EMPTY MANIPULATION: BANKRUPTCY PROCEDURE RULE 2019 AND OWNERSHIP DISCLOSURE IN CHAPTER 11 CASES

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I. INTRODUCTION

Debtors, creditors, and equity holders in Chapter 11 proceedings are waging war with one another[1] over the application of Federal Rule of Bankruptcy Procedure 2019 ("Rule 2019").[2] Rule 2019 is the latest weapon in the

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[1] *See, e.g.*, Memorandum of Law of the Ad Hoc Committee of Equity Security Holders in Opposition to Debtors' Motion (I) For Civil Contempt, (II) For Protective Order, and (III) for Relief Concerning the Ad Hoc Equity Committee's Rule 2019 Statement, at 1, 3, *In re* Nw. Airlines Corp., Case No. 05-17930 (Bankr. S.D.N.Y. Feb. 13, 2007) (arguing that the debtor's motion for Rule 2019 disclosure is a "bully's tactic" and that the motion seeks to "attack, abuse, bully, and punish" the Ad Hoc Equity Security Holders Committee).

[2] Bankruptcy Rule 2019(a) provides, in relevant part:

> In a chapter 9 municipality or chapter 11 reorganization case, except with respect to a committee appointed pursuant to § 1102 or 1114 of the Code [official committees], every entity or committee representing more than one creditor or equity security holder . . . shall file a verified statement setting forth
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> > (1) the name and address of the creditor or equity security holder;
> > (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;
> > (3) . . . in the case of a committee, the name or names of the entity to entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and
> > (4) with reference to the time of . . . the organization or formation of the committee . . . the amounts of claims or interests owned by the entity, the members of the committee . . . the times when acquired, the amounts

arsenals of debtors facing increasingly aggressive distressed investors and traders who speculate in the debt and equity of bankrupt companies. Bankruptcy judges and scholars have begun to recognize the ability of distressed investors to greatly influence the reorganization process while reducing or eliminating their economic risk.[3] All parties risk confusion, delay, and waste if a consistent and rule-based disclosure scheme is not developed.

Bankruptcy Procedure Rule 3001(e)(2), which allows for the relatively free trading of bankruptcy claims, leaves open a regulatory gap because it does not effectively mandate any disclosure regarding the details of an investor's claims or interests.[4] The securities laws, specifically the ownership disclosure scheme that requires disclosure of large holders' interests, have not been applied to bankruptcy claims.[5] In a decision that rattled the distressed investor community, the bankruptcy court in the *Northwest Airlines* case mandated, under Rule 2019, that an ad hoc committee of hedge funds disclose the specific prices paid for their claims and interests, as well as the dates on which they were acquired.[6] Potential conflicts of interest inside bankruptcy reflect the same types of conflicts as "empty voting" does outside of bankruptcy.[7] Distressed investors can separate voting rights from economic ownership in bankruptcy, and can use a widening array of financial instruments to accomplish idiosyncratic investment strategies.[8] Claim or interest holders with a significant number or percentage of holdings have the best

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> paid therefor, and any sales or other disposition thereof.

Fed. R. Bankr. P. 2019(a) (2007).

[3] *See infra* Part II.

[4] *See infra* Part III.E.

[5] *See* Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 571 (2002) (concluding that, generally, the securities laws have not been applied to bankruptcy claims).

[6] *See infra* Part II.F.

[7] *See infra* Part II.C.

[8] *See infra* Part II.

opportunity to frustrate the fundamental Chapter 11 policies of rehabilitation of debtors and maximization of going-concern value.[9]

The Court in *Northwest* recognized the broader issue: hedge funds and distressed investors have the potential to manipulate and frustrate the Chapter 11 process through hedging and arbitrage strategies that reduce or eliminate economic risk.[10] However, an adequate solution providing for ownership disclosure in bankruptcy has not been developed or proposed. An ad hoc application of the current Rule 2019 has led to unreliable results and left open the potential for abuse in Chapter 11 cases, particularly in the context of the confirmation vote.[11] A uniform, rule-based disclosure regime should be adopted in the Bankruptcy Code in order to better reflect the modern financial landscape.

This Note explores the issue of investor disclosure of bankruptcy claims and interests ("ownership disclosure").[12] Part II outlines the current state of bankruptcy claims trading and the potential for abuse when distressed investors hedge away their economic risk while retaining the right to vote for a debtor's reorganization plan as well as other rights in bankruptcy. Part III reviews the solutions that have been proposed or developed to increase disclosure in bankruptcy or otherwise address "empty manipulation" schemes.[13] This Note concludes that potential conflicts of

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[9] A firm has going-concern value when it is worth more in operation than in liquidation. *See* BLACK'S LAW DICTIONARY 712 (8th ed. 2004) (defining a going concern as "[a] commercial enterprise actively engaging in business with the expectation of indefinite continuance.").

[10] *See infra* Part II.F.

[11] *See infra* Part II.

[12] Neither creditors nor equity holders technically "own" a firm in Chapter 11 because disposition of the case will determine the firm's new owners. For the sake of consistency, "ownership disclosure" is used throughout this Note in reference to both claims (debt) and interests (equity) held by investors in bankruptcy cases.

[13] The term "empty manipulation" is used throughout this Note in order to simplify the analogy to "empty voting." *See infra* Part II.C. Outside bankruptcy, an investor may separate voting rights from economic ownership using a variety of strategies including short sales and

interest resulting from the separation of control rights and economic rights in bankruptcy warrants a new, broad ownership disclosure rule for Chapter 11 cases. Part IV proposes that the Bankruptcy Code adopt a mandatory ownership disclosure rule that would require investors to reveal economic incentives that may frustrate a debtor's reorganization.

II. CLAIMS AND CONFLICTS

A. Bankruptcy Claims Trading[14] and the New Chapter 11

In the bankruptcy cases of large public companies, participation of distressed investors, often disparagingly called "vulture investors,"[15] including hedge funds, has dramatically increased since the early 1990s.[16] Distressed investors often act as secondary lenders or equity holders by either purchasing debt on the secondary trading market, taking it off the hands of primary lenders such as large banks, or by purchasing shares in a bankrupt company.[17] Commentators have characterized the motivations of distressed investors as falling into one of two modes: passive

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derivatives. Empty voting can occur when voting rights exceed an investor's economic risk. An investor in bankruptcy can utilize the same strategies to separate voting and other rights in bankruptcy from economic ownership. Empty manipulation can occur when the rights retained in a bankruptcy case exceed an investor's economic risk.

[14] Bankruptcy claims trading is "the buying and selling by creditors of claims against a bankrupt corporate debtor." Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 86 (2007).

[15] *See generally* HILLARY ROSENBERG, THE VULTURE INVESTORS (1992).

[16] *See* Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191 (2005) (examining the rise of bankruptcy claims trading).

[17] *See generally* Chaim J. Fortang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990).

investors, who buy claims in hopes of profiting from a higher payout either before or after the reorganization plan, and active investors, who either wish their debt claims to be converted to equity ownership in the reorganized company, or seek to block a debtor's reorganization plan and extract more value for their own claims.[18] It is these active investors who, because they have the ability to shut down a debtor's ability to reorganize, present the greatest threat to the effective rehabilitation and reorganization of debtors, which are the two primary goals of Chapter 11.[19]

Legal scholars, practitioners, and investment industry professionals fiercely debate the prudence of the increased presence of distressed investors in the bankruptcy reorganization process.[20] Proponents argue that the liquidity provided by distressed investors allows lenders to promptly exit the bankruptcy process when they do not wish to participate, allows claims to be more accurately valued, and reduces the cost of capital for corporations looking to borrow.[21] In contrast, others argue that hedge funds seeking primarily short term gains have led to an increased rate of

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[18] *See* Anne M. Huber & Thomas H. Young, *The Trading of Bank Debt In and Out of Chapter 11*, 15 J. BANKR. L. & PRAC. 1, 2 (2006) (describing passive investors as those who buy claims in hopes of profiting from a higher payout either before or after confirmation of the reorganization plan, and active investors as those who wish to either take control of the debtor through a conversion from debt to equity ownership after reorganization, or attempt to block the reorganization through voting and thus obtain a higher payout).

[19] *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2014-16 (2002) (noting the negative impact that distressed investors and hedge funds have made on the essential policies of Chapter 11—the rehabilitation and reorganization of debtors).

[20] *Compare* Goldschmid, *supra* note 16 (arguing that distressed investors have made a positive impact in Chapter 11 cases by reducing the amount of time debtors spend in bankruptcy and helping to preserve going-concern value), *with* Miller, *supra* note 19 (arguing that the presence of distressed investors leads to an increased rate of recidivism among Chapter 11 debtors).

[21] *See* Levitin, *supra* note 14, at 87-88.

recidivism among Chapter 11 debtors.[22] Regardless, distressed investors are here to stay, [23] and claims trading has dramatically altered the landscape of Chapter 11 bankruptcies.[24] This Note takes no position on whether or not the participation of distressed investors and claims traders has provided for positive developments in Chapter 11, but only assumes that their presence is growing, likely permanent, and lightly regulated thus far.

Distressed investors often generate substantial returns by exploiting illiquidity and information asymmetry in the bankruptcy claims trading market.[25] A sophisticated hedge fund with vast resources and expertise may take advantage of an unsophisticated, unsecured, and possibly even "involuntary" creditor.[26] The information gap between buyers and sellers of bankruptcy claims is most evident in the market for unsecured trade claims.[27] A simple hypothetical will illustrate the issue. Suppose that Supplier sells packaged food on credit to Airline, who recently filed for relief under Chapter 11 of the Bankruptcy Code.[28] At filing, Airline owed Supplier $200,000 for food delivered the previous month. The automatic stay prevents Supplier from

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22 *See* Miller, *supra* note 19.

23 *See* Fortang & Mayer, *supra* note 17, at 115 ("[T]he explosion of claims trading and the increase in contests for control of chapter 11 debtors have set in motion swift new currents in chapter 11 practice, carrying the bankruptcy bench and bar in directions unknown. All that is certain is that the voyage is underway.").

24 *See* Levitin, *supra* note 14, at 86 ("[T]he growth of bankruptcy claims trading has been the most important development in corporate reorganizations in the past two decades.").

25 *See* Marie Leone, *Taking a Bite out of Bankruptcy Claims*, CFO.COM, May 16, 2007, http://www.cfo.com/article.cfm/9184071.

26 *See id.* In addition, a trade creditor, such as "Supplier" described in Part II.A., is in a sense "involuntary" in that it contracts to sell goods instead of lend capital.

27 *See* CHANGING ROLES IN COMMERCIAL CASES: THE IMPACT OF HEDGE FUNDS ON THE RESTRUCTURING LANDSCAPE, 14TH ANNUAL ABI SOUTHWEST BANKRUPTCY CONFERENCE 6 (2006) [hereinafter CHANGING ROLES], *available at* http://abiworld.net/newsletter/financialadvisors/vol3num2/ChangingRoles.pdf.

28 11 U.S.C. § 301 (2007).

collecting its claim until disposition of the bankruptcy case.[29] Supplier will likely want to sell its trade claim to Investor and avoid participation in Airline's bankruptcy case for several reasons. First, like most food supply companies, Supplier's business model probably does not contemplate tying up capital in bankruptcy court, but instead focuses on the marketing and sale of Supplier's products.[30] Second, Supplier probably does not want to wait out the Chapter 11 process, which can often take several years.[31] Third, Supplier does not likely have the legal or financial expertise, or incentives (due to the claim's small dollar amount), to research and value its trade claim, which can be a complicated and imprecise task.[32] On the other hand, Investor, with its team of finance and accounting experts, may have been researching Airline's struggling business for some time, using sophisticated models and pricing projections, and may plan to buy claims up and down the debtor's capital structure.[33] Due to Supplier's lack of expertise, as well as the lack of liquidity in the market for

[29] Upon commencement of a case, the Bankruptcy Code freezes the debtor's assets such that creditors, in order to recover their claims, must either petition the court to lift the stay or wait until disposition. *Id.* § 362(a).

[30] Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy* 12 (Working Paper 2007) (on file with author) (noting that a trade creditor's business model relies on cash flow from operations and is not built for participation in a drawn out bankruptcy case).

[31] According to Professor Lynn LoPucki's Bankruptcy Research Database, http://lopucki.law.ucla.edu, the average amount of time firms spent in Chapter 11 from 1990 to 2007 was 497 days.

[32] *See* Baird & Rasmussen, *supra* note 30, at 13 (noting that trade creditors have difficulty assessing their rights against the debtor and the value they should expect to receive at the end of a bankruptcy case).

[33] *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 AM. BANKR. INST. J. 24 (Dec. 2006-Jan. 2007) (describing a hypothetical bankruptcy case in which a distressed investor buys various claims within the debtor's capital structure, including trade claims).

small trade claims, Investor will likely pay a deeply discounted price for Supplier's claim.[34]

Bankruptcy Procedure Rule 3001(e), as amended in 1991, regulates the transfer of claims inside of bankruptcy.[35] In order to increase the liquidity of the bankruptcy claims trading market, and to provide a better opportunity for primary lenders to remove potentially risky loans from their balance sheets, Congress no longer requires a claims transferee to report the terms or consideration of the transfer to the bankruptcy court. Now, only evidence of the transfer must be reported.[36] Due to large loan participation and syndication, many claims transfers are not even reported to the court.[37] In addition, the equity and debt of bankrupt companies is traded over-the-counter, rather than on an organized exchange. Hedge funds may even establish a separate, ambiguously-named entity for the sole purpose of buying up claims while concealing their identities.[38] The end result is a fairly liquid but extremely opaque market for bankruptcy claims. Hedge funds and other distressed investors may move in and out of the various levels of a debtor's capital structure without the knowledge of the court, debtor, or other investors.[39]

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[34] *See* Baird & Rasmussen, *supra* note 30, at 12-13 (suggesting that a distressed investor's knowledge of the bankruptcy process, liquidity, and longer time horizon can help it profit in the market for bankruptcy claims).

[35] Fed. R. Bankr. P. 3001(e)(2) (2007).

[36] *See* W. Andrew P. Logan III, Note, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 500-03 (1994).

[37] Posting of Adam Levitin to Credit Slips Blog, http://www.creditslips.org/creditslips/2007/09/bankruptcy-clai.html (Sept. 20, 2007, 22:18 EST).

[38] *See* Baird & Rasmussen, *supra* note 30, at 27 ("To guard their anonymity, buyers of claims often establish a new entity. The only task of this entity is to buy claims in a given bankruptcy case. The name of the entity gives no clue as to who the ultimate owner is.").

[39] Professor Adam Levitin has suggested that bankruptcy claims trading under Rule 3001(e)(2) has produced "an unregulated residual securities market in which virtually all purchasers (but not all sellers) are sophisticated parties." Levitin, *supra* note 37.

B. Potential Conflicts of Interest

Hedge funds traditionally focus on short term gains instead of the long term maximization of a company's value,[40] counter to bankruptcy policy's goal of long term debtor rehabilitation.[41] Potential conflicts of interest can exacerbate this tension. In Chapter 11 bankruptcy cases, hedge funds often pursue idiosyncratic investment strategies in order to maximize total return, as opposed to working in concert with other parties to ensure a successful reorganization.[42] An example helps illustrate the potential conflicts of interest held by a distressed investor who buys and sells short the various claims of a debtor in Chapter 11. Suppose Investor, a sophisticated hedge fund focusing on distressed debt investments, buys $2 million worth of Debtor's first lien debt from the member of a bank syndicate (the original lender) on the secondary bankruptcy claims trading market. At the same time, Investor sells short $3 million worth of Debtor's

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[40] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1087 (2007) (discussing the problems associated with excessive short-termism and stating that "[s]hort-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism.").

[41] *See* Fisher & Buck, *supra* note 33 ("Simply stated, the focus of many hedge funds on the maximization of relatively short-term returns is often in tension with the [Bankruptcy] Code's traditional emphasis on the rehabilitation of debtors.").

[42] *See* CHANGING ROLES, *supra* note 27, at 10 ("Hedge funds often have conflicting interests and values with other debt holders. A hedge fund becomes involved in a distressed company to make a return based on a certain strategy. It is not concerned with the ultimate well-being of the company or the ultimate restructuring success, but with the effect of any action or plan on making its investment return."). In the ongoing *Delphi* Chapter 11 case, the debtor has accused at least one of its creditors of using investments in the company's securities to bet on the failure of the case. *See* Marie Beaudette, Joseph Rebello & Terry Kosdrosky, *Delphi Claims Backer is Betting on Collapse*, WALL ST. J., Mar. 7, 2008, at A4. In a recent court filing, the debtor stated that it "has 'credible information' that at least one member of its investor group has been 'trading and/or shorting' the company's public securities." *Id.*

second lien debt.[43] Investor's overall financial interest in the Chapter 11 case is net short—it will make money if the total value of claims in Debtor decreases. During the bankruptcy proceeding and because of its control position as a creditor, Investor may use several tactics to delay and frustrate the Chapter 11 process, in hopes of reducing the overall value of claims in Debtor and realizing a return on its net short position. For example, Investor may delay the process unnecessarily by filing motions to lift the automatic stay in order to recover or preserve the value of its claims,[44] objecting to Debtor's use of its own capital for operating or other purposes that are outside the "ordinary course of business," objecting to Debtor's reorganization plan,[45] recruiting others to vote against Debtor's plan,[46] or perhaps even moving to lift Debtor's exclusive right to file a reorganization plan and file a plan of its own.[47] In addition, Investor may not seek recovery through disposition in bankruptcy at all, but instead hope for a short term return as a result of its "activism" in the Chapter 11 proceedings by selling its claims to a third party before the case is over.

In the example above, Investor's status as a creditor, due to her long position, gives her powers under the Bankruptcy Code, including the right to vote for the debtor's confirmation plan. However, Investor's larger short position means that, overall, she retains "negative economic ownership."[48] The

[43] The short selling of debt is accomplished when an investor borrows debt from a lender, usually an institutional investor, and sells it into the open market. The borrower then has a negative economic stake. The short sale investment is completed when the borrower purchases debt from the open market and returns it to the lender.

[44] 11 U.S.C. § 362(d) (2007).

[45] *Id.* § 1129.

[46] *Id.* § 1125.

[47] *Id.* § 1121(b).

[48] Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, (Univ. of Tex. Working Paper, 2008) [hereinafter Hu & Black, *Empty Voting II*], *available at* http://ssrn.com/abstract=1030721 (describing "economic ownership" as the economic returns associated with shares, and "negative economic

value of claims in Debtor will decline if the reorganization is delayed or, of course, fails. Investor thus has an incentive to use her powers as a creditor to manipulate the case in a negative way such that her actions comport with her negative economic ownership position. Investor's economic interest runs directly counter to the interests of Debtor and other creditors: she will profit when Debtor's Chapter 11 case is delayed or fails.[49]

This situation, however, is merely the tip of the iceberg. Other examples may contemplate a distressed investor's use of the Chapter 11 process to manipulate the trading prices of its various holdings, hoping that some of their values increase and some decrease, in order to maximize total return.[50] A distressed investor may buy and sell any number

ownership" as economic returns which move in the opposite direction as the return on shares).

[49] Administrative costs which the debtor must pay, including attorney, accountant, and investment banking fees, can eat away at the assets of the debtor. Professors Baird and Rasmussen describe additional situations in which an investor would have an incentive to see the debtor's reorganization fail:

> Someone who is the record owner of a particular type of bond may also be a credit protection seller and his total position may be short. Far from wanting the company to reorganize successfully, he may be better off if the business blows up. In addition to voting against plans of reorganization, he has an incentive to derail the reorganization process.

Baird & Rasmussen, *supra* note 30, at 9.

> [50] [W]hen a hedge fund holds multiple investments, it only seeks to promote its total return; it cares little about how that return is allocated among various investments. In some situations, it may be beneficial for the hedge fund to press for a lower return on one of its investments in order to secure a higher return on another one. Indeed, it may have bought the one investment precisely in order to gain leverage so that it could increase the return on a different investment.

Id. at 28; *see also* Fisher & Buck, *supra* note 33 (describing a hypothetical bankruptcy case in which a distressed investor holds long positions in the debtor's bank, unsecured, and trade debt, but a short position in the of bankruptcy claims or equity interests and may hedge itself using an array of complicated financial instruments and derivatives. The explosion of the market for equity and credit derivatives, such as credit default swaps,[51] has compounded this problem by allowing distressed investors to hedge away the risk of default and become even more adverse to the goals of bankruptcy policy and the interests of other parties.[52] Credit default swaps, which are private third party transactions, may allow a distressed investor to hold a net short position while at the same time hiding the investor's financial incentives from all other parties in the bankruptcy case.[53]

C. Analogy to Empty Voting

The conflicts of interest created by a distressed investor who purchases a debtor's claims but hedges away its economic risk through short sales or derivatives are similar to the issue of "empty voting" seen outside bankruptcy. Empty voting "is an example of an old problem—conflicts of interests created by exploiting the separation of legal and beneficial ownership—aggravated by modern financial innovation."[54] Outside bankruptcy, a hedge fund or other sophisticated investor may retain beneficial voting power by holding equity in a company, but may hedge away its economic risk through short sales or derivatives.[55] It may

debtor's equity; this investor will profit greatly if the values of its long positions increase while the value of its short position decreases).

[51] *See generally* Frank Partnoy & David Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CINN. L. REV. 1019 (2007) (discussing credit derivatives and their use in the bankruptcy process).

[52] *See* Baird & Rasmussen, *supra* note 30, at 15 ("The incentive of individual investors to hold discrete pieces of the business (a short position in stock; a long position in a particular type of bond) may run contrary to the interests of all the investors as a group.").

[53] *Id.* at 22. Professors Baird and Rasmussen also note, however, that credit default swaps will likely only create conflicts of interest before and immediately after the filing of a Chapter 11 case.

[54] Kahan & Rock, *supra* note 40, at 1076.

[55] *Id.* at 1075-76.

use its voting power in a way that does not reflect the company's best interests, or the best interests of other shareholders, but instead maximizes the value of its particular investment strategy.[56] The separation of voting rights from economic risk has been termed "decoupling."[57] Currently, the ownership disclosure scheme in the federal securities laws neither prohibits these types of investment structures, nor does it require disclosure to other investors.[58] To remedy these potential conflicts, Professors Henry Hu and Bernard Black recommend increased disclosure of schemes that generate empty votes, so that even short sales would be disclosed.[59] For example, to calculate the 5% equity ownership trigger under Schedule 13D,[60] they propose measuring the gross amount of the owner's interest in a firm, both long and short, instead of the net amount of interests, to more accurately reflect the economic realities of the modern investment climate.[61]

Like the securities laws, the Bankruptcy Code assumes that cash flow rights and control rights go hand in hand.[62] In fact, however, hedge funds and other sophisticated distressed investors have the ability to decouple these rights inside bankruptcy.[63] As a result, parties that formerly held

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[56] *See* Henry T.C. Hu & Bernard S. Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) [hereinafter Hu & Black, *Empty Voting I*].

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1 (2007) ("Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D.").

[61] *See* Hu & Black, *Empty Voting I*, *supra* note 56.

[62] *See* Baird & Rasmussen, *supra* note 30, at 24.

[63] *See id.* (noting that the liquidity and secrecy of hedge funds undermines the traditional assumption that cash flow rights and control rights go together in bankruptcy).

incentives aligned with other creditors may undermine the debtor's reorganization by promoting positions that not only advance their financial interests but seek to destroy the reorganization altogether.[64]

Hu and Black have recently described an "empty creditor" as one who hedges herself against economic risk through, for example, a credit default swap, but retains voting and other rights under the Bankruptcy Code.[65] Empty creditors in bankruptcy are essentially investors with the ability to engage in empty manipulation. The traditional assumption that voting and other rights in bankruptcy are held by creditors with the incentive to maximize the value of the firm no longer holds true; decoupling allows creditors to use their powers under the Bankruptcy Code to frustrate a debtor's reorganization.[66]

Empty voting and its close cousin in bankruptcy, what I have termed "empty manipulation," present what law and economics adherents refer to as a moral hazard problem.[67] Put simply, the moral hazard framework suggests that if one

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[64] *See id.* (suggesting that an investor sitting on a creditor's committee and holding a net short position may secretly try to ensure that no agreement between the debtor and creditors is ever reached).

[65] Hu & Black, *Empty Voting II*, supra note 48, at 730-31 ("A creditor who has partly or fully hedged through a credit default swap nevertheless retains . . . full voting rights in bankruptcy.").

[66]
> Both loan contracts and the Bankruptcy Code are premised on the assumption that creditors are adverse to downside risk, but otherwise have an economic interest in the company's success and will behave accordingly. Voting in bankruptcy, in proportion to principal amount of debt held, rests on the same logic as a one-share-one-vote regime on the equity side – that control rights should be held by those with an incentive to increase the value of the firm, or at least the value of the asset class that is held. Large-scale, hidden debt decoupling weakens our ability to rely on these assumptions.

Id. at 734.

[67] *See generally* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996) (discussing the history and uses of moral hazard analysis).

fails to adequately punish bad behavior, the bad behavior will continue.[68] In the empty voting or empty manipulation context, the investor may bear little to no economic risk for her actions. Voting and other rights have been decoupled from economic risk. The moral hazard problem here suggests that the investor will vote and act contrary to the welfare of other investors, encounter an asymmetric amount of the risk, and leave other investors to suffer the consequences.

D. Federal Rule of Bankruptcy Procedure 2019

Bankruptcy Rule 2019 is "part of the disclosure scheme of the Bankruptcy Code and is designed to foster the goal of reorganization plans that deal fairly with creditors and that are arrived at openly."[69] The modern Rule 2019 is the successor to Rule 10-211 of the Bankruptcy Act, which Congress passed as a result of an extensive SEC report regarding abuses by unofficial committees in corporate reorganizations.[70] The rule was adopted to prevent exploitation by "protective committees" in bankruptcy proceedings.[71] "Protective committees" were non-statutory committees organized by insider groups dominated by the debtor and/or its investment bank and institutional investors who would solicit smaller investors to enter into a "deposit agreement."[72] Under this agreement, the smaller investor would deposit his or her securities with the larger investor, and the "committee" would negotiate with the debtor with little, if any, participation by the smaller holders that the committee represented.[73] The purpose of Rule 2019 was to

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[68] *Id.* at 238.

[69] ALAN N. RESNICK ET AL., COLLIER ON BANKRUPTCY ¶ 2019.01 (15th ed. 2006).

[70] SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937).

[71] *Id.*

[72] *See* Kurt A. Mayr, *Bankruptcy Rule 2019: To Disclose or Not To Disclose, That Is the Question*, 24 BANKR. STRATEGIST 11 (2007).

[73] *Id.*

establish a fiduciary relationship between the committee and depositors because of the control the committee wielded.[74]

Bankruptcy courts have commented on Rule 2019's purposes, highlighting the significant role that information disclosure plays in an effective reorganization.[75] It is important to distinguish the ownership disclosure scheme mandated by Rule 2019 and the disclosure required by the federal securities laws.[76] Rule 2019 requires an "entity" or "committee" acting in a representative capacity to disclose the amount of claims (debt) or interests (equity) it holds in the debtor, and the dates acquired.[77] In contrast, Schedule 13D, which applies to large shareholders, mandates disclosure of the "beneficial ownership" of public companies, triggered at 5% equity ownership.[78] The other federal ownership disclosure rules apply individually to institutional investors,[79] insiders and 10% shareholders,[80] and mutual funds.[81] Neither the ownership disclosure scheme under the securities laws nor that mandated by Rule 2019 strictly require the disclosure of derivatives or other agreements that may hedge an investor's economic risk, but preserve his or her voting rights.[82] Outside bankruptcy an investor may retain voting rights, such as the ability to approve or reject a

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[74] *Id.*

[75] *See* Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm. (*In re* Congoleum Corp.), 321 B.R. 147, 157 (D.N.J. 2005) (quoting *In re* CF Holding Corp., 145 B.R. at 126) ("[I]t is clear that the proper filing of Rule 2019 disclosures, which are intended, *inter alia*, to ensure 'complete disclosure during the reorganization process,' is essential to final confirmation of the Reorganization Plan . . . .").

[76] *See* Hu & Black, *Empty Voting I*, *supra* note 56, at 866 (providing a chart that simplifies and outlines the ownership disclosure scheme mandated by the federal securities laws).

[77] Fed. R. Bankr. P. 2019(a) (2007).

[78] Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1 (2007).

[79] SEC Form 13F, Report of Institutional Investment Managers Pursuant to Section 13(f) of the Securities Exchange Act of 1934, 17 C.F.R. § 249.325 (2005).

[80] Exchange Act § 16, 15 U.S.C. § 78p (2007).

[81] *See* Hu & Black, *Empty Voting I*, *supra* note 56, at 875.

[82] *See id.* at 818.

merger agreement,[83] while retaining no economic risk. Inside bankruptcy an investor may retain voting and control rights, such as the ability to effectively block a debtor's plan of reorganization,[84] while retaining no economic risk. Neither the securities laws nor Bankruptcy Code require disclosure of such "decoupling" schemes.

E. Ad Hoc Committees in Chapter 11 Cases

Groups of distressed investors or hedge funds that hold a bankrupt company's debt or equity may find it advantageous to form an unofficial or "ad hoc" committee under the Bankruptcy Code.[85] Members of an ad hoc committee have the ability to share the cost of counsel and generally wield more power through numbers.[86] In addition, as opposed to members of official committees, ad hoc committee members are usually not privy to confidential financial information about the debtor, and thus are not subject to trading restrictions,[87] such that even while a debtor remains in bankruptcy, ad hoc committee members may continue to trade in the debtor's claims and interests. The ad hoc committee may even file objections to a debtor's plan of

[83] *See infra* note 169 and accompanying text. For a further discussion and examples of empty voting strategies, see generally Hu & Black, *Empty Voting I*, *supra* note 56.

[84] A party holding at least one-half in number or two-thirds in amount of claims in a particular class may block a debtor's plan of reorganization by voting against the plan. *See* 11 U.S.C. § 1126(c) (2007). The debtor may overcome the party's vote only through a cramdown. *See infra* Part IV.

[85] Section 1109(b) of the Bankruptcy Code provides:

> A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.

11 U.S.C. § 1109(b) (2007).

[86] Mayr, *supra* note 72.

[87] 11 U.S.C. § 1102 (2007).

reorganization.[88] Generally, a court will form official creditors and equity security holders committees when the judge expects a particular group to obtain a recovery on disposition of the bankruptcy case.[89] Section 1102, discussed in Part III.C, governs the disclosure requirements for unofficial committees. At this point, however, it is important to note that the scope of disclosure for official and unofficial committees is different: unofficial committees must disclose their holdings to the public through Rule 2019 while official committees need only disclose their holdings to other creditors who hold similar claims.[90]

F. The *Northwest Airlines* Decision

During the wave of airline bankruptcies in 2005, speculation about mergers, including a potential buyer for bankrupt Northwest Airlines, prompted many hedge funds and distressed investors to speculate on the claims and interests of the bankrupt airlines.[91] A group of hedge funds that had purchased approximately 27% of Northwest's equity,[92] in hopes that equity owners would receive some value if Northwest was acquired by another airline, became active in the bankruptcy proceedings. First, the group requested formation of an official equity security holders

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[88] *See In re* Calpine Corp., Case No. 05-60200 (Bankr. S.D.N.Y. 2006).

[89] *See* Hon. Robert D. Drain, *A Short Summary of Chapter 11 of the United States Bankruptcy Code*, 898 PLI/COMM 103, 85 (2007) (observing that when equity security holders have a realistic prospect for recovery, the bankruptcy court will appoint an official committee).

[90] *See* Anupama Yerramalli, Note, *Deciphering the Statutory Language of 11 U.S.C. Section 1102(B)(3): Information Disclosure Requirements Imposed on Creditors' Committees*, 15 AM. BANKR. INST. L. REV. 361, 390-91 (2007).

[91] Julie Johnson & Michael O'Neal, *Funds Not Hedging on Airline Stocks: Gambling on Mergers, Hedge Funds Control Large Chunks of Shares at United and Others*, CHI. TRIB., Dec. 17, 2006. In addition, purchases of companies in Chapter 11 as going-concerns are common today, especially by competitors.

[92] *In re* Nw. Airlines Corp., 363 B.R. 704, 708 (Bankr. S.D.N.Y. 2007).

committee under Section 1102 of the Bankruptcy Code.[93] Here, the group would have its costs reimbursed by the debtor as administrative expenses;[94] the ad hoc committee stated, however, that its reason for the request was acknowledgement of the rights of Northwest's public stockholders.[95] The group later withdrew its motion after being denied the ability to investigate the potential for a post-confirmation merger.[96] The group then began filing motions as the Ad Hoc Equity Security Holders Committee ("Ad Hoc Committee"), seeking to share the cost of counsel, combine strategies, and persuade the court of its positions through collective action.[97] Next, the debtor filed a motion under Rule 2019, requesting the Ad Hoc Committee disclose the nature of its claims and interests in the debtor, specifically the amounts and times at which the committee's members acquired its claims and interests.[98] Judge Gropper, of the Southern District of New York Bankruptcy Court, granted the motion to compel the Rule 2019 disclosure,[99] and subsequently denied the Ad Hoc Committee's request to file the trading and ownership information under seal.[100]

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[93] Motion of Ad Hoc Committee of Equity Security Holders Requesting Formation of Official Equity Security Holders Committee, *In re* Nw. Airlines Corp., Case No. 05-17930 (Bankr. S.D.N.Y. 2007).

[94] 11 U.S.C. § 503 (2007).

[95] Statement of Ad Hoc Committee Withdrawing Motion for Official Equity Committee, *In re* Nw. Airlines Corp., Case No. 05-17930 (Bankr. S.D.N.Y. Feb. 28, 2007).

[96] *Id.*

[97] Paul D. Leake & Mark G. Douglas, *Ad Hoc Committee Disclosure Requirements – A Bitter Pill to Swallow for Distressed Investors*, Business Restructuring Review, Jones Day Memorandum (2007), *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4311.

[98] Debtors' Motion to Compel Rule 2019 Disclosure, *In re* Nw. Airlines Corp., Case No. 05-17930 (Bankr. S.D.N.Y. 2006).

[99] *In re* Nw. Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (ruling that the ad hoc committee of hedge funds must disclose the prices for which they paid for their claims and interests, as well as the times at which they acquired them).

[100] *In re* Nw. Airlines Corp., 363 B.R. 704 (Bankr. S.D.N.Y. 2007) (holding that the ad hoc Committee must disclose its trading information to the public at large).

The court's ruling sent shock waves through the hedge fund and distressed investor communities, prompting many law firms to issue cautionary memos to their clients in the industry.[101] One firm noted that "[t]hese rulings are significant as, in practice, such information had generally not been included in Rule 2019 statements,"[102] while another postulated more broadly that "this seemingly innocuous opinion on a mundane Bankruptcy Rule by Judge Gropper may change the current dynamics of Chapter 11 cases."[103] Judge Gropper's decision was motivated by several factors. First, in discussing the history of Rule 2019 and its adoption following the influential SEC report, he noted that "[a]mong other things, the SEC Report warned of possible conflicts of interest by outside as well as inside financial interests . . . ."[104] Members of the Ad Hoc Committee purported to own not only equity but debt in Northwest, and the judge apparently sought for them to reveal any "divided loyalties" by making full disclosure under Rule 2019.[105] Second, Judge Gropper found that the Ad Hoc Committee acted in a representative capacity and stood in a fiduciary relationship to all holders of Northwest stock.[106] He found that all stockholders should receive the Ad Hoc Committee's trading information under

[101] *See, e.g.*, *Court Denies Hedge Funds' Motion to Seal Confidential Trading Information*, Schulte Roth & Zabel LLP Client Memorandum (Mar. 12, 2007), *available at* http://www.srz.com/files/031207_Court%20 Denies%20Hedge%20Funds'%20Motion%20.pdf.

[102] *Bankruptcy Court Requires Ad Hoc Equity Committee Members to Submit Detailed Information on Holdings Under Bankruptcy Rule 2019(a)*, Cleary Gottlieb Client Memorandum (Mar. 13, 2007), *available at* http://www.lexology.com/library/detail.aspx?g=59827714-31b5-40dd-aa62-8617ac29264e.

[103] Jonathan S. Henes, *Rule 2019 Opinion May Transform The Dynamics Of Chapter 11 Cases*, KIRKLAND & ELLIS DAILY BANKRUPTCY REVIEW (Mar. 7, 2007), *available at* http://www.kirkland.com/site content.cfm?contentID=223&itemId=2242.

[104] *In re* Nw. Airlines Corp., 363 B.R. 704, 707 (Bankr. S.D.N.Y. 2007).

[105] *Id.* at 707-08 (noting that the point of Rule 2019 disclosure is to provide "the court and all parties in interest of the actual economic interest of all persons participating in the proceedings").

[106] *In re* Nw. Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

Rule 2019, so that each of them could decide whether to join the Ad Hoc Committee or proceed independently.[107] Judge Gropper demanded detailed disclosure of the Ad Hoc Committee members' interests and claims in the debtor.[108] Third, the judge was motivated by the investor group's formation of a committee in order to more strongly influence the proceedings.[109] In addition, the public nature of Northwest's bankruptcy, and the airline bankruptcies in general, prompted much public interest and even a motion from Bloomberg News seeking to intervene on behalf of the public at large.[110]

Implicit in Judge Gropper's reasoning is the tension between distressed investors, such as those in the Ad Hoc Committee, who pursue aggressive investment strategies and may have conflicts of interest, and the traditional bankruptcy goals of debtor rehabilitation and reorganization. This tension is exacerbated by the opaque nature of bankruptcy claims trading, discussed *supra*, as well as by courts' failure, until this point, to apply the federal securities laws to bankruptcy claims.[111] Indeed, it may be that "the

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[107] *In re* Nw. Airlines Corp., 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007) ("Assuming . . . that the Committee does not act as a fiduciary, Rule 2019 is based on the premise that other shareholders have a right to information as to Committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests . . . . It also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in the bankruptcy case and play a major role.").

[108] *Id.*

[109] *Id.* at 708 ("By acting as a group, the members of the shareholders' Committee subordinated to the requirements of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the Debtors' securities.").

[110] Memorandum of Law of Bloomberg News in Support of Intervention and in Opposition to the Ad Hoc Equity Security Committee's Request for an Order Sealing its Rule 2019(a) Disclosures, *In re* Nw. Airlines Corp., Case No. 05-17930 (Bankr. S.D.N.Y. Mar. 5, 2007).

[111] *See* Drain & Schwartz, *supra* note 5, at 577 (concluding that, at this point, bankruptcy claims have not been treated as securities for purposes of the federal securities laws, such as those mandating ownership disclosure).

battle is not really about Rule 2019 at all: The rule is simply the latest weapon in the arsenal that debtors seek to employ against the owners of their debt, particularly those owners who tend to be more assertive about their economic views."[112]

G. The *Scopac* Decision

Not long after *Northwest*, Judge Schmidt of the Southern District of Texas Bankruptcy Court faced a similar situation when debtor Scotia Pacific Company ("Scopac") filed a motion requesting Rule 2019 disclosure from a group of noteholders ("Noteholders").[113] At first, the Noteholders, in motions before the court, described themselves as an ad hoc "committee." However, upon realizing they might be subject to the types of specific disclosure mandated of the Ad Hoc Committee in *Northwest*, the Noteholders in *Scopac* began referring to themselves as a "group."[114] The court eventually denied the debtor's motion and, in a ruling devoid of detail, held simply that the Noteholders did not fall within Rule 2019's definition of "committee" and were therefore not subject to its disclosure requirements.[115]

The tension between bankruptcy policy and the interests of distressed investors once again surfaced in *Scopac* where the debtor, in its motion requesting Rule 2019 disclosure, stated that "the need for the Ad Hoc Committee to fully comply with Rule 2019 is particularly critical in this case

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[112] Evan D. Flaschen & Kurt A. Mayr, *Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds*, 26 AM. BANKR. INST. J. 16, 49 (Sept. 2007).

[113] *In re* Scotia Pac. Co. LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex. 2007).

[114] *See, e.g.*, Noteholder Group's Objection to Scotia Pacific Company LLC's Motion for an Order Compelling the Ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing its Membership and their Interests, *In re* Scotia Dev. LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 6, 2007).

[115] *In re* Scotia Pac. Co. LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex. 2007); *see also* Flaschen & Mayr, *supra* note 112 (discussing the *Scopac* case and arguing that *Northwest* was wrongly decided and *Scopac* correctly decided).

given the Ad Hoc Committee's overly aggressive behavior, repeated baseless filings, and unwillingness to compromise—tactics and strategies that are diverting Scopac's attention away from, and, therefore, delaying the successful reorganization of its business."[116]

The battle over Rule 2019 underscores a broader, yet subtle, issue: aggressive distressed investors, under the current Bankruptcy Code, have the ability to significantly frustrate the reorganization process and act contrary to the best interests of all other parties. The issue is not which particular group should be considered a "committee" within Rule 2019. As *Scopac* illustrates, creditors may manipulate their names or constituencies in order to skirt the rule's definition. The question of whether a particular group acts in a representative capacity merely highlights the broader issue. One group of practitioners has noted that some ad hoc committees of hedge funds are recharacterizing themselves as "groups" instead of "committees" and arguing, as did the hedge funds in both *Northwest* and *Scopac*, that they do not represent the interests of anyone but themselves.[117] In addition, hedge funds may avoid Rule 2019's disclosure requirements by arguing that their trading information is confidential and proprietary and specifically exempted from disclosure under the Bankruptcy Code.[118]

These developments demand a more cogent and consistent solution to ownership disclosure within bankruptcy. The courts in *Northwest* and *Scopac* have accurately diagnosed the issue, but without a more bright

[116] Scotia Pacific Company LLC's Motion for An Order Compelling the Ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing its Membership and Their Interests, *In re* Scotia Dev. LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Mar. 16, 2007).

[117] *See* Mark N. Berman, *Hedge Funds Meet the Bankruptcy Process*, Nixon Peabody LLP Hedge Fund Alert (Apr. 4, 2007).

[118] *See* 11 U.S.C. § 107(b) (2007). The Bankruptcy Code protects from disclosure information consisting of trade secrets, confidential research, developments, or commercial information. Although the hedge funds in *Northwest* argued vigorously for application of this section, Judge Gropper was not persuaded.

line rule mandating the disclosure of claims and interests in a debtor, the battle will continue to destroy value and waste time.

III. CURRENT DISCLOSURE REGULATIONS AND PROPOSALS

Commentators and bankruptcy judges have struggled to come up with a reliable and uniform solution to the potential conflicting economic incentives posed by aggressive distressed investors,[119] as in the example of the net short position discussed in Part II *supra*. Claim and interest holders with significant voting power but zero economic risk, or even a negative economic interest,[120] have the ability to manipulate the bankruptcy process and destroy value. The recent decisions in *Northwest* and *Scopac* have only served to further highlight the potential problems. Several provisions of the Bankruptcy Code, as well as other remedies, have been suggested as providing potential solutions to conflicting interests held by distressed investors in Chapter 11 cases. Part III will examine the solutions that have been proposed and conclude that each does an inadequate or incomplete job of preventing empty manipulation in bankruptcy.

A. The Pre-*Northwest* Conception of Rule 2019 Disclosure

Before *Northwest*, the custom in Chapter 11 cases had been for ad hoc committees consisting of creditors or equity holders to voluntarily file Rule 2019 disclosure statements that merely reported their names and aggregate holdings in

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[119] *See* Fisher & Buck, *supra* note 33 (describing the potential for bankruptcy courts, even before *Northwest* was decided, to fashion equitable and other remedies such as stricter Rule 2019 disclosure to deal with hedge funds that retain ownership interests at various levels of a debtor's capital structure).

[120] Outside bankruptcy, Hu and Black have concisely stated that "an investor can have a large voting stake, yet a zero or even negative stake in the company's welfare." Hu & Black, *Empty Voting II*, *supra* note 48, at 634.

the debtor.[121] Short positions, derivatives, and interests in a competitor did not trigger disclosure. Judge Gropper's ruling, however, mandated a more specific type of disclosure: the Ad Hoc Committee members were told to reveal the specific holdings of each member (both equity and debt), and to reveal the dates on which each member purchased its respective claims or interests.[122] Prior to *Northwest*, disclosure under Rule 2019 was seen as a mere formality; it did not reveal to the court the individual interests of the investors, nor any hedging agreements they may have had that reduced or eliminated their economic stake, but preserved their power under Chapter 11.[123]

The current Rule 2019 produces fragmented arguments and litigation, allowing some parties to avoid disclosure altogether. It has the potential to reveal conflicts of interest only when the investors form an ad hoc committee and then, only when the judge finds their committee fits within Rule 2019's definition. A broader, rule-based disclosure regime should apply to all investors, whether members of a committee or not.

B. Repeal Rule 2019

On November 30, 2007 the Loan Syndications and Trading Association ("LSTA") and the Securities Industry and Financial Markets Association ("SIFMA"), two investment industry groups with a significant number of distressed debt investor members, submitted a brief to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States requesting the repeal of Rule 2019.[124] LSTA and SIFMA, who also filed amicus curie

[121] *See* Mayr, *supra* note 72 (noting that ad hoc committees have long submitted voluntary disclosure statements, but had never been forced to disclose their individual holdings, the prices paid, or the dates acquired before *Northwest*).

[122] *Id.*

[123] *Id.*

[124] Letter from Loan Syndications and Trading Association & the Securities Industry and Financial Markets Association to the Committee on Rules of Practice and Procedure of the Judicial Conference of the

briefs in both *Northwest* and *Scopac* on behalf of the ad hoc committees, argued that Rule 2019 "does not sensibly implement Federal bankruptcy law, has become obsolete due to changes in the nature of chapter 11 cases, and adversely affects, with no compensating benefit, the interest of key participants in the chapter 11 process."[125] While the brief's reasoning rests on several assumptions regarding the positive aspects of distressed investor presence in Chapter 11 cases, its observation that Rule 2019 is ineffective in its current form finds evidence in the loose and inconsistent application of the rule.[126] One need only look to *Northwest* and *Scopac* to find that a fragmented application of Rule 2019 to some ad hoc committees and not others, only serves to add confusion to the process.

LSTA and SIFMA note, somewhat ironically, that recent disputes over the application of Rule 2019 to ad hoc committees has led to ad hoc litigation over the rule's language and purposes.[127] Bankruptcy courts are not the proper venue to settle these arguments.[128] Rule 2019 was designed to provide the disclosure of a committee's interest in the debtor so that other creditors and equity holders, to whom the committee held a fiduciary responsibility, would be informed as to the committee's loyalties.[129] The rule was not designed to punish bad actors who trade in the debtor's claims and interests or remedy the moral hazard problem, in an ad hoc fashion.

LSTA and SIFMA seem motivated by the contention that an inconsistent application of Rule 2019 will dry up the

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United States (Nov. 30, 2007), *available at* http://www.sifma.org/regulatory/pdf/BankruptcyRule2019Letter.pdf.

125 *Id.*

126 *Id.*

127 *See id.* at 6 ("LSTA and SIFMA do not concede that *Northwest Airlines* correctly interpreted Rule 2019, but, in light of the failure of any subsequent case to generate a contrary precedential ruling, have concluded that *ad hoc* litigation about the application of the Rule will not provide a forum in which the soundness of the Rule itself can be properly debated, and have determined, therefore, to seek repeal of the Rule.").

128 *Id.*

129 *See supra* Part II.D.

market for distressed debt and equity, drastically reduce liquidity in these markets, and will result in the distressed investors' exit from the bankruptcy process. However, it would be unwise to abolish Rule 2019 without providing a replacement rule mandating some sort of ownership disclosure of bankruptcy claims. LSTA and SIFMA correctly observe that the current Rule 2019 singles out ad hoc committees for disclosure. A uniform disclosure standard that applies to all claim and interest holders in bankruptcy is needed.

C. Mandate Disclosure Under Bankruptcy Code Section 1102

Section 1102 of the Bankruptcy Code governs the appointment and use of official committees in Chapter 11 cases,[130] as opposed to the unofficial or ad hoc committees covered in Rule 2019.[131] Under Section 1102(b)(3), official committees must "(A) provide access to information for creditors who—(i) hold claims of the kind represented by the committee; and (ii) are not appointed to the committee."[132] At least one commentator has noted the glaring ambiguities regarding the types of "information" that must be disclosed by official committee members to claim or interest holders not sitting on the committee.[133] The type of specific disclosure required by official committees appointed under Section 1102 is anything but clear. Although commentators have suggested that members of official committees must "disclose conflicts of interest to the committee as soon as they

[130] *See* Drain, *supra* note 89, at 84-86 (discussing the role of official committees in Chapter 11).

[131] 11 U.S.C. § 1102 (2007). The United States Trustee typically appoints official creditors committees consisting of the largest holders of claims in the debtor.

[132] *Id.* § 1102(b)(3).

[133] *See* Yerramalli, *supra* note 90, at 390-91 (arguing that an amendment to section 1102(b)(3) is necessary to provide clarity and uniformity with respect to official committees' duty to disclose information to other creditors and equity holders).

arise,"[134] this disclosure requirement is not specifically mandated by the rule. Professors Hu and Black have noted that, at least in theory, a sophisticated bankruptcy trustee could mandate the disclosure of conflicts of interest before appointing an investor to an official committee.[135]

Other analysts have argued that the apparent lack of consistent information disclosure requirements in Rule 2019 and section 1102 seems absurd: why must unofficial committees reveal more information and to a broader audience than official committees?[136] Ironically, an investor seeking to avoid strict Rule 2019 disclosure could gain appointment to an official committee and exert more influence.[137] Clearly a more uniform disclosure rule is needed.

After *Northwest*, bankruptcy courts may follow Judge Gropper's lead and more strictly enforce Rule 2019 disclosure requirements. If so, hedge funds and other distressed investors wishing to act in concert or serve on a committee, while at the same time continuing to trade claims and interests in the debtor, may find themselves between a rock and a hard place. The *FiberMark*, *Galey & Lord*, and *WorldCom* bankruptcy courts found that hedge funds serving on official committees violated their fiduciary duties because, among other things, the hedge funds had continued to trade

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[134] Michael P. Richman & Jonathan E. Aberman, *Creditors' Committees Under the Microscope: Recent Developments Highlight Hazards of Self-Dealing*, 26 AM. BANKR. INST. J. 22, 63 (Sept. 2007).

[135] *See* Hu & Black, *Empty Voting II*, *supra* note 48, at 733 n.264 ("In theory, a sophisticated bankruptcy trustee could condition appointment of a creditor to an official committee on disclosure of coupled assets.").

[136] *See* Flaschen & Mayr, *supra* note 112 ("If official committees with clear fiduciary duties do not have to make Rule 2019 disclosure, then it makes no sense that *ad hoc* committees with no duties to anyone should have to make Rule 2019 disclosure.").

[137] *See* Hu & Black, *Empty Voting II*, *supra* note 48, at 733 (citing Flaschen & Mayr, *supra* note 112, at 16) ("In any case, creditors can avoid [Rule 2019] in a number of ways, including not serving on ad hoc committees and, oddly, gaining membership on an official creditor committee; official committees are exempt from Rule 2019.").

based on confidential information about the debtor.[138] A distressed investor who wishes to continue to trade may form or join an ad hoc committee, but must then be concerned about submitting to the potentially stricter requirements of Rule 2019. In contrast, creditors or equity holders who are represented by the official committee, but do not serve on the official committee, and do not join an ad hoc committee, can seemingly avoid ownership disclosure requirements altogether.

D. Punish Bad Behavior Using Courts' Equitable Powers

Section 1126(e) of the Bankruptcy Code allows courts to, upon an impaired creditor's vote to accept or reject a reorganization plan, "designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith . . . ."[139] This "good faith" requirement is designed to prevent creditors from voting for or against a plan while acting under an ulterior motive, such as management entrenchment or the financial interests of a competitor.[140] The court may use its equitable powers to disqualify the votes of a creditor who exhibits such "bad behavior."

Perhaps the most prominent and oft-cited example of a bankruptcy court designating the votes of a large creditor and claims-buyer is *In re Allegheny International, Inc.*[141] In *Allegheny* the court found that Japonica, a hedge fund, had exhibited bad faith by purchasing claims constituting a blocking position in the debtor near the end of the case, during the debtor's disclosure statement hearing.[142] These last minute claims purchases were made with the purpose of

[138] *See* Richman & Aberman, *supra* note 134 (discussing recent misbehavior by members of official committees).

[139] 11 U.S.C. § 1126(e) (2007).

[140] *See* Figter Ltd. v. Teachers Ins. & Annuity Ass'n, 118 F.3d 635, 638-40 (9th Cir. 1997).

[141] *In re* Allegheny Int'l, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990).

[142] *See id.* at 289-90.

establishing a blocking position within a class, so that creditor Japonica would hold enough claims to effectively prohibit the debtor's reorganization plan from gaining approval, and could subsequently take control of the debtor.[143]

Aside from *Allegheny*, where the creditor's bad faith consisted of a back-handed attempt to take control of the debtor, courts have generally been reluctant to designate the votes of claims buyers who act in their own financial interests.[144] Buying up claims in order to constitute a blocking position is suspicious but not prohibited by the Bankruptcy Code without the presence of an ulterior motive.[145] Merely seeking returns on a sophisticated, narrowly-tailored investment strategy does not violate the good faith principle.[146] In short, Section 1126(e) does not prohibit empty manipulation schemes; and the opaque nature of claims trading makes it unlikely that a court will uncover them.[147]

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[143] *See* Huber & Young, *supra* note 18, at 5.

[144] *See* Baird & Rasmussen, *supra* note 30, at 26.

[145] *See In re* 255 Park Plaza Assocs. Ltd. P'ship, 100 F.3d 1214, 1219 (6th Cir. 1996) ("If bad faith could be found any time a claim is purchased to block approval of a plan, there would be no incentive to purchase claims."); *see also* Huber & Young, *supra* note 18, at 5 ("Generally courts agree that the mere purchase of claims in order to block the debtor's plan of confirmation does not itself amount to bad faith.").

[146] *See* Figter Ltd. v. Teachers Ins. & Annuity Ass'n, 118 F.3d 635, 638-40 (9th Cir. 1997) (holding that selfish motives and "enlightened self interest" do not violate good faith; however, acting to frustrate the reorganization for an ulterior motive will indicate bad faith).

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> [B]ankruptcy judges . . . sometimes see odd behavior in their courtrooms, which 'empty crediting' might help to explain. For example, one bankruptcy judge described a recent case wherein a junior creditor complained of too *high* a valuation being assigned to the bankruptcy estate, for reasons the creditor did not offer to the judge. One possible explanation is that the junior creditor had negative economic ownership of this debt class–or perhaps of the company's shares.

Hu & Black, *Empty Voting II*, *supra* note 48, at 733-34.

It remains crucial to emphasize at this point that *Allegheny* was decided in 1990, before the 1991 amendment to Rule 3001(e) that streamlined bankruptcy claims trading, and before the explosion in the market for the equity and debt of bankrupt companies.[148] Since 1990, the market for distressed debt and equity has increased exponentially,[149] while the ownership disclosure requirements have actually decreased. Professors Baird and Rasmussen note that the potential for empty manipulation as a result of financial innovation may prompt bankruptcy judges to use Section 1126(e) more often to subordinate the votes of strategic investors with multiple positions in the debtor.[150] However, a bankruptcy judge's ability to spot these types of investors is severely undermined by the extremely opaque nature of bankruptcy claims trading and the secrecy of hedge funds.

At least one commentator has argued for looser application of Section 1126(e), suggesting that courts establish a presumption that claims traders act in good faith in order to, among other things, preserve a liquid market in bankruptcy claims and provide for more consistent regulation of primary investing behavior.[151] The doctrine of good faith, especially when applied to the opaque practice of claims trading, provides courts with an equitable but unpredictable remedy[152] for the situation in which a distressed investor purchases claims for ulterior motives. Bad faith is not a uniform ownership disclosure scheme but an equitable doctrine which judges may apply in particularly malevolent circumstances; it does not mandate disclosure at certain levels of ownership and thus cannot expose problematic but discrete conflicts of interest.

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[148] *See supra* Part II.

[149] *See supra* Part II.A.

[150] *See* Baird & Rasmussen, *supra* note 30, at 26.

[151] *See* Andrew Africk, Note, *Trading Claims in Chapter 11: How Much Influence Can Be Purchased in Good Faith Under Section 1126?*, 139 U. PA. L. REV. 1393, 1419-22 (1991).

[152] *See* Huber & Young, *supra* note 18, at 5.

E. Further Amend Rule 3001(e)(2)

Bankruptcy Procedure Rule 3001(e)(2) has streamlined the claims trading process, allowing the entire capital structure of a debtor to change hands in a matter of days or even hours.[153] Claims purchasers may conduct trades without approval of the court and without providing notice of transfer to the debtor.[154] The result is often a cloak over the identities of the debtor's claim and interest holders. In order to provide more market efficiency and fairness to small, unsophisticated creditors such as the unsecured "Supplier" discussed in Part II *supra*, some commentators have suggested amending Rule 3001(e)(2) to force claims buyers to disclose the terms and prices of their trades.[155] Here the increase in transparency would allow small creditors to more accurately price their claims, perhaps receiving a fairer value, and decreasing the information gap between buyers and sellers.

This solution, however, does not address the potential conflicts of interest held by distressed investors. It would not require disclosure of short sales or derivative contracts which separate control rights from economic interests. Amending Rule 3001(e)(2) in a way to force price disclosure of every trade would likely prompt the exit of so many distressed investors as to almost completely dry up the market for bankruptcy claims. Especially if we recognize that liquidity in the market for bankruptcy claims represents a positive development in Chapter 11 cases from the past two decades, a more sensible and consistent ownership disclosure regime is warranted.

[153] *See* Goldschmid, *supra* note 16.

[154] *Id.*

[155] *See* Logan, *supra* note 36, at 503-05.

F. Apply the Securities Laws to Bankruptcy Claims

Generally, bankruptcy courts have been reluctant to apply the securities laws to bankruptcy claims.[156] Even outside bankruptcy, the test to determine which financial instruments fall within the scope of the securities laws is somewhat unclear.[157] Certain obligations, such as trade debt, are not typically subject to the securities laws outside bankruptcy, but are transformed into tradable instruments as a result of the bankruptcy filing.[158] Bankruptcy judge Robert Drain and practitioner Elizabeth Schwartz have argued that the federal securities laws should not be applied to bankruptcy claims for several reasons.[159] Primarily, the authors suggest that bankruptcy courts are well equipped to handle the regulatory gap left by section 3001(e)(2) through other, more equitable provisions of the Bankruptcy Code, such as sections 510(c), 1123(a)(4), 1125(b) and 1126(e).[160] These provisions, however, do not address the conflict of interest and moral hazard problems of empty manipulation.[161] They are tools, to be sure, that judges may use to combat bad behavior in egregious situations, but unlike a mandatory disclosure rule, they cannot detect conflicts of interest that fly under the radar.[162]

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[156] *See* Drain & Schwartz, *supra* note 5, at 571 (observing that no courts have directly applied the securities laws to bankruptcy claims trading).

[157] *See* Huber & Young, *supra* note 18, at 3-4 (explaining the Supreme Court's test for determining which investments constitute "securities").

[158] *See* Drain & Schwartz, *supra* note 5, at 570.

[159] *See id.*

[160] *See id.* at 577.

[161] *See supra* note 137 and accompanying text.

[162] In Hu & Black, *Empty Voting I*, *supra* note 56, the authors' proposals for the short term consist primarily of broad disclosure reforms. In Hu & Black, *Empty Voting II*, *supra* note 48, the authors extend their proposals to include possible amendments to corporate charters which prohibit empty voting, as well as other methods which would disqualify empty votes. In addition, "the Securities and Exchange Commission (SEC) is known to be considering disclosure reforms, but no public proposal has been made." Hu & Black, *Empty Voting I*, *supra* note 56, at 630-31.

Like empty voting outside bankruptcy, distressed investors have the ability to separate control rights and economic ownership inside bankruptcy and engage in empty manipulation. The methods presented thus far by commentators and judges designed to prevent creditors from acting contrary to the goals of Chapter 11 fail to remedy the problem presented by distressed investors who retain voting and other rights in bankruptcy but little or no economic risk.[163]

IV. TOWARD AN OWNERSHIP DISCLOSURE RULE FOR BANKRUPTCY CLAIMS

Essentially, Congress adopted Rule 2019 to protect small creditors' rights when larger creditors act in a representative capacity during bankruptcy.[164] Cases such as *Northwest* suggest Rule 2019 can also be used to flush out the motivations of dynamic investors whose incentives do not comport with the traditional Chapter 11 goals of debtor rehabilitation and reorganization. Rule 2019 does have value in the context of ownership disclosure but its requirements should apply without regard to committee membership.[165] An extensive and rule-based disclosure

[163] *See* Drain & Schwartz, *supra* note 5, at 571-72 (noting that litigation over section 1126(e) has actually decreased since the amendment to Rule 3001(e), "despite an ever-growing amount of vulture investing, which often occurs with an eye to obtaining a controlling interest in the reorganized debtor's equity securities by means of acquiring bankruptcy claims," or the employment of so called "loan-to-own" strategies); *see also In re* Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006) (discussing an alleged "loan-to-own" strategy).

[164] *See supra* Part II.D.

[165] Indeed, bankruptcy practitioners Eric Fisher and Andrew Buck seem to have predicted that bankruptcy judges may, as a result of the types of conflicting incentives discussed in Part II, *supra*, more strictly enforce Rule 2019 as the court did in *Northwest*. *See* Fisher & Buck, *supra* note 33 ("We may then see a trend in which courts mandate more complete disclosure from active hedge funds than that which is strictly required by Rule 2019, including, for example, the disclosure of short positions and positions in potential buyers of the debtor, as well as credit derivatives

regime in bankruptcy would serve to uncover empty manipulation schemes and more efficiently rehabilitate debtors.[166] Part IV will outline proposals for increased ownership disclosure in bankruptcy, drawing on concepts from the securities laws as well as recommendations from Professors Hu and Black. There are three different points during the Chapter 11 process at which Congress could mandate ownership disclosure; however, regardless of timing, the substance of the disclosure rules should remain the same.

A. Ownership Disclosure Under the Securities Laws and the Bankruptcy Code

For purposes of the following discussion, the term "ownership" with regards to the phrase "ownership disclosure" will refer to the residual actors both inside and outside bankruptcy. Residual actors drive the direction of a corporation outside bankruptcy through the shareholder vote.[167] Although creditors in bankruptcy are not "owners," because they do not (yet) possess shares in the debtor, they arguably have the most power, through the confirmation vote and other mechanisms, to determine the fate of the debtor.

Just as "[t]he vote is the core source of shareholder power"[168] outside bankruptcy, so too is the vote the primary source of power inside bankruptcy, albeit in a slightly different context. For example, outside bankruptcy shareholders have the ability to approve or reject the terms of a merger agreement[169] or the sale of substantially all the

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and other structured instruments that sophisticated investors might employ to manage risk.").

[166] *See* Hu & Black, *Empty Voting II*, *supra* note 48, at 683 ("[I]n a world of easy, large-scale decoupling of economic from voting ownership . . . a massive OTC derivatives market, and a pool of sophisticated hedge funds with the skill and incentives to use decoupling to hide ownership or cast empty votes, broader, more consistent coverage is needed.").

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

[168] Hu & Black, *Empty Voting I*, *supra* note 56, at 814.

[169] *See, e.g.*, DEL. CODE ANN. tit. 8, § 251 (2007).

assets of the corporation.[170] Inside bankruptcy, impaired creditors (those receiving less than full value for their claims), and less often shareholders, have the ability to approve or reject a debtor's plan of confirmation through voting.[171] Outside bankruptcy, the federal securities laws establish an ownership disclosure scheme aimed at providing all investors with information about the holdings of large shareholders, who are the investors most likely to wield extraordinary power in the voting process.[172] Under Schedule 13D, an active shareholder who acquires 5% of a corporation's equity must, within ten days of crossing the 5% barrier, disclose the number and percentage of shares owned.[173] Although owners must also disclose "any contracts, agreements, understandings, or relationships"[174] regarding the corporation's securities, "[s]hort positions, whether in shares or derivatives, do not trigger disclosure."[175] The specific information that must be disclosed under the securities laws is far from clear. However, disclosure, as a policy, leads to more efficiently and accurately priced shares, and consequently greater investor confidence in the stock market as a whole.[176]

Schedule 13D requires reporting of "beneficial ownership" interests, generally construed to mean an investor's legal

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[170] *See, e.g.*, *id.* § 271.

[171] 11 U.S.C. § 1126 (2007).

[172] *See* Hu & Black, *Empty Voting I*, *supra* note 56, at 877.

[173] Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1(a), (i) (2005).

[174] *Id.*

[175] Hu & Black, *Empty Voting I*, *supra* note 56, at 867.

[176]
> These [disclosure] requirements are rooted in the belief that investors, as well as society at large, should know who a company's major shareholders are. Investors should also know whether those shareholders are buying and selling and should have an opportunity to respond. From an economic standpoint, share pricing will be more efficient if investors know what major investors are doing and have advance notice of possible changes in control. The integrity of, and confidence in, the stock market will be enhanced.

Hu & Black, *Empty Voting II*, *supra* note 48, at 683-84.

right to vote his or her shares.[177] This creates a problem when beneficial ownership is separated from economic ownership—and the result is potential empty voting. Inside bankruptcy, an investor may have an economic interest in the firm's debt or equity, but the definition of beneficial ownership is quite different. Neither creditors nor equity holders technically "own" a firm in Chapter 11, since disposition and the reorganization plan will determine the firm's new owners. Arguably, the role of legal or beneficial owners in bankruptcy is assumed by creditors and especially impaired creditors, who have the right to vote for a debtor's plan of reorganization.[178] Thus, it seems, the closest party to "legal owners" inside of bankruptcy are impaired creditors. Indeed, the debtor in *Northwest* observed the analogy between Rule 2019 and Schedule 13D by stating that "Rule 2019 is a similar regulation designed to promote the same principle of transparency in bankruptcy cases" when it successfully argued that the ad hoc committee of hedge funds trading information should not be filed under seal.[179]

Shareholder voting power outside bankruptcy rests on the economic theory that shareholders are the best residual actors—more than any other party, their individual economic interests are most directly aligned with the interests of the corporation as a whole.[180] Inside bankruptcy, however, the concept changes. After filing, creditors take hold of the debtor's future and this increasingly means that distressed

[177] 17 C.F.R. § 240.13d-1(a), (i).

[178] 11 U.S.C. § 1126 (2007).

[179] *See* Debtors' Objection to Motion of the Ad Hoc Equity Committee for an Order (A) Pursuant to Sections 105(a) and 107(b) of the Bankruptcy Code and Rule 9018 of the Federal Rules of Bankruptcy Procedure Granting Leave to File its Bankruptcy Rule 2019(a) Statement Under Seal, (B) Limiting the Disclosure Required in Their Rule 2019 Statement and (C) Granting a Temporary Stay Pending Determination of this Motion, *In re* Nw. Airlines Corp., Case No. 05-17930 (Bankr. S.D.N.Y. Mar. 5, 2007).

[180] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991).

investors and hedge funds control the debtor's fate.[181] Essentially, impaired creditors inside bankruptcy act as shareholders do outside bankruptcy. They make motions and vote on confirmation so as to maximize their recovery from the debtor. The debate as to which particular creditors serve as the best residual actors in bankruptcy is far from settled.[182] However, all impaired creditors have the ability to vote whether to accept or reject a debtor's plan of confirmation.[183]

B. Proposal for an Ownership Disclosure Rule in Chapter 11 Cases

The Bankruptcy Code's ownership disclosure scheme, consisting primarily of Rules 3001(e) and 2019 along with section 1102 for official committees, is fragmented and ineffective. Currently, ownership disclosure in the securities laws scheme does not prohibit empty voting nor does it require disclosure of short positions or third party contracts.[184] In the same way, the ad hoc ownership disclosure scheme in the Bankruptcy Code and Rules does not prevent the type of divided loyalties that present the potential for empty manipulation of Chapter 11 cases.

The broad ownership disclosure scheme proposed by Professors Hu and Black is designed to prevent abuses by equity investors who separate their voting and economic interests in a corporation.[185] It would require disclosure of all positions resulting in voting or economic ownership (positive and negative), including short sales and derivatives

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181 *See* Goldschmid, *supra* note 16 (arguing that distressed investors, rather than "relationship" creditors, are the best residual actors in Chapter 11 cases).

182 *See id.* at 196-200 (examining the residual actor problem in bankruptcy and suggested theoretical solutions).

183 11 U.S.C. § 1126 (2007).

184 *See* Hu & Black, *Empty Voting I*, *supra* note 56, at 818 (noting that state corporation law does not reach empty voting schemes and "[f]ederal ownership disclosure rules scarcely touch [empty voting] . . .").

185 *See id.* at 819 (proposing that new disclosure rules should capture both economic and voting ownership).

which may create negative economic ownership.[186] Their proposal does not change the securities laws' disclosure thresholds such that, for example, a large active shareholder would only be affected when she reaches the 5% ownership point required in Schedule 13D.[187]

The substance of the ownership disclosure rule adopted with respect to bankruptcy claims and interests should be analogous to the ownership disclosure scheme proposed by Hu and Black in the context of equity securities. Both bankruptcy control rights and economic rights (positive and negative) should be disclosed to the court as well as other parties in the case. The Bankruptcy Code should incorporate a system that mandates disclosure of short positions in the debtor's equity or debt, derivatives or other third party contracts that reduce or eliminate an investor's economic risk, as well as interests in major competitors of the debtor. Investors with zero economic risk in the debtor's successful reorganization should at least be required to reveal their divided loyalties, if any. A further regulation, either by strict statute or at the discretion of bankruptcy judges, could subordinate the votes and other powers of these investors.

Debtors have used Rule 2019 as a sword to attack aggressive distressed investors who seek to maximize the return on their risky investments. Conflicting economic incentives, like empty voting, are a potential problem; but a problem which Rule 2019 is presently not designed to solve. Currently, Rule 2019 only applies to "entities" and "committees" which act in a representative capacity.[188] Indeed, entities and committees, specifically unofficial or ad hoc committees, have the power to disrupt and delay the reorganization process. But a fragmented application of Rule 2019 will only lead to confusion and delay—the very things bankruptcy judges seek to prevent. A consistent application of the rule is needed, triggered by a meaningful

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186 *Id.* at 876.

187 *See id.* at 877 ("In offering this proposal, we do not reassess the current disclosure thresholds . . . we assume that there is rough economic or political logic supporting the current rules.").

188 *See supra* Part II.D.

level of interest. Although an ad hoc committee with significant claims or interests in the debtor may frustrate the reorganization, a creditor's most powerful voting position comes when he or she owns one half in number or one third in amount of claims in a certain class. Here, a creditor may block a plan of reorganization, and force the debtor to invoke a cramdown,[189] which is costly and time consuming.[190] The debtor as well as other creditors want to avoid the cramdown at almost all costs—not just because the process is expensive (a barrage of experts must be hired to value the firm) but also because the time value of money will eat away at the debtor's value.[191]

As in the securities laws, the Bankruptcy Code should adopt a threshold that provides for disclosure at a meaningful level of ownership. The bankruptcy ownership disclosure rule should be triggered when a creditor or equity security holder in a Chapter 11 case possesses the ability to block a debtor's plan of confirmation by holding one half in number or one third in amount of claims or interests in a particular class.[192] These parties have the most potential to

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[189] *See* 11 U.S.C. § 1129(b)(1) (2007) (a bankruptcy court may override the objections of impaired creditors only if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.").

[190] *See* BARRY E. ADLER, DOUGLAS G. BAIRD & THOMAS H. JACKSON, BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 681 (4th ed. 2007) (noting that the cramdown requires the court to value the debtor as a going concern).

[191] *See* Huber & Young, *supra* note 18, at 12 ("One of the largest and most uncertain risks is the risk that a plan will not be proposed and confirmed before the time value of money eats away all the investors return, since Chapter 11 cases can last four years or more.").

[192] 11 U.S.C. § 1126(c) (2007) provides:

> A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

thwart an effective reorganization by leveraging the threat of a cramdown.[193] A creditor with a powerful blocking position in a class may effectively halt the reorganization process, thereby reducing the value of the firm's debt.[194]

Although the solution presented here may lead to fewer distressed investors purchasing large amounts of claims in a certain class (such as those exceeding 33%)—a balance must be struck between the financial goals of hedge funds and the broader bankruptcy policy. Just as ownership disclosure under the securities laws aims to provide all investors with adequate information so that they may accurately price securities, ownership disclosure in bankruptcy should alert judges and debtors to the motivations of distressed investors so that debtors may successfully reorganize.

The proposed rule mandating ownership disclosure when a party acquires one half in number or one third in amount of claims or interests would occur toward the end of the Chapter 11 case, when the confirmation plan separates the parties into classes.[195] Ex ante, this regime would likely induce distressed investors to either avoid engaging in empty manipulation schemes altogether or attempt to evade disclosure by acquiring less than the threshold amounts. The Bankruptcy Code should provide investors with a clear disclosure rule so they may conduct their primary investing behavior in anticipation of the requirements.[196] Unlike the

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[193] *See* ADLER, BAIRD & JACKSON, *supra* note 190, at 873 ("It is possible, therefore, that the secured creditor can use the confirmation process, including the threat of cramdown, to achieve private and not socially optimal ends."). A debtor can use the cramdown to override a creditor's dissenting vote, but the cramdown requires a valuation of the firm by experts, which is costly and time-consuming.

[194] *See* Baird & Rasmussen, *supra* note 30, at 26 ("By obtaining a blocking position in one class, an investor can thwart a reorganization and drive down the value of debt. By shorting enough debt, such a strategy in principle can be profitable.").

[195] *See* Drain, *supra* note 89, at 98-99 (describing the requirements of a confirmation plan).

[196] *See* Baird & Rasmussen, *supra* note 30, at 38 ("Perhaps the most important thing that courts can do in fashioning rules is ensuring that

application of Section 1126(e) or an ad hoc application of Rule 2019, the ownership disclosure scheme proposed here would provide distressed investors with a predictable and clear rule.[197]

The threshold amounts under the rule proposed here will not be known until the confirmation plan is proposed and the classes are divided. This may lead to creditors, especially those engaged in empty manipulation, to push for a sale of the firm (either piecemeal or as a going concern) under Section 363, in order to avoid the disclosure rule.[198] The proposed rule may also allow investors to engage in empty manipulation throughout the case,[199] and then sell their interests to third parties before the plan is proposed and the parties are separated into classes.[200] These potential effects may suggest that the Bankruptcy Code should mandate disclosure earlier in the Chapter 11 case.

1. Alternate Points for an Ownership Disclosure Rule

Two earlier points during the Chapter 11 case present opportunities for the application of a broad ownership disclosure rule. The substance of the disclosure scheme, however, which would require the disclosure of short sales, derivatives, interests in a competitor, and other agreements that separate voting and economic interests, should remain the same throughout. First, the rule could mandate ownership at the beginning of the case, when the debtor files

whatever is put in place gives clear benchmarks that future investors can use to navigate their way.").

[197] *See supra* Part III for a discussion of the applications of Section 1126(e) and Rule 2019.

[198] 11 U.S.C. §363 (2007) (with approval of the court, the trustee in bankruptcy may sell property of the estate).

[199] For examples of ways in which a distressed investor engaged in empty manipulation can delay and frustrate the Chapter 11 case even before the confirmation vote, see *supra* Part II.B.

[200] *See* Hu & Black, *Empty Voting II*, *supra* note 48, at 695 (recognizing that after-the-fact disclosure allows empty voting to harm other shareholders).

its petition for relief.[201] At this point the debtor must file a list of its twenty largest unsecured creditors.[202] The bankruptcy court can decide to limit the participation of investors engaged in empty manipulation by refusing to appoint them to a committee or threatening to disqualify their votes later in the case.

Second, the rule could mandate the same broad disclosure when the debtor files its schedule of assets and liabilities along with its list of creditors.[203] The debtor must file this sworn schedule within thirty days of filing its petition for relief.[204] The ex ante effect here may be that debtors choose to file their schedules immediately after their petitions in order to force ownership disclosure on the first day of the case.

Both of these solutions would provide for disclosure much earlier in the Chapter 11 case. Each, however, would likely require an ongoing obligation on the part of investors to disclose economic interests which are separated from voting and other rights in bankruptcy. Monitoring and policing by bankruptcy judges would remain essential, and disqualification of votes should occur when an investor fails to disclose promptly. The opaque nature and extensive amount of bankruptcy claims trading, however, could make monitoring difficult.[205]

Importantly, disclosure at the earlier points would not be triggered by crossing a threshold, but instead would provide

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[201] 11 U.S.C. § 301 (2007) (voluntary filing); *id.* § 303 (involuntary filing).

[202] *See* Drain, *supra* note 89, at 82 ("In chapter 11 cases, the debtor must also file a list of its twenty largest unsecured creditors (for notice purposes and also to assist the United States Trustee to form an official creditors committee), excluding insiders.").

[203] 11 U.S.C. §521 (2007).

[204] *Id.*

[205] *See* Baird & Rasmussen, *supra* note 30, at 27 ("The original holder of the claim has to file a proof of claim in the bankruptcy proceeding unless the debtor lists the creditor on its schedule. As these claims trade hands, however, it often becomes quite murky as to who the players actually are. . . . This quest for opaqueness makes it somewhere between difficult and impossible to assess a party's true economic interest.").

a broad requirement reaching all creditors and equity holders. At these early points the parties have not yet been divided into classes; the amount and number of claims a particular party holds within a certain class cannot be determined. On the positive side, the rule would not allow parties that hold claims of less than the one half in number and one third in amount to escape disclosure. However, investors with smaller claims may be dissuaded from buying claims in the first place in an effort to guard their investment strategies. A steep reduction in the liquidity of bankruptcy claims may occur. Also, mandating ownership disclosure from every creditor and equity holder in a large Chapter 11 case would likely create prohibitively expensive administrative costs. As such, it seems reasonable to include a de minimis exception for investors with small amounts of claims or those engaging in a small amount of hedging.[206]

Requiring ownership disclosure at the beginning of the Chapter 11 case would also better capture conflicts of interests created by credit default swaps.[207] A bankruptcy filing usually terminates the swap agreement and the swap purchaser must transfer the underlying defaulted loan to the swap seller.[208] In large Chapter 11 cases with sophisticated

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[206] Recently, Hu and Black have suggested that broad disclosure of empty voting should be extended to bankruptcy cases, with a possible de minimis exception: "We believe that disclosure of coupled assets should become a routine part of bankruptcy proceedings, perhaps with an exception for de minimis hedges or general hedges tied to an asset class, rather than a particular company's debt. Put differently, fully or partly empty creditors should disclose their 'hidden *non-interest*': their lack of economic exposure to the company." Hu & Black, *Empty Voting II*, *supra* note 48, at 734-35.

[207] Credit default swaps (CDS) provide investors with insurance against a "credit event" such as a loan default or bankruptcy filing. *See* John T. Lynch, Note, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention – A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1384 (2008) ("A CDS is like a homeowner's policy—the protection buyer pays a premium (called a CDS spread) to the protection seller, whereby the seller will compensate the buyer for any loss resulting from a 'credit event' incurred by the reference entity.").

[208] *See* Baird & Rasmussen, *supra* note 30, at 22.

parties, credit default swaps are unlikely to create empty manipulation because the parties will transfer the loan, and thus the risk, immediately after the debtor files its petition.[209] However, in smaller cases, and if fundamental decisions are made in the first few days of a bankruptcy, a creditor holding both debt and a credit default swap may have the opportunity to manipulate the case while holding little or no economic risk; before transferring the loan, the creditor could act contrary to the best interests of the debtor and other parties in the case.[210] A rule that mandates disclosure of derivative contracts at the beginning of the Chapter 11 case would help prevent empty manipulation by these investors.

Parties have the ability, in some cases, to avoid the potential for empty manipulation through private contracting. Intercreditor agreements, which specify rights as between creditors, may provide part of the solution by disabling a particular creditor's ability to act with conflicting interests.[211] Provisions adopted into a corporation's charter may prohibit empty voting schemes.[212] However, especially considering modern financial innovations and the sophistication of hedge funds, contracts between creditors and corporate charters cannot replace the broad-based disclosure regime necessary to curb empty manipulation.[213]

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[209] *See id.* (noting that credit default swaps only create conflicts of interest before and immediately after the debtor files its Chapter 11 petition).

[210] *See id.* (discussing how, since many crucial decisions are made at the beginning of a Chapter 11 case, including on the first day, a creditor holding a credit default swap may still influence the case before that creditor has transferred the loan to the swap seller).

[211] *See id.* at 18 ("To prevent second-lien holders from interfering with the ability of the senior lending group to control the case, some intercreditor agreements provide that if the second-lien holder buys some of the first lien debt on the secondary market, the second-lien holder cannot participate in the decisionmaking process of the first lien group.").

[212] *See supra* note 162 and accompanying text.

[213] *See* Baird & Rasmussen, *supra* note 30, at 38 ("Modern judges are likely to enforce intercreditor agreements as written, but in a world in

Greater disclosure requirements may also be needed in the case where a reorganization plan purports to give a creditor a majority interest in the reorganized debtor.[214] Here, the potential conflicts of interest created by empty manipulation of the Chapter 11 case could result in the approval of a plan which does not maximize value. Of course, once the debtor exits bankruptcy, majority and other large shareholders will be subject to both federal ownership disclosure rules as well as state corporate law.

V. CONCLUSION

The decisions in *Northwest* and *Scopac* regarding the scope of disclosure required under Rule 2019 have only aggravated the struggle between debtors and creditors for power and control in Chapter 11 reorganizations. An ad hoc application of Rule 2019, as written, will only create uncertainty and confusion; a more consistent scheme of ownership disclosure with respect to claim and interest holders is needed in the Bankruptcy Code. A system that relies on concepts derived from corporate securities law will provide a more reliable solution. In corporate law, shareholders determine the fate of firms through voting. In Chapter 11 cases, creditors (and less often, shareholders) determine the fate of firms through the confirmation vote. The potential for conflicts of interest arises, both inside and outside bankruptcy, when voting and other control rights are "decoupled" from economic risk. The ownership disclosure scheme in bankruptcy should reflect the fact that creditors with large claims or interests in the debtor retain a great amount of power but also the potential for abuse and manipulation.

which the financial instruments are new, the agreements are likely incomplete and some recourse to gap-filling is necessary.").

[214] *See id.* at 7 ("Banks want their money back; hedge funds loan to own. Far from having a liquidation bias, a hedge fund may affirmatively want to advance a reorganization plan in which it ends up with the equity of the business.").