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ABSTRACT

Federal law restricts insider trading. Yet these restrictions operate differently on insolvent or bankrupt firms. The law is more constraining in some respects: federal law extensively regulates the trading of residual claims in solvent firms but not insolvent firms. However, the law is more constraining in other respects: insider trading law does little to limit debt-trading at solvent firms, but a bankruptcy enmeshes all creditors in a web of insider trading rules. This Article identifies insolvency's economic and legal influence on insider trading law and then normatively evaluates this transformation.

INTRODUCTION

Are insolvent firms different from solvent firms with respect to insider trading law and policy?[1] Formally, the law does not change. But economic realities and non-securities law duties change. As a result, the insider trading landscape changes considerably. The law is more permissive in some ways, and more constraining in others, as troubled instruments trade.

One difference is the level of regulation of trading in the residual claims of the firm. In solvent firms, the residual claims are equity securities, and equity securities are subject to the full ambit of trading restrictions. In insolvent firms, non-equity claims are typically residual claims.[2] These non-equity residual claims are subject to less stringent regulation precisely because they are not equity and they may not even be securities. As a result, insider trading regulations apply with lesser force to the most economically

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* Associate Professor of Law, Wake Forest University School of Law. Steve Nickles, Gabriel V. Rauterberg, and participants in the Symposium improved this Article through useful comments.

1. The Brooklyn Law School Spring 2018 Symposium on "The Market for Corporate Control in the Zone of Insolvency," sponsored by the *Brooklyn Journal of Corporate, Financial & Commercial Law* and the Center for the Study of Business Law and Regulation, addressed the market for corporate control in the zone of insolvency. Henry Manne's main insight about the market for corporate control is a reciprocal relationship between governance and liquidity: governance conditions can be the cause or consequence of liquidity conditions. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73:2 J. POL. ECON., 110–20 (1965). While most of this Symposium's panelists focused on governance (and thus corporate law), this Article considers the other side: liquidity. It examines a body of law intended to alter liquidity conditions: insider trading laws. Rather than asking whether insolvent firms are different with respect to corporate law, I ask whether they are different with respect to insider trading regulation.

2. Claims in bankruptcy are extensively traded. *See* Jared A. Ellias, *Bankruptcy Claims Trading*, 15:4 J. EMP. LEGAL STUD., 774 (2018) (showing that "heavy claims trading is a pervasive feature of most large Chapter 11 cases" and that "Chapter 11 bonds are . . . among the most heavily traded bonds in the corporate bond market as a whole").

significant and informationally-sensitive interests in an insolvent company. Insolvency is therefore deregulatory.

While insolvency deregulates, it also expands the reach of other aspects of federal insider trading law. That is because bankruptcy law creates new roles and new duties. The managers in a Chapter 11 case pick up new duties to the creditors, and creditors take on new duties by virtue of their involvement in creditors' committees. Since insider trading law hinges on duties, these new relationships expand the coverage of insider trading restrictions.

Careful consideration of insider trading policy makes clear that these differences have both advantages and disadvantages. At the margin, I suggest two tentative conclusions. First, we should not rush to close the "loopholes" in insider trading law that open with regards to the residual claims. Deregulating insider trading is a Faustian bargain—greater price accuracy at the risk of lesser liquidity, fairness, and managerial integrity—but we should be more willing to accept bargain with respect to insolvent firms than solvent ones. Second, we should be solicitous of efforts to shield members of creditors' committees from extensive insider trading regulation because these creditors occupy a position without analogue in the solvent firm: they both *receive* and *contribute* material, nonpublic information. Traditional insider trading law theory may not have the resources to manage a two-way flow of information, requiring new and accommodating thought.

The structure of this Article is as follows: Part I introduces the basic law and policy of insider trading regulation. Part II identifies features of the insider trading landscape that change when firms are insolvent, bankrupt, or both. Part III normatively evaluates the differences identified in Part II in light of the policy considerations from Part I. The Article then concludes.

Two comments about the scope of this Article are in order. First, the bankruptcy material is generally focused on Chapter 11.[3] Second, this Article focuses solely on federal insider trading law. It does not address state law statutory[4] or common law claims.[5] It does not address federal wire fraud

3. *See* 11 U.S.C. §§ 1124, 1129 (2012).

4. *See, e.g.*, CALIFORNIA CAL. CORP. CODE § 25402 (creating a cause of action against trading entities, officers, directors, controlling persons, and "or any other person whose relationship to the issuer gives him access, directly or indirectly" to material nonpublic information).

5. *See, e.g.*, Brophy v. Cities Serv., 70 A.2d 5, 7–8 (Del. Ch. 1949); Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969).

jurisprudence.[6] Nor does it address bankruptcy-specific remedies for insider trading[7] or rules conjured up by courts and enforced by contempt of court.[8]

I. RECALLING INSIDER TRADING LAW

American insider trading law restricts rather little. It covers only "securities."[9] Accordingly, executives may lawfully buy up commodities and land without disclosing to the seller nonpublic information bearing on its value.[10] It also permits trading securities based upon informational advantages as long as the information was not acquired or used in breach of a duty of trust and confidence.[11] For example, celebrity University of Oklahoma football coach Barry Switzer was watching his son compete in a high school track meet when he overheard another spectator discussing whether to merge his oil and gas company with a competitor.[12] Switzer correctly guessed that the news of the merger would boost the value of the loose-lipped executive's company.[13] Switzer and his associates told their brokers to invest $400,000 in the company, buying stock from existing investors who were unaware of the merger plans.[14] Switzer and his associates resold all of the shares once the merger was announced a few days later for $700,000.[15] Switzer was prosecuted but then acquitted on the merits because

6. *See generally* William K.S. Wang, *Application of the Federal Mail and Wire Fraud Statutes to Criminal Liability for Stock Market Insider Trading and Tipping*, 70 U. MIAMI L. REV. 220 (2015) (discussing the disparity between the Department of Justice and Securities and Exchange Commission standards in fraud liability). The choice to exclude wire fraud from analysis is in part a convention: most scholarship makes the same omission. It is in part a sense of relative importance. Only the Department of Justice (DOJ) can bring a mail and wire fraud case, meaning that defendants need not fear Securities and Exchange Commission (SEC) or private suits, greatly reducing the volume of actual and potential cases. Also, it is not clear that the DOJ brings insider trading cases that are strong under mail or wire fraud statutes but weak under conventional insider trading jurisprudence.

7. *See* 11 U.S.C.A. § 547(b)(4)(B) (2012) (permitting avoidance of preferences made up to a year before the filing of the bankruptcy petition, if it is made to an "insider"). Notice also that the Bankruptcy Code has its own definition of "insider." 11 U.S.C. § 101(31) (2012).

8. *See, e.g.*, Alison Frankel, *GM Judge Aims to Prevent Insider Trading by Distressed Debt Funds*, REUTERS: BLOG, July 15, 2013, http://blogs.reuters.com/alison-frankel/2013/07/15/gm-judge-aims-to-prevent-insider-trading-by-distressed-debt-funds/; Transcript of Hearing, *In Re* Motors Liquidation Co., 447 B.R. 150, 21 (Bankr. S.D.N.Y. 2013) (No. 09-50026-reg), *available at* http://blogs.reuters.com/alison-frankel/files/2013/07/gmbankruptcy-transcript.pdf (threatening contempt of court if hedge funds trade based on information from settlement negotiations).

9. *Fast Facts: Insider Trading*, SEC. & EXCH. COMM'N (May 16, 2018), https://www.sec.gov/fast-answers/answersinsiderhtm.html.

10. *See* Andrew Verstein, *Insider Trading in Commodities*, 107 VA. L. REV. 447, 474–75 (2016); *see* Ian Ayres & Joseph Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235, 252–53 (2001).

11. Chiarella v. United States, 445 U.S. 222, 228, 230–33 (1980).

12. SEC v. Switzer, 590 F. Supp. 756, 761–62 (W.D. Okla. 1984).

13. *Id.*

14. *Id.* at 762–63.

15. *Id.*

federal insider trading rules do not restrict trading on fortuitously acquired information.[16]

In Section A below, I discuss the three bases under which some traders might face more severe consequences than Switzer enjoyed. Section B then discusses some of the main policy considerations relevant to debating the appropriate extent and contours insider trading law.

A. INSIDER TRADING LAW

1. 16(b)

Section 16 of the Securities Exchange Act of 1934 applies to officers, directors and owners of at least 10% of a publicly-traded entity's shares (a trio sometimes called *statutory insiders*).[17] These individuals are liable for disgorgement of any profits from trading their company's shares within a six-month window:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction. . . .[18]

It is relatively easy to compute insiders' profits because Section 16(a) requires these individuals to report their trades to the United States Securities and Exchange Commission (SEC) "before the end of the second business day following the day" on which they transacted.[19] These prompt filings (reported on a *Form 4*) and an annual summary (*Form 5*) are available on the SEC's filing website, *EDGAR*, so anyone can track insider trades and compute their profitability.

Profits are determined through "arbitrary matching to achieve the showing of a maximum profit" and therefore maximum forfeiture.[20] Under this approach, individuals can owe disgorgement even if they suffered a net loss.[21] The disgorged profits go back to the entity, though any shareholder has a private right to pursue the trader if the entity declines to do so.[22] A shareholder need only demand that the entity bring the suit and then wait

16. *Id.* at 765–66.

17. Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p (2011).

18. Securities Exchange Act of 1934 § 16(b).

19. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-46421, SEC File No. S7-31-02 (Aug. 29, 2002).

20. Smolowe v. Delendo Corp., 136 F.2d 231, 237 (2d Cir. 1943).

21. *E.g.*, Gratz v. Claughton, 187 F.2d 46, 50–52 (2d Cir. 1951) (noting that the trader owed $400,000 despite suffering a $300,000 loss over relevant period).

22. *Id.*

sixty days.[23] Small shareholders frequently bring 16(b) suits, even though they stand to gain very little personally.[24] Instead, it appears that law firms actively monitor Form 4 filings and then bring suits with nominal plaintiffs in order to charge attorney fees against the recovery.[25]

Although Section 16 is "for the purpose of preventing the unfair use of information,"[26] 16(b) is not well suited to that purpose. Trading within the six-month window is subject to disgorgement even if the trader and informed trading outside of the window or by lower-level managers and investors is exempt.[27] Section 16(b) "operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt insiders who skirt the letter of the prohibition."[28] One way to think about 16(b) is as an extremely blunt insider trading restriction, which also tends to discourage other kinds of manipulative or speculative trading by insiders.[29]

2. 10b-5

No federal statute prohibits insider trading by name, nor even by direct reference. Instead, most insider trading cases are pursued under the Securities Exchange Act of 1934 (Exchange Act), a disclosure-oriented law prohibiting "fraudulent and deceptive practices."[30] To pursue insider trading under the Exchange Act, prosecutors or plaintiffs are required to argue that insider trading is not just unfair but is actually fraudulent.[31] This could be difficult since most securities trade in anonymous markets, in which traders make no affirmative representations at all, let alone false representations. Insider trading law overcomes this problem by identifying circumstances in which silence can be fraudulent. The law "prohibits undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage."[32]

23. *Id.*

24. *See, e.g.*, *Smolowe*, 136 F.2d at 241 (plaintiff shareholder's pro rata share of recovery was only $3 while his law firm received $3,000 in attorney's fees).

25. *See, e.g.*, *id.*

26. Securities Exchange Act of 1934 § 16(b).

27. *See, e.g.*, Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2149 (1994) (noting exemption for trades prior to becoming an "officer").

28. Magma Power Co. v. Dow Chem. Co., 136 F.3d 316, 320–21 (2d Cir. 1998).

29. Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L. J. 391 (1991).

30. Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j (2010); 17 C.F.R. § 240.10b-5 (1973) [hereinafter Rule 10b-5].

31. *See* Chiarella v. United States, 445 U.S. 222, 233 (1980) (rejecting "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information").

32. Salman v. United States, 137 S. Ct. 420, 423 (2016).

A trader who takes on a duty of trust and confidence to her counterparty defrauds that counterparty by silence—given their relationship, the trader really ought to disclose to the counterparty the material nonpublic information before taking advantage of the counterparty. This duty of candor to the counterparty is the wellspring of the *classical* theory of insider trading.[33] Officer and directors (*classical insiders*) have a duty to the shareholders of the firm by virtue of their role. After all, what sort of trustee would buy property from her ward without disclosing vital information about the property that the trustee learned in her trusted capacity at work?

The classical theory is *robust*, insofar as it cannot be waived by the information's source: a chief financial officer (CFO) defrauds her shareholder counterparty through silence even if the board of directors permits the CFO to engage in insider trading.[34] The classical theory is *expansive*, as it applies both to classical insiders and to "constructive" or "temporary" insiders who are brought into a position of trust from the outside, such as an attorney hired to assist with a client matter. But the classical theory is also *parochial*: it directly concerns only the equity securities of the company at which the insider is a fiduciary. The classical theory does not bar trading in the equity of other firms.[35] Nor would it seem to cover debt or derivative securities of any firm.[36]

The second important fraud-based theory of insider trading identifies the deceived individual as the source of the information. A trader who implicitly feigns loyalty to a company or person to gain access to secrets, or explicitly promises confidentiality, ultimately defrauds his source out of information when he misuses the information for trading. This *misappropriation* theory is more *cosmopolitan* than the classical theory: it clearly covers securities of any firm (not just the securities of the source/employer),[37] as well as non-equity securities.[38] It is also applicable where the source is not necessarily a

33. United States v. O'Hagan, 521 U.S. 642, 643 (1997).

34. Whether it can be waived by the counterparty (i.e., victim) is a source of continuing controversy. *See* Edwin D. Eshmoili, Note, *Big Boy Letter: Trading on Inside Information*, 94 CORNELL L. REV. 133, 140 (2008).

35. *Chiarella*, 445 U.S. at 230; *O'Hagan*, 521 U.S. at 643.

36. *See* STEPHEN M. BAINBRIDGE, INSIDER TRADING LAW AND POLICY 79–81 (2014) (arguing first that the classical theory of insider trading should not apply to debt securities, second that asserting that the only successful insider trading actions concerning debt securities involved equity-like convertible debt). Congress acted to ban insider trading in options. 15 U.S.C. § 78t(d) (2012) (making option trading illegal whenever informed securities trading would be illegal). Prior to that, the regulation of derivative trading was tenuous. *See* William K.S. Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 HARV. L. REV. 1056, 1057–58, 1058 n.11 (1988); Steve Thel, *Closing A Loophole: Insider Trading in Standardized Options*, 16 FORDHAM URB. L.J. 573, 575 (1988) ("If insider trading is illegal or wrong simply because insider traders violate duties they owe to corporate security holders, there is little reason to object to insider trading in options.").

37. *O'Hagan*, 521 U.S. at 643.

38. DONALD LANGEVOORT, 18 INSIDER TRADING REGULATION, ENFORCEMENT, AND PREVENTION § 3:12 (2018) ("With very few exceptions—for example, the situation where the issuer

trusted insider. Brokers violate the misappropriation theory when they front-run their clients, even if their client was just a private person with no link to the company traded. Yet the misappropriation theory is *conditional*. Traders can avoid liability if they obtain valid permission to trade from the source.[39]

In recent years, many insider trading cases have focused on "tippees," or outsiders to the firm who were given information from traditional insiders.[40] For example, a banker helping a client (a temporary insider) may share secrets with his family about the client's pending acquisitions.[41] The family members might not be liable under the classical theory directly, since they are not insiders at the bank or client firm, nor would they be directly liable on the misappropriation theory, since the banker might know that his family would trade using the information. Instead, the family members participate in the banker/tipper's liability. The latter shares information in breach of a duty, converting her principal's secret for a personal benefit—in this case, a gift to enrich beloved family.[42] Similar violations—implicating both the secret giver and getter—occur when the tippee buys the tip with a quid pro quo payment of some kind.[43]

There is some debate about whether an individual violates Rule 10b-5 by trading merely while *aware* of material nonpublic information, or if they may lawfully trade so long as they have independent (and perhaps preexisting) lawful reasons to trade, apart from the material nonpublic information acquired.[44] The most probable answer, particularly with respect to the classical theory or with respect to civil liability on either theory, is that "knowing possession" suffices for liability.[45]

3. 14e-3

A tender offer is a public invitation to sell or tender securities to an acquirer,[46] often in connection with an attempt to take over a company

is aware of the trading before it occurs—the misappropriation theory is fully adequate to reach abuses in the trading of debt securities.").

39. Even without permission, traders may avoid liability if "they make appropriate disclosures ahead of time." Salman v. United States, 137 S. Ct. 420, 423 (2016).

40. *See, e.g.*, *id.*

41. *Id.* at 423–24.

42. *See id.* at 424; *see also* United States v. Martoma, 869 F.3d 58, 70–71 (2d Cir. 2017).

43. Dirks v. SEC, 463 U.S. 646, 663–64 (1983).

44. Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1134–35 (1999).

45. 15 U.S.C. § 78u-1(a)(1) (2012) (imposing civil fines for trading "while in possession of" material nonpublic information.); § 78t-1(a) (2012) (providing for a private right of action against defendants who traded "while in possession of" material nonpublic information); *see* United States v. Rajaratnam, 719 F.3d 139, 158–59 (2d Cir. 2013) (discussing the elevation of Teicher's "knowing possession" standard to the "law of the Circuit" following the promulgation of Rule 10b5-1).

46. *See* Wellman v. Dickinson, 475 F. Supp. 783, 823–24 (S.D.N.Y. 1979) (reciting the SEC's definition of tender offer as including: "(1) active and widespread solicitation of public shareholders for the shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are

without the approval of the target company's board. SEC Rule 14e-3 prohibits trading while in possession of material nonpublic information about a pending tender offer, without regard to whether there is a relationship of trust or confidence, and without the challenge of defining "on the basis of."[47] Rule 14e-3 applies by its terms to equity, bonds, and other securities.[48]

Unlike Rule 10b-5's fraud-based insider trading theories, Rule 14e-3 does not require any special relationship between the trader and either the source or the counterparty; it is enough to trade while knowing the proscribed

firm rather than negotiable; (5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased; (6) offer open only a limited period of time; (7) offeree subjected to pressure to sell his stock . . . [(8)] public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company's securities"). Note that Rule 14e-3 does not in fact define *tender offer*. *Id.* at 823.

47. 17 C.F.R. § 240.14e-3 (2018). The bidder itself may, of course, buy shares while knowing about its own plans, subject to the other disclosure requirements of the Williams Act. The SEC considered and rejected a fuller prohibition that would have prohibited even the bidder from buying prior to its own tender offer. *See generally* Tender Offers 44 Fed. Reg. 9956 (proposed Feb. 15, 1979) (proposed Rule 14e–2); Tender Offers, 44 Fed. Reg. 70326, 70338, 70348 (proposed Dec. 6, 1979) (proposed Rule 14e–2). The rule is only triggered if a bidder has taken a substantial step towards commencing a tender offer, though the trader need not know who the bidder is nor whether that bidder has in fact taken a substantial step. *See* 3C HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 19:30 (Supp. Dec. 2018). Furthermore, the defendant need not know that the information is nonpublic or that the source was a bidder or a bidder's associate, so long as she has reason to know. *Id.*; *see also* SEC v. Ginsburg, 362 F.3d. 1292, 1304 (11th Cir. 2004) ("Rule 14e-3, by its terms, does not require that the offender know or have reason to know that the information relates to a tender offer, so long as the information in fact does relate to a tender offer and the offender knows or has reason to know the information is nonpublic and was acquired by a person with the required status."). Likewise, Rule 14e-3 is triggered only if the informed trader knows that their information comes from the bidder; the target company; or an officer, director, partner, or employee of the bidder or target. § 240.14e-3(a); *see also id.* § 240.14e-3(b)(2) (establishing a defense for legal entities that implement a compliance program intended to prevent agents from acquiring and trading on tender offer information). For further discussion of Rule 14e-3, *see generally* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING §§ 9.1–9.4 (3d ed. 2010).

48. Other aspects of the Williams Act apply only to exchange-traded securities. For instance, regulation 14(D) requires pro-rata uptake of tender offer acceptances, rather than privileging earlier tenders, but only for exchange-traded securities. 17 C.F.R. § 240.14 (2018).

information.[49] However, the trader need not know *who* the bidder is[50] or *whether* that bidder has in fact taken a substantial step.[51] Furthermore, the defendant need not know *whether* the information is nonpublic or *whether* the source was a bidder or their associate, so long as she has reason to know.[52] It is for this reason that Rule 14e-3 has been variously called a "strict liability"[53] offense or vindication of "equal access" principles.[54] It is to principles such as equality that we now turn.

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49. SEC v. Mayhew, 121 F.3d 44, 49 (2d Cir. 1997) ("[R]ule 14e-3 . . . imposes liability . . . without regard to whether the trader owes a fiduciary duty to respect the confidentiality of the information."); SEC v. Anticevic, No. 05 CV 6991(KMW), 2010 WL 2077196, at *5 (S.D.N.Y. May 14, 2010) ("Rule 14e-3 imposes an obligation 'to disclose or abstain' from trading or tipping regardless of whether the individual [1] owes a fiduciary duty to respect the confidentiality of the information; [2] has knowledge that the material, nonpublic information in his or her possession relates to a tender offer; and/or [3] actually used the information." (citations omitted)); SEC v. Sekhri, No. 98 Civ. 2320 (RPP), 2002 WL 31100823 at * 14 (S.D.N.Y. July 22, 2002). The wide scope of Rule 14e-3 is no coincidence. The SEC promulgated this Rule to respond to the perceived injustice of its loss in *Chiarella*. *See generally* 18 DONALD LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT, AND PREVENTION § 7:1 (Supp. Apr. 2017); Karen A. Tallman, Note, *Private Causes of Action Under SEC Rule 14e-3*, 51 GEO. WASH. L. REV. 290, 295–96 (1983) (discussing whether Rule 14e-3 is consistent with Congress' purpose in enacting the Williams Act).

50. *See* United States v. O'Hagan, 139 F.3d 641, 648 n.3 (8th Cir. 1998) (describing the fact that the defendant did not know the identity of the bidder as "of little significance").

51. *See id.* at 650 ("The rule does not require the defendant to have knowledge of these acts."); BLOOMENTHAL & WOLFF, *supra* note 47, § 19:30.

52. *See Ginsburg*, 362 F.3d at 1304 ("Rule 14e-3, by its terms, does not require that the offender know or have reason to know that the information relates to a tender offer, so long as the information in fact does relate to a tender offer and the offender knows or has reason to know the information is nonpublic and was acquired by a person with the required status."); BLOOMENTHAL & WOLFF, *supra* note 47, § 19:30.

53. *See* John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 369 n.208; *see also* Joanna B. Apolinsky, *Insider Trading as Misfeasance: The Yielding of the Fiduciary Requirement*, 59 U. KAN. L. REV. 493, 535 (2011); Maria Babajanian, *Rewarded for Being Remote: How* United States v. Newman *Improperly Narrows Liability for Tippees*, 46 STETSON L. REV. 199, 218 (2016); Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 179 (2003).

54. *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1198 (1995) (asserting that Rule 14e-3 represents an effort to "revive the [*Texas Gulf Sulphur*] equal access to information rule"); Thomas W. Joo, *The Worst Test of Truth: The "Marketplace of Ideas" as Faulty Metaphor*, 89 TUL. L. REV. 383, 430 (2014) (stating, in the context of Rule 14e-3, that the SEC "views equalization . . . as an important aspect of market health"); Steve Thel, *Statutory Findings and Insider Trading Regulation*, 50 VAND. L. REV. 1091, 1101 (1997) (describing the promulgation of Rule 14e-3 as "adoption of a principle of equal access to information"). Rule 14e-3 is also said to support a parity-of-information regime. *See* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 96 (1998); *see also* Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L. J. 1083, 1135 (1985) ("The only significant difference between [R]ule 14e-3 and the parity of information approach concerns the scope of application."). Rule 14e-3 does contain some protective limitations: the Rule is only violated if the information came from certain sources (e.g., the bidder) and is used after someone takes a "substantial step" toward a nonpublic tender offer. *Id.* at 1134.

B. INSIDER TRADING POLICY

This Section presents some familiar policy considerations militating for or against insider trading restrictions. It does not take a view on the rightness or implications of any of these debates, though it does point out some of the weaknesses that a given policy's proponent would need to overcome.

1. Fairness

When executives and those close to a company trade, they may take advantage of the ignorance of third-parties with less access to information about the firm's true value.[55] The apparent unfairness of this informational asymmetry animated several early federal insider trading decisions.[56]

Yet scholars struggle to articulate a defensible fairness-based argument for insider trading restrictions that does not end up condemning or prohibiting far too much conduct.[57] Differences in information levels are inevitable and are tolerated by background principles of contract law.[58] Indeed, fairness often inclines us to reward individuals who work to develop an informational advantage.[59]

It is also unclear whether this inequality actually leaves ordinary investors worse than they started.[60] In a competitive market, investors will demand and receive a discount on stock that will be subject to predation.[61]

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55. Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979). *But see* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 330 (1981) (noting that investors' skill, wealth, and human capital differences result in different abilities to use the information they discover); Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 478 (2001) (pointing out that individuals might opt to become an executive in order to acquire information).

56. *In re* Cady, Roberts & Co., Exchange Act Release No. 34-6668, 1961 WL 60638, at *5 (Nov. 8, 1961) (discussing the "inherent unfairness" when the parties to a trade do not have the same information); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (stating that the rule "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information").

57. For one attempt, *see* Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 376–77, 381 (1999).

58. Anthony T. Kronman, *Mistake, Disclosure, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 28 (1978).

59. Laidlaw v. Organ, 15 U.S. 178, 193 (1817) (no fraud had been perpetrated by insider trading, "unless rising earlier in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated, be such").

60. *See* Merritt B. Fox & Kevin Haeberle, *Evaluating Stock-Trading Practices and Their Regulation*, 42 J. CORP. L. 887, 909–12 (2017); *see also* John P. Anderson, *Green, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 7–9 (2014) (reviewing Henry Manne's version of the "no victim" argument); *but see* William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 46–48 (2000).

61. Easterbrook, *supra* note 55, at 325; Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy*, 9 J. LEGAL STUD. 801, 807–09 (1980).

The founders receive less in the initial public offering, but subsequent investors are on net compensated for their expected losses to insider traders. Is insider trading unfair if investors are compensated ex ante for their losses?

Whatever the state of unfairness, *perceived* unfairness may affect the legitimacy and vibrancy of trading markets.[62] A key goal of the Securities Acts was to encourage retail investors to place their trust in public markets after the stock market crash of 1929.[63] Reducing seemingly inequitable practices may be important, regardless of the true normative status of these practices.

2. Incentives

If those close to a firm get to trade on its secrets, they may act in ways that are harmful to the firm. For example, managers may push the firm to take more risks or to reduce the quality of periodic disclosures,[64] to multiply the opportunities for the insider to trade ahead of a wild price swing.[65] Trading may distract employees.[66] The very act of trading might spill the beans on an employer's proprietary secrets.[67] For example, when mining executives buy their company's shares en masse, it may hint to other prospectors where they should dig to find valuable minerals.[68]

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62. Fox & Haeberle, *supra* note 60, at 912–13. *But see* John Anderson, *Insider Trading and the Myth of Market Confidence*, 56 WASH. UNIV. J. OF L. AND POL'Y (forthcoming 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3041344.

63. S. Rep. No. 73-22, 73rd Cong. at 2983 (1933), *as reprinted in* https://congressional.proquest.com/legisinsight?id=CR-1933-0508-PL73-22-S&type=CONGRESSIONAL_RECORD.

64. Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1054–55 (1982) ("Subordinates would stall the upward flow of critical information to maximize their opportunities for financial gain."); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1437 (1967). Cf. Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 425 n.18 (2000) ("The prospect of insider trading profits can . . . encourage insiders to invest in projects that are difficult for outsiders to assess, whether these projects are otherwise desirable or not, in order to increase the information asymmetry between themselves and public shareholders . . . ."). *But see* Stephen M. Bainbridge, *Insider Trading*, in 3 Encyclopedia of Law and Economics 772, 787–88 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), at http://encyclo.findlaw.com/5650book. pdf (arguing that delay is unlikely).

65. Easterbrook, *supra* note 55, at 332 (arguing that insider trading may lead to excess volatility); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) ("[T]he temptation of profit might actually encourage an insider to act against the corporation's interest."); *but see* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 874–76 (1983) (arguing risk-averse managers need such incentives, and their team dynamics limit how far things can go without a leak).

66. James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L. J. 628, 646 (1986).

67. James D. Cox, *Seeking an Objective for Regulating Insider Trading Through Texas Gulf Sulphur*, DUKE PUB. L. & LEGAL THEORY SERIES NO. 2018-47, 18–22, June 18, 2018, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3194542.

68. Verstein, *supra* note 10, at 490–91.

Others have argued that insider trading offers an important opportunity to improve incentives. Henry Manne famously argued that insider trading opportunities could constitute an appropriate means of paying employees, by compensating hard-to-observe innovation.[69] An employee may be more likely to improve the business if she can buy large amounts of stock upon realizing that her improvement worked. Executives seem to be willing to take a meaningful pay cut—perhaps 20%—to preserve the flexibility to trade.[70]

3. Market Quality

Two central goals of market regulation are to improve liquidity and price accuracy.[71] Insider trading is thought to affect both.

Liquidity, the ability to buy or sell assets quickly and with little transaction cost or price impact, is of obvious value to market participants.[72] Immediately, it is why traders come to a market at all. At a higher level of generality, the availability of a liquid secondary market is valuable to primary market investors. It is easier to raise money for your garage-based startup if the angel investors know that someday, somehow, it will be possible to sell their investments. Conversely, if secondary markets prove costly or troubled, then the only primary investors are those patient and rich enough that they can make an essentially permanent investment of capital.

Accurate asset prices are an important informational externality of public markets.[73] Third parties can observe trading results and learn information that is useful to make real (i.e., non-financial) investment decisions. For example, if stock prices are high at tech firms, it suggests that the sector is productive and primed for growth. Venture capitalists may direct their energy toward nurturing early stage companies in one sector over another sector in light of this information. Conversely, a sudden decline in the stock price of a company may communicate information that will lead to a reduction in real investment in and through that troubled company. Lenders will be less prone to lend against the depleted market cap, making it harder for the struggling

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69. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 138 (1966). *See also* Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561, 571–72 (1971) ("The cotton gin had obvious speculative implications for the price of cotton . . . ."). Many scholars have noted the profits available to employees trading the stock of other companies. Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 25–26 (2006) (arguing that such trading is important to compensate producers of intellectual property).

70. M. Todd Henderson, *Insider Trading and CEO Pay*, 64 VAND. L. REV. 505, 507 (2011); *but see* Dirks v. S.E.C., 463 U.S. 646, 653 n.10 (1983) (quoting Matter of Cady, Roberts & Co., 40 S.E.C. 907, 4 n.15 (Nov. 8, 1961) (rejecting the notion that insider trading is "a normal emolument of corporate office").

71. Merritt B. Fox et al., *The New Stock Market: Sense and Nonsense,* 65 DUKE L. J. 191, 222 (2015).

72. *See* Yakov Amihud et al., *Liquidity and Asset Prices*, 1 FOUNDATIONS AND TRENDS® IN FINANCE 269, 270 (2005); Yair Listokin, *Taxation and Liquidity*, 120 YALE L. J. 1682, 1690 (2011).

73. *Cf.* F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 525–28 (1945).

firm to flounder along. When companies lack an efficient use for more investment capital, a decline in trading price often presages the end of the company's expansion. A dip in stock price also signals that the current management may be making mistakes—and it gives shareholders an incentive to oust them.

Price accuracy and liquidity can be mutually reinforcing. If asset prices are completely accurate, then investors will readily buy and sell without wondering if a little more research would reveal that an asset is under or overvalued. And unreserved trading redounds benefits. If many people are happy to trade, then there are always fresh transactions to observe as signals of the current price and health of a company.

Yet price accuracy and liquidity do not always go in the same direction, and insider trading is thought to put the two into tension. Insider trading, as a species of informed trading, tends to improve price accuracy. Traders who buy while knowing that the stock price is too low will set in motion "the mechanisms of market efficiency,"[74] leading to an eventual increase in the price. Tempted by these trading profits (buying at the current price and then owning shares at a newly appreciated price), informed traders will be drawn to deploy their private knowledge of asset prices.[75] Specifically, individuals who would otherwise be reluctant to share information may be willing to do so when they will profit by revealing it through trading. For example, an executive aware of bad news for her company may try to hide or delay its disclosure, putting off the day of reckoning as long as possible. But if she can short her company's stock today, the trade (or a public disclosure encouraged by the possibility of profits) may publicize important information about the company's value.[76] Those without inside information might regard trading profits as an inducement to go ahead and develop useful information. Market analysts and stock pickers of all stripes try to develop information that is useful for trading; if they succeed, they improve the price accuracy of stock in a way that it would not be improved if these traders were forbidden from trading.

74. Ronald T. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

75. To be sure, there are ways for insider trading to reduce stock price accuracy too. Michael J. Fishman & Kathleen M. Hagerty, *Insider Trading and the Efficiency of Stock Prices*, 23 RAND J. ECON. 106, 110 (1992); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1238–43 (2001). Laura Nyantung Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 276 (2007) (showing that stock prices are "presumably more informative" in countries with insider trading restrictions).

76. *See* Dirks v. S.E.C., 463 U.S. 646, 649–50 (1983), in which executives of a company tried to hide the fraud, and when others tried to disclose it, they were rebuffed by the Wall Street Journal. In the end, it was a selloff by tipped investors that help publicize the fraud. *Id.* at 650–651.

On the other hand, informed trading is thought to generally lower market liquidity,[77] because informed traders' profits act as a tax on their counterparties, which are usually trading intermediaries known as *market makers*. Market makers set a price at which they are willing to buy and sell, hoping to cover their costs through tiny profits on a large volume. When market makers trade against informed traders, they systematically lose, requiring them to set a higher per-charge implicit cost for other investors. The higher trading cost per trade amounts to a friction on trading and, thus, a drag on liquidity.

4. Uniformity

One important question in the debate on insider trading law concerns the need for uniform, mandatory law.[78] It is possible that most firms and their shareholders benefit from meaningful insider trading restrictions. But do all firms benefit from the same laws? Perhaps some firms have less need for insider trading restrictions than others. Perhaps some firms would be able to manage the agency costs and adverse selection costs in exchange for greater manager innovation and price accuracy—with a sophisticated investor-base that accepts the apparent unfairness as an overall fair result. Each firm could have the optimal degree of insider trading restrictions, some higher than others, if personalization were feasible

One way to personalize insider trading would be to give each corporation the right to opt in or out of some default level of restriction. The thought here is that companies largely internalize the costs and benefits of insider trading in their shares.[79] We trust companies to make many sensitive decisions that

77. *See* Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71, 72–77 (1985); Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315, 1332 (1985); *see also* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 488 (1970) (discussing liquidity of durable goods); Walter Bagehot (pseudonym for Jack Treynor), *The Only Game in Town*, 27 FIN. ANALYSTS J. 12, 13–14 (1971) (discussing the role of market makers in providing liquidity); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1251 (2001) ("It is widely agreed that insider trading diminishes liquidity. This view is based on a theoretical model that suggests that market makers will offset the risk of trading against insiders by increasing the bid-ask spread."); Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 467, 469–70 (2001) (discussing the mixed evidence on how insider trading affects liquidity); John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y. L. J., July 31, 1997, at 5–6 (suggesting that impaired disclosure affects market efficiency).

78. On the optimal degree of personalization in law, *see* Verstein, *Privatizing Personalized Law*, 86 U. CHI. L. REV. (forthcoming 2019) (manuscript 5–11); *see also* Omri Ben-Shahar & Ariel Porat, *Personalizing Negligence Law*, 91 N.Y.U. L. REV. 627, 633 (2016) (favorably comparing personalized to uniform standards); Omri Ben-Shahar & Ariel Porat, Personalizing Mandatory Rules in Contract Law, 86 U. CHI. L. REV. (forthcoming 2019).

79. Manne, *supra* note 69, at 138–141; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305–

bear on incentives and fairness—for example, whether to pay their executives in options or salary. Deciding whether their shareholders would prefer lower trading costs or higher price accuracy is another such choice. A firm-specific insider trading law would allow some experimenting with insider trading, while protecting firms and investors that deem it harmful.

Conversely, uniformity may be desirable if one firm's insider trading policies have an impact on other firms.[80] More importantly, if executives cannot be trusted to set their own insider trading policies,[81] then uniformity may be necessary. Even if non-uniform insider trading rules would be optimal, someone would need to decide to opt out of the default insider trading regime. The government presumably lacks the resources to enact granular requirements on a firm-by-firm basis, and so there would be no one in a fair position to opt out of uniformity.

II. INSIDER TRADING AT INSOLVENT FIRMS

Insider trading law does not formally change when a firm becomes insolvent. However, insolvency alters the economic landscape in which traders operate, and bankruptcy proceedings superimpose new legal structures onto which insider trading theories may be applicable. The functional result is to both expand and contract the reach of federal insider trading restrictions.

A. NEW ECONOMICS, REDUCED REGULATION

In a solvent, publicly-traded firm, the residual claimants on firm value are the stockholders.[82] It is their capital that remains at risk if firm value declines, since those higher in the priority hierarchy must fully replenish their fixed claims before equity can so much as recover its initial investment.[83] And gains in enterprise value that exceed the fixed claims inure to the equity class. As a residual claim, equity is a volatile asset. As a volatile asset, it is a barometer of firm value and a motivated advocate for efficient operations. As

07 (1976); *but see* Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 320–21 (2002) (arguing that firms fail to internalize costs of trading other firms' stock).

80. Coffee, *supra* note 77, at 4; *see* Fox, *supra* note 71, at 267.

81. *See supra* Part I.B.2.

82. Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777, 788 (1972); Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & ECON. 395, 403 (1983). This claim has been contested. *See generally* Lynn M. Lopucki, *The Myth of the Residual Owner,* 82 WASH. U. L. Q. 1391 (2004); *see also* Bernard S. Black, *Corporate Law and Residual Claimants*, 5 (Johm M. Olin Program in Law and Econ., Working Paper No. 217, 2009). A skeptical reader can read all references to residuality as relative: equity is often, awfully residual in its claim relative to other tranches.

83. This is the absolute priority rule. Higher priority claimants must fully recover before those with lower priority obtain anything. Douglas G. Baird Thomas, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. CHI. L. REV. 738 (1988); Lynn M. LoPucki William C., Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. PA. L. REV. 669, 682 (1993).

a risky security, valued both for its ability to swing with earnings reports and to swing the balance of power in the market for corporate control, common stock is properly at the center of securities regulation. In a solvent firm, the residual claims are subject to the full ambit of regulations, including insider trading laws.

In insolvent firms, the locus of residual clemency shifts. Equity is likely to be valueless (or to retain value only in the form of a "tip" from senior creditors grateful for prompt surrender),[84] and some other claimants will recognize that the value of their claims is now in flux.[85] This "fulcrum" class of creditors will stand to recover only part of their claim in cash or debt—the rest will either go uncompensated or will come in the form of equity securities. The fulcrum class is therefore the residual claimant of the firm—both for the instant action, since each dollar recovered directly accrues to their class, and going forward, insofar as they will receive the new equity tranche.

An important legal change results from this shift in residual claim status: a partial exemption from insider trading regulations for the most important instruments. Some insider trading rules apply only to equity, but at least until the plan is confirmed, the fulcrum class does not involve equity. Executives find the law is less of an impediment to informed or manipulative short-swing trading as the firm dips into insolvency.

The rest of the insider trading rules apply to all securities, but only some fulcrum creditors hold securities. Others own non-securities claims, such as trade creditor claims and bank loans. To whatever degree these assets constitute the fulcrum class, no federal insider trading laws apply to the residual claims. As a result, insider trading restrictions fully apply to the residual claims on solvent publicly-traded firms but something far less restricts trading in the residual claims in insolvent firms.

1. 16(b) does not apply to residual claims in insolvency

Rule 16(b), the short-swing profits rule, applies to equity securities.[86] However, its text does not penalize trading in debt securities.[87] A trader of distressed debt, who buys a large amount of the fulcrum debt and then sells it at a profit a few months later would be exempt from 16(b). Likewise, officers and directors may trade in fulcrum debt securities without violating

84. Douglas Baird, *Bankruptcy Law's Quiet Revolution*, 91 AM. BANKR. L.J 593, 602–03 (2017).

85. Andrew A. Wood, *The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies*, 85 AM. BANKR. L. J. 429, 436–38 (2011) (showing negligible recoveries in Chapter 11 for equity).

86. It also applies to security-based swap agreements.

87. By contrast, 16(b) does seemingly permit debt security investors to press claims. *See* 15 U.S.C.A. § 78p (West 2011) (permitting suits by "the owner of any security of the issuer").

the short-swing profits rule. The volatile residual claims at insolvent firms are not subject to statutory disgorgement.

There is a contrary argument to consider. The fact that fulcrum securities may be converted to equity in the near future suggests that 16(b) *could* be extended to cover them. That is because the SEC now takes the position that ownership of derivatives can count toward the 10% threshold for 16(b) purposes.[88] A holder of 10% of the fulcrum class might be considered a holder of a call option for 10% of the future equity.

This position is not reasonable prior to plan confirmation, however. [89] The position of the fulcrum creditors is highly uncertain, at least early on. Indeed, the actual identity of the fulcrum class may be debatable. Rather than "option holders" who could soon own debt, fulcrum creditors are creditors who may soon own options—the terms of which they are now negotiating.

Other anomalies might arise from treating fulcrum creditors as 16(b) insiders. 16(b) insiders must publicly disclose their trading positions within three days of any change.[90] If all fulcrum creditors are treated as equity holders, then they should be promptly disclosing all of their trades.[91] Since very few fulcrum creditors currently make Section 16 filings, either that the law does not apply to them or fulcrum creditors are nearly uniformly breaking securities laws.

Even if 16(b) applied to trading debt securities in the fulcrum class, it would not apply to non-securities claims in the fulcrum. 16(b)'s coverage would remain patchy, governing some transactions at some firms and no transactions at firms where the fulcrum class does not contain securities. It would therefore be subject to *partial* insider trading restrictions of the sort discussed below.

88. Sec. Exch. Commission, Release No. 34–28869, 1991 WL 292000, (1990–1991 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 84, 709 (Feb. 21, 1991). Rule 16b contain an exemption for exercises of many rights and warrants. *See* 17 C.F.R. 240.16b-6(b) (1996).

89. There is some chance that post-confirmation, non-securities that qualify for exchange into equity securities might be subject to 16(b). *Cf.* Sec. & Exch. Comm'n v. Texas Intern. Co., 498 F. Supp. 1231, 1245 (1980).

90. 17 C.F.R. § 240.16(a) (2011).

91. Federal Rule of Bankruptcy Procedure 2019 requires creditors' committee members to disclose their "disclosable economic interest" in the debtor as of the date that the committee was formed. However, this disclosure is unlike 16(a) filings in many ways. First, it does not require disclosure of price. Second, it either requires no disclosure on the dates of trade or it permits a netting of all positions across an entire quarter. 2019 filings *may* require committee members to file new statements about their current economic interest in the debtor, but only when the committee takes a position before the court or solicits votes on a plan. This is relatively often, but it is far from twice a week, which Rule 16(a) can require. FED. R. BANKR. 2019.

2. 10b-5 and 14e-3 have limited application to residual claims in insolvency

Section 10b-5 and 14e-3 only apply to securities. Bankruptcy claimants trade "claims," which are "right[s] to payment."[92] There is a longstanding debate among bankruptcy scholars and practitioners about how to characterize bankruptcy claims in light of the securities laws. One view holds that none of the bankruptcy claims are securities: people are trading and pressing claims created by the bankruptcy process—the pre-existing securities do not trade anymore and have become unimportant now that they have matured into bankruptcy claims.[93] A second view holds that all (or most) bankruptcy claims are transformed into securities.[94]

The moderate view is that pre-bankruptcy securities remain securities and pre-bankruptcy non-securities remain non-securities. That means that similar instruments in the bankruptcy process are governed by radically different insider trading rules. Bonds are long-term debt instruments held by sophisticated parties, managed by a delegated trustee or agent; so are bank loans or "leveraged loans."[95] Bonds and loans trade for similar prices with similar terms, but the former are subject to the securities laws while the latter are not.[96] Insider trading laws apply to the bonds but not to bank loans.[97] Likewise, insider trading laws do not apply to the claims of trade creditors, tort creditors, and a bevy of other entitlements.

If the fulcrum class is composed entirely of non-securities creditors, then the residual claims of the insolvent firm are completely exempt from 10b-5's fraud based trading restrictions and 14e-3's tender offer based restrictions, in

92. 11 USC § 101(5) (2010).

93. Anthony Michael Sabino, *No Security in Bankruptcy: The Argument against Applying the Federal Securities Laws to the Trading of Claims of Chapter 11 Debtors*, 24 PAC. L. J. 109, 139 (1992) (reviewing legal developments in bankruptcy and concluding that bankruptcy claims are not securities); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 2–3 (1990); 6 COLLIER ON BANKRUPTCY ¶ 94.08 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("The securities laws do not, . . . as interpreted by recent decisions, define trade claims in bankruptcy as 'securities.'").

94. *See, e.g.*, Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 617 (2002); James D. Prendergast, *Applying Federal Securities Law to the Trading of Bankruptcy Claims*, 3 FAULKNER & GRAY'S BANKR. L. REV. 9 (1992).

95. Elisabeth De Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725, 757 (2014).

96. *See* Banco Espanol de Credito v. Security Pacific National Bank, 973 F.2d 51, 54–55 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) (holding loan participations are not securities). De Fontenay argues that as a doctrinal matter, the *Reves* test militates against exempting leverage loans from the Securities Acts. *Id.* at 55. Still, at least for now, the market operates as though there is no securities regulation for these instruments. *Id.* at 56.

97. The application of insider trading laws to bonds is contested, but at least on the misappropriation theory, it seems sound. BAINBRIDGE, *supra* note 36, at 79–81.

addition to 16(b) being inapplicable.[98] That means there would be no federal insider trading liability for a company executive tipping a hedge fund to sell bank debt before publicly disclosing a breakdown in negotiations once anticipated to yield substantial repayment, nor would there be liability for a hedge fund manager's therapist buying up some trade debt after learning that the manager has been losing sleep about a planned tender offer for the trade debt.

If the fulcrum class contains both securities (e.g., bonds) and non-securities (e.g., trade and bank claims), then some but not all of the fulcrum class would be subject to insider trading rules. A creditor committee member would violate Rule 10b-5 if he bought bonds on the basis of what he learned in confidential meetings, but not if he bought up trade debt.

It is surprising and anomalous that three bankrupt firms may have similar economic properties, but one of them has insider trading laws apply to its residual claims, a second does not, and the third has the law apply only to a given portion of the residual claims.

B. NEW ROLES, INCREASED REGULATION

Although insider trading law covers fewer of the important *assets* in an insolvent company, it covers more of the important *persons*. The legal transformations contemplated in a bankruptcy proceeding create duties of trust and confidence sufficient to animate insider trading restrictions. Importantly, efforts by market actors to avoid these results are not fully effective. As a result, there is an important sense in which bankruptcy amplifies insider trading law.

1. The Debtor (and its Managers)

Many of insider trading law's duties remain the same in insolvent firms. Regulation FD (Fair Disclosure) prevents selective disclosure of information to institutional investors, securities-holders likely to trade, and others.[99] Managers who misappropriate corporate information are restricted from trading securities—debt or otherwise. However, some aspects of insider trading law change because relationships and duties change.

In a Chapter 11 bankruptcy, the debtor's existing management continues to run the bankrupt entity.[100] However, the commencement of the bankruptcy

98. One important caveat is that post-confirmation, non-securities claims may be subject to securities regulation, if they are scheduled for conversion into securities. *See* Sec. & Exch. Comm'n v. Texas Intern. Co., 498 F. Supp. 1231, 1240 (1980).

99. 17 C.F.R. § 243.100(a) (2011); 17 C.F.R. § 243.100(b)(1) (2011).

100. 11 U.S.C. § 1106, 1107 (2012). By contrast, the debtor loses control over the entity in a typical Chapter 7 bankruptcy, in favor of the bankruptcy trustee. 11 U.S.C. § 322(b)(1), 701 (2012). A Chapter 13 bankruptcy assigns some control to the U.S. Trustee's Standing Trustee for the district (a federal officer), while some control remains in the debtor. *See* 28 U.S.C. § 586(b) (2012); 11 U.S.C. § 1302 (2012); 11 U.S.C. 1327(b) (2012).

definitively alters the managers' duties. When a venture is solvent, managers owe duties only to the entity and its shareholders—not to the creditors.[101] By contrast, federal bankruptcy law clearly imposes a series of duties (at least some of which are fiduciary) onto the managers to look after the creditors' interests.[102]

Since there are role-specific fiduciary duties to the creditors and the estate, managers are presumably subject to insider trading restrictions as to the firm's debt securities. Managers may not personally buy or sell bankruptcy claims while in possession of material nonpublic information, under the classical theory. Nor may managers authorize third parties to trade. The classical theory is not waivable.

One interesting feature of this is that the debtor is presumably barred from buying back debt securities while aware that these securities are undervalued by the market. Solvent securities issuers are classical insiders with respect to their equity investors due to the duties owed them,[103] and such duties presumably apply to debt securities holders in insolvency.

2. The Creditors

A Chapter 11 bankruptcy sets in motion the creation of official and unofficial creditor committees. Official creditors' committees are appointed by the Office of the United States Trustee under § 1102 of the Bankruptcy Code.[104] An official committee is empowered to consult concerning the administration of the case, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, participate in formulation of the plan, request appointment of a trustee or examiner under § 1104. Committee members bring important information to the committee. Some information is intentionally developed in their capacity as investors and claims traders, and some they acquire automatically. For example, committee members always

Chapter 11 powers and responsibilities actually run to the Debtor in Possession, but it can be useful to remember that we are ultimately talking about the officers and directors, as a functional matter, and so this Article retains the "manager" terminology familiar from corporate law scholarship.

101. Delaware law has varied on this point, sometimes recognizing a duty to creditors while in the proximity of insolvency. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *1155–57 (Del. Ch. Dec. 30, 1991); Production Resources Group, L.L.C. v. NCT Group, Inc., et al., 863 A.2d 772, 788 (Del. Ch. 2004). More recently, Delaware has limited any duty to moments of actual insolvency. *See* Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007); Trenwick Am. Litig. Tr. v. Ernst & Young, 906 A.2d 168, 175 (Del. Ch. 2006); Quadrant Structured Products Co. v. Vertin, 102 A. 3d 155 (Del. Ch. 2014). *See generally* Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1390 (2007).

102. *See* John A. E. Pottow, *Fiduciary Duties in Bankruptcy and Insolvency*, THE OXFORD HANDBOOK OF FIDUCIARY L. 4–16 (Evan J. Criddle, Paul B. Miller, & Robert H. Sitkoff, eds.) (forthcoming 2018).

103. Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801, 813–14 (2014); Mark Lowenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45, 70–72 (2005).

104. *See* 11 U.S.C. § 1103(c) (2012); *see also* 11 U.S.C. § 1102(a)(1), (b)(1) (2012).

know their own willingness to settle, and they may also know the true underlying value of certain collateral if they are the ones who sold it (on credit) to the debtor and remain familiar with the secondary market for such collateral.

Committee membership entails duties.[105] By virtue of membership on an official committee, a committee member necessarily assumes duties to other creditors in their class,[106] and they may often have duties to all creditors.[107] By virtue of their close relationship with the debtor, members of the committee will often have an obligation to the debtor to keep information confidential.[108] Committee members may also have duties to one another to keep one another's secrets.[109]

As a result, these committees can create insider trading risks for their members when they trade because committee membership confers both nonpublic information and duties not to trade on the basis of it. There is evidence that these trading risks are material.[110]

For one example, the SEC filed an enforcement action against Barclays and its head of distressed debt trading, accusing them of insider trading bonds while aware of material nonpublic information received from the creditors' committee on which Barclays sat. The complaint alleged that Barclays owed fiduciary duties to all bondholders.[111]

The most notorious incident was in connection with the Washington Mutual bankruptcy.[112] There, Judge Walrath denied confirmation of the bankruptcy plan and raised the specter of more punitive measures, such as equitable disallowance, in light of allegations that members of the creditors' committee may have traded based on what they learned through their role.

Although the court did not rule on the merits of the case, and although the case was later vacated in part,[113] it caused the four hedge funds involved to pay approximately $30 million the complaining equity investors.[114] The immediate impact was a "chilling impact,"[115] with creditors reluctant to serve

105. Unofficial committees have duties, too. *See In re* Northwest Airlines Corp., 363 B.R. 704, 708–09 (Bankr. S.D.N.Y. 2007); *see also* Official Comm. of Equity Sec. Holders of Mirant Corp. v. Wilson Law Firm, P.C. (*In re* Mirant Corp.), 334 BR. 787, 793 (Bankr. ND. Tex. 2005).

106. *In re* Refco Inc., 336 B.R. 187, 197 (2006).

107. *Cf. Commodore Int'l Ltd. v. Gould* (*In re* Commodore Int'l Ltd.), 262 F.3d 96, 100 (2d Cir. 2001).

108. *Id.* at 196.

109. *Id.*

110. *See infra* notes 108, 109.

111. SEC v. Barclays Bank PLC, Litigation Release No. 20132 (May 30, 2007).

112. *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229, 2012 WL 1563880, at *59 (Bankr. D. Del. Feb. 24, 2012). For a discussion and analysis on this case, *see generally* Hon. James M. Peck, *Settlement Talks in Chapter 11 After "WaMu": A Plan Mediator's Perspective*, 22 AM. BANKR. INST. L. REV. 65 (2014).

113. *See In re Wash. Mut., Inc.*, 2012 WL 1563880, at *59.

114. *Vulture funds surrender $30 mlm in new WaMu reorganization plan*, REUTERS, Dec. 12, 2011, 7:30 PM, https://www.reuters.com/article/idUS285643983620111214.

115. Peck, *supra* note 112, at 71.

on creditors' committees or else to participate only on the most formalistic terms, without the informed and open dialogue necessary to inform the estate of the creditors' knowledge and priorities or to make a real negotiation possible.[116] As Judge Peck put it, "Many distressed hedge funds are opting not to engage in negotiations that might expose them to any incremental threat of potential liability based on insider trading claims, however remote such claims may be . . . . No one disputes that this is rational behavior. Unfortunately, it is also behavior that tends to slow things down, increase administrative costs and unduly complicate the rules of engagement."

Four techniques are used to lure creditors back on to the committee in light of the risk and constraint that active traders seem to assume by virtue of committee membership. First, creditors may demand assurances from the debtor or the committee that information will cease to be confidential after some period of time. This technique is imperfect: the classical theory regulates trading on the basis of nonpublic information because of the unfairness of a fiduciary-insider or constrictive insider taking advantage of the investors who are beneficiaries of the duty. Until the information is actually disseminated, classical insiders may not trade. The source of information is not allowed to just waive the duty.

Second, active traders may send a "Big Boy" letter to their counterparty, warning them that the trader may have access to nonpublic information and seeking a waiver of liability for any such non-disclosure.[117] This method is also imperfect.[118] Most importantly, a trading counterparty does not appear to be in the position to release traders from liability under the misappropriation theory, since it is not their information that is being misappropriated.

A third technique, popular among large creditors, is the adoption of ethical walls. These metaphorical walls instruct personnel in one department of the entity from communicating with their colleagues elsewhere in the entity. Specifically, the creditor takes steps to ensure that the committee's confidential information is not shared with the individuals who actually make trading decisions.[119] Such separation may help remove the possibility and appearance of trading on the basis of confidential information.

116. *Id.* at 66.

117. *Cf.* Harsco Corp. v. Segui, 91 F.3d 337, 343–49 (2d Cir. 1996) (honoring such a letter in a sale of business context).

118. Such letters are of questionable prophylactic value as against the counterparty. They do not bind other plaintiffs, such as contemporaneous traders, who may have a statutory right to sue anyone who violates Rule 10b-5 by trading. 15 U.S.C. § 78t-1 (2012).

119. *In re* Washington Mut., Inc., 461 B.R. 200, 266 (Bankr. D. Del. 2011), *vacated in part,* No. 08-12229 MFW, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012) ("[C]reditors who want to participate in settlement discussions in which they receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case."); *see In re* Federated Dep't Stores, Inc., No. 1-90-00130, 1991 WL 79143, at *1 (Bankr. S.D. Ohio Mar. 7, 1991) (crediting the importance of an information wall).

Yet, the use of ethical walls may be costly and infeasible for small creditors.[120] It is also of uncertain effectiveness. Later investigators and plaintiffs may cast doubt on the effectiveness of the wall. More importantly, a fiduciary who learns material nonpublic information from any source violates the classical theory if they trade with the duty's beneficiary.[121] That means that a trader who learns material nonpublic information through, say, diligent research *would* have the right to trade on it but *would lose* that right if she became a fiduciary of the counterparty. A creditor that sits on the creditors' committee is a fiduciary of creditors from whom she buys debt, and this will be true even if the trading department has not received any information from the department entrusted with the committee work. Plausibly, creditors who join a committee obtain new trading restrictions that cannot be controlled by an information wall.[122]

A fourth and closely related technique involves the bankruptcy judge issuing a "comfort" order or "trading" order. These orders often state that the designated creditor may continue to trade so long as they comply with appropriate conditions (which include the creation of an ethical wall).[123] One such order was deployed shortly after WaMu in *In re Vitro*. Judge Peck oversaw the use of another such order in his capacity as mediator.[124]

These orders have reassured creditors, but it is not clear that creditors are right to be comforted. Bankruptcy judges can neither directly decide criminal liability nor civil liability under the federal securities laws; as a result, their orders do not directly create or reduce such liability.[125] It is slightly more plausible that bankruptcy court orders can alter the mid-level legal determinations, such as whether there was a duty or whether reliance was reasonable: a federal bankruptcy case depends on a duty of trust and confidence; perhaps a court order blessing an active trading desk will tend to undermine plaintiffs' later claims that they reasonably placed their trust in

120. Taken to its extreme, a sole human creditor cannot subdivide her own knowledge – what she learns in a committee necessarily informs her trading decisions. Slightly larger firms can build partitions only if both parts of the firm are sufficiently large and well-resourced to operate without working together and to document that there is no sharing. Even larger firms increasingly find it prudent to hire an outside fiduciary to represent them in the committee business, and therefore protect personnel from allegations of improper information acquisition and use.

121. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1339 (2009).

122. *See* Daniel Sullivan, Note: *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533, 557–58 (2008) ("The firm may have a longstanding relationship with the debtor, for instance, that affords it access to inside information. Or the firm may be a hedge fund immersed in the industry and privy to rumors from other parties involved about the reorganization process.").

123. *See*, *e.g.*, *In re* Calpine Corp., No. 05-60200 (Bankr. S.D.N.Y. Feb. 15, 2006); *In re* the Bon-Ton Stores, Inc., No. 18-10248 (Bankr. D. Del. Apr. 11, 2018); *In re* Innatech, LLC, No. 10-49380 (Bankr. S.D. Mich. May 11, 2000); *In re* Jevic Holding Corp., No. 08-11006 (BLS) (Bankr. D. Del. Aug. 18, 2008). However, courts sometimes refrain from granting this relief. *See*, *e.g.*, *In re* Spiegel, 292 B.R. 748, 749 (Bankr. S.D.N.Y. 2003).

124. Peck, *supra* note 112, at 71.

125. Stern v. Marshall, 564 U.S. 462, 508 (2011).

the defendant's circumspection. Yet this position also shows some limitations. The classical theory of insider trading may not allow disclaimers under any circumstances, so how can a judge disclaim it for the trader? Likewise, a judge's determination within the bankruptcy process that a fiduciary did not breach their duty would likely not be binding on an Article III court deciding that question for other matters.

The scope of insider trading law widens in bankruptcy to cover actors who are unaccustomed to trading restrictions. Those actors work with judges, firms, and counterparties to circumvent insider trading restrictions, but they are not fully successful in avoiding the reach of insider trading law. Bankruptcy supports the imposition of insider trading restrictions that are not trivial.

III. INSIDER TRADING IN THE ZONE OF INSOLVENCY

The operation of insider trading law differs materially in and around insolvency. This Part contemplates whether these changes are for good or for ill. Section A applies the familiar insider trading policy considerations to the insolvent or bankrupt firm. Section B draws out some tentative conclusions—mostly that judges and policymakers should approach changing the status quo cautiously.

A. THE POLICIES IN INSOLVENCY

Whatever the merits of the various policies animating debates about insider trading law, the policies likely apply with different (and often lesser) force in the context of insolvent firms.

1. Fairness

Fairness considerations may matter less in insolvent firms than in solvent firms. The fulcrum class will be creditors, and most creditors are more sophisticated than the shareholders who stand as residual claimants of a solvent firm. Holders of bonds and leveraged loans tend to be more sophisticated than, say, retirees who hold index-funds (which hold the equity of a solvent firm). Even trade creditors are at least businesspeople who decide who they want to do business with and on what terms. They are capable of eyeballing the value of their claims against offers that may come in the mail.[126]

Of course, many debt-holders are not sophisticated. Tort victims, for example, may not have opted in to their position. They may not understand how much their claims are worth. Their non-adjusting posture makes them closer to naïve shareholders in their need for protection.

126. Analogously to equity investors, who are said to have discounted the security by the expected losses to insiders, many unsecured creditors are "adjusting" and so cannot be said to have unfairly lost value in expectation.

Then again, one part of the fairness argument for shareholder protection involves encouraging shareholders to invest at all. Unsophisticated creditors are less likely to adjust their behavior in response to perceived unfairness. Sadly, non-consenting creditors cannot easily vow to avoid the firm—this is upsetting from a moral point of view but marginally less worrying from an economic point of view. Likewise, trade creditors become trade creditors by virtue of their business. They can choose to extend credit less readily if they find the deal to be unfair but are unlikely to withdraw from their trade altogether. Equity investors may instead put their money under their mattress. Sellers of uranium or propane, on the other hand, are unlikely to put their wares under their mattress. Therefore, the downstream fairness effects are largely weaker in the insolvency context.

2. Incentives

Proponents of allowing insider trading believe that it will encourage talented individuals to serve as executives, and to perform better as executives. Opponents of insider trading (that is to say, proponents of robust regulation) fear that executives will manipulate company decisions and information flows in order to maximize their trading opportunities.

Both theories are probably intensified in insolvent firms, making uncertain the overall benefit or cost of insider trading as to incentives. It is clear how individuals would be tempted to take advantage of their position to create trading opportunities in insolvent firms. A manager in control of the precarious debtor can sabotage business prospects. It will often be possible to disguise the wasteful decision as one of the many tough calls that managers must make under uncertainty at a rickety firm. Likewise, any setbacks at an insolvent firm can have a disproportionate effect in depressing the value of the residual claims.

A creditor with a blocking position knows better whether a plan is likely to be approved,[127] and she can buy or sell claims based on that information. Anyone with a window into that creditor's thinking—an executive at that creditor firm; a lawyer for the creditor firm; another creditor on the committee, with whom discussions had been taking place—will be tempted to trade. Any such individuals will be tempted to restrict information flows and send out false signals in order to increase the difference between the pre- and post-disclosure claim price. Manipulative incentives will also grow,

127. An investor has a "blocking position" if they can prevent acceptance of a plan. A plan is accepted by an impaired class of creditors if two-thirds of the face-value of the class's claims accept the plan. 11 U.S.C. § 1126(c)(2012). An investor who acquires one-third of the class can hold up an otherwise acceptable plan. John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1223 n. 50 (1991).

since spiteful uses of a blocking position generate information worthy of a trade.

Bad incentives also infect seemingly neutral choices like how to categorize the different claimants. An extremely narrow fulcrum class would see its value swing more widely based on information. But a narrow class might mean ignoring similarities among creditors (some of whom would be pushed up or down a class), leading to contentious fighting over designation. And it might be harder to secure supermajority approval of the fulcrum creditors if heavy losses are imposed on a small group of creditors than moderate losses on a larger group. Would-be traders have an incentive to push for a narrow class, regardless of whether doing so is in the interests of other creditors or the overall process.

On the other hand, advocates for deregulated insider trading believe that it can be an incentive for the best and brightest executives to show up to work at a company. An analogous thought can be applied to participation on the creditors' committees.

A creditor who joins a creditors' committee assumes trading restrictions. A creditor who robustly participates in the committee process will obtain information that blocks them from trading. Yet the most useful creditors are often the ones who would actively trade. They may have financial expertise, and they may be doing research into asset values that could be useful to the committee. If they lose these rights, they will be less inclined to join the committee. Efforts to protect their trading rights, such as ethical walls, reduce the legal tax on committee participation, but they do not eliminate it.

A unique feature of the insolvency context is that creditors are sometimes both givers and receivers of useful information. Typically, in solvent firms, some individuals know more than others and the question is whether they should be able to trade on that knowledge (or share it with potential traders). An insider trading rule of one sort or another blocks the transmission of information one way—it prevents certain trading or sharing *outward* from the firm. However, the insolvent firm is different. It relies on important creditors for information. A rule that restricts insider trading *both* restricts *outflows* of information from the firm to the creditors (or to the market by way of the creditors' trades) and the *inflow* of information into the firm from creditors now reticent to join the committee. This two-way flow is a difficult challenge, but it surely militates in favor of more liberal trading possibilities at the margin.

3. Market Quality

Both price accuracy and liquidity are valuable in insolvent firms, as they are for any firm. However, at the margin, price accuracy probably takes on greater importance than in solvent firms and liquidity takes on lesser importance. Insofar as insider trading tends to improve price accuracy at the expense of liquidity, insider trading is likely more beneficial (or less harmful) for insolvent firms.

Price accuracy is largely valuable because it can guide decisions in the real economy. Nowhere is real economy investment more discretionary than in a bankruptcy case. The parties are literally deciding whether to sell the assets piecemeal, as a set, or to continue the business on essentially the same terms as before. A central consideration in bankruptcy is whether the business is fundamentally efficient apart from its debt service, or whether the underlying venture is inefficient and should be discontinued. The parties need whatever information they can get, and the value of the claims of residual claimants ought to give continual insight into the value of certain strategies. If a plan proposed and the fulcrum claims plummet in value, the price decrease alerts onlookers that the proposed plan may be value destroying.[128] A jump in the value of the fulcrum class tends to suggest that the plan is value creating, just as the jump in stock prices in an event study tends to suggest that the treatment effect was beneficial.

As important as this information is, it comes at a time when the parties are particularly information starved. Orderly information-gathering and reporting systems of the insolvent firm may have broken down. Its prospects may look particularly bleak as suppliers, employees, and creditors distance themselves from the flailing venture. These effects can be permanent or temporary – each patron has private information about their willingness to rejoin the rehabilitated entity after bankruptcy, and hence of the value of the residual claims of that entity.

At present, there is mixed evidence on whether trading produces information about insolvent firms.[129] On the one hand, bankruptcy claims appear to trade rarely during the bankruptcy case,[130] suggesting that little information is produced day-to-day. On the other hand, changes in bond ownership often indicates a major change in the quality of the debtor (and the debt).[131]

Liquidity is not unimportant. If bankruptcy claims are highly illiquid, they become less attractive ex ante, raising the cost of capital for all firms. Also, fear of being locked into a bankruptcy process may lead to a flight of

128. To be sure, it is not an unambiguous signal. Other claimants may gain by more than the fulcrum class loses. Or the price may be manipulated or subject to irrational noise trading. But at the margin, a clear look at the fulcrum class should deliver important information.

129. Professor Ellias's data appears to be localized in corporate bonds. *See* Ellias, *supra* note 2. To the degree that other instruments, such as trade debt, are carrying trade-based information about the market, his results have downward bias on the information value of claims trading. *See* Robert E. Scott et al., *Hidden Holdouts: Contract Arbitrageurs and the Pricing of Collective Rights*, (NYU Ctr. for Law, Economics and Organization, Working Paper No. 18-27, 2018) (showing that some distress sovereign debt is not priced in ways that reflect important information about repayment quality). Scott, Gulati, and Choi's findings put pressure on a price-information justification for claims trading, albeit in a setting that is defined by the absence of bankruptcy. *See id.*

130. Ellias, *supra* note 2.

131. *Id.*

creditors prior to insolvency, which could aggravate a firm's downward spiral. Nor is reduced liquidity likely to be borne equally across creditors. Sophisticated creditors are likely to adjust more readily to post-insolvency illiquidity by bargaining for shorter-term loans or quickly selling their positions in the shadow of insolvency. Unsophisticated investors are likely to be left behind; at the extreme, tort creditors do not get to negotiate to set the maturity of their claims: they must either hold their claims forever or sell them in whatever liquidity conditions exist at the time when they wish to sell.

Despite all that, liquidity likely matters less for the residual claims of insolvent firms than it matters for the residual claims of solvent firms. First, there is ample controversy about whether liquid claims are actually useful for the bankruptcy estate as a matter of bankruptcy policy.[132] There are those who argue that liquidity is on balance a bad thing for the bankruptcy process. Regardless of how that debate is resolved, no such debate arises for solvent firms.

Second, the residual claims of insolvent firms are usually unsecured debt claims. Such claims were never as liquid as equity securities. Unsecured debt claimants never had a reasonable expectation of liquidity, so failing to vindicate it upon bankruptcy is not an appreciable reduction.

Third, bankruptcy is a temporary process—a period of weeks, months, and sometimes years. Liquidity matters less when we are considering just a short window of a company's life, whereas liquidity policy for a solvent firm is intended to address the company's needs over the long haul, a period of decades.

The insolvency context tends to increase the value of price accuracy relative to liquidity at the margin. At the margin, this suggests that the social cost (benefit) of insider trading is lower (higher) in insolvent firms than in solvent firms.[133]

4. Uniformity

Whatever the value of a mandatory, uniform insider trading law in solvent companies, the value would seem to be lower in insolvent firms. First, the contamination effect of investor demoralization from unfairness is naturally cabined to the peculiar situation of insolvency, where expectations are already in disarray. If a solvent firm is allowed to experiment with

132. Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1714–29 (1995–96); Edward J. Janger, *The Costs of Liquidity Enhancement: Transparency Costs, Risk Alteration and Coordination Problems*, 4 BROOK. J. CORP. & FIN. L. 39, 53–56 (2009); Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. & FIN. L. 23, 25–29 (2009); *see generally* Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. & FIN. L. 67 (2009).

133. Of course, more granular analysis is appropriate before arriving at confident conclusions. Insider trading can reduce price accuracy in some cases, for example, if it leads some actors to delay or distort information in order to protect their trading prospects.

deregulation of insider trading, investors must learn to distinguish between the experimenting firms and the rest—or else project their surprise and disappointment onto all firms. By contrast, if the only firms allowed non-standard insider trading practices are already insolvent, many investors will be able to mentally separate the healthy and fair firms from the outliers. To put this point by analogy, "do no harm" is a great starting point for medical ethics because it relieves patients from distrusting the medical profession; a patient will not do *worse* by going to a doctor, so she ought not overthink going or be fearful. However, it is probably possible to allow a doctor to risk their patient's health when they care for a terminally ill individual. That person may be happy to risk her health for a potential cure—and if the experimental treatment actually speeds her decline, ordinary healthy patients are unlikely to draw the inference that medicine is generally a bad deal. That same separation is likely to allow "unfairness" at insolvent firms without undermining trust in the solvent ones.

Second, insofar as uniform law is justified in part by a desire to spare the parties a need to come to bargain for actual consensus on their preferred insider trading policy, the bankruptcy context stands as quite different: all the firm's patrons are investing time and money to negotiate the important questions for the company. In that context, the savings from a majoritarian default rule wane and the possibility of customization becomes more attractive.

Third, the insider trading law applicable to solvent firms is imposed at a distance. All securities are subject to Rule 10b-5; all are also subject to government enforcement or private litigation if a violation is detected, but all otherwise operate without careful scrutiny from law enforcement agents. It is rare to actually come into contact with the law. Few individuals and firms are subject to SEC or DOJ investigation, and few individuals and firms seek out voluntary conversations with those investigators. The government is not giving action-by-action guidance to securities issuers. Even SEC no-action letters, which provide non-binding guidance, are made public and presumptively applicable to anyone with similar circumstances. The system is built to be impersonal, which is why the normative debate accepts that the government will operate through general patterns—the only question is whether private actors should be allowed to opt into their own customized regime.

The bankruptcy system has a very different posture. All bankruptcy matters are already in the hands of a judge, who inevitably becomes familiar with the parties' myriad concerns. The week-to-week contact between the bankruptcy judge, presiding over an insolvent firm, has no analogue in solvent firms.

In this highly interactive and personalized context, it becomes practical to craft customized law for the trading of particular firms. Doing so is not appropriate: uniformity remains valuable, and there are economic and jurisprudential reasons to resist ad hoc, case-by-case rules. But at the margin, uniformity seems like it is less valuable for insolvent firms.

B. APPLYING THE POLICIES

This Section considers possible conclusions in light of the previous Section's normative analysis. One of its main conclusions is that the difference in insider trading realities for solvent and insolvent firms may not require a change. There are some attractive features to maintaining the status quo, including both the relatively less compelling argument for regulation in the zone of insolvency and the information to be gleaned from comparing the markets. The other conclusion urges caution in imposing insider trading restrictions on creditor committees. Insider trading law is designed to reduce the flow of information. Usually, that means the flow of information *from* the issuer to traders. In bankrupt firms, insider trading law can also chill information going *in* to the issuer from to traders. That is a perverse outcome worth avoiding.

1. Re-regulating the Residual Claims?

It has struck many as surprising that insider trading laws might apply differently to one bankruptcy claim than another.[134] There is a straightforward argument for harmonization, whether to level up regulation of all non-securities bankruptcy claims (vesting all bankruptcy claims with federal insider trading restrictions and protections) or level down all securities bankruptcy claims (stripping them of their insider trading law in deference to the bankruptcy process).

Such a proposal faces obvious problems: how does one handle the cliff effect, by which non-securities flip into securities regulation? How does one impose just the ex post liability for non-compliance with the securities regimes' numerous requirements if the instruments were created without regard to those requirements?

At root, harmonization implicates the more general questions of whether and why we allow similar instruments to be traded alongside one another subject to different regulatory regimes. Elizabeth De Fontenay has studied parallel instruments, one less regulated than the other, at solvent firms.[135] Her normative conclusion is that we ought to let them both survive, if only for scientific purposes: studying how two economically identical markets operate in the face of different laws allows us to understand our laws better.[136]

134. Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 47 (1990) ("Why should trade creditors be treated any differently than debenture holders?").

135. *See* Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725 (2014).

136. *See* Verstein, *supra* note 10, at 494–99.

Even if we are not interested in learning about the properties of securities laws by way of the bankruptcy laboratory, there probably remains a different epistemic justification for the continued existence of unregulated claims alongside regulated ones. That is the informational value gleaned from asset trading to benefit the bankruptcy decision makers. If it is indeed true that unregulated insider trading improves the price accuracy of the traded instruments, then unregulated fulcrum debt should be a vital barometer for the parties and the court – shutting down that channel of information in the name of harmonization alone would be premature. At the same time, the continued existence of a regulated channel would mean that creditors who do not want to swim with sharks could hold or trade regulated instruments that are protected by insider trading laws. The market could segment, with insider trading laws protecting the small fry and allowing rough play for sophisticated traders in non-securities claims.

If anything, the problem with a disharmonious regime concerns initial endowment. Securities laws protect sophisticated bondholders, rather than unsophisticated trade creditors and tort victims. Perhaps a grace period allowing holders of non-securities to swap them for the securities claims early in the process would set the table straight as to fairness so that the experiment can then go on.

Similar arguments apply to imposing Rule 14e-3's tender offer rules to tender offers for fulcrum securities. However, one additional reason would seem to caution against application of Rule 14e-3 to non-securities claims: differential risk and reward. One rationale in favor of Rule 14e-3 is to constrain the apparent gross unfairness of those close to an offeror making a gigantic risk-free profit in anticipation of a tender offer. Trading in front of equity tender frequently delivers stupefying windfalls to insiders. The same cannot be said with confidence for debt. I do not know of reliable evidence about the tender offer or control premium expected by sellers of tort or trade credit. It may or may not be as staggering as for equity shares. Either way, it is hardly a risk-free trade. Every moment of bankruptcy is precarious, and claims trading never presents a free lunch.

Rule 16(b) penalizes short swing trading by statutory insiders as to equity but not as to residual claimant debt. Insofar as Rule 16(b) serves an important prophylactic function—stopping trades that are manipulative or informed but would be hard to prove as such, as well as manipulative conduct—extending its reach to the volatile fulcrum claims would seem appropriate.

However, there are reasons for caution here. First, Rule 16(b) is not popular among securities scholars who consider it a rough tool.

Second, the manipulative potential for large debt holders of insolvent firms is smaller than for large equity holders of solvent firms. A 51% owner of a solvent company's equity controls a firm almost completely. A 51% owner of a company's fulcrum class of debt holds a blocking position and no more: she cannot fire the management, as controlling shareholders can. She also holds just one blocking position among many. Thus, the special risk of abusive conduct by a powerful equity investor seems greater than the potential for abuse by the residual claimant in an insolvent firm.

Also, the limited duration of bankruptcy proceedings effectively converts a six-month trading constraint into a ban on trading altogether for most bankruptcies. A trader who bought into a bankruptcy would have no interest in tendering to a coalition-building bidder until half a year went by. Perhaps trading restrictions are warranted, but it would seem both premature and incomplete to resolve that debate by harmonizing Rule 16(b) to cover any fulcrum securities.

2. Protecting the Creditors' Committee?

A creditors' committee (and its participant creditors) is an institution without analog in solvent firms. In solvent firms, some individuals are naturally informed while others are not. The naturally informed individuals, such as executives, are tempted to trade or to share information with uninformed individuals. The purpose of insider trading law is to restrict some of the trading and sharing by informed individuals. It is only in an attenuated manner that solvent companies experience two-way information flows, and so insider trading law does not directly threaten the inflow of information necessary to operate the business.[137]

Creditors' committees present a quite different context. Members of the creditors' committee learn valuable information from their fellows and from the debtor, but they also share valuable information. They know their private willingness to settle, their subjective valuation of certain assets, their sense of market conditions. They know information generated, one way or another, to benefit their trading division. They also know things learned by having a trading division, such as the appetite for certain types of claims. A law that restricts information sharing both from *and to* the issuer comes at a higher comes at a high price.

There is reason to believe that insider trading restrictions tend to discourage creditors from joining committees or participating openly:

> investment funds, acting prudently and naturally wanting to limit or reduce the perceived incremental risks associated with obtaining material non-public information in plan negotiations, may decide not to engage in such discussions at all, may choose to do so only through retained professional firms acting as intermediaries, or may adopt a layered approach to managing risk that includes information barriers, short term voluntary restrictions on trading set forth in heavily negotiated non-disclosure agreements that call

137. Henry Manne argues that stock price is an important indicator for managers. Thus, they stand to both share and learn information with free insider trading laws, and restrictions choke off both channels. Henry Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167 (2005).

> for the public disclosure of information at the conclusion of the trading restrictions and even comfort orders issued by the bankruptcy court. What funds are most reluctant to do is to restrict their ability to trade for extended periods of time or to assume any open-ended risks of potential claims based on their own conduct or the inferences to be drawn from that conduct.[138]

Insider trading restricts the sharing and use of information, but this is not altogether good when it comes to creditor committees. Therefore, there is a higher cost to insider trading restrictions in insolvent firms than in solvent firms. Liquidity restrictions result in a two-way reduction in information sharing. This informational dynamic urges caution before aggressive enforcement against trading by committee members.

Yet, aggressive trading by committee members may also undermine trust and information sharing and cause additional problems. Perhaps the most we can say is that the context-specific features of insider trading policy apply even more contextually in insolvent firms. The justifications for uniformity are weaker here than in solvent firms. If ever it were useful to customize insider trading law to the particular firm, it would be for insolvent firms.

In fact, the desire for customization is already emerging in an incomplete way: judicial comfort orders are party-specific declarations about trading rights. Judges have found that these are an important and practical way to increase creditor participation in the bankruptcy process. It has proven feasible to implement these for insolvent companies because there is a government actor, the judge, providing oversight of the process in a way that normal public companies lack.

It is too early to determine whether comfort orders are an enduring and helpful feature of our bankruptcy environment, but there is reason for optimism. In the future, it may be appropriate to expand the reach and power of comfort orders. Right now, bankruptcy judges are unable to fully protect creditors from the reach of insider trading law. Perhaps a federal statutory amendment should vest bankruptcy judges with that power. Perhaps exemptions should be available subject to certification by a federal district court judge or the SEC.

If that experiment is successful, limited experiments with ad hoc insider trading rules at solvent public companies could be considered. Recently, the SEC has taken to trying sample pools for regulatory changes. It might be possible to test out theories—does insider trading law lead to bad incentives? Does it improve price accuracy—with a small set of firms deemed worthy of a temporary comfort letter authorizing a try? Personalization processes from bankruptcy law could be used to teach us more about the law of solvent firms.

138. Peck, *supra* note 112, at 67.

CONCLUSION

The market for corporate control is one of the most important and discussed topics in the corporate law literature. It is fitting that it has finally received ample application to the special context of insolvent companies. Control is exercised differently in bankrupt firms, and "the market" works differently in terms of its trading patterns and laws. Insider trading laws are one important set of laws bearing on liquidity, so it makes sense to take careful stock of their application in bankruptcy.

Our securities statutes (and interpreting rules and cases) do not formally distinguish between solvent and insolvent firms. Nevertheless, insider trading laws undergo meaningful translation in the bankruptcy context. The main restrictions targeting insider trading apply to the residual claimants of solvent firms, but they provide only spotty coverage in insolvent firms. The restrictions that remain may realign their coverage (including more debt than ever) and cover new actors (such as creditors).

These changes follow from existing doctrine and matter-of-fact observations about the process of bankruptcy and economics of insolvency, but they deserve normative evaluation in light of the policies undergirding insider trading law. A preliminary look at these policies suggests a tentative endorsement of the status quo, with the caveat that new restrictions on creditors come at a price. Over the last seven years, courts have experimented with strategies for alleviating perceived insider trading risks for these creditors on a case-by-case basis. In doing so, they have been sensitive to the cost of imposing new duties by way of a new rule. The courts have also taken the first step in a regulatory experiment. To ask whether insider trading law should operate differently in insolvency is to distinguish among firms. Courts are making finer distinctions, deciding that particular debtor-creditor relationships deserve looser insider trading rules than others. At the point that such distinctions are made, it sets the imagination toward other potential distinctions, say among solvent firms too. And so, a meditation in the bankruptcy context sets a course toward the possibility of non-uniform and experimental application of insider trading law in the solvent world as well.