe there is value to protect in the exit opportunity from claims trading, it also means that we have to protect sufficient entry opportunities, as every claims trade requires a buyer and a seller. While claim purchases raise several problematic strategies, purchases are necessary for sales and vice versa.

2. Buyers

Claims buyers are a more complicated group than sellers. Every claims trader is looking to buy low and sell high, but beyond that, it is hard to generalize when and what, much less why, they are buying. Some of their activities are quite innocent while others raise serious policy concerns.

Some claims purchasers buy before the bankruptcy petition is filed, some at the beginning of the case, and some towards the end. For example, there are investors who look to purchase at low prices either when a business is failing or early in the bankruptcy and ride through the case until payouts are fairly certain.¹⁴⁹ These investors might be hoping to buy at 30 cents on the dollar and get a payout at 70 cents on the dollar. Perhaps if they waited another six months, the payout would be 74 cents on the dollar, but the additional 4 cents on the dollar for six months might not be a worthwhile return for the time value of the investment.

Other investors might not want to assume the risk that exists in the early days of a case when the fate of the debtor is much less certain, but they would gladly purchase at 70 cents on the dollar at the end of the case to get a payout of 74 cents on the dollar six months later.

Some buyers focus on a particular asset class, while others buy up and down the capital structure, using one class of debt as a hedge on another.¹⁵⁰ As for why they are buying, several different types of claims trading may be observed, at least in Mega-Cases.

149. See Harner, *supra* note 5, at 716.

150. Coco, *supra* note 5, at 617.

As with consumer bankruptcies, there are simple passive arbitrageurs looking to make a spread between the price they pay for a claim and the ultimate payout, discounted for some time value.¹⁵¹ These buyers do not appear in court and are not active in the case. They 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.¹⁵² Similarly, there are arbitrageurs who are not looking to make their spread based on the ultimate payout in the case, but rather as broker-dealers, earning a commission or markup on the claims.¹⁵³ These passive investment types of activity are, by themselves, harmless, except to the extent claims trading volume overall is a problem.¹⁵⁴

Also, there are arbitrageurs, typically activist investment funds, who are active in the case, appearing in court, taking part in plan negotiations, and litigating to improve their payouts.¹⁵⁵ These purchasers contribute to the reorganization process both through their expertise and ability to fund the reorganization, either through DIP lending or exit financing.¹⁵⁶ These funds buy in because they want to impact the restructuring strategically.¹⁵⁷ Sometimes this is simply with an aim to increase the payout. Other times it is because they see bankruptcy as an acquisition strategy.

Claims purchasing can also be a takeover strategy. There are claims purchasers who look to acquire the so-called “fulcrum security”—the class(es) of claims that will be paid with equity in the reorganized firm.¹⁵⁸ Investors can purchase debt claims and end up as owners of the reorganized firm. This strategy is another type of arbitrage, because it uses claims trading as a way to acquire the reorganized debtor at a discounted price. Sometimes buyers will aim for the fulcrum security after a bankruptcy filing, but often they will get involved pre-bankruptcy, as part of a loan-to-own strategy with a distressed company.¹⁵⁹

There is reason to believe that bankruptcy might allow for cheaper acquisitions than outside of bankruptcy. First, there is uncertainty as to

151. Fortgang & Mayer, *Trading Claims*, *supra* note 5, at 5.

152. *See* 11 U.S.C. § 1122(b) (2006).

153. Beranek & Jones, *supra* note 27, at 77.

154. *See infra* Part III.

155. *See, e.g.*, Harner, *supra* note 5, at 731.

156. *Id.* at 734–36.

157. Harner, *supra* note 87, at 70 n.3, 95; Tung, *supra* note 5, at 1686.

158. Press Release, Kirkland & Ellis L.L.P., Seminar Grapples with Hedge Funds’ Influence (Apr. 10, 2007), <http://www.kirkland.com/sitecontent.cfm?contentID=230&itemId=6927> (explaining “some funds don’t want to make investments in the fulcrum security, the debt instrument most likely to convert to equity ownership in restructuring”).

159. Second lien debt is particularly popular as a potential fulcrum that also provides leverage to force a bankruptcy. *See* Gordon L. Su, Bankruptcy Implications of Second Lien Loans 1 (unpublished manuscript), available at <https://www.turnaround.org/cmaextras/Paper—Bankruptcy Implications.pdf>.

where in the capital structure the fulcrum security will lie. There might be reduced demand for what turns out to be the fulcrum security, and hence a lower price.

Second, bankruptcy claims can be acquired very quietly. There is no equivalent to the Williams Act provision requiring a public filing if a shareholder acquires more than 5% of a company's securities.¹⁶⁰ As a result, a purchaser might avoid paying the control premium. This is not necessarily a problematic strategy from a policy perspective, but the ability to arbitrage regulatory regimes to gain a bargain raises the specter of companies being pushed into bankruptcy to facilitate cheaper takeovers that impose costs on other creditors and shareholders.

There are also claims traders who use claims as a method of shorting reorganizations. An entity might purchase bankruptcy claims because it is short on a reorganization due to another investment (such as an investment in a competitor), because it wishes to force an asset sale, or because they are competitors of the debtors.¹⁶¹ The purchaser's incentive in plan confirmation voting is to delay or block confirmation, and force a liquidation.

From a bankruptcy policy viewpoint, this looks quite bad, but it needs to be considered as part of the larger debate on shorting, which is essential for market discipline.¹⁶² The possibility of parties being short in reorganizations is typically part of the parties being long in other investments. By the same token, a party that is long on a bankruptcy reorganization might have hedged it with a short position on a competitor or index. If parties are to be encouraged to be long on reorganizations, they might need to be short elsewhere, and if shorting is acceptable outside of bankruptcy, it should be so in bankruptcy. Trading strategies that seem distasteful when viewed solely in a bankruptcy context can have a more neutral tone when the interconnectedness of bankruptcy markets to other markets is considered.

160. 15 U.S.C. § 78n(d)(1) (2006).

161. Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1394378&rec=1&srcabs=1371089.

162. See, e.g., Arturo Bris et al., *Efficiency and the Bear: Short Sales and Markets Around the World*, 62 J. FIN. 1029, 1072 (2007) (finding "a negative association between short sales restrictions and the diffusion of negative information into prices"); José Scheinkman & Wei Xiong, *Overconfidence and Speculative Bubbles*, 111 J. POL. ECON. 1183 (2003) (short sales constraints can be a cause or a necessary condition for asset bubbles and excessive volatility); Eli Ofek & Matthew Richardson, *DotCom Mania: The Rise and Fall of Internet Stock Prices*, 58 J. FIN. 1113 (2003) (short sales constraints result in stock prices failing to fully incorporate information); Charles M. Jones & Owen A. Lamont, *Short-Sale Constraints and Stock Returns*, 66 J. FIN. ECON. 207 (2002) (demonstrating that stocks that are expensive to short have high valuations, but low returns, indicating that they are overpriced).

Additionally, there are claims purchasers who are seeking to acquire information about the debtor's operations and assets.¹⁶³ The information might be valuable to a competitor of the debtor or to a party interested in purchasing a specific asset. Courts have begun to be more careful about this and restrict trading of parties with access to information, despite a very open-ended disclosure provision in the Bankruptcy Code.¹⁶⁴

Finally, there are greenmailers who accumulate enough claims of a particular impaired class to block plan confirmation.¹⁶⁵ Greenmailers play on hostage value, using this blocking position to extract a greater payout in a plan of reorganization for their class of claims or to get bought out.¹⁶⁶ The goal of the blocking position is not to force a better plan overall, in which the greenmailer will benefit, but to have value reallocated from other creditors to the greenmailer, either in the form of a direct buyout from the parties that have a strong interest in plan confirmation or via a shift in plan distributions.¹⁶⁷

To the extent the greenmailer uses bankruptcy's procedural requirements as a mechanism to extract value from other parties, it is an abuse of the process that undermines essential policy goals of efficiency and fairness and should be cause for vote designation or even equitable subordination. But determining whether an investor obtained a blocking position for greenmail purposes or to push an alternative vision of a reorganization could present difficult evidentiary challenges. Greenmail seems to be more a possibility to be dreaded and suspected than a clearly identifiable practice.

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. Alternatively, an attempt to gain a blocking position might be unsuccessful, but a fallback would be making a simple spread. While a basic typology of claims trading is possible, we do not know how neat these categories are in practice.

The foregoing discussion of claims markets and claims trading strategies underscores that claims trading is comprised of dynamic, multi-motivational, and overlapping sub-markets, which raise distinct policy

163. Robert P. Enayati, Note, *Undermining the Trading Wall: The BAPCPA's Affront on the Creditors' Committee's Duty of Confidentiality in Chapter 11 Bankruptcies*, 21 GEO. J. LEGAL ETHICS 703, 706 (2008).

164. See 11 U.S.C. § 1102(b)(3) (2009) ("A committee . . . shall (A) provide access to information for creditors who . . . (i) hold claims of the kind represented by that committee; and (ii) are not appointed to the committee."); see also Enayati, *supra* note 163.

165. A plan of reorganization must be approved by creditors "hold[ing] at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors," 11 U.S.C. § 1126(c) (2006), and, if it is not a cramdown plan, by those requisite majorities for every impaired class, 11 U.S.C. § 1129(a)(8), (b) (2006).

166. Lipson, *supra* note 161, at 6.

167. *Id.*

concerns. Some claims trading is beneficial, and some is value eroding. The key value added elements of claims trading are that it allows an exit for parties (which can have upstream effects on market liquidity, capital availability, and the cost of capital) and that it allows entrance to parties that can bring in the expertise and financing to speed along a reorganization. In other words, claims trading can help with efficient allocations of capital in the market. In order to preserve the essential exit opportunities, there must be sufficient entrance opportunities and vice-versa. Thus, greater liquidity in claims trading would appear to be beneficial to the bankruptcy process.

Yet, it is possible that distinctions in claims trading do not matter because the key issue is the impact on the bankruptcy process of trading volume (in terms of number of trades) and the creditor churn it produces. This issue is considered in the following section.

III. ANTICOMMONS, EMPTY CORES, AND THE COMING OF THE ANTIBANKRUPTCY

In a forthcoming article, Baird and Rasmussen, articulate a sharp argument that implicates claims trading *in general*, along with other financial innovations, as detrimental to the bankruptcy process.¹⁶⁸ Baird and Rasmussen argue that changes in finance in recent years, including claims trading, the entry of distressed debt investors into the bankruptcy world, and the rise of derivatives, have created an “anticommons” problem in bankruptcy.¹⁶⁹ An anticommons problem exists when there are too many rights holders with the ability to exclude others from using a resource and none with the exclusive right to use the resource.¹⁷⁰ The result is that the resource is underused.¹⁷¹

The collective action problem posed by the anticommons problem is particularly troubling, because an essential function of bankruptcy is to mitigate collective action problems. Bankruptcy can become a tragedy of the anticommons if the existence of too many claimants frustrates the formation of a plan that would maximize the value of the bankrupt firm’s assets. If a sufficient coalition for a value-maximizing plan cannot be formed, the firm’s assets may not be put to their best use. As Baird and Thomas Jackson have explained in their seminal works, bankruptcy is designed to deal with the collective action problem of creditors competing

168. Baird & Rasmussen, *supra* note 5.

169. *Id.*

170. Michael A. Heller, *The Tragedy of the Anticommons: Property in The Transition from Marx to Markets*, 111 HARV. L. REV. 622, 624 (1998).

171. *Id.*

for a common pool.¹⁷² Unremedied, the collective action problem will often result in a loss of value of the bankrupt firm relative to an orderly process.

Bankruptcy is thus, in the Proceduralist view, a legislative correction of a market failure.¹⁷³ The marketization created by financial innovation, including claims trading, undermines some of the procedural correction by substituting the transaction costs of a collective action problem caused by fragmented and shifting creditor identities for the collective action problem of the common pool.

Baird and Rasmussen observe that in the current bankruptcy world, “ownership interests are fragmented and conflicting. This is quite at odds with the standard account of corporate reorganizations—that it solves a tragedy of the commons, the collective action problem that exists when general creditors share numerous dispersed, but otherwise similar, interests. Bankruptcy has become antibankruptcy.”¹⁷⁴

Today, Baird and Rasmussen argue that coalitions are more difficult to form because of the multiplicity of parties and the difficulty for parties in assessing each other’s true economic interests.¹⁷⁵ For the Proceduralist view of bankruptcy, this is an eschatological scenario that we might term “the Coming of the Antibankruptcy.”¹⁷⁶

The anticommons problem Baird and Rasmussen identify is due to what game theory terms the problem of an “empty core”—a status in which multiple parties “cannot reach a stable agreement with each other because some other agreement always exists that some parties prefer . . . [causing the parties to] defect from any tentative agreement that might be made and hence none ever is.”¹⁷⁷ For any group of three or more parties, there are multiple possible coalitions, including singleton coalitions.¹⁷⁸ A party will opt to join a coalition only if that coalition offers it at least as much as any other coalition.¹⁷⁹ A core constitutes the set of possible coalitions from which there will not be defection. The core can be empty, have one possible outcome, or many.¹⁸⁰ If there is a nonempty core, it will include a Pareto

172. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors’ Bargain*, 91 YALE L.J. 857, 860, 867–68 (1982); see also Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 112–13 (1984).

173. See *infra* Part I.B.

174. Baird & Rasmussen, *supra* note 5 (manuscript at 6).

175. *Id.* (manuscript at 4).

176. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 777–85 (2002) (asserting that bankruptcy is unnecessary for large corporations where control rights are “coherently allocated”).

177. Baird & Rasmussen, *supra* note 5 (manuscript at 5 n.11).

178. *Id.*

179. Lester G. Telser, *The Usefulness of Core Theory in Economics*, 8 J. ECON. PERSP. 151, 154 (1994).

180. *Id.* at 152.

optimal outcome, in which it is not possible to make any party better off without making at least one party worse off.¹⁸¹

In bankruptcy terms, for a core to be nonempty, the proposed coalition must offer a better deal (a plan) to a sufficient number of claimants (the votes needed for confirmation) than any of the other deals that those claimants could get. If there are too many competing deals, there might not be a stable equilibrium for forming a plan. Hence, the core would be empty; a Pareto optimal outcome would not exist. Thus, in bankruptcy, there is competition among multiple possible coalitions including numerous potential alternative reorganization plans, liquidation (via a Chapter 11 plan or a conversion to Chapter 7, which will occur if a sufficiently large coalition cannot be formed), and the sale of the claim.¹⁸² As seen by Baird and Rasmussen, there is an anticommons problem when stable coalitions cannot be formed due to an empty core.¹⁸³ In Yeats' eschatology, when there is an empty core, "the centre cannot hold."¹⁸⁴

Baird and Rasmussen's argument has an important implication for claims trading policy because it suggests that claims trading has an overall negative impact on bankruptcy.¹⁸⁵ To be sure, Baird and Rasmussen make no argument about claims trading's net impact outside of bankruptcy, but their argument draws into question the utility of claims trading.

Does bankruptcy really suffer from an anti-commons problem due to an empty core? If so, is that a function of claims trading or other changes in finance? Baird and Rasmussen's story is one of financial innovation leading to increasingly fragmented ownership by parties whose interests lead them away from the traditional patterns of bankruptcy negotiation coalitions.¹⁸⁶ The result is that there are more possible competing coalitions and thus a greater chance of an empty core.

While Baird and Rasmussen's story is quite compelling, it relies on two questionable assumptions: First, that claimholdings are actually more

181. *Id.* at 156. Presumably, Kaldor-Hicks efficiency is the better metric for core theory because of the possibility of negotiations.

182. We can also add to all of these alternatives variations from investment strategies outside of the bankruptcy that will shift the value of deals.

183. Baird & Rasmussen, *supra* note 5 (manuscript at 4–5).

184. WILLIAM BUTLER YEATS, *The Second Coming*, THE DIAL (1920), reprinted in THE COLLECTED POEMS OF W.B. YEATS 187, 187 (Richard J. Finneran ed., Simon & Schuster Inc., rev. 2d ed. 1996) (1956). The Yeats reference in bankruptcy scholarship was first employed in Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425, 429 (2006). The titles of Baird and Rasmussen's recent joint opera contain more than a hint of bankruptcy eschatologies. See Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 176.

185. See Baird & Rasmussen, *supra* note 5 (manuscript at 12–19).

186. *Id.* (manuscript at 43–53) (explaining "[c]oalition [f]ormation and the [p]roblem of the [e]mpty [c]ore").

fragmented than in the past, and second, that this is causing more problems in forming coalitions, resulting in suboptimal outcomes.

A. HAVE CLAIMHOLDINGS BECOME MORE FRAGMENTED?

Baird and Rasmussen's fragmentation story is about bank debt, not claims trading or derivatives. As they explain, syndication and second lien loans have resulted in a fragmentation of interests in secured bank debt.¹⁸⁷ Claims trading and derivatives play a role in this story because they mean that creditor identities have changed and that their interests are opaque.¹⁸⁸ The traditional creditor structure of a single senior secured bank, bondholders, and trade claimants, all of whom are long on the reorganization, has been replaced with multiple secured parties. In addition bond and trade claims are held by constantly shifting distressed debt investors who may or may not be long on the reorganization and who might have holdings throughout the capital structure.¹⁸⁹ The result is that historical patterns of reorganization negotiations no longer hold.¹⁹⁰ These historical patterns had an anchoring effect on negotiations that reduced the allure of alternative coalitions; bankruptcy negotiations had a stylized choreography that made them work.¹⁹¹ Today, there is no anchoring and negotiation chaos ensues.¹⁹²

Baird and Rasmussen's fragmentation story assumes a factual situation that has a limited anecdotal evidentiary basis and for which there are reasons to doubt. Are there more parties involved in a bankruptcy now than in the halcyon days of corporate reorganization when banks were banks, trade was trade, bondholders were passive, and everyone was long on the reorganization? Quite possibly, but we don't actually know.

Fragmentation is not a new phenomenon in bank lending, as large bank loans have been syndicated since at least the 1980s.¹⁹³ The number of large banks has declined because of consolidation in the banking space,¹⁹⁴ but

187. *Id.* (manuscript at 6).

188. *Id.* (manuscript at 22–23).

189. *Id.* (manuscript at 2–4, 21–22).

190. *Id.* (manuscript at 2–3).

191. *Id.* (manuscript at 2–5).

192. *Id.*

193. Allison A. Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan Markets*, in THE HANDBOOK OF LOAN SYNDICATION AND TRADING 21, 23 (Allison Taylor & Alicia Sansone eds., 2007); see also Baird & Rasmussen, *supra* note 5 (manuscript at 22).

194. For example, instead of Manufacturers Hanover, Chemical Bank, Chase, BankOne, and JPMorgan, there is now just JPMorgan Chase. The total number of depository institutions declined from 13,853 at the end of 1992 to 8,099 as of September 30, 2009. See Federal Deposit Insurance Corporation, Statistics on Depository Institutions, <http://www2.fdic.gov/sdi/index.asp> (to obtain the aforementioned numbers: follow "Retrieve Reports" hyperlink, then follow "Run Report" hyperlink for "Standard Report #4," then set report date and follow "Update Report" hyperlink and note total reporting institutions).

they have simply been replaced by investment funds, including actively managed structured investment vehicles (such as Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs)) as members of the bank group. The fragmentation story depends on whether syndication is more common in current years than in the past, whether syndicates now have more members, and whether the syndicate members are now more active investors. The potential membership in syndicates has definitely grown as syndication agreements have become less restrictive, but that does not mean that there are more parties involved in any particular syndication.¹⁹⁵ Rather, less restrictive syndication agreements are more likely a reflection of the development of a secondary market in leveraged loans, which more than doubled in volume from 1998 to 2005.¹⁹⁶ We simply do not know whether there are more parties holding a stake in the bank debt in today's median large bankruptcy than in 1990.¹⁹⁷ It is likely, however, that syndicate members include more active members, such as distressed debt funds, and their agendas may be quite different from that of the lead bank.

B. IS THE EMPTY CORE A (NEW) PROBLEM?

Assuming that Baird and Rasmussen are correct about fragmentation, did financial innovation, including claims trading, produce an empty core problem? Again, there are reasons to think otherwise. Assuming for the time being that there is in fact an empty core problem in bankruptcy, the causal link with financial innovation is tenuous.

Bankruptcy *always* features an anticommons issue and always has a potential empty core problem. The nature of bankruptcy is that there are multiple claims on the estate. Some have the potential to exclude others from confirming a plan, but typically no single claimant can impose an outcome on all of the others. Anticommons is the nature of bankruptcy, but it is not always a tragedy.

Possible empty core problems are endemic to bankruptcy. An empty core problem can exist with as few as three claimants. Indeed, Baird and Rasmussen's illustration of an empty core in bankruptcy does not involve fragmented interests, claims trading, or derivatives.¹⁹⁸ Instead, it is a potential problem present in any multi-party negotiation. Short of unanimous plan votes, the core is by definition "empty" because some

195. See Baird & Rasmussen, *supra* note 5 (manuscript at 22).

196. Taylor & Yang, *supra* note 193, at 25–27.

197. Baird and Rasmussen do not discuss the securitization of bank debt, but this is a factor that could cut both ways in terms of number of parties with a voice in the reorganization, and which could add in a level of agency issues. See generally Baird & Rasmussen, *supra* note 5.

198. *Id.* (manuscript at 47–48).

creditors have, through their vote, expressed that they prefer a different arrangement.

The Bankruptcy Code is designed to deal with these problems. It does not require unanimity of creditors. Instead, it allows for somewhat flexible classification and requires dual majorities in each class for consensual plan confirmation.¹⁹⁹ It also allows for nonconsensual cramdown confirmation in which only a single impaired class needs to accept the plan for confirmation.²⁰⁰

There are also contractual mechanisms that can be used to counteract the problems created by the churn in creditors.²⁰¹ Debtors “may negotiate provisions in its pre-petition credit agreements which restrict the lender’s trading of its claims.”²⁰² Alternatively, a debtor can employ lock-up agreements that commit signing creditors to vote for the debtor’s plan, place restrictions on their trading or require them to use their best efforts to see the plan confirmed.²⁰³ Lock-ups can be done in out-of-court restructurings or prepackaged plans without court approval.²⁰⁴ Lock-ups can also be done with the court’s approval of a stipulation that settles a creditor’s claim in exchange for the creditor agreeing to vote for the plan.²⁰⁵

The way a lock-up agreement operates to restrict trading may be seen from the Plan Support Agreement (the Agreement) filed with the court in the Freedom Communications Bankruptcy.²⁰⁶ The Agreement committed the debtor and certain creditors to “cooperate with each other in good faith and shall coordinate their activities in connection with (a) the implementation of the Restructuring and (b) the pursuit of the Restructuring and confirmation and consummation of the Plan.”²⁰⁷ The Agreement applied to all claims purchased in the future by its creditor signatories,²⁰⁸

199. The Bankruptcy Code requires two-thirds in claim amount, over one-half in number of claims. 11 U.S.C. § 1126(c) (2006).

200. 11 U.S.C. § 1129(b) (2006).

201. There are transaction costs to these mechanisms. Lock-up via stipulation is costly and might be hard to do on a wide-enough scale to sufficiently mitigate the effects of claims trading; many parties do not want to sign lockup agreements, and even when they are possible, they come with transaction costs. That said, the costs of any such contractual solutions are not borne by the debtor *per se* but by the residual creditor(s). Accordingly, there is little reason that a debtor should not utilize them.

202. Groshong, *supra* note 5, at 640. This takes some foresight, however, when negotiating a credit agreement, and most debtors do not borrow with an expectation of bankruptcy.

203. *Id.* at 635.

204. See Richard E. Mikels & Charles W. Azano, Mintz, Levin, Cohn, Ferris, Glovsky & Pompeo P.C., *Lock-Up Agreements* (Aug. 1, 2003), <http://www.mintz.com/media/upload/docs/dyn/publications/Scanner - 11-03-06 - QD46BNS.pdf>.

205. Groshong, *supra* note 5, at 635.

206. Plan Support Agreement, *In re Freedom Communications Holdings, Inc.*, No. 09-13046, (Bankr. D. Del. Sept. 1, 2009).

207. *Id.* at 2.

208. *Id.* at 10. Section 9 of the Agreement provides:

and prohibits the sale of claims by the signatory creditors unless the purchaser agreed to be bound by the Agreement or received the debtor's consent.²⁰⁹ The existence of devices like lock-up agreements, and prepetition credit agreements indicates that empty cores might not be creating the havoc in Reorgland that Baird and Rasmussen fear.

The question then is whether financial innovations over the past couple decades, including claims trading, have increased the likelihood of an empty core. Increased fragmentation of interests would increase the number of parties involved in a negotiation, and thus mean that there are more conditions that must be satisfied. Therefore, if the number of parties involved in bankruptcy negotiations has increased, there is a greater likelihood of an empty core. If Baird and Rasmussen are correct about fragmentation, this will add to the risk of an empty core, although the question of magnitude of impact remains.

The impact of claims trading on the core is uncertain. Economist Lester G. Telser has noted, "[t]he larger the number of traders, the smaller is the range of outcomes without deadweight losses."²¹⁰ The number of coalitions that can be formed in any situation, q , is $2^n - 1$, where n is the number of parties involved.²¹¹ Thus, an increase in the number of parties involved (n) increases the number of possible coalitions (q) exponentially.

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- (a) Nothing in this Agreement shall be deemed to limit or restrict the ability or right of a Consenting Lender to purchase or take assignment of any additional Secured Lender Claims ("Additional Claims") against or interests in any Debtor or any affiliate of any Debtor; *provided, however*, that in the event a Consenting Lender purchases or takes assignment of any such Additional Claims or other interests after the date hereof, such Additional Claims or other interests shall immediately upon such acquisition become subject to the terms of this Agreement.

Id. (emphasis in original).

209. *Id.* at 11. Section 10 of the Agreement provides:

- (a) Except as set forth in Section 10(b), each Consenting Lender hereby agrees that . . . it shall not sell, transfer or assign all or any of its Secured Lender Claims, as the case may be, or any option thereon or any right or interest (voting, participation or otherwise) therein (each, a "Transfer") without the prior written consent of Holdings.
- (b) Notwithstanding the foregoing, any Consenting Lender may Transfer any or all of its respective Secured Lender Claims, provided that, as a condition precedent, the transferee thereof agrees in writing, in the form attached hereto as Exhibit B, to be bound by the terms of this Agreement.
- (c) Any Transfer of any Secured Lender Claim that does not comply with the foregoing shall be deemed void *ab initio*.

Id.

210. Telser, *supra* note 179, at 152.

211. *Id.*

Claims trading has cross-cutting effects on n , and thus, on q . On the one hand, claims trading increases the number of possible coalitions because every possible claims purchaser is an additional party. The ability to trade a claim means that every claimholder has the possibility of forming a coalition with each possible claim purchaser. In most cases, however, this will result in only linear, rather than exponential growth in the number of possible coalitions, because most claims trades are exclusive, bilateral coalitions.²¹² That growth will depend on the number of potential distressed debt investors, which is limited because the sunk research costs of investing in any case will, at some point, outweigh the benefits of diversification. This limits the number of investments a distressed debt investor can pursue. While we cannot be sure of the magnitude, claims trading adds an alternative coalition to the mix that increases the chance of a nonempty core.²¹³

Yet claims trading can also *reduce* the chance of a nonempty core. The number of participants in the bankruptcy negotiation process is not static. The number of claimholders can be divided or consolidated. The key question is not the total number of parties ever involved in the bankruptcy, but the lowest number involved at any given instant in the case before a plan vote, since that instant represents the point when there would be the least chance of an empty core and the best chance of a deal, all else being equal. Claims trading can help consolidate the number of claimholders, which would decrease the number of potential coalitions exponentially and thereby decrease the chance of an empty core.²¹⁴

Does claims trading reduce the number of claimants, and, if so, how quickly? These are currently unanswered empirical questions. But until we can answer them, we cannot know the net effect of claims trading on the lowest number of parties involved in a bankruptcy case at any point prior to plan confirmation voting. At the very least, there is anecdotal evidence that

212. There is also the possibility of a multiparty coalition with another claimant and/or multiple claim purchasers. In that case, the number of coalitions would go up exponentially, but claims trading usually involves bilaterally negotiated trades. The transaction costs for multilateral trades are too high. For simplicity, let us assume there are the same number of potential purchasers for each of the claimants.

In practice there will not be, but it does not affect the principle that claims trading has a linear, rather than exponential effect, on the number of coalitions. For example, if there are five claim holders, there will be thirty-one possible coalitions. But if there are 3 possible purchasers for each of their claims, there will be 15 more possible coalitions for a total of 46, not 224 more for a total of 255. Thus, if T is the number of potential claims purchasers, the possibility of claims trading increases the number of coalitions by $n*T$. Therefore, $q=2^n-1+(n*T)$.

213. A casual perusal of some Mega-Case dockets indicates that there are usually no more than a dozen purchasers of trade claims. The point is not to pinpoint an exact number, but to provide a sense of the order of magnitude being in the tens, not the hundreds or thousands.

214. Drain & Schwartz, *supra* note 5, at 575–76.

claims trading is not causing a rampant empty core problem. As one leading practitioner has noted:

The complication today is not claims trading. We've dealt with it for years and there are many ways to lock in votes notwithstanding later trades of the voted claims. It is very rare that the group that negotiates with the debtor calls up in the middle of negotiations and says it no longer owns the claims and you must find the new owners. In fact, I've never seen that happen. When a minority of negotiating creditors have sold their positions, the new owners have always followed through on the deal under negotiation. In fact, they purchased their claims because they approved of the deal being discussed.²¹⁵

It is not unreasonable to theorize that claims trading reduces the number of parties involved and thereby *facilitates* negotiation.²¹⁶ Perhaps the Yeatsean gyre is narrowing, not widening.²¹⁷ If this is correct, then Baird and Rasmussen's view about the effect of financial innovation on large business bankruptcies is upside down.²¹⁸ 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.

Such a theory is consistent with two measures of bankruptcy negotiations. First, cramdown plans, where a broad negotiated deal could not be reached, continue to remain relatively rare.²¹⁹ And second, as figure 1 below shows, the duration of large public bankruptcy cases has fallen for the past three decades.²²⁰ If there is an empty core problem associated with financial innovations in the past decade or two, bankruptcy cases should have started to take longer because creditor churning leads to interminable negotiations. Durations drop, regardless of whether one controls for the

215. E-mail from Martin J. Bienenstock, Partner, Dewey & Leboeuf L.L.P., to Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center (Sept. 7, 2009, 23:58 EST) (on file with author).

216. Consolidation of claims is analogous to the impact of vertical integration on empty core problems. See Telser, *supra* note 179, at 160–62.

217. See YEATS, *supra* note 184, at 187.

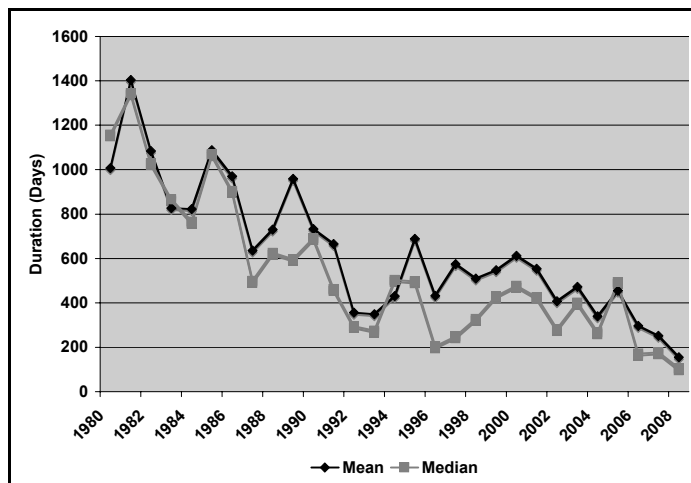
218. Baird & Rasmussen, *supra* note 5 (manuscript at 31–43) (arguing that financial innovations have hindered the coalition building necessary for reorganizations).

219. Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 930, 932 (2006) (noting rarity of insistence on absolute priority). To be sure, these are perhaps suboptimal plans, but there is no good way to verify this.

220. There is remarkably little discussion in the academic literature about why durations of bankruptcy cases have dropped. See Skeel, *supra* note 28, at 922, 928 (suggesting that speed might be a function of management incentive packages and financing agreements).

type of outcome (sale of substantially all assets, conversion, plan confirmation, etc.), whether a prepackaged plan was involved, or whether it was a Delaware case.²²¹ To be sure, there are other reasons why case durations might be falling that could overwhelm the visible effect of an empty core problem, but it is hard to see evidence of an empty core problem at least with this metric.

Figure 1: Duration of Large Public Bankruptcy Cases²²²



221. Cf. Lynn M. LoPucki & Joseph W. Doherty, *Delaware Bankruptcy: Failure in the Ascendancy*, 73 U. CHI. L. REV. 1387, 1394–95 (2006) (noting that the difference in magnitude of speed between Delaware bankruptcy cases and others is small). *But cf.* Ayotte & Skeel, *supra* note 184, at 461–62 (finding a statistically significant difference in speed between Delaware cases and other cases).

Jiang *et al.* argue that hedge fund involvement in bankruptcies, which is heavily related to claims trading, is associated with longer case duration. Jiang *et al.*, *supra* note 24, at 22. Their findings are not credible for two reasons. First, their methodology significantly undercounts hedge fund involvement in bankruptcies because it is only able to track hedge fund involvement when hedge funds hold legal title to bankruptcy claims. *See generally id.* Accordingly, they are unlikely to have observed hedge fund involvement in bankruptcy claims via loan syndications (where the agent bank holds title to a claim), total return swaps on loans (where the swap protection seller holds title to a claim), and bond claims (where the debt is held in street name). Second, they are only able to observe hedge fund direct holdings and trades for which Rule 3001(e) filings were made. *See id.* As a result, they observe minimal hedge fund involvement in prepackaged bankruptcies, where there is little trading in the claims post-petition. The hedge fund involvement they do observe is in non-prepackaged cases, which have longer duration. Thus, their finding that hedge fund involvement in Chapter 11 increases case duration is driven by the limitations on the ability to observe hedge fund involvement in bankruptcy overall, and especially in prepackaged bankruptcies.

222. *See* Lynn M. LoPucki, Web BRD Lynn M. LoPucki’s Bankruptcy Research Database, <http://lopucki.law.ucla.edu/index.htm> (to obtain the numbers in the graph above: submit a query for each year, use the default settings for “cases,” then select “duration in days” and “disposition” for each year) (note, the graph above was created by the author using data downloaded from the LoPucki database).

In fact, claims trading might well be responsible for faster case resolution, because it serves as a mechanism to assess risk and brings in parties with a willingness to supply fresh capital to support the reorganization. Claims purchasers are vigilant about the progress of the case in a way that an original lender with deal fatigue is not, because the claim is their business opportunity, rather than an attempt to salvage a bad situation. Thus, a pair of studies has found that the presence of distressed debt investors in Chapter 11 cases increases overall value.²²³ Absent the ability to trade, distressed debt investing would be sharply curtailed because of lack of entry and exit opportunities for investors. Moreover, the investment funds that purchase claims often supply the capital for the reorganization through the DIP loan (if they purchased claims pre-petition) and exit financing. The factors contributing to the increased speed of large Chapter 11 cases have yet to be systematically explored,²²⁴ but increased access to capital for bankrupt companies due, in part, to claims trading, might well play an important role.

C. WHAT IF THE CORE IS EMPTY?

It is possible, however, that the Bankruptcy Code is simply not designed well enough to deal with the anticommons and empty core problems. The Code might be obsolete. If so, what is to be done? Is there any way to make deals stick?

223. Hotchkiss & Mooradian, *supra* note 24, at 401 (finding that “vulture investors add value by disciplining managers of distressed firms”); Jiang et al., *supra* note 24, at 32 (noting that the “prevalence of hedge funds contributes to the trend toward a more management-neutral restructuring process, and is viewed by the market as enhancing the overall value of bankrupt firms”). To be sure, Jiang *et al.* summarily conclude that claims trading itself does not enhance value. See Jiang et al., *supra* note 24 (manuscript at 31). This conclusion rests on a regression of reorganization value against the presence of distressed debt investors (as identified by the authors), controlling for whether the debt was purchased post-bankruptcy or not. See *id.* at 17. This regression does not provide a good measure for the value of claims trading, however, because liquidity is a major consideration for any investor, and without the ability to sell a bankruptcy claim, many investors would never invest in distressed debt in the first place. Therefore, claims trading must be credited with some of the benefits that Jiang *et al.* find stemming from the presences of distressed debt investors who purchased their holdings before bankruptcy. See *id.* at 19.

Irrespective of the interpretive problems with Jiang *et al.*'s regression, its outputs are likely specious because they are based on an unrepresentative data sampling. Jiang *et al.* are able to observe only trades in which legal title is transferred. See *id.* at 17, 30. As a result, they are unable to observe most of the trades in bank and bond debt. Accordingly, their data is unrepresentative of claims trading as a whole, and cannot support conclusions about claims trading's impact. More generally, the data problem means that they are not capable of tracking the full range of distressed debt investor activities in bankruptcy, which casts doubt on all of their findings.

224. One factor that might have driven quicker resolutions is increased liquidity in the market generally, as it enables a viable threat of a sale of the bankrupt company or its principal assets as an alternative to a negotiated plan of reorganization. In the current market, the lack of liquidity is also contributing to shorter case durations as companies lack the funds for a lengthy reorganization process.

Core theory's solution for a problem of an empty core caused by too many possible coalitions is to restrict the number of possible coalitions. As Telser has written, "[r]estricting the number and composition of coalitions can result in a nonempty core with respect to those coalitions that are legal."²²⁵ In claims trading terms, this would mean restricting claims trading volume or participants²²⁶ or lowering plan voting thresholds.²²⁷

Restricting the number of possible coalition, however, does not guaranty Pareto optimality. If coalition possibilities are over-restricted, results may be suboptimal.²²⁸ As Telser has noted:

There is always a set of legal coalitions giving Pareto optimality, and we can [as an abstract theoretical matter] calculate which coalitions to allow that can give the maximal amount of competition consistent with Pareto optimality. Allowing more than this number causes the core to vanish, and allowing less may not give Pareto optimality.²²⁹

Thus, core theory suggests that there is a delicate balance between allowing too much claims trading and not enough. What that equilibrium is (or equilibria are), however, is unknown in real world conditions. This is an empirical question, but given the state of data on claims trading, we cannot begin to answer it.

There is reason to question, as a positive matter, Baird and Rasmussen's story of financial innovation having a severely negative impact on the bankruptcy process. But if they are correct, their suggested reforms are relatively moderate given the problem they diagnose.²³⁰ Baird and Rasmussen do not even broach the possibility of limiting the use of any of the innovative financial products they outline.²³¹ Instead, they focus on finding offsetting negotiation facilitation mechanisms.²³²

As they astutely note, negotiation is the lifeblood of bankruptcy, and bankruptcy judges should be given the tools to facilitate negotiated agreements.²³³ Accordingly, they raise some possible tools: limiting the number of potential coalitions through greater plan exclusivity,²³⁴ applying

225. LESTER G. TELSER, *ECONOMIC THEORY AND THE CORE* 4 (1978).

226. This could negatively impact on capital markets and on the reorganization process to the extent it facilitates negotiations through consolidation of claimants. See Telser, *supra* note 179, at 159 ("[A] general method of resolving an empty core requires imposition of suitable upper bounds on the quantities that may be sold by certain sellers. Such bounds always exist.").

227. This raises the concern that dissenting creditors will be steamrolled.

228. TELSER, *supra* note 225.

229. *Id.*

230. Baird & Rasmussen, *supra* note 5 (manuscript at 48–54).

231. This might well be the proper conclusion, but use restrictions should at least merit consideration before rejection, particularly given the lessons from core theory about resolving empty cores.

232. Baird & Rasmussen, *supra* note 5 (manuscript at 48–54).

233. *Id.* (manuscript at 53).

234. *Id.* (manuscript at 48–49).

plan solicitation restrictions more leniently,²³⁵ reducing the number of priorities,²³⁶ or giving bankruptcy judges a “nuclear option” to force a sale as a method for focusing bargaining.²³⁷

Baird and Rasmussen rightly recognize that these methods either create more problems than they solve or are likely too weak to meaningfully facilitate negotiations.²³⁸ Nonetheless, they resign to a credo of markets correcting themselves, an odd display of faith in markets given the story they have told of government correcting one market failure—the race to the courthouse—through bankruptcy’s collective procedure, only to have the market generate another market failure.²³⁹

Capitalism is, as they note, “still very much a work in progress,”²⁴⁰ but that is cold comfort if we are faced with the Coming of the Antibrupcty. If the landscape for reorganizations is as dire as Baird and Rasmussen believe, salvation will lie only in the Second Coming, a New Bankruptcy Code, written against a backdrop of fragmented interests, claims trading, and empty cores, rather than attempting to jury-rig the current Bankruptcy Code, which was written for a different era of finance.²⁴¹ For bankruptcy agnostics and nonbelievers, however, we might think about some modest reforms to improve claims trading markets.

IV. CONCLUSION: IMPROVING CLAIMS TRADING

Claims trading has revolutionized the bankruptcy world, but no one can say for sure whether it is for the better or worse. While claims trading may well cause problems in the reorganization process, there is a general resignation to its continued existence.²⁴² If claims trading is to be a feature of the bankruptcy world (and this may very well be a good thing), there are ways in which it can be improved. Some issues, like improved disclosure of economic interest in claims, are unlikely to be easily resolved, but there are other more readily achievable and less controversial reforms.

The 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

235. *Id.* (manuscript at 50).

236. *Id.* (manuscript at 51).

237. *Id.* (manuscript at 52–53).

238. *Id.* (manuscript at 49–50).

239. *Id.* (manuscript at 54).

240. *Id.*

241. The Bankruptcy Code was written against a different financial markets backdrop, but it has stood up surprisingly well. The critical stresses on the Bankruptcy Code for business bankruptcy are not those created by claims trading, but rather those created by the automatic stay exceptions for certain financial contracts, 11 U.S.C. § 362(b)(6), (7), (17), (27) (2006), and the disparity in creditor protections for sales, 11 U.S.C. § 363 (2006), and plan confirmations, 11 U.S.C. § 1129 (2006).

242. *See supra* p. 75.

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.

Inefficiency adds to the allure of the claims trading market because it can create profitable arbitrage opportunities, such as between trade claims and bond claims—both unsecured debt with the same place in the capital structure, but potentially priced quite differently. There is little likelihood that the market will correct this problem. If the claims market were fully efficient, there would be only minimal profit margins. This means that the repeat market participants—dealers and attorneys—have little incentive to make the market more efficient. An exchange would provide the best price disclosure mechanism, but bankruptcy claims, particularly trade claims, are ill-suited for an exchange. They are insufficiently standardized and are too illiquid. There is too much claim-specific diligence required because of counterparty risk for trade-claims to ever be exchange traded the way shares of IBM are.

One possibility would be an electronic quotation bulletin board, like the Pink Sheets or OTC Bulletin Board, where market makers post recent bids and asks, providing potential buyers and sellers with some sense of the market. Some steps have been taken in this direction, although it remains to be seen if it is a viable model. For such a system to work, however, there would need to be dedicated market makers in particular bankruptcies. It is not clear whether claims brokers would want to assume that role.

A more feasible alternative would be to utilize creditors committees as a platform for facilitating claims trading, whether by simply informing claimholders of the possibilities of claim purchases and issues in the market or by posting information on claim trade prices when available. A move in this direction can be observed in the bankruptcy of Dana Corporation.²⁴³ Dana's Official Unsecured Creditors' Committee listed the contact information of claims purchasers on its website to help the creditors it represented obtain maximum value for their claims.²⁴⁴

Arguably facilitating claims trading is part of creditors' committees' duties. If creditors' committees are responsible for maximizing the return for their constituents *as they exist at any particular time*, that could be accomplished either through working for a better plan *or* by providing their constituents with improved immediate exit opportunities.

These are not separate possibilities—if plan payouts look better, the price for claims should go up. And claims trading could derail plan

243. *In re Dana Corp.*, No. 06-10354-brl (Bankr. S.D.N.Y. Mar. 3, 2006).

244. See Dana Corp. Official Unsecured Creditors Committee, <http://www.danacreditorcommittee.com/content.asp?C=892> (last viewed Sept. 2, 2009).

confirmation and add delay, which might drive down the price of claims for remaining constituents. Nonetheless, creditors' committees should start to consider what role they have in increasing the value of their constituents' claims, be it through a plan or through a trade. Creditors' committees may not be the ideal mechanism for improving market efficiency by enabling claims sellers to comparison shop among buyers' offers, but they represent the most easily achievable step in that direction.

Bankruptcy law will always straddle market and communitarian tendencies, but the Great Normative Bankruptcy Debate about what bankruptcy should be 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.