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THE COSTS OF LIQUIDITY ENHANCEMENT: TRANSPARENCY COST, RISK ALTERATION, AND COORDINATION PROBLEMS

Edward J. Janger*

Markets breathe liquidity like fire breathes air. In the 1980s, when I was in law school, Richard Helmholz would describe the history of property law as a long, gradual, but largely successful, assault on alienation restrictions. Helmholz's statement was an exaggeration. Inalienability rules still exist, notwithstanding the University of Chicago Law School's attempt to abolish them.¹ Nonetheless, his statement reflects a widespread understanding about business law. Commercial law should facilitate the movement of property in commerce.² At least as an initial matter, there is no reason to except bankruptcy law from this general proposition, and current bankruptcy law does not prohibit or even regulate (in any systematic way) the trading of claims against the debtor while the case is pending.³

Liquidity enhancement through negotiability is a key device for facilitating the trading of debt. Douglas Baird (again back in the 1980s), in his course on commercial paper, referred, over and over again, to the "holder in due course"⁴ as being "the most exalted status in all of Anglo-American law."⁵ In this regard, the holder-in-due course doctrine for negotiable instruments is one of a species of purchaser protections that exist throughout commercial law—other examples include the buyer in the ordinary course of business⁶ and the good faith purchaser⁷—that allow a seller, even a wrongful one, to transfer better title to a purchaser than they have themselves.⁸ The purpose is to enhance the liquidity of, and hence

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1. For a discussion of inalienability rules in property law, see Susan Rose Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931 (1985).

2. Richard A. Epstein, *Why Restrain Alienation?*, 85 COLUM. L. REV. 970, 971 (1985) ("As a first approximation it appears that any restraint upon the power of an owner to alienate his own property should be regarded as impermissible.").

3. Indeed, in 1991, Rule 3001(e) was amended to eliminate the role of bankruptcy courts in determining whether a transfer of a claim was "unconditional" (a sale) or "conditional" (a security interest). FED. R. BANKR. P. 3001(e), advisory committee's note ("Subdivision (e) is amended to limit the court's role to the adjudication of disputes regarding the transfers of claims.").

4. U.C.C. § 3-302 (2002).

5. See Albert J. Rosenthal, *Negotiability—Who Needs it?*, 71 COLUM. L. REV. 375, 377 (1971); see also *Miller v. Race*, (1758) 97 Eng. Rep. 398 (K.B.).

6. U.C.C. § 1-201(9) (2001); U.C.C. § 9-320 (2008).

7. U.C.C. § 2-403 (2003).

8. See discussion *infra* Part II.

create a market for, a particular type of asset.⁹ Often overlooked, however, when such liquidity enhancing doctrines are created, is that, historically, there has been a quid pro quo for their protection (good faith); these doctrines have been created sparingly; and they have been narrowly tailored to facilitate particular types of transactions. These limitations exist because liquidity enhancement has costs, both to the transacting parties, and, seemingly paradoxically, to the market itself.

As modern techniques for enhancing liquidity have developed, this insight has been ignored. Little attention has been paid to these costs, either before or after a debtor files for bankruptcy. This Article takes a skeptical look at liquidity enhancement, seeking to catalogue the direct (transactional) and indirect (social) costs of enhancing liquidity, and then questioning certain assumptions about the justification for facilitating the post-petition trading of claims in bankruptcy. In Part I, I will describe the traditional doctrines used to enhance the liquidity of otherwise illiquid assets, and detail the modern transactional devices that are used to similar effect on new categories of assets, regardless of whether the traditional prerequisites for liquidity enhancement are met. In Part II, I will catalogue the various transparency, and other costs, associated with liquidity enhancement generally, and the novel liquidity enhancement devices in particular. Part III will describe a number of contexts in bankruptcy where courts have been faced with a tension between liquidity enhancement and bankruptcy policies. In most of these cases, liquidity policies have won out over bankruptcy policies. I will conclude by arguing that the debate about post-bankruptcy claims trading operates from the wrong baseline. Regulation of claims trading is generally treated as liquidity harming, but actually, allowing any claims trading post-bankruptcy should be viewed as a liquidity enhancement doctrine, and its desirability as policy should be weighed against its effects on reorganization policy. In my view, bankruptcy policy and the market will be better served by close attention to the traditional limits on liquidity enhancement than by a mindless solicitude for debt markets.

9. *Miller*, 97 Eng. Rep. at 401. Lord Mansfield is quite clear on this point, basing the holder in due course doctrine on the fact that bank notes function as money substitutes:

Now they are not goods, not securities, nor documents for debts, nor are so esteemed: but are treated as money, as cash, in the ordinary course and transaction of business, by the general consent of mankind; which gives them the credit and currency of money, to all intents and purposes. They are as much money, as guineas themselves are; or any other current coin, that is used in common payments, as money or cash.

Id.

I. LIQUIDITY ENHANCEMENT

A. OLD SCHOOL – THE HOLDER IN DUE COURSE AND THE GOOD FAITH PURCHASER

The law of personal property sales and the law of negotiable instruments each take markets seriously. Each body of law is designed to facilitate the transfer of ownership. Sales law facilitates the flow of goods in commerce.¹⁰ The law of negotiable instruments facilitates the movement through the financial system of paperized debt obligations.¹¹ In each case, to receive purchaser protection, the transaction must fall into a category where enhanced liquidity is necessary for a trading pattern to function, and in addition, the purchaser must be innocent of any knowledge that he is purchasing from a thief or notice of defenses on the underlying transaction.¹² The scope of the legal subsidy is limited, and the law takes steps to minimize secondary costs.

One classic example of liquidity enhancement is the doctrine of entrustment under UCC § 2-403.¹³ Under that section, a person who entrusts goods to someone who is a seller of goods of the kind gives that seller the power, though not the right, to transfer good title to a person who is a buyer in the ordinary course of business.¹⁴ The logic here is that goods markets will not function properly if, every time someone walks into a jewelry store or antique dealer, they have to establish that their seller has clear title to the goods.¹⁵ Under § 2-403, it is enough that the purchaser walks into the jewelry store and purchases a watch out of the display case to give them good title.¹⁶ This is true even if the jeweler was only in possession of the watch because the original owner had brought it in for a repair.¹⁷

A second classic example of liquidity enhancement is the holder in due course doctrine.¹⁸ To become a holder in due course, one must have purchased a negotiable instrument¹⁹ in good faith,²⁰ for value,²¹ without notice of any defenses to enforcement of the instrument,²² and the purchaser must have taken possession through a valid negotiation.²³ If one satisfies

10. *See generally*, U.C.C. art. 2 (2003).

11. *See generally*, U.C.C. arts. 3–4 (2002).

12. U.C.C. § 1-201(20) (2001).

13. U.C.C. § 2-403 (2003).

14. *Id.*

15. *Id.* cmt 1–4.

16. § 2-403.

17. *Id.*

18. U.C.C. § 3-302 (2002).

19. U.C.C. § 3-104 (2002).

20. U.C.C. § 1-201(20) (2001).

21. U.C.C. § 3-303 (2002).

22. U.C.C. § 3-302(2) (2002).

23. U.C.C. § 3-301 (2002).

these requirements the effect is powerful and surprising. A negotiable instrument is nothing more than a paperized debt obligation. The maker/issuer of a promissory note promises to pay the note according to its terms to a person entitled to enforce the note.²⁴ The drawer/issuer of a check or draft instructs a third party to make payment on the instrument, and promises to pay the item according to its terms if it is dishonored.²⁵ Up to this point, negotiable instrument law has merely made contractual obligations assignable. It has not altered the content of those rights. The holder of the instrument has no greater rights than the original payee or their transferor. The holder in due course doctrine, however, goes further. It gives a person who purchases the instrument for value and without notice of any competing claims against the instrument, or defenses on the underlying obligation, the right to enforce the note regardless of whether the obligor had valid defenses that could have been asserted against the original payee.²⁶ Moreover, the holder in due course "owns" the instrument free of any claims from competing owners.²⁷

In both of these cases, the class of transactions subject to liquidity enhancement is limited, and the procedures are well established.²⁸ There are a number of reasons for these formal limitations. The first is the need to ensure that the transaction falls into the category of transactions where liquidity enhancement is beneficial.²⁹ The second is based in notice (both to the issuer and to third parties). Liquidity enhancement often has the effect of defeating the reasonable expectations of at least one of the parties to the transaction and may confer a windfall on another.³⁰ The maker/issuer of a negotiable promissory note may be surprised to find out that even if he or she has a valid defense on the transaction, she must pay a holder in due course on the note. Similarly, the owner of the watch described above may find it hard to believe that the watch cannot be recovered after it has been purchased by a buyer in the ordinary course of business.

In each of these examples, the marketability of an asset is enhanced through a legally created doctrine that enhances the value of the asset in the hands of the transferee. In both cases, liquidity is enhanced by freeing the asset from the property claims of competing owners. In the case of a negotiable instrument, liquidity is further enhanced by depriving the obligor of any defenses it might have to enforcement. These remarkable doctrines

24. U.C.C. § 3-412 (2002).

25. U.C.C. § 3-414 (2002).

26. U.C.C. § 3-305(a), (b) (2002).

27. § 3-305.

28. U.C.C. § 2-403 (2003) (entrustment doctrine); U.C.C. § 3-302 (2002) (holder in due course doctrine).

29. See *supra* text accompanying note 9.

30. Official Comment 2 to 3-104 explains that preventing surprise due to freedom from defenses is one of the reasons that "words of negotiability" are a requirement for the applicability of Article 3, and hence of the holder in due course doctrine. U.C.C. § 3-104 cmt. 2 (2002).

of freedom from claims and freedom from defenses advantage the buyers and sellers of goods and negotiable instruments over the owners of goods and the issuers of negotiable instruments.

B. NEW SCHOOL – STRUCTURED FINANCE

Negotiability and good faith purchaser protections evolved in an era of limited liquidity and costly, imperfect communication.³¹ Modern capital markets and financial institutions, blessed with electronic communications, rating agencies, and credit scores, have become much more comfortable trading debt. One of the hallmarks of the new economy is the creation of new types of financial instruments that trade freely. Another aspect is the extent to which financial obligations are sliced, diced, repackaged, and repriced through the use of pooling, tranching, and hedging.³² Loan participations allow multiple institutions to share exposure to a single credit. Securitization has made it possible for interests in assets to be pooled and then repackaged as securities representing an interest in the pool.³³ Resecuritization of debt into collateralized debt obligations (CDOs) can take very risky underlying obligations and sell portions of them as ostensibly low risk debt instruments.

These new trading structures require liquidity enhancement as well, but the liquidity enhancements are not as obvious or understandable as the old style good faith purchaser protections, though they often accomplish—by design and sometimes by subterfuge—the same thing. For example, securitization deals are often said to require “asset isolation.”³⁴ The concept here is that the securitized assets must be divorced from any claims against the originator. The securitization structure must be “bankruptcy remote.”³⁵ Just like good faith purchaser protection, the securitized assets must be isolated from other potential claims.³⁶ In addition, in order to trade freely, some securitized obligations need to achieve a certain minimum credit rating.³⁷ In order to accomplish this, credit enhancements such as bond insurance or credit default swaps are built into the securitization structure,³⁸

31. See, e.g., JAMES STEVEN ROGERS, *THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES* 32–43 (J.H. Baker ed., 1995).

32. MARCIA STIGUM & ANTHONY CRESCENZI, *STIGUM’S MONEY MARKET* (4th ed. 2007).

33. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 145–46 (1994).

34. See *id.* at 135 (explaining the use of special purpose vehicles “to separate the receivables from risks associated with the originator”).

35. *Id.*

36. *Id.* at 135–36.

37. *Id.* at 136–37 (discussing the impact of debt securities ratings on investor behavior).

38. The role of AIG in issuing bond insurance and credit default swaps is now well understood. See Adam Davidson, *How AIG Fell Apart*, REUTERS, Sept. 18, 2008, <http://www.reuters.com/article/newsOne/idUSMAR85972720080918?sp=true>. One of the reasons that the Federal Reserve felt that it could not let AIG fail was that the evaporation of the credit default insurance policy would have constituted a default on many thousands of securitization facilities and would have

or tranching is used to give certain securities a distributional preference over others.³⁹ Like the “freedom from defenses” that accompanies holder in due course status, these credit enhancements free the purchaser of the asset from the need to worry about the soundness of the underlying obligation.

At least in the first instance, these financial products are creatures of contract, transferring or parceling out the ownership of a single claim or a pool of claims. The liquidity of large claims is enhanced by the ability to spread the risk among various investors, while the liquidity of small claims is enhanced by both the ability to spread risk among investors and the ability to pool the risk of various loans.

But, as it turns out, contract law is not enough. There is hydraulic pressure behind liquidity logic that has cascaded toward legal liquidity enhancement by *fait accompli*. Essential to the marketing of these repackaged interests in debt is the ability to obtain a legal opinion stating that the pooled assets are free from any claims that might be asserted by creditors of the issuer. As has been widely noted, certainty that the assets have been subject to a true sale has been hard to come by.⁴⁰ Indeed, the centrality of freedom from claims, and the need for credit enhancement, can be seen in legislative pressure exerted by the industry to pass statutes that would insulate securitizations, heavy with credit enhancement through recourse, from being recharacterized as loans under the doctrine of true sale.⁴¹ First, efforts were made to place a securitization safe harbor into the then pending bankruptcy reform bill. When that failed, more successful efforts resulted in the Asset Backed Securities Facilitation Act passed in Delaware, and similar statutes passed in several other jurisdictions.⁴²

C. NEW SCHOOL – CLAIMS TRADING AND CREDIT DERIVATIVES

Even without the benefit of securitization, or negotiability enhancement, claims against debtors in bankruptcy now trade freely. There are now money managers and hedge funds that focus on investing in distressed

triggered an even worse credit collapse. See Kevin G. Hall, *AIG Bailout: Questions and Answers*, MCCLATCHY-TRIB. NEWS SERVICE, Sept. 18, 2008, available at http://www.catholic.org/national/national_story.php?id=29443.

39. Andreas A. Jobst, *A Primer on Structured Finance*, 13 J. OF DERIVATIVES & HEDGE FUNDS 199, 205 (2007).

40. See, e.g., Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008).

41. See DEL. CODE ANN. tit. 6, §§ 2701A–2703A (2003); see also ALA. CODE § 35-10A-2(a)(1) (2003); LA. REV. STAT. ANN. § 10:9–10:9(e) (2003); N.C. GEN. STAT. § 53-425-26 (2004); OHIO REV. CODE ANN. § 1109.75 (West 2001); S.D. CODIFIED LAWS § 54-1-10 (2003); TEX. BUS. & COM. CODE ANN. § 9.109(e) (Vernon 2001).

42. Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759 (2004) [hereinafter Janger, *The Death of Secured Lending*]; Edward J. Janger, *Muddy Rules for Securitization Transactions*, 7 FORDHAM J. CORP. & FIN. 301 (2002) [hereinafter Janger, *Muddy Rules*]; see also sources cited *supra* note 41.

debt.⁴³ Some are merely seeking arbitrage, buying up trade claims at a discount. Others are engaged in more complicated strategies, perhaps hoping to play a role in plan negotiations, or even obtaining control of the reorganized debtor.⁴⁴ But again, once these new types of debt markets have developed, pressures have emerged for negotiability-like protections. One form of liquidity enhancement, again, is a product of contract. Credit default swaps have allowed claims traders to leverage or hedge the risk attributes of their investments, depending on their assessment of the debtor.⁴⁵

However, the same hydraulic pressure for legally protected liquidity enhancement exists here as well. As discussed below, those interested in enhancing the market for bankruptcy claims have argued forcefully against any bankruptcy court rulings that might threaten the liquidity of their claims, either by subjecting the claims to defenses, undercutting asset isolation, or requiring disclosure of a claim holder's economic position.⁴⁶ In short, even here, free alienability is not enough. Once a market for claims is created, the market itself generates pressure for liquidity enhancement.

Each of these types of liquidity has benefits, but liquidity itself, and liquidity enhancement even more so, come at some cost. It is with this question in mind that in the next section I will seek to catalogue the risks associated with extending liquidity enhancing protections to new transactions. My focus is on the costs, but I remain cognizant of the benefits associated with making debt more liquid.

II. THE COSTS OF LIQUIDITY ENHANCEMENT

In order to understand the costs of liquidity enhancement, it is necessary to understand the basic principles associated with creating liquid assets. Two hallmarks of liquid assets are (1) transferability and (2) readily ascertainable value. The paradigmatic liquid asset is the dollar bill. Ownership can be transferred simply by transferring possession. Value is ascertainable on the face of the instrument.

The attributes of liquidity are shared by a broad variety of assets; they are shared equally by a Snickers bar, a mobile home, and broccoli. Title can be transferred in a straightforward and well understood fashion, and the purchaser can tell, by examining the item itself, how much he or she is willing to pay. The point is a bit less obvious when talking about negotiable

43. Stuart C. Gilson, *Investing in Distressed Situations: A Market Survey*, FIN. ANALYSTS J., Nov.-Dec. 1995, at 8, 8.

44. For an example, see Louise Story, *Investors Stalk the Wounded of Wall Street*, N.Y. TIMES, Apr. 4, 2008, at A1, available at http://www.nytimes.com/2008/04/04/business/04vultures.html?_r=1.

45. See Stephen J. Lubben, *Credit Derivatives and the Resolution of Financial Distress*, in CREDIT DERIVATIVES HANDBOOK: GLOBAL PERSPECTIVES, INNOVATIONS, AND MARKET DRIVERS 47, 49-52 (Greg N. Gregoriou & Paul Ali eds., 2008) (explaining credit default swaps).

46. See discussion *infra* Part III.

instruments, but a promissory note or a check can be transferred in commerce just like a dollar bill. In both cases, however, liquidity enhancement through good faith purchaser protection serves an important purpose. The purchaser knows that he or she has good title and, with the holder in due course doctrine, the purchaser of a debt obligation also knows that they purchase the item free of any defenses that the obligor might be able to assert on the underlying obligation. Therefore, the purchaser need only worry about the creditworthiness of the obligor, not the rhyme or reason underlying the promise to pay.

The core doctrines of liquidity enhancement, freedom from claims and freedom from defenses, seek to enhance the value of a transferred asset by making title more certain and value more transparent. The results are sometimes shocking. A thief can transfer good title and an obligor may be forced to pay for goods and services that were never delivered or, in certain instances, which have already been paid for. As a consequence, these doctrines that facilitate negotiability have second order effects that are often overlooked.

The first set of costs of liquidity enhancement run to their effects on the issuer of an instrument.

A. TRANSPARENCY OF THE ISSUER/ORIGINATOR/SELLER

One effect of liquidity enhancement is that it may undercut the transparency of the issuer. Two examples illustrate this effect, one old school, the other new school:

- First, the holder in due course doctrine itself makes the affairs of an instrument's originator less obvious. Imagine a debtor who has entered into a contract to purchase a widget. Imagine that the widget cost \$100,000, and the purchaser bought on credit, by issuing a negotiable promissory note. Immediately after the transaction closed, the seller sold the promissory note to a holder in due course. The next day the widget malfunctioned and proved to be worthless. As between the buyer and the seller, the buyer could have repudiated the transaction and paid nothing. Even if the seller were insolvent, the buyer would have recourse through recoupment. However, where the seller has financed the transaction with a negotiable promissory note, he or she may still be liable for the full purchase price to a purchaser of the negotiable promissory note. This is a simple version of the transparency cost associated with liquidity enhancement. Investors in a firm may not be able to properly value the contingent liability associated with having issued negotiable instruments. While cash transactions similarly leave the buyer with only an action against the seller,

negotiable instruments accomplish this in a less obvious and less transparent way.

- Second, the further one moves from the core functions of negotiability, the greater these transparency costs become. While freedom from defenses on a check may be tolerably well understood, Enron provides an extreme example of the transparency costs of modern structured finance transactions.⁴⁷ When Enron used structured finance transactions to raise capital, it made various warranties as to the value of assets transferred to a securitization pool.⁴⁸ Such warranties are not particularly unusual. But the contingent liabilities they create may be (and in the case of Enron were) difficult to value and may not be (and in the case of Enron were not) apparent on a company's balance sheet. Enron was a radical illustration of this effect, and its failure to disclose the full extent of its liabilities rose to the level of fraud.⁴⁹ Nonetheless, this transparency reducing effect is present to a lesser degree in many entities with securitized assets.

B. RISK ALTERATION

Many firms choose to enhance the liquidity of their debt obligations by issuing asset backed securities, rather than borrowing against their assets.⁵⁰ The classic example is receivables-based financing. A company that chooses to securitize its receivables, instead of borrowing against them, may receive a lower interest rate, but will also significantly reduce the likelihood that it will be able to reorganize should it fall upon hard times. Encumbered assets (including cash collateral) may be used by the debtor during the reorganization. Securitized assets, it is argued, may not.⁵¹ Thus, the securitization of assets may harm the creditors of the originator by making their investment more risky than would a secured loan. This shifting of risk from one class of creditors to another is present any time a debtor offers one class of creditors a distribution preference over another. One response to this is that the remaining creditors can adjust their interest rates or prices to reflect this enhanced risk. But, as has been explored at length elsewhere, both secured credit and securitization allow the debtor and the secured lender or asset-backed securities (ABS) purchaser to externalize risk at the expense of nonconsensual and certain nonadjusting

47. BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 151, 155–57 (2003).

48. *Id.*

49. *Id.*

50. Janger, *Muddy Rules*, *supra* note 42.

51. See *In re LTV Steel Co.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001).

creditors.⁵² To the extent that ABS purchasers receive even better treatment in bankruptcy than secured lenders, the externality associated with risk alteration is even more problematic. In this context, the exigencies of liquidity enhancement (freedom from claims) run smack into the bankruptcy policy of allowing debtors to use encumbered assets during reorganization.⁵³ This, in turn, increases the risk faced by those employees, tort claimants, and other unsecured creditors who might benefit from a going concern reorganization.

C. DISTORTION OF MONITORING INCENTIVES

It is axiomatic that asset based lending causes creditors to focus their attention on monitoring the assets of a debtor instead of the debtor itself. This has been described as one of the beneficial effects of secured credit.⁵⁴ Lenders with particular monitoring advantages divide up the monitoring effort efficiently.⁵⁵ Some lenders might monitor receivables, others inventory, and yet others equipment, or real estate.⁵⁶ However, asset backed securitization takes this balkanization of the debtor to a new level in the interest of liquidity. Liquidity enhancement through asset isolation can distort monitoring incentives in two distinct ways: It can create conflicts of interest and it can render monitoring infeasible.

1. Conflict of Interest

Securitizations generally require assurance that the securitized assets have been legally separated from the bankruptcy risks of the debtor. This is done not for the purpose of creating a monitoring efficiency, but to relieve the asset purchasers of monitoring costs.⁵⁷ For example, in a securitization, bond insurance may divorce the credit risk of the instrument from the underlying asset. Worse yet, as some of the previous panelists suggested, the use of credit default swaps and other derivatives may make it possible

52. See Janger, *The Death of Secured Lending*, *supra* note 42; Janger, *Muddy Rules*, *supra* note 42; see also Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147 (1998). Note, some creditors who cannot adjust their interest rate after entering into a credit relationship can factor this into their price. Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 880-92 (1996). Suppliers and fixed rate lenders fall into this category. See *id.* Other non-adjusting creditors are not so lucky. Employees, for example, generally do not factor their employer's creditworthiness, or future creditworthiness, into their wage demands. *Id.* at 884.

53. 11 U.S.C. § 363 (2006).

54. Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

55. *Id.* at 932.

56. *Id.*

57. See generally STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (Adam D. Ford ed., 3rd ed. 2002).

for investors to hedge out all of their risk, or even “short” the debtor.⁵⁸ Thus, capital markets investors may not care about monitoring the underlying investment or, if they do, they may not care in a way that is efficiency enhancing. The importance of this conflict of interest is brought out more starkly in bankruptcy, where debt claims carry with them governance rights.

2. Infeasibility – Transparency of the Investment

At a certain point, however, these liquidity enhancements can go off the deep end. Resecuritization of a debt obligation into a CDO may make it impossible to discern the nature of the original asset. The structure of many mortgage backed securities is such that some of the assets held by the securitization vehicle may be derived from a pool of mortgages, but other assets may be buckets of other mortgage backed and/or synthetic securities, created through the matching of various swaps.⁵⁹ When this is the case, none of the actual investors in a mortgage backed security, for example, will be in a position to monitor either the underlying assets or the servicer who is charged with maximizing the asset’s value. Instead, the sole monitoring responsibility will fall to the originator, who in the case of a structured finance vehicle will be the “debtor/originator,” and in the case of mortgage backed securities, will likely be the “mortgage broker/originator.”⁶⁰ In either case, the originator/servicer’s incentives may be quite different from those of the investors. For instance, in the case of mortgage backed securities, the originator/servicer may not have a real economic interest in the mortgage pool but may stand to make more money charging fees for foreclosing on the asset than by restructuring.⁶¹ In the case of a structured finance vehicle, the investors may be subject to the same agency problems as appear in the context of public equity securities.⁶² Disbursed ownership leaves individual owners of shares with little incentive to monitor. Similarly, disbursed ownership of an investment vehicle may lead to suboptimal monitoring.

D. AGENCY COSTS – “EMPTY VOTING” IN BANKRUPTCY

As noted above, the credit enhancement conferred legally by freedom from claims and freedom from defenses, and conferred contractually through credit default swaps and other credit enhancements, may distort

58. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1034 (2007).

59. See SCHWARCZ, *supra* note 57.

60. See Scott, *supra* note 54, at 918.

61. Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Loans*, N.Y. TIMES, July 29, 2009, at A1, available at <http://www.nytimes.com/2009/07/30/business/30services.html>.

62. See generally Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775 (2005) (explaining that one share, one vote, does not make sense where hedging has separated the investor’s voting interest from his or her economic interest in the company).

monitoring incentives. But, the problem runs deeper than that in bankruptcy. In a reorganization case, debt claimants have governance rights.⁶³ During the case, they have the power to object to non-ordinary course borrowing decisions, to non-ordinary course asset sales, to seek dismissal or conversion, and, more importantly, to vote on the plan of reorganization.⁶⁴ When the holder of governance rights has a conflict of interest, the result is a principal/agent problem.

When a claim is repackaged and enhanced through the use of a credit default swap or other hedge, the voting rights may be divorced from the economic interest associated with the claim. In nonbankruptcy securities markets, derivatives trading may lead to the so-called “empty voting” problem, where a single investor may hold both an equity (stock) interest in a company and a short position against the same company.⁶⁵ This hedge reduces the shareholder’s economic stake in the company. To make matters worse, the same shareholder may decide to “go short” by purchasing a greater amount of “insurance” than they hold stock. If they do this, the shareholder may actually benefit from a drop in the company’s shares value. They may, therefore, vote their shares against the company’s interest.⁶⁶

This same “empty voting” problem now occurs in bankruptcy with debt claims. Holders of one class of debt may not share the same economic interest as other members of that class because they have hedged their claim. Thus, even these contractual liquidity enhancements can have considerable costs.

E. ANTICOMMONS PROBLEMS

Liquidity enhancement allows debtors to carve their debt obligations up into smaller and smaller chunks. It also allows creditors who may have a large exposure to a particular debtor to spread their risk to multiple investors. While liquidity may reduce the cost of capital, it can considerably increase the costs of constructing a consensual restructuring of the debtor’s obligations. A debtor with one creditor may be able to negotiate a sensible restructuring, whereas a debtor with multiple creditors may be faced with coordination and holdout problems that lead to inefficient liquidation. While this is the classic justification for a reorganization statute, it was not fully appreciated until recently that carving up the capital structure of a debtor into small pieces through the use of structured finance and

63. 11 U.S.C. § 1126 (2006).

64. 11 U.S.C. §§ 363(b), 364, 1112, 1129 (2006).

65. Partnoy & Skeel, *supra* note 58, at 1034–35; Martin & Partnoy, *supra* note 62, at 778–79.

66. Recently, there has been speculation in the press that Chrysler bondholders may have refused to cooperate in the proposed out of court restructuring, at least in part, because they held credit default swaps issued by AIG. Ryan Grim, *Confirmed: Barofsky Investigating Chrysler Bondholders*, HUFFINGTON POST, May 6, 2009, http://www.huffingtonpost.com/2009/05/06/confirmed-barofsky-invest_n_197974.html.

derivatives might create these problems as well.⁶⁷ Worse yet, as discussed in Part III, this fragmentation, along with post-bankruptcy claims trading, may undercut the ability of debtors to cobble together a confirmable plan of reorganization.

F. ENDOGENEITY

A key assumption in the issuance of ABS is that the purchaser need only look to the credit attributes of the purchased assets and not to the creditworthiness of the originator.⁶⁸ A further assumption here is that the securitization of assets will not affect the value of the assets themselves, other than to make them more efficient forms of collateral.⁶⁹ This same assumption is true of claims trading generally: the creation of a market for claims will not have a negative impact on the obligor. This assumption has proven false in a number of contexts. The “empty voting” problem described above is one example.⁷⁰ Another current example, that applies to other forms of securitization as well, is that the slicing and dicing of investor interests in the underlying assets may affect the value of the assets themselves in two distinct ways. The anticommons problems, mentioned above, may make it harder to maximize the value of those assets, should there be a default on the underlying obligation.⁷¹ One aspect of the current foreclosure crisis is that mortgages have become harder to restructure because the servicer of the mortgages cannot, as a practical matter, obtain consent to the restructuring from all of the investors with an interest in the mortgage.⁷² As a result, foreclosures may be happening in instances where the way to maximize the value of a mortgage might be to restructure. Mortgages are just one particularly salient example of how too much liquidity may actually impair the value of assets.

But even these examples may be too narrowly focused because they focus only on the particular assets and the particular debtor/originator. The negative effects of too much liquidity enhancement can affect the risk attributes of the broader market as well. *Liquidity enhancement is not always market perfecting*. This second aspect of liquidity enhancement has been remarked on in connection with the current mortgage meltdown. To the extent that a pool of assets is tied to one market, the development of a new financing device can affect the value of the assets themselves. As

67. Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1197 (1999). Fragmentation of assets creates problems in other bankruptcy contexts as well. See Edward J. Janger, *Privacy Property, Information Costs, and the Anticommons*, 54 HASTINGS L.J. 899, 921–22 (2003).

68. See SCHWARCZ, *supra* note 57.

69. See Michael Lewis, *The End*, PORTFOLIO.COM, Nov. 11, 2008, <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom/>.

70. *Id.*

71. *Id.*

72. *Id.*

money poured into U.S. mortgage markets, it had an inflationary effect on the value of homes.⁷³ These home values then formed the basis of mortgages underwritten in the prime market as well.⁷⁴ As a result, problems in the subprime market exposed even prime mortgages to risk associated with deflation of the housing bubble.

Each of the “costs” of liquidity enhancement described above can be expected to have market wide effects in varying degrees. The insight here, though, is that these effects may not always be positive. Liquidity is value creating. However, liquidity enhancement is, at bottom, distributive. We are willing to harm originators, issuers, debtors, and creditors of debtors at the behest of purchasers in the interest of liquidity. Therefore, the question of “optimizing” the amount of liquidity enhancement is not a simple exercise.

G. CONCLUSIONS – THE “NUMERUS CLAUSES,” THIRD PARTIES, AND THE ABSENCE OF VERIFICATION INSTITUTIONS

It should be noted that some of the costs associated with liquidity enhancement are imposed on the debtor and its other creditors. Transparency and risk alteration fall into this category. In both of these cases, the owners of the debtor, and the owners of the liquidity enhanced investment benefit from liquidity enhancement at the expense of the debtor’s other creditors. Other costs of liquidity enhancement actually undercut the value of the liquidity enhanced investment itself. Most of the costs described above fall into this category. Agency, anticommons, and endogeneity costs are all exacerbated by the very institutions that are used to enhance liquidity. It is this tradeoff that is generally unrecognized and that has led to many of the difficulties in the current economic downturn.

To put it a different way, the costs of liquidity are all “third party” costs, but the two families of costs impose harm on two distinct sets of third parties. Transparency and risk alteration allow the debtor and liquidity enhanced creditors to externalize costs to the debtor’s other creditors. Agency, anticommons, and endogeneity, by contrast, impose costs on liquidity enhanced creditors (the capital market investors) themselves. This last set of costs is well understood by property theorists but not by market participants or policy makers. Creating new and complex forms of property has costs. Civil law countries recognize this through the “numerus clauses” – an affirmative limit on the number of forms that property interests may take.⁷⁵ Henry Smith and Thomas Merrill have argued forcefully that creation of novel forms of property can have considerable third party costs

73. *Id.* (providing an excellent description of the perfect storm that led to the current mortgage meltdown).

74. *Id.*

75. Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1, 24 (2000) (discussing restraints on alienation in the number of forms property interests may take).

because of the inability of third parties to understand the attributes of an ownership interest.⁷⁶ Henry Hansmann and Reinier Kraakman have responded to Smith and Merrill by arguing that the content of a property right need not be regulated, so long as an institution exists that enables third parties to verify who controls the various incidents of ownership.⁷⁷ But even they would balk at securitization, credit derivatives, and free-for-all claims trading.⁷⁸ These ownership transactions all serve to obscure the nature and location of ownership in ways that even the most ardent fans of free alienability should concede justify regulation. Again, it is this last set of costs that has been underappreciated in the ongoing policy debates.

III. WHEN LIQUIDITY AND REORGANIZATION POLICY COLLIDE

Notwithstanding these costs, the rhetoric of bankruptcy claims trading has treated liquidity as an unalloyed good, worthy of protection and enhancement. Bankruptcy claims trading, it is argued, facilitates restructuring, because claims purchasers who purchase claims at a discount may be more willing to accept a reduced distribution under the plan. Specialized investors may be able to realize value where others might not. Allowing claims trading after bankruptcy will increase the liquidity of a distressed debtor prior to bankruptcy because traders know that they will still be able to sell the debt after bankruptcy. These are all valid points. But, in a number of cases where a conflict has arisen between bankruptcy policies and liquidity enhancement, liquidity has won.

A. RULE 2019

A first example lies in the recent set of attacks on Federal Rule of Bankruptcy Procedure 2019.⁷⁹ Rule 2019 requires members of unofficial or ad hoc committees to disclose their holdings in the debtor.⁸⁰ As Judge Gropper pointed out in the *Northwest* case, this is a disclosure rule.⁸¹ Because other creditors or interest holders may seek to free ride on the efforts of the Committee when deciding whether to support or oppose a plan of reorganization, Committee members are required to disclose their economic positions.⁸² This is not an accident. Indeed, it is part of the logic behind committees. Committee support of the plan of reorganization, it is

76. *Id.* at 24–42.

77. See Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerous Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373, 382–83, 398 (2002).

78. *Id.*

79. Fed. R. Bankr. P. 2019.

80. *Id.*

81. *In re Northwest Airlines Corp.*, 363 B.R. 701, 702–03 (Bankr. S.D.N.Y. 2007).

82. Sparkle Alexander, *The Rule 2019 Battle: When Hedge Funds Collide with the Bankruptcy Code*, 73 BROOK. L. REV. 1411, 1428 (2008).

hoped, will signal to the key constituencies that the plan is a good deal for similarly situated creditors.

This function is undercut when claimants who are not members of the Committee cannot discern the economic position of the members. However, it is quite possible that a member of an official or ad hoc committee may have purchased a claim at a discount, or even hedged out the risk associated with its investment. Paradoxically, the holder of a claim may even reverse its economic position through the use of hedging and other strategies, such that it might benefit from the debtor's failure to reorganize. Distressed debt investors, perhaps for this very reason, have objected vociferously to being forced to make this disclosure.⁸³ They have argued that to do so will either shut down claims trading or force traders to avoid becoming members of a committee.⁸⁴ Two courts have been convinced by this argument.⁸⁵ A Texas court in *In re Scotia Development, L.L.C.* held that the disruption to the bond market would be too great to require committee members to comply with Rule 2019.⁸⁶ By contrast, in *In re Kaiser Aluminum*, a Delaware case, committee members were required to disclose their positions but were allowed to do so under seal.⁸⁷ Finally, and uniquely, Judge Gropper, in the *Northwest* case required the committee members to actually disclose their positions.⁸⁸ The result was a firestorm, calling for repeal or amendment of the rule or reversal of the opinion.⁸⁹

The arguments against the application of Rule 2019 were various, but the theme was that if claims traders were required to disclose their positions, they would not be able to pursue their investment strategies, causing a reduction in the value of claims both inside and outside of bankruptcy.⁹⁰ Judge Gropper responded that, while this might be true, he was bound by the text of the rule.⁹¹ More importantly though, he pointed out that in a bankruptcy case, investors rely on committees to help them determine whether supporting a plan is in their best interests.⁹² Toward this end, they may rely on the position taken by a creditor who they believe is similarly situated.⁹³ Where a creditor has hedged their position or bought debt of a different type, and not disclosed that position, such reliance may be misplaced.

83. *Id.* at 1420–21.

84. *Id.* at 1440.

85. *Id.* at 1435, 1443.

86. Transcript of Record at 3–6, *In Re Scotia Development L.L.C.*, 58 Collier Bankr. Cas. 2d (MB) 823 (S.D. Tex. Sept. 21, 2007) (No. 07-20027).

87. *Kaiser Aluminum Corp. v. Future Asbestos Claim Representative (In re Kaiser Aluminum)*, 327 B.R. 554, 560 (Bankr. D. Del. 2005).

88. *In re Northwest Airlines Corp.*, 363 B.R. 701, 702–03 (Bankr. S.D.N.Y. 2007).

89. See Alexander, *supra* note 82, at 1421, 1424–27.

90. See *id.* at 1425, 1433, 1438–39.

91. *In re Northwest Airlines*, 363 B.R. at 704.

92. Alexander, *supra* note 82, at 1416.

93. *Id.* at 1441–42.

B. CREDIT DEFAULT SWAPS, CLASSIFICATION, AND VOTING

When a debtor is constructing a plan of reorganization, classification rules require that claimants cannot be classified together, unless their interests are substantially similar.⁹⁴ The use of credit default swaps and other default insurance to enhance the liquidity of claims against the debtor so that they can be sold may have the effect of distorting the classification schemes constructed by a debtor. A creditor who appears to hold an unsecured claim may, by virtue of purchasing insurance or a swap, actually have an entirely different economic interest from the other creditors holding similar claims.⁹⁵ Here, liquidity, or liquidity enhancement, can undercut the ability of a debtor to negotiate a confirmable plan with creditors.

C. BEYOND HOLDER IN DUE COURSE

Perhaps the most remarkable example of liquidity enhancement at the expense of reorganization policy is the Enron equitable subordination case.⁹⁶ Prior to Enron filing for bankruptcy, Citibank was heavily involved in putting together Enron's structured finance vehicles.⁹⁷ Many of these financings were later found to be fraudulent.⁹⁸ As a sponsor for these deals, Citibank ended up holding a substantial number of claims against Enron.⁹⁹ Citibank feared that its claims against Enron might be equitably subordinated, so it sold its Enron claims to other banks.¹⁰⁰ These banks knew that Enron had filed for bankruptcy, and they also knew of Citibank's subordination risk.¹⁰¹ Indeed, as part of the deal to purchase Citibank's Enron claims, the purchasers insisted that Citibank indemnify them against subordination risk.¹⁰²

Sure enough, when the issue was joined, Judge Gonzales subordinated Citibank's claims.¹⁰³ This then raised the question of whether the subordination of Citibank applied to the claims or whether the purchasers took free of the estate's "subordination" claim against Citibank.¹⁰⁴ Stripped to its bare essentials, the purchaser sought to be given the same treatment as a holder in due course. The bankruptcy court would have none of this and

94. 11 U.S.C. § 1122 (2006).

95. See *supra* text accompanying note 66.

96. See *Enron Corp. v. Springfield Assoc. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007), *vacating*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

97. *Id.* at 429.

98. *Id.* at 429.

99. *Id.* at 428.

100. *Id.* at 428–29.

101. *Id.*

102. *Id.*

103. *Id.* at 437.

104. *Id.* at 427–28.

concluded that the subordination of Citibank ran with the claim and extended to the purchasers.¹⁰⁵

The response of the bond marketing industry was swift and forceful. They argued that this opinion endangered the market for distressed debt.¹⁰⁶ If a bond purchaser had to worry that its claim might later be subordinated, this would undercut the liquidity of the corporation's debt not just after bankruptcy, but before. This fear of harming the liquidity of corporate debt caused the District Court for the Southern District of New York, on appeal, to reverse the bankruptcy court and hold that an assigned claim did not carry with it the assignor's subordination.¹⁰⁷

While there is no doubt that the purchasers of Citibank's Enron claims did not qualify as holders in due course, both because the claims were not negotiable instruments, and because the purchasers had notice of possible defenses, the court accorded them holder in due course-like treatment.¹⁰⁸ In short, the imperatives of claim liquidity trumped the bankruptcy policies associated with claim subordination.

CONCLUSION: CHAPTER 11 AS LIQUIDITY ENHANCEMENT

Two main points emerge from this discussion. First, doctrines that enhance liquidity may have costs. Information flows may be disrupted, incentives may be altered, and coordination problems may be created. Second, liquidity enhancement provides considerable benefits to the holders of liquidity enhanced debt. In seeking the benefits of liquidity, the costs of liquidity enhancement should not be overlooked. Traditionally, liquidity enhancement has been used with great care. Only certain sellers, whose exposure to market discipline make it unlikely that they will abuse the power, have the ability to transfer rights to a buyer in the ordinary course. Negotiable instruments law hems in the status of holder in due course with formal requirements that put parties on notice of what they are doing when they create such an instrument and require certain conditions of purchasers before according them special protection.

Modern advocates of liquidity appear to not care about the nature of the transaction or the holder of the claim. Neither do they consider the costs that might be incurred by granting protection. Indeed, whenever there is discussion of possibly curtailing the liquidity of claims after bankruptcy, the argument is that this effect would not be limited to the claims post-bankruptcy; it would also limit liquidity pre-bankruptcy.¹⁰⁹ This may be true, but it may not be relevant. On one level, Chapter 11 is a liquidity enhancing

105. *Id.* at 437.

106. *Id.* at 428.

107. *Id.* at 448–49.

108. *Id.* at 446.

109. Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 149–52 (2007).

device all by itself. In the absence of Chapter 11, claims trading would stop with the declaration of bankruptcy, or upon the liquidation of assets. Bankruptcy would be a realization event. The existence of Chapter 11 and post-bankruptcy trading are what prevents the filing of a petition itself from operating as a realization event. The claims continue to carry with them the value of a possible reorganization, and hence, increased value. To the extent that the possibility of a reorganization is actually liquidity enhancing, it stands to reason that liquidity regulation in the interest of bankruptcy reorganization would not result in a deprivation of some inherent value held by the owner of the claim. When considering liquidity enhancement, it is appropriate, and indeed essential, to consider the costs that such enhancement might have for a debtor seeking to reorganize.

