One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy

Edward J. Janger[*] *& Adam J. Levitin*[**]

ABSTRACT: In bankruptcy, creditors exercise governance rights over a debtor firm—they vote to accept or reject a proposed plan of reorganization. These governance rights are apportioned based on the amount of a creditor's claim: "one dollar, one vote." This allocation assumes a claim reflects the creditor's true economic interest in the debtor, and the creditor is thus presumed to use its governance rights in the bankruptcy to maximize the value of the debtor, and hence its claim.

Yet a creditor's financial interest is not always limited or even linked to the face amount of its claim. For example, the interest of employee creditors extends beyond recovering back pay to ensuring future employment, while a landlord's interest may be less in recovering back rent than in being able to terminate a lease so it can relet the property at a higher rate. Historically, this has been a discrete and manageable problem. Two recent developments in financial markets, however, have made the mismatch between a creditor's total economic interests and its claim—and the concomitant governance rights—more problematic.

First, a robust market has arisen in distressed debt, enabling investors to purchase bankruptcy claims—and thus governance rights—at a discount. Second, the emergence of derivatives markets now enables investors to go "short" on the debtor and benefit from its misfortune. Combined, these developments enable investors to cheaply acquire governance rights in bankruptcy and then use that power to further the value of their extraneous

[*] David M. Barse Professor of Law & Associate Dean for Faculty Research and Scholarship, Brooklyn Law School.

[**] Agnes N. Williams Research Professor and Professor of Law, Georgetown University Law Center. This Article has benefitted from the comments of Miriam Baer, Corinne Ball, Anne Fleming, Riz Mokal, Spencer Webber Waller, and from workshop participants at the Georgetown University Law School Faculty Workshop, the University of Pennsylvania Wharton School Legal Studies and Business Ethics Department's Faculty Workshop, and the 2016 Financial Lawyers Seminar (including from the participant who generously referred to this as our "creepy paper"), as well as the Brooklyn Law School Summer Faculty Workshop and the Brooklyn Law School Dean's Research Fund. Mistakes are, of course, ours alone.

interests rather than maximizing the value of their bankruptcy claim. As a result, the "one dollar, one vote" principle underlying bankruptcy governance is now in question.

This Article illustrates problems that result from the divergence of economic interests and governance rights in bankruptcy. It shows that existing bankruptcy law tools, such as disclosure, vote designation, trading bars, equitable subordination, and equitable disallowance, fail to provide adequate remedies for the problems. Accordingly, we propose an administrable system of "mark-to-market governance," in which the governance rights, but not the economic distribution rights, associated with a creditor's bankruptcy claim would be adjusted to reflect the creditor's true net economic position. Under mark-to-market governance, hedgers and shorts would be subject to proportional dilution, claims purchasers would have their governance rights discounted based on purchase price, and secured creditors would have their credit bidding rights limited to the value of their collateral. Together these adjustments will promote the core bankruptcy policies of maximizing the value of the debtor firm and equitably distributing its value.

I. INTRODUCTION

Bankruptcy is a system for maximizing, realizing, and fairly distributing the value of a failed firm to its stakeholders. In Chapter 7 of the Bankruptcy Code an independent and disinterested trustee liquidates the debtor firm.[1] Secured creditors are paid from the proceeds of their collateral, and any

1. 11 U.S.C. § 704 (2012).

remaining realized value is distributed among unsecured creditors and equity holders according to a prescribed statutory waterfall.[2] Because the Chapter 7 liquidation system is nondiscretionary, it establishes a distributional baseline and raises relatively few governance questions.

In contrast, Chapter 11 provides a mechanism for restructuring a firm as a going concern.[3] Governance questions abound because the firm needs to continue operating while in bankruptcy, while simultaneously formulating a plan for its post-bankruptcy operations and determining how to compensate the various stakeholders. How can the value of the firm be maximized? How should it be allocated? How should asset-based priority be determined when the assets are not being sold? If the firm is not liquidated, how does the Bankruptcy Code allocate any asset value or going-concern value created or preserved by the bankruptcy process?[4]

To address these strategic and distributional questions, Chapter 11 implements a governance regime that allows pre-bankruptcy managers to remain in control as debtors-in-possession ("DIP"), but gives creditors and other interested parties greater voice in any decisions outside "the ordinary course of business."[5] During the case, creditors may challenge the DIP's actions as inconsistent with "business judgment."[6] But, most importantly, at the end of the case, creditors (and equity holders) have a vote on whether to accept or reject a plan.[7] In theory this vote allows stakeholders to express their preferences on how best to maximize firm value and to negotiate as to how that value should be allocated. The Chapter 11 negotiation takes place against the backdrop of certain statutory minima—the hypothetical liquidation value creditors would receive in Chapter 7 and the "fair and equitable" (also known as "cramdown") standard.[8]

A fundamental assumption of Chapter 11's distributional and governance schemes are that a stakeholder's economic interest in the debtor is reflected in the face amount of its claim, and that it will act accordingly.

---

2. *Id.* §§ 725–726.

3. *See id.* §§ 1122–1129.

4. Chapter 11 improves on compulsory state process in a variety of ways. It can improve recovery on assets by facilitating a value-maximizing sale, and it can preserve the value of operations by keeping the business alive as its capital structure is remade. For a more detailed discussion of entitlements to this "Bankruptcy-Code-created value" and how it should be allocated, see Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 892–95, 916–26 (2014); and Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673, 682–87 (2018) [hereinafter Jacoby & Janger, *Tracing Equity*].

5. 11 U.S.C. § 363(c).

6. *See, e.g.*, *In re* Curlew Valley Assocs., 14 B.R. 506, 507–08 (Bankr. D. Utah 1981) (raising objection to debtor's decision to bale hay instead of cubing it).

7. 11 U.S.C. §§ 1126, 1129(a)(8), 1129(a)(10). In bankruptcy jargon, creditors have "claims" against the debtor and equity holders have "interests" in the debtor. We generally refer to creditors in this Article as a catchall phrase for all financial stakeholders.

8. *Id.* §§ 1129(a)(7), 1129(b).

Distribution of value to an individual unsecured creditor is allocated pro-rata, in proportion to the total amount of debt in the class.[9] This same pro-rata principle is implemented for governance rights through the principle of "one dollar, one vote."[10] While Chapter 11 contains a variety of other statutory protections for creditors and other financial stakeholders,[11] many are aimed at preserving the integrity of the vote, which is arguably the creditors' most important protection.[12]

The "one dollar, one vote" principle is simple, and can be viewed as a corollary to the principle of equal (or *pari passu*) treatment.[13] Where a class of creditors' rights are unimpaired, they have no standing to object to plan confirmation and no right to vote.[14] But if a class is not being made whole, the distributional burden should be shared proportionally—and so should decision-making power. If a creditor is owed $20 million, and the plan of reorganization proposes paying 10% of the face amount of the claims, that creditor will receive $2 million as a distribution. If there are a total of $80 million in unsecured claims outstanding, that creditor's distribution will represent one-quarter of the assets distributed. That same creditor will also control one-quarter of the votes that decide whether that class will accept the proposed plan.

The assumption that underlies giving creditors governance rights is that the interests of the creditor and the firm are aligned—that the creditor's motivating economic interest is maximizing its recovery on that $20 million claim. The Code assumes that creditors are "long" and favor a larger recovery for the creditor's class, or at least that they are not "short," meaning that the creditor would, because of extraneous interests, prefer a smaller recovery from the debtor or the liquidation of the debtor firm.

The alignment between claim and economic interest has never been perfect: creditors with similar legal rights may see things differently. For example, suppliers and bondholders may take different views of how to

---

9. *Id.* §§ 726(b), 1123(a)(4), 1129(a)(7).

10. *See id.* § 1126(c). To be more specific, the Code requires two majorities: one-half in number and two-thirds in amount. *Id.* In one case it is one claim, one vote. In the other it is one dollar, one vote. As a practical matter, it is usually the two-thirds figure that comes into play.

11. *See, e.g.*, *id.* §§ 1122, 1123(a)(4), 1125, 1129(a)(1)–(3), 1129(a)(7), 1129(a)(9), 1129(a)(11), 1129(b). Indeed, the Supreme Court recently affirmed the importance of maintaining the integrity of the plan process. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 986 (2017) ("[T]he distributions at issue here more closely resemble proposed transactions that lower courts have refused to allow on the ground that they circumvent the Code's procedural safeguards.").

12. *See infra* text accompanying note 216. Section 1125 assures adequate disclosure, and § 1126 deals specifically with the voting process. *See* 11 U.S.C. §§ 1125–1126.

13. The *pari passu* principle is often attributed to Lord Mansfield, who famously said, "The policy of the bankrupt law introduced by 21 Jac. 1, c. 19, and followed ever since, is to level all creditors, who have not actually recovered satisfaction, or got hold of a pledge which the bankrupt could not defeat." Worseley v. De Mattos (1758) 97 Eng. Rep. 407, 416 (KB).

14. 11 U.S.C. §§ 1124, 1126(f), 1129(a)(7), 1129(a)(8), 1129(b)(1).

maximize value: one hoping for future business from the debtor; the other hoping to maximize the immediate return on their bonds. Unlike bondholders, suppliers may be willing to take greater losses on existing debts in order to ensure the survival of a customer. Furthermore, creditors have long been able to separate their economic interest from their voting power in other ways: through investments in the debtor's competitors or by holding multiple interests across the capital structure.

As a result of these issues, there have always been some basic procedures in place to remedy conflicts of interest and to punish bad behavior.[15] These include separate classification, vote designation, and equitable subordination. The advent of modern financial derivatives and the increased liquidity of distressed debt markets present a serious challenge to the existing safeguards in three ways: (1) by making it easier for creditors to take economic positions that run counter to the stated face amount of their claims; (2) by making it easier to accumulate control, and/or blocking positions at a discount; and (3) by making these facts considerably less transparent.

First, modern derivative instruments, such as options and credit default swaps, enable investors with significant claims to construct positions that link significant voting power to economic positions that are indifferent or even economically "short."[16] These investors are often called "empty creditors," in that their voting rights are not tied to their economic interest.[17] Indeed, when such empty creditors are economically "short," they may actually profit from the firm's further misfortune, and, because of their voting rights, may have the power to bring such misfortune about.

For example, a creditor can transfer the economic risk—the distributional rights—on a bankruptcy claim to a third-party through the purchase of a (transferrable) swap that guaranties the purchaser a fixed return. The value of this swap to the purchaser/creditor increases as the value of the creditor's distributional rights in the bankruptcy decline. Thus, the risk of what the debtor will pay out on a $1 million bankruptcy claim can be offset by a swap for $1 million (minus the cost of the swap). The swap will pay the purchaser the difference or "spread" between the face amount of the claim ($1 million), and the actual distribution. The "spread" increases as the value of the bankruptcy distribution falls. For example, if the bankruptcy distribution on the $1 million claim is $400,000, then the swap will pay $600,000, while if the bankruptcy distribution is only $200,000, then the swap will pay $800,000. The decrease in the value of the distributional rights from the claim will be offset by the increase in value of the swap: a $1 million swap operates as a hedge against the credit risk associated with $1 million claim.

---

15. *See infra* Sections IV.A–.D.

16. *See, e.g.*, Samuel M. Kidder, Comment, *What's Your Position? Amending the Bankruptcy Disclosure Rules to Keep Pace with Financial Innovation*, 58 UCLA L. REV. 803, 807 (2011).

17. *See, e.g.*, Henry T.C. Hu & Bernard Black, *Debt and Hybrid Decoupling: An Overview*, M&A LAW., Apr. 2008, at 1, 5.

Unlike insurance, however, a swap need not be tied to an "insurable interest." A swap can be used to make a bet, unlinked to any economic interest in the debtor whatsoever. The swap purchaser need not be a creditor. A so-called "naked" credit default swap that is unmatched to an actual economic interest is an economically "short" bet on creditworthiness of the firm.

Naked shorts are not inherently problematic. A "short" that is unlinked to an actual economic interest in the firm does not directly affect the firm —though it may have an indirect effect.[18] More importantly, a short that is unlinked to any power to influence the firm does not affect the firm's decision-making processes. When, however, an economically short interest is linked to the power to influence the firm, mischief may ensue.[19] For example, if a creditor has a claim against the debtor sufficient to block the confirmation of a plan of reorganization, and the creditor purchases swap protection in an amount greater than the face amount of the claim, then the combined positions leave the investor net "short." Thus, the risk associated with the payout on a $1 million claim (which will almost never be more than $1 million, unless, for some reason, the claim was purchased above par) can be more than offset by a swap based on a $3 million fixed payment. The result is that the claimant will have an incentive to exercise its control rights to harm the debtor in order to maximize its return on the swap.

The second challenge is a product of the liquidity of distressed debt in modern commercial markets. Modern claims trading now makes it easier for incumbent creditors and even third parties to purchase debt in order to accumulate a control position. Accounts receivable have always been freely assignable.[20] Contractual debt can be embodied in negotiable instruments, which are both freely assignable,[21] and transferred in physical form as

18. Short derivative positions can indirectly impact firms. The nature of credit default swaps is that for one party to go short, it needs to be paired with another investor that wants to go long. This means that there are two ways of going long on a firm, directly and derivatively, so there will be opportunities to arbitrage between the two types of long positions. Accordingly, the greater the short demand there is in the swap market, the greater the price that one can get for taking the long position in a swap. That in turn exerts a downward effect on the market price of the direct long position. In and of itself, this has no effect other than to create short pressure on a firm, but in certain circumstances, it can affect firm behavior. Thus, during the housing bubble in the United States in the 2000s, short demand for swaps had the ironic effect of temporarily pumping up housing prices. *See generally* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177 (2012) (explaining the impact that short derivative positions have on firms). In order for mortgage lenders to compete for the business of longs with the swaps market, they had to offer ever higher yields, which mean making ever riskier mortgages, which had the short-term effect of expanding housing credit and boosting housing prices. *See id.* at 1244–49.

19. *See infra* text accompanying notes 67–69 for an egregious example.

20. *See, e.g.*, N.Y. GEN. OBLIG. § 13-101 (Mckinney 2019) (stating actions unrelated to personal injury are freely assignable); U.C.C. § 9-406(d), (f) (AM. LAW INST. & UNIF. LAW COMM'N 2000).

21. U.C.C. § 3-104(a)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2002).

property.[22] Indeed, legal doctrines such as "holder in due course"[23] and federal programs that guarantee residential mortgages or bank deposits are designed to enhance the value of debt transferred as property.[24] Lending and information technology, have, however, both greased the wheels. Sophisticated swaps and derivatives, coupled with mechanisms for transferring claims quickly and cheaply have changed the landscape. [25]

Bankruptcy is no different. Debt and equity continue to trade freely even after the debtor has filed for bankruptcy. The automatic stay that enjoins most collection efforts against the debtor does not interfere with a creditor's right under non-bankruptcy law to assign its claim.[26] Bankruptcy law requires only registration of the transfer of a claim; the court does not police such transfers or record the price.[27] The ability to buy and sell bankruptcy claims means that investors can simply buy claims and acquire both distributional rights and governance rights. Derivatives, in turn, make the economic interest associated with such positions less transparent because a party's derivative holdings, and hence net economic interest, are not generally publicly observable.

---

22. *Id.* § 3-201.

23. *Id.* §§ 3-302, 3-305–3-306.

24. Edward J. Janger, *The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration, and Coordination Problems*, 4 BROOK. J. CORP. FIN. & COM. L. 39, 46 (2009); Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance*, 46 U.C. DAVIS L. REV. 1111, 1141 (2013).

25. *See generally* MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT (2014) (providing extreme examples of swaps impacting the economic landscape).

26. 11 U.S.C. § 362(a) (2012).

27. FED. R. BANKR. P. 3001. The rule does not even require timely registration of the transfer. *See id.*

While the 1983 comment to Rule 3001(e) reflected a concern with claims trading, the 1991 amendments were expressly intended to limit the role of the court in policing transfers of claims, making it clear that no statement of the consideration paid was required. *Id.* The original comment to Rule 3001(e) states:

> *Subdivision (e).* . . . The interests of sound administration are served by requiring the post-petition transferee to file with the proof of claim a statement of the transferor acknowledging the transfer and the consideration for the transfer. Such a disclosure will assist the court in dealing with evils that may arise out of post-bankruptcy traffic in claims against an estate.

Id. Advisory Committee's Note to 1983 Amendment.

The requirement of a statement of consideration was removed, however, in 1991, with the Advisory Committee Report stating as follows:

> *Subdivision (e)* is amended to limit the court's role to the adjudication of disputes regarding transfers of claims. If a claim has been transferred prior to the filing of a proof of claim, there is no need to state the consideration for the transfer or to submit other evidence of the transfer. . . . In that event, the clerk should note the transfer without the need for court approval. If a timely objection is filed, the court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law. This rule is not intended either to encourage or discourage postpetition transfers of claims . . . .

Id. Advisory Committee's Note to 1991 Amendment.

To be sure, claims trading is not all bad. Indeed, it may often be good. As a "behavioral" matter, a claims trader who buys at $20 and sells at $30 feels different having gained $10 and may negotiate with clearer eyes than a creditor who loaned $100 and is losing $70.[28] Similarly, the availability of an economic exit through a liquid market for claims may make the debt itself more valuable, and may thus reduce the cost of credit.[29] On the other hand, to the extent that claims carry with them voting rights, they also create the ability to transfer control. Therefore, the ability to buy into a bankruptcy provides an opportunity to buy control on the cheap—at least relative to the pre-distress creditors. Moreover, the seller of a control block may be able to sell that control at a premium—a control premium.

Thus, we have identified two potentially problematic types of creditors, at least from the perspective of "one-dollar, one-vote." The first type is a creditor that benefits from the debtor's failure—a short. Neither of us is tall, so we have never liked the derogatory term "shorts." Therefore, we borrow the word "*Schadenfreude*"—taking pleasure in the misfortune of others—from German to describe as "*Schadenfreude* investors" those who wish for (and benefit from) the misfortune of the debtor. The second type is the creditor who has purchased control on the cheap and wishes to throw its weight around—a bargain basement bully (hereinafter, just a "bully").

The difference is important. A *Schadenfreude* investor has made a bet on a particular distributional outcome—the economic interest. A bully, by contrast is concerned with power—governance. Separately, neither is particularly problematic. However, there is yet a third type of problematic creditor: one who links the economic short interest to governance power purchased on the cheap—a *Schadenfreude* investor who is also a bully. The combination of conflicted interest and power is dangerous, especially when economic positions are not transparent. At that point, the claimant may become, in effect, a "Trojan Horse." To the extent that the Bankruptcy Code embodies certain distributional principles, the "Trojan Horse" creditor may seek to distort them. Worse yet, when such a creditor purchases control on the cheap and uses it to realize on a short position, it does not just reallocate the value of the debtor firm, but actually destroys it.

We are not the first to identify this dynamic. Professors Henry T.C. Hu and Bernard Black, somewhat less colorfully describe a creditor who has delinked economic interest and governance rights as an "empty creditor."[30]

---

28. While this argument is frequently made by advocates of claims trading, we are not entirely convinced. It seems to us to simply be an example, and exaltation, of the sunk cost fallacy. The ability to make an economic exit, however, seems to be an unalloyed good, unless it undercuts governance.

29. *See* Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 73, 93 (2009).

30. Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663, 680 (2008) [hereinafter Hu & Black, *Debt,*

This Article amplifies and further explores those concerns. We explore the extent to which the problem in bankruptcy is magnified by claims trading after insolvency, and consider whether bankruptcy law can be adapted to realign economic interest and governance rights.

We go further, however, than Hu and Black. Our concerns go beyond governance alone, and loop back to concerns about distribution. The role and meaning of "equity" in bankruptcy is complex and contested.[31] But, as one of us has explained elsewhere, the Bankruptcy Code is premised on a principle of equal distribution of a firm's value based on the relative position of creditors established on the date of the bankruptcy petition.[32] To the extent that a control premium can be realized by certain stakeholders and not others who were similarly situated on the petition date, the principle of equality of distribution is violated. We therefore consider whether "claims purchasers," as well as "shorts" should have their claims discounted.[33] Finally, we recognize that the "property rights" of secured creditors can confer practical leverage that allows them to use control over the debtor's property to distort the Bankruptcy Code's distributional scheme.[34]

We conclude that the current tools available under the Bankruptcy Code are inadequate to the problems posed by credit derivatives and claims trading more generally. We propose an approach that we call "mark-to-market governance." This approach has four components:

(1) improved disclosure requirements mandating that certain claimants reveal the timing of their purchase, the price, and their true economic position;

(2) proportional designation of hedged creditors' votes that would cause their voting rights to mirror their actual economic interest (a process we refer to as "mark-to-interest");

Equity and Hybrid Decoupling]; Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 728–29 (2008) [hereinafter Hu & Black, *Equity and Debt Decoupling and Empty Voting II*]; Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 348–49 (2007) [hereinafter Hu & Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership*]; Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006) [hereinafter Hu & Black, *The New Vote Buying*].

31. *Compare* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 688 ("An 'Equitable Snapshot' establishes the relative position of creditors as of the petition date. The Snapshot fixes, as of the petition date, the relative positions of unsecured creditors in relation to one another for purposes of *pari passu* distribution. It also establishes the relationship between secured (asset-based) and unsecured (firm-based) claims by fixing the pool of collateral that is encumbered."), *with* David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors,"* 166 U. PA. L. REV. 699, 714 (2018) (asserting that the equality principle is easily avoided in practice).

32. Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 713.

33. *See infra* Part III.

34. *See infra* Part IV.

(3) allocation of governance rights to claims purchasers based on their basis (purchase price) to prevent trading based on control premia (a process we refer to as "mark-to-basis"); and

(4) limitation of secured creditors' right to credit bid in an asset sale to the value of a secured creditor's collateral itself (the allowed secured claim), exclusive of any control premium or bankruptcy created value (a process we refer to as "mark-to-value").

We acknowledge that this approach is not a panacea, but argue that it is a tool that should be added to the existing governance toolkit.

The Article proceeds as follows. Part II develops the phenomenon of "empty voting"—the separation of economic interest and voting rights—and reviews the mechanisms by which it can be accomplished in bankruptcy cases. Part III explores the dynamics of empty voting within the context of particular bankruptcy cases and illustrates the problems empty voting can create. Part IV reviews the existing bankruptcy remedies for empty voting and their limitations. Part V proposes a solution based on the concept of mark-to-market governance rights. We offer a practical approach to enforcing the principle of "one dollar, one vote" and consider possible objections. We conclude by outlining what is possible within the existing legal framework and which the statutory adjustments would be required to implement a full mark-to-market governance system.[35]

II. EMPTY VOTING AND EMPTY CREDITORS IN BANKRUPTCY

A. *EMPTY VOTING*

The academic literature on corporate governance has recognized the negative consequences that can follow when a firm's owner's economic interest in a firm is separated from that owner's voting rights as a shareholder.[36] This phenomenon has been described as "empty voting."[37] Most investors purchase stock based on an economic bet. They hope that the company—and their ownership interest in it—will increase in value or yield dividends. Based on this assumption, stockholders are given the power to vote on corporate directors and on certain major corporate decisions. It is possible, therefore, to purchase stock in a company and influence the company's fate. These control rights have economic value, at least if one has accumulated enough stock to wield influence.[38] Usually, the control rights are

35. *See infra* Part VI.

36. *See* Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 776–78.

37. *See* Hu & Black, *Debt, Equity and Hybrid Decoupling*, *supra* note 30, at 680; Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 728–29; Hu & Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership*, *supra* note 30, at 348–49; Hu & Black, *The New Vote Buying*, *supra* note 30, at 815.

38. While creditors are usually characterized as fixed claimants, creditors can influence corporate governance decisions, even outside of bankruptcy. Corporate debt obligations—notes,

exercised in disputes about how to *increase* the value of the firm, but they can also be exercised in fights over how to *allocate* that value, or to shift risk allocations within the firm.

For example, it is possible to hedge one's position, and thereby limit one's exposure to the company's future financial risks. "Hedging" may serve legitimate purposes, such as reducing a stockholder's economic exposure to market fluctuations and facilitating planning. But hedging may also affect stockholder incentives. A hedged investor, with its downside covered, may prefer riskier strategies, or engage in suboptimal monitoring.

More troubling, however, is that a stockholder may "insure" more stock than it owns (because no insurable interest is required to purchase a "short" position). Such a stockholder will benefit on net if the stock price declines. Accordingly, the investor will have an economic incentive to exercise their governance rights to *harm* the company. As we explain below, these concerns arise in bankruptcy as well.

B. EMPTY GOVERNANCE IN ASSET-BACKED SECURITIES

Securitizations present a parallel problem. In a securitization, the assets are managed on a day-to-day basis by an entity called a servicer.[39] The servicer maintains control over the securitized assets (generally loans)—a position analogous to governance rights in a firm—and thus is in a position to affect the performance of the securitized assets and hence the value of the asset-backed security ("ABS").[40] The servicer is a presumptively long party to a securitization because of its reputational risk, because its compensation depends on the volume of performing assets, and because it is responsible in some situations for advancing payments on defaulted loans.[41] Likewise, the originator of the assets and the sponsor of the securitization deal have a quasi-governance role in terms of creating and selecting the assets for the securitization. The originator and sponsor are presumptively long parties on the ABS because of their reputational risk and, if the securitized assets do not conform to representations and warranties, their risk of having to repurchase the assets.[42]

The servicer is in a position to take steps to decrease the value of the securitized assets and hence of the ABS. If the servicer is hedged and a net short, it might be incentivized to act to decrease the value of the ABS.

---

bonds, debentures, and loans—contain various covenants that place restrictions on the obligor's activities, such as mergers, acquisitions, sales, and borrowing, or require maintenance of certain financial targets. These debt covenants limit managerial autonomy and give certain creditors a measure of control over corporate governance.

39. *See* ADAM J. LEVITIN, BUSINESS BANKRUPTCY: FINANCIAL RESTRUCTURING AND MODERN COMMERCIAL MARKETS 124 (2d ed. 2019).

40. *See id.*

41. *See* Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 24 (2011).

42. *See* LEVITIN, *supra* note 39, at 125.

Likewise, if the originator or sponsor are in fact net short on the ABS, they might be incentivized to securitize poorer quality assets in order to boost the value of their short position.

The problem of empty governance has already been partially addressed in the context of asset-backed securities. Regulation AB II, the revised Securities and Exchange Commission ("SEC") regulation for offerings of ABS, requires that the originator, sponsor, and the servicer disclose any hedge (including by an affiliate) related to the credit risk on the asset-backed securities.[43] This disclosure mandate is backed up by both public enforcement by the SEC and private rights of action.[44] Additionally, the sponsor, depositor, and issuing entity have to disclose any material business relationships with any other entity involved in the securitization that is outside of the ordinary course of business or on non-arm's length terms.[45] This means that any attempt at buying influence of the servicer or trustee or other party involved in the securitization through transactions at non-arm's length terms would have to be disclosed.

C. EMPTY CREDITORS

Outside of bankruptcy, or at least absent default, creditors do not generally have formal governance rights. Indeed, a number of doctrines even prohibit creditors from exercising control to disadvantage other creditors.[46]

---

43. 17 C.F.R. §§ 229.1104(g), 229.1108(e), 229.1110(b)(3) (2018).

44. 15 U.S.C. § 77h-1 (2012) (allowing public enforcement by the SEC); *id.* § 77k (allowing private enforcement); *id.* § 77l (allowing private enforcement).

45. 17 C.F.R. § 229.1119(b).

46. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 311 (1939) (discussing equitable subordination and equitable disallowance); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 308–09, 324 (1939) (discussing recharacterization); Bergquist v. First Nat'l Bank of St. Paul (*In re* Am. Lumber Co.), 7 B.R. 519, 529 (Bankr. D. Minn. 1979) (discussing equitable subordination).

It should be noted that in restructurings involving public debt, empty voting may occur. *See* William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597, 1635–36 (2018) (discussing empty voting in out-of-court debt restructurings, which takes on a different flavor). Empty voting can occur in out-of-court restructurings of corporate debt. *Id.* Publicly-issued corporate debt securities ("bonds") are subject to a federal securities law known as the Trust Indenture Act, which prohibits the impairment of a bondholder's right to payment without that individual bondholder's consent. 15 U.S.C. § 77ppp(b). This ability to withhold consent from a restructuring means that individual bondholder can holdout and free ride on the restructuring benefits; all of the concessions made to achieve the restructuring are borne by the consenting bondholders. *See* Bratton & Levitin, *supra*, at 1608. The Trust Indenture Act thus enables individual bondholders to holdout in the face of proposed restructurings of payment terms, which in turn discourages other bondholders from accepting restructuring proposals because they must bear the cost of paying the holdouts. *Id.*

The bond issuer response is to use so-called "exit consents" to coerce bondholder acceptance of debt exchange offers. *Id.* at 1609–10. In an exit consent transaction, an exchange offer will be paired with a preceding vote to strip out various covenants that indirectly protect the bondholders' right to payment. *Id.* The result is to make the unexchanged bonds less valuable, and thereby encourage acceptance of the exchange offer. *Id.* Exit consents involve a type of empty voting, because the exchanging bondholders are voting to strip out covenants—change

But things change both as a practical matter upon insolvency, and as a formal matter in bankruptcy.[47] Creditors have the power to influence the conduct of the case in various ways, and acquire key governance rights with regard to bankruptcy plan confirmation. The junior creditors, who hold the residual (and hence variable) claim to the firm's value, become, in effect, the "owners" of an insolvent company, and investors in this so-called "fulcrum" security may actually gain control of the reorganized firm upon exit from bankruptcy.[48] The distribution to them under a Chapter 11 plan may be a controlling interest in the equity of the reorganized firm.[49]

Prior to plan confirmation, creditors have voice, both individually and collectively, through creditors' committees.[50] Unsecured creditors can object to non-ordinary course transactions during the bankruptcy case.[51] Unsecured creditors also have the power to vote on the plan (if their claims are impaired) and insist upon certain minimal distributions of assets.[52] Secured creditors too have the right to vote if impaired.[53] They can insist upon a distribution that matches the value of their encumbered collateral,[54] and have a right to "adequate protection" against depreciation of their collateral.[55] Indeed, they can seek a lifting of the automatic stay—the injunction that comes into place against collection actions against the debtor upon the filing of the bankruptcy petition—if adequate protection is not provided.[56] Finally, lenders that provide debtor-in-possession financing—new financing for the debtor during the bankruptcy—often have extraordinary governance rights by contract and court order, including selection of certain officers of the debtor, the ability to insist on sales of certain of the debtor's assets, budgets for the debtor's operations, and timelines for the debtor's reorganizational process.[57]

---

governance rights—from debt that they will no longer own. *Id.* The exchanging bondholders are exercising governance rights that are unattached to their economic interests. *Id.*

47. As we will discuss below, upon default, the practical power of creditors to exercise their remedies grants tremendous holdout power to a variety of key players. Bankruptcy limits these unilateral veto rights, in exchange for formal governance rights.

48. Levitin, *supra* note 29, at 92–94.

49. Jared A. Ellias, *Bankruptcy Claims Trading*, 15 J. EMPIRICAL LEGAL STUD. 772, 790–91, 791 n.32 (2018) (noting that claims trading is prevalent in the "fulcrum" class or classes of claims).

50. *See* LEVITIN, *supra* note 39, at 367–68.

51. 11 U.S.C. § 363(b) (2012) (governing transactions outside of the ordinary course of business); *id.* § 1109 (governing the right to be heard).

52. *Id.* § 1129(a)(7) (asserting the best interest test for minimum distribution); *id.* § 1129(a)(8), (a)(10) (voting); *id.* § 1129(b)(2)(B)(ii) (codifying the absolute priority test for distributional fairness).

53. *Id.* § 1126.

54. *Id.* §§ 725, 1129(a)(7), 1129(b)(2)(A).

55. *Id.* § 362(d)(1).

56. *Id.*

57. LEVITIN, *supra* note 39, at 409–11; Sris Chatterjee et al., *Debtor-in-Possession Financing*, 28 J. BANKING & FIN. 3097, 3098–99 (2004) (detailing terms of DIP loans).

The assumption underlying bankruptcy law is that these powers will be exercised by stakeholders with mutually aligned interests to maximize their recovery. Because interests are aligned, this rational behavior will serve to maximize the value of the firm. If, however, the economic interest of a creditor diverges from the interest listed in its proof of claim, conflicts of interest can arise that may impair the ability of the debtor and other stakeholders to engage in value-maximizing decision-making. As a result, the "empty voting" problem appears in bankruptcy as an "empty creditor" problem, at least in theory.[58] As noted, Professors Henry Hu and Bernard Black have published a controversial article describing what they call the "empty creditor" hypothesis,[59] but the problem they identify does not appear to be merely theoretical. Indeed, the "empty voting" problem appears to be a driving force in the run-up to many of the most contested bankruptcies of recent years.[60]

For example, in the lead up to Caesars Entertainment's bankruptcy, Caesars alleged that some of its second-lien noteholders were seeking to thwart an out-of-court restructuring in order to bolster the value of credit default swaps they held on Caesars.[61] Likewise, there was speculation that prior to the Chrysler bankruptcy some of the secured creditors had hedged their positions, encouraging them to engage in holdout behavior.[62] Similar speculation existed for Tower Automotive's bankruptcy.[63]

In the Lyondell Chemical bankruptcy, the judge even noted that it had been reported that "certain holders of credit default swaps have attempted to aggregate [a sufficient percentage of the debtor's notes] in order to accelerate them and create a 'termination event' that would entitle them to

58. Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 731–32; *see also* Patrick Bolton & Martin Oehmke, *Credit Default Swaps and the Empty Creditor Problem*, 24 REV. FIN. STUD. 2617, 2618 (2011) (arguing that "a creditor with a [credit default swaps] contract may indeed be more reluctant to restructure the debt of a distressed debtor . . ."); Yesha Yadav, *Empty Creditors and Sovereign Debt: What Now?*, 9 CAP. MKTS. L.J. 103, 104 (2014) (stating how "[o]n the surface, credit protection sellers and protection buyers [of CDS] appear locked in battle").

59. Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 728.

60. *See* Daniel Hemel, Comment, *Empty Creditors and Debt Exchanges*, 27 YALE J. ON REG. 159, 160–61 (2010) (noting cases of alleged empty creditor behavior in the run-up to bankruptcy); *Is the 'Empty Creditor' Theory Itself Empty?*, N.Y. TIMES: DEALBOOK (Dec. 21, 2009, 4:54 AM), https://dealbook.nytimes.com/2009/12/21/is-the-empty-creditor-theory-just-empty (detailing alleged empty creditor situations in international restructurings); *see also* Henry T.C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 BUS. LAW. 347, 371–72 (2015) (detailing several recent high-profile bankruptcies).

61. Complaint at 22, Caesars Entm't Operating Co. v. Appaloosa Inv. Ltd. P'ship I, 48 Misc. 3d 1212(A) (N.Y. Sup. Ct. Aug. 5, 2014) (No. 652392/2014).

62. *See* Mark A. Hofmann, *TARP Inspector Asked to Probe CDS Link to Automakers*, BUS. INS. (May 6, 2009), https://www.businessinsurance.com/article/20090506/NEWS/200016128.

63. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1034–35 (2007).

payment on the credit default swaps from their swap counterparties."[64] Even putting aside the alleged bad behavior, the Lyondell Chemical court noted that

> [m]any of the objecting parties [to a stay of collection actions against non-debtor guarantors] are holders of the 2015 Notes ("2015 Noteholders"), though some are also parties to credit default swaps that protect such holders from the risk of nonpayment—and whose interests are materially different from those who simply hold the 2015 Notes. Expressing a concern that is increasingly common in the large chapter 11 cases in this Court, some of the 2015 Noteholders argue that they would be affected much more dramatically by an inability to recover on the 2015 Notes than a 2015 Noteholder with a credit default swap would.[65]

Similarly, it was noted that when auto parts manufacturer Delphi filed for bankruptcy, the price of its securities went up because various derivatives needed to be physically settled.[66] The supply of actual debt securities ($2 billion) was not sufficient to meet the derivative market's demand ($25 billion of credit default swaps ("CDS") coverage outstanding) when all of the derivatives had to be settled simultaneously, thereby driving up the securities prices.[67] The same phenomenon appeared with Eastman Kodak, where there were notional $773 million of CDS outstanding against $1 billion of debt securities, only around $227 million of which appear to reflect hedged "basis players" who arbitrage between the spreads on the bonds and the spreads on the CDS.[68] The implication is that roughly $500 million of the CDS on Eastman Kodak were naked, unhedged bets on the firm's solvency. Notably, after the CDS auction settlement for Kodak, bond prices rallied, as another cadre of investors sought to purchase them for purposes of investing in the bankruptcy.[69]

The most direct allegation of a creditor taking actions to harm a debtor in order to collect on derivative positions comes from the on-going Windstream bankruptcy. In 2015, Windstream, a rural telecommunications company, engaged in a sale-leaseback transaction that violated the terms of some of its bond indentures.[70] Aurelius, a distressed debt hedge fund,

64. Lyondell Chem. Co. v. CenterPoint Energy Gas Servs. Inc. (*In re* Lyondell Chem. Co.), 402 B.R. 571, 585 n.26 (Bankr. S.D.N.Y. 2009).

65. *Id.* at 577–78 (emphasis omitted).

66. Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 416 (2007).

67. *Id.*; Melissa Mott, *Kodak CDS Auction Sheds Light on Settlement Process*, REUTERS (Mar. 2, 2012, 3:11 PM), https://www.reuters.com/article/markets-credit-idUSL2E8E28EZ20120302.

68. Mott, *supra* note 67.

69. *Id.*

70. U.S. Bank Nat'l Ass'n v. Windstream Servs., LLC, No. 17-CV-7857 (JMF), 2019 U.S. Dist. LEXIS 26129, at *3, *66 (S.D.N.Y. Feb. 15, 2019).

purchased some of Windstream's bonds and then sought to enforce the covenant default two years after it had occurred.[71] Windstream alleged that Aurelius held a large CDS short position on its bonds, and that Aurelius's litigation over a technical default was motivated solely by Aurelius's desire to trigger a payout on its CDS position.[72] Following an unsuccessful attempt to restructure its debts to gain waiver of the default, Windstream filed for bankruptcy.[73]

In addition to CDS allegedly being used by shorts to harm debtors, debtors have sometimes actually collaborated with both longs and shorts seeking to manipulate their recovery on a CDS position. Perhaps the most aggressive manipulation of the CDS and related debt markets observed to date involves Hovnanian Enterprises, a large homebuilder.[74] GSO Capital Partners, a hedge fund embedded in the Blackstone Group, one of the world's largest private equity firms, purchased some $330 million in CDS protection on Hovnanian's debt from Solus Alternative Asset Management LP, another hedge fund.[75] GSO then offered to refinance some of Hovnanian's debt on substantially below market terms.[76] The refinancing included the requirement that Hovnanian issue some new debt to a Hovnanian affiliate and then default on that debt by making a $1.04 million interest payment to its affiliate a few days late, at a time when Hovnanian had over $500 million cash on hand.[77] The default was too small to trigger cross-default clauses on Hovnanian's other obligations, but was just large enough to trigger a credit event on the CDS.[78] Moreover, the new debt issued by Hovnanian to its affiliate was itself on substantially below market terms, thereby depressing the market price of the debt.[79] Because the payout on the CDS is based on the pricing of the cheapest-to-deliver debt of the entity referenced in the swap,

71. *Id.* at *3, *24.

72. Windstream Holdings, Inc., *Windstream Holdings, Inc. Files for Voluntary Reorganization Under Chapter 11 of the U.S. Bankruptcy Code Following Judge Furman's Decision*, WINDSTREAM (Feb. 25, 2019), http://news.windstream.com/news-releases/news-release-details/windstream-holdings-inc-files-voluntary-reorganization-under.

73. Declaration of Tony Thomas, Chief Executive Officer and President of Windstream Holdings, Inc., (I) in Support of Debtors' Chapter 11 Petitions and First Day Motions and (II) Pursuant to Local Bankruptcy Rule 1007-2, *In re* Windstream Holdings, Inc. at ¶¶ 9–10, 14, No. 19-22312 (RDD) (Bankr. S.D.N.Y. Feb. 25, 2019) (No. 27), http://www.kccllc.net/windstream/document/192231219022500000000240.

74. *Hovnanian Enterprises Inc. CI A*, BARRON'S, https://www.barrons.com/quote/stock/us/xnys/hov/company-people (last visited Mar. 9, 2019).

75. Mary Childs, *The Hedge Fund Skirmish that Could Kill the CDS Market*, BARRON'S (Jan. 26, 2018, 7:32 PM), https://www.barrons.com/articles/the-hedge-fund-battle-that-could-kill-the-cds-market-1517013136.

76. Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., No. 18 CV 232-LTS-BCM, 2018 WL 620490, at *1 (S.D.N.Y Jan. 29, 2018).

77. *Id.* at *4.

78. *Id.*

79. *Id.*

the issuance of the below market debt ensured that the payout to GSO would be larger.[80] Lest this be thought a "one-off," GSO had previously engaged in a similar transaction involving the CDS on the Spanish gaming conglomerate Codere, SA, a deal that merited mention on *The Daily Show*.[81]

Moreover, GSO was not alone in playing the CDS manipulation game. Solus—the protection seller to Hovnanian—had itself unsuccessfully offered Hovnanian below market financing that would have been coupled with "an unusual provision under which Hovnanian would be in default under Sol[u]s' financing instruments if any failure by Hovnanian to pay any of its debt obligations constituted a failure to pay Credit Event with respect to CDS contracts."[82] Apparently, the debtor accepted the better offer. They chose to trigger the payout on a CDS. Litigation over the Hovnanian transaction settled,[83] but it shows how players with short positions via CDS can engage in manipulative transactions with the entity whose debt is referenced by the CDS.[84]

---

80. *Id.*

81. Stephanie Ruhle et al., *Blackstone Unit Wins in No-Lose Codere Trade: Corporate Finance*, BLOOMBERG (Oct. 22, 2013, 10:02 AM), https://www.bloomberg.com/news/articles/2013-10-22/blackstone-unit-wins-in-no-lose-codere-trade-corporate-finance; *see also The Daily Show with Jon Stewart: Blackstone & Codere*, COMEDY CENT. (Dec. 4, 2013), http://www.cc.com/video-clips/og8sum/the-daily-show-with-jon-stewart-blackstone—codere (covering—in a comedic manner—GSO's nefarious behavior and highlighting the lack of coverage of this transaction by 24-hour financial news networks).

82. *Solus Alt. Asset Mgmt. LP*, 2018 WL 620490, at *3.

83. Claire Boston & Sridhar Natarajan, *Blackstone, Solus Settle Fight Over Hovnanian CDS Trade*, BLOOMBERG (May 30, 2018, 6:00 PM), https://www.bloomberg.com/news/articles/2018-05-30/hovnanian-pays-overdue-interest-on-bonds-within-grace-period.

84. Radio Shack's bankruptcy illustrates the flip-side of the Hovnanian situation, in which long, rather than short, creditors engage in the manipulation of the market. Some of Radio Shack's creditors had allegedly sold CDS protection on Radio Shack debt, making them extra long. *See* Michael Aneiro, *What's Keeping Radio Shack Afloat? Credit Derivatives*, BARRON'S (Dec. 19, 2014), https://www.barrons.com/articles/whats-keeping-radio-shack-afloat-credit-derivatives-1419003199. When it appeared that Radio Shack would default, these creditors extended a new loan to Radio Shack so that it would only default after the expiration of the credit default swaps. *See id.*

In reaction to situations like Hovnanian and Codere, the International Swaps and Derivatives Association ("ISDA") announced in March 2019 a proposal to "re-defin[e] failure to pay" under "credit event" as part of its Master Agreement to exclude failures to pay that are not causally linked with a deterioration of a firm's creditworthiness or financial condition. Benjamin Bain et al., *Wall Street Titans Cut Deal to Clean Up Shady CDS Trades*, BLOOMBERG (Mar. 6, 2019, 10:00 AM), https://www.bloomberg.com/news/articles/2019-03-05/wall-street-titans-said-to-cut-deal-to-clean-up-shady-cds-trades (internal quotation marks omitted). The proposal, undertaken in the shadow of a threat of regulation by the Commodities Futures Trading Commission, would limit the ability of investors to engage in corporate debt transactions to manipulate CDS, but it would leave untouched the ability of investors to exploit combined CDS and debt positions. *See generally* INT'L SWAPS & DERIVATIVES ASS'N, PROPOSED AMENDMENTS TO THE 2014 ISDA CREDIT DERIVATIVES DEFINITIONS RELATING TO NARROWLY TAILORED CREDIT EVENTS (2019), https://www.isda.org/a/nyKME/20190306-NTCE-consultation-doc-complete.pdf (stating the proposed amendments and explaining the reasoning behind them). A CDS holder who holds bonds or other debt may refuse to cooperate in a restructuring—thereby triggering a

While most evidence of empty creditor behavior shows up in the distressed debt market on the threshold of bankruptcy, there are some indications that it may be continuing in bankruptcy. In broadband communication company LightSquared's bankruptcy, entities affiliated with DISH Network, a competitor of the debtor, allegedly purchased the debtor's secured debt in the bankruptcy claims market in order to block a reorganization plan pushed by the debtor's controlling shareholder.[85] Another DISH-affiliated entity also made a low-ball asset purchase offer in order to confuse the market regarding the value of the debtor's assets and thereby chill bidding.[86] Similarly, in broadband company DBSD's bankruptcy, DISH Network again attempted to block a plan by purchasing a position in DBSD's secured debt.[87] DISH's supposed goal in this scheme was to force DBSD into a strategic transaction with DISH by precluding alternative transactions.[88]

Likewise, while bankruptcy constitutes a "credit event" for CDS that entitles the protection buyer to terminate the swap and collect payment, the payout on the CDS to the protection buyer is not immediate. The payout amount on the CDS is calculated based on the clearing price in an auction for the referenced debt conducted by the International Swaps and Derivatives Association ("ISDA"). The ISDA auction date is set by an ISDA Determinations Committee,[89] but may easily take place a month or more after the bankruptcy filing, depending on the complexity of the legal issues that need to be addressed regarding the auction, such as precisely which debt instruments are eligible for inclusion in the auction. The auction mechanics are complicated and need not concern us here; the bottom line is that the higher the auction price of the covered debt obligations, the lower the payout on the CDS by the protection sellers.

The delay between the bankruptcy filing and the ISDA CDS clearing auction means that parties invested in CDS have a post-bankruptcy exposure window. Post-bankruptcy exposure creates an incentive for the swap counterparties to attempt to affect the fortunes of the debtor firm in order to affect the market value of the debt insured by the CDS and thereby increase

default and increasing their CDS recovery. In other words, even if the ISDA proposal is adopted, it will not affect the empty creditor problem, but only what one might term the "empty counterparty." The situation alleged to exist in Lyondell and Windstream is thus not addressed by the ISDA proposal.

85. Harbinger Capital Partners LLC v. Ergen (*In re* LightSquared Inc.), 504 B.R. 321, 332–33 (Bankr. S.D.N.Y. 2013).

86. *Id.* at 333.

87. Dish Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 104 (2d Cir. 2010).

88. *Id.*

89. Int'l Swaps & Derivatives Ass'n, The Credit Event Process, at slide 12 (last visited Mar. 9, 2019), *available at* https://www.isda.org/a/cKwEE/TheCreditEventProcess.pdf.

(in the case of protection buyers) or decrease (in the case of protection sellers) the payouts on CDS.

Thus, in Sears' bankruptcy, the hedge fund Cyrus Partners LP had sold CDS protection on Sears debt.[90] Cyrus first attempted to prevent Sears from selling certain pre-existing intercompany obligations into the market because of a concern that those obligations could be bid into the CDS clearing auction and by virtue of expanding the pool of debt, lower the auction price and therefore increase the payout on the CDS.[91] Having failed to prevent the sale of the intercompany obligations, Cyrus then bought the notes itself,[92] even as it lobbied ISDA to make the intercompany obligations ineligible for the auction. And finally, Cyrus made a second-lien DIP loan to Sears, which increased the likelihood of Sears' survival and thus the value of its bonds, which reduced the payout on the CDS.[93] Cyrus is a case of a party pursuing governance strategies based on being extraneously *long* on the debtor, but it's notable that Cyrus was opposed in its efforts by CDS protection buyers, who were *short* on Sears. Both longs and shorts in the CDS market have an interest in affecting corporate governance in bankruptcy because of the delay between bankruptcy and the determination of the payouts on the CDS.

Although Hu and Black recognize that there may be an empty voting problem in bankruptcy, they do not identify the extent to which it goes to the very heart of the bankruptcy system. As a response, Hu and Black principally propose an enhanced disclosure regime. They passingly acknowledge that disclosure may be insufficient, and that adjustment of voting rights may be necessary.[94] But the problem runs deeper than they recognize—going to the very heart of the Code's distributional scheme. Accordingly, they do not seek to operationalize this suggestion, nor do they explore when and why disclosure may be insufficient.[95] Hu and Black work from a straight analogy to the "empty voting" problem with regard to equity investments in a solvent

90. Jessica DiNapoli, *Sears Investors Claim Hedge Fund Cyrus Improperly Influencing Credit Market: Letter*, REUTERS (Nov. 20, 2018, 7:24 PM), https://www.reuters.com/article/us-sears-bankruptcy-cyrus/sears-investors-claim-hedge-fund-cyrus-improperly-influencing-credit-market-letter-idUSKCN1NQ04K.

91. *See id.*

92. Andrew Scurria, *Sears's $82.5 Million Note Sale to Cyrus Is Thrown into Doubt*, WALL ST. J. (Dec. 20, 2018, 7:20 PM), https://www.wsj.com/articles/searss-82-5-million-note-sale-to-cyrus-is-thrown-into-doubt-11545351623.

93. Lillian Rizzo, *Sears Finds New Bankruptcy Loan Lender in Swap Seller*, WALL ST. J. (Nov. 27, 2018, 7:42 PM), https://www.wsj.com/articles/sears-finds-new-bankruptcy-loan-lender-in-swap-seller-15433657 21.

94. *See* Hu & Black, *Debt, Equity and Hybrid Decoupling*, *supra* note 30, at 684–85.

95. *Id.* (suggesting that given the problems of conflicted plan voting, the use of asset sales without voting to effectuate reorganization might be preferable, but noting the problem of credit bidding by empty creditors); Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 731–32.

company.[96] Because of this, they do not recognize ways in which insolvency changes the landscape both as a strategic matter—altering the practical and legal power held by a Trojan Horse creditor—and as a policy matter —implicating the bankruptcy policy of equitable distribution of firm value (discussed in the next subpart).

Schadenfreude creditors, bullies, and Trojan Horse creditors in bankruptcy raise additional concerns that may require more aggressive intervention than Hu and Black recognize. First, claims trading in distress situations implicates more than ownership. The future of the firm and its very viability are at stake. Second, control rights may be purchased at a discount. Third, the Bankruptcy Code, by design, gives more voice to various creditor constituencies, making it even easier to obtain a blocking position. And fourth, to the extent that this leverage changes hands after insolvency, it creates opportunities to distort the Bankruptcy Code's priority scheme. In this Article, we seek to identify the full breadth of situations where such governance distortions occur (including with regard to secured creditors) and suggest a practical approach to remedying their effects.

D. Empty Creditors, Economic Exit and Equality of Distribution

As the preceding section shows, the empty creditor problem can arise both as a result of trading in claims of the debtor, and through the purchase of related assets.[97] The key point developed above is that control rights have economic value that is separate and distinct from the economic interest underlying the claim, and that they can be used in ways that harm the debtor or other claimants. This is a governance problem because it can create conflicts of interest (loyalty), that distorts the way governance rights (voice) are used. It also complicates the problem of exit. It creates a distinction between creditors who make an economic exit by selling their claim, from those who sell at a premium because they exit by selling into a control block.

This exit distinction has governance implications, because an ordinary creditor who sells to a Trojan Horse creditor not only receives a premium on the value of their claim, the governance rights associated with that claim may be used to harm the remaining incumbent shareholders, either to reduce the value of the debtor or reallocate value. This raises separate and distinct concerns about the bankruptcy policy of equality of distribution and its interaction with governance rights.

There are many benefits to allowing creditors to assign their claims after bankruptcy—to make an economic exit. They may not be well equipped to participate in a bankruptcy case.[98] They might prefer to recognize their losses,

96. Hu & Black, *Debt, Equity and Hybrid Decoupling*, *supra* note 30, at 684–85; Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 731–32.

97. *See supra* Section II.C.

98. *See* Levitin, *supra* note 29, at 93.

etc.[99] Also, a market for claims, at least to the extent it is transparent, provides information about the value of the firm, because it indicates the market's valuation of different claims on the capital structure of the firm; to the extent that the market places a low value on a claim, it is an indication that the market believes that the firm is worth less than the aggregate amount of all senior claims. Critically, claims trading does not distort the relative position of claims.

However, where governance rights are part of the proposed trade, this is not the case. To understand this point requires a brief discussion of a deeper point about the Bankruptcy Code, and Chapter 11 in particular. In *Tracing Equity: Realizing and Allocating Value in Chapter 11,* Edward Janger and Melissa Jacoby explain the concept of equality of distribution in bankruptcy.[100]

Chapter 11 allows a debtor to delay realization of the value of the firm, and therefore of claims, beyond the filing date.[101] To do this the Code must establish a way of allocating changes in the value of the firm over time, which it does by separating the process of realization into two moments, through a process that we call, "Equitable Realization." Those two moments of realization are: (1) the filing of the bankruptcy petition; and (2) plan confirmation or collateral realization.

At the moment of the bankruptcy filing, Equitable Realization occurs, and the relative positions of creditors are fixed. Unsecured creditors' claims are fixed relative to each other,[102] and the pool of encumbered assets is fixed as well.[103] The economic value of their claim, by contrast, is not determined until the moment of "Value Realization," either the effective date of the plan, when a distribution is received, or when collateral is disposed of.[104]

Control rights, to the extent that they inhere in a particular class of claims, are not an asset of a particular creditor but of the class itself. Also, to the extent that there is a control premium associated with a block of shares, that value is not available to the class as a whole, only to those creditors who sell into the control block. Thus, the distortions created by the Empty Creditor problem implicate both the bankruptcy policies of value maximization and equality of distribution, as they alter the relative distributions of value to creditors within the same class.

E. MECHANISMS FOR SEPARATING ECONOMIC INTEREST FROM GOVERNANCE RIGHTS

Debt-based governance rights can be separated from economic interests in more ways than one might think. In this section we discuss the way

99. *See id.*
100. *See* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 688–93.
101. *See id.* at 684–88.
102. 11 U.S.C. § 502 (2012).
103. *Id.* § 552.
104. *Id.* §§ 552(b), 1129(b)(2)(A).

derivatives can be used to construct such a mismatch, and then go further. Derivatives are not the only way to create such a mismatch.[105] Some such conflicts are more deeply imbedded and harder to address, as discussed in Section IV.C.

1. Put Options

The most straightforward way to bet against a debtor would be to purchase a put option on the debt.[106] Put options enable a creditor to sell its debt holdings at a fixed strike price. The put option caps the creditor's downside exposure to the debtor at the strike price, and because the value of the put option rises as the debt's market value falls, the creditor may be incentivized to exercise its governance rights to increase the value of the put option, especially if the put option is for a greater amount than its current debt holdings. Thus, a creditor might have a put option for $10 million at par, but only hold $3 million in debt. The creditor might use the governance

105. Two other methods of separating economic interest from governance rights are purchasing debt at a discount from face and securitizations and participations. Purchasing debt at a discount from face, whether through secondary market purchase or original issue discount means that the governance rights on the debt—including voting rights in bankruptcy—track the face amount of the debt, but the economic interest is based on the purchase price as well as the face amount. The purchase price represents the maximum downside exposure for the investor, even as the face amount represents the maximum upside. Thus, two creditors holding debts for identical face amounts, but one having purchased the debt at a steep discount, have different incentives in exercising the governance rights associated with that debt.

Likewise, securitization inherently involves a separation of governance rights over securitized assets and economic interest in the assets. *See* Hu & Black, *Debt, Equity and Hybrid Decoupling*, *supra* note 30, at 665, 691. The securitization investors maintain the economic interest in the assets, but the assets are managed by a servicer and legal title to the assets is held by either a trustee or a corporate entity. *See id.* at 665. As a result, securitization investors do not get to vote on bankruptcy plans and even standing to appear in bankruptcy court to raise objections. *See In re* Innkeepers USA Tr., 448 B.R. 131, 142–45 (Bankr. S.D.N.Y. 2011) (finding commercial mortgage securitization investors lack standing to object to sale bidding procedures, only the special servicer does); *In re* Shilo Inn, 285 B.R. 726, 729 (Bankr. D. Or. 2002) (finding commercial mortgage securitization investors do not individually have the right to vote on a Chapter 11 plan, only the special servicer does). Loan participations operate much the same in terms of the separation of governance and economic rights—the original lender maintains legal title and servicing rights on the loan, while the participants have only economic rights. *See* LEVITIN, *supra* note 39, at 81; *see also* Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 736–37 (6th Cir. 2001) (explaining operation of loan participations).

106. *See, e.g.*, Arturo Bris et al., *Efficiency and the Bear: Short Sales and Markets Around the World*, 62 J. FIN. 1029, 1070–72 (2007) (explaining how put options function as a mechanism for taking a short position); Bartley R. Danielsen & Sorin M. Sorescu, *Why Do Option Introductions Depress Stock Prices? A Study of Diminishing Short Sale Constraints*, 36 J. FIN. & QUANTITATIVE ANALYSIS 451, 454–58 (2001) (explaining the same); Bruce D. Grundy et al., *Do Option Markets Undo Restrictions on Short Sales? Evidence from the 2008 Short-Sale Ban*, 106 J. FIN. ECON. 331, 332, 340–41 (2012) (explaining the same); *see also* Olagues v. Icahn, 866 F.3d 70, 72 n.1 (2d Cir. 2017) ("The buyer of a put option and the seller of a call option, by contrast, anticipate the stock price to drop (a 'short' position).").

rights on that $3 million to push down the value of the debt and then go and purchase another $7 million of debt (now trading at a discount).

2. Credit Default Swaps

Credit derivatives can have a similar effect. For example, a CDS between a protection buyer and a protection seller pays the protection buyer when a debtor files for bankruptcy. An investor can go short via CDS protection either as a protection buyer without an actual holding of the referenced debt instrument (a "naked short"), or as a protection buyer that holds the referenced debt instrument (a "clothed protection buyer"), but is more than fully-hedged via CDS (a "clothed short"). CDS protection may affect the willingness of a clothed protection buyer to negotiate a workout prior to bankruptcy, either by making it easier to favor a risky strategy, or, if short, to actually seek to trigger the default.

CDS can obviously complicate out-of-court debt restructurings. They can also affect creditor behavior in the run-up to the bankruptcy.[107] As a governance matter this is problematic, because creditors' pre-bankruptcy behavior may reduce the value of the firm and foreclose potential restructurings in bankruptcy. Any remedy in bankruptcy would, of course, have to be imposed ex post.

Critically, however, CDS can also affect creditor behavior at the beginning of bankruptcies. Under the standardized International Swaps and Derivatives Association documentation, a CDS will be triggered by the bankruptcy filing itself.[108] Since 2009 CDS are, by default, settled through cash-payment at an auction-determined rate, although a physical settlement option remains.[109]

As noted above, the auction to determine the settlement price does not occur immediately upon the bankruptcy filing, but at some point thereafter. The timing of the auction is left to the discretion of an ISDA Determinations Committee, but the more complicated the legal questions involved —particularly issues about what debt obligations are eligible to be bid in the

---

107. Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 683 (2010) ("Credit default swaps create a moral hazard problem only before the Chapter 11 begins and in its immediate aftermath.").

108. *See, e.g.*, Int'l Swaps & Derivatives Ass'n, Inc., 2002 ISDA Master Agreement between Bank of Am., N.A. & LKQ Corp. § 5(a)(vii)(4)(A) (March 22, 2011), https://www.sec.gov/Archives/edgar/data/1065696/000119312511118050/dex101.htm; *see also* INT'L SWAPS & DERIVATIVES ASS'N, INC., USER'S GUIDE TO THE ISDA 2002 MASTER AGREEMENT 14 (2003), https://www.isda.org/a/lAEDE/UG-to-2002-ISDA-Master-Agreement.pdf ("Section 5(a)(vii) applies to each party, any Credit Support Provider of a party and any applicable Specified Entity of a party. It is drafted so as to be triggered by a variety of events associated with bankruptcy or insolvency . . . .").

109. *See* MARKIT & CREDITEX, CREDIT EVENT AUCTION PRIMER 2 (2010), http://www.creditfixings.com/information/affiliations/fixings/auctions/docs/credit_event_auction_primer.pdf.

auction—the greater the delay. For example, Sears filed for bankruptcy on October 15, 2018, but the CDS auction did not take place until January 17, 2019.[110] During the window between the bankruptcy filing and auction to determine the CDS settlement price, both protection sellers and protection buyers are incentivized to take actions to affect the settlement price in their favor, and this means taking actions to attempt to further or hinder the debtor's reorganization prospects.

The window between the bankruptcy filing and the CDS auction is likely to be fairly limited in most cases, however, perhaps a month or so. Once the CDS settlement price is set, the incentive for CDS counterparties to affect the debtor firm's prospects disappear. In most situations this means that bankruptcy voting will be unaffected. Unless there is a pre-packaged or pre-negotiated bankruptcy in which voting takes place before or shortly after the filing of the petition, any vote on a plan will likely be after the CDS settlement price is fixed.[111]

3. Total Return Swaps

There are other derivative devices that continue to operate, even once a debtor has filed for bankruptcy. For example, a total return swap ("TRS") is a swap in which one party to the swap commits to swapping a sum certain for the total return of the counterparty on a specified reference asset.[112] Because TRS are triggered by the occurrence of a date certain, rather than by a credit event such as a bankruptcy filing, a TRS can continue to be in place after a bankruptcy filing, or could even be purchased after a bankruptcy filing.[113] Thus, if our creditor holds a $10 million note and purchases a $12 million TRS, triggered in three years, that creditor would continue to be net short throughout the term of the swap, regardless of when, or if, the debtor filed for bankruptcy.

TRS are a limited subset of credit derivatives[114] and have not been specifically linked with bankruptcy empty-creditor problems. But there are myriad ways for the holder of a claim in bankruptcy to use derivatives to hedge risk, or take a short position. Simply buying a put option after the bankruptcy

110. *See Sears Roebuck Accep Corp CDS Credit Event Auction*, CREDITEX (Jan. 17, 2019), http://www.creditfixings.com/CreditEventAuctions/holdings.jsp?auctionId=9129 (showing that the Sears CDS clearing auction was held on January 17 of 2019).

111. In cases where the bankruptcy is prearranged, or a restructuring support agreement is negotiated, CDS may affect dynamics as well.

112. JOHN D. FINNERTY, PRICEWATERHOUSECOOPERS, THE PRICEWATERHOUSECOOPERS CREDIT DERIVATIVES PRIMER 6, https://www.pwc.com.tr/en/assets/about/svcs/abas/frm/creditrisk/surveys/pwc_credderi.pdf (last visited Mar. 9, 2019).

113. The duration of TRS can itself affect parties' incentives in a bankruptcy, but that is a secondary issue.

114. We have been unable to identify reliable information on the size of the TRS market. Statistics on the credit derivatives market do not break out TRS separately from CDS.

on the claim will do.[115] If the claim's value falls beneath the strike price, the option holder will exercise the option and sell the claim. The claimholder is thus hedged for any decline below the strike price.

4. Investment in Competitors

The same is true, derivatives aside, if a creditor has an interest in a competitor of the debtor. The value of the interest in the competitor might increase if the debtor is unable to reorganize and liquidates.[116] One such example occurred in *Dish Network v. DBSD*, where a competitor of the debtor bought up claims against the debtor and sought to use them to vote against the plan of reorganization.[117] In that case, the court "designated" those creditors' claims and denied them their voting rights.[118] A similar situation was alleged to have occurred in *LightSquared* (with the same defendant).[119]

5. Investment Across the Capital Structure

Creditors also frequently invest across the capital structure of the debtor.[120] For example, a first lien secured creditor might also hold an unsecured position, a second lien position, an equity position, or any of the above. One might assume that such a creditor would want to maximize the value of each of its various investments. However, this may not always be the case. It is possible that the investment in one part of the capital structure may be for the purposes of obtaining a return, while the investments in the other parts of the capital structure may be for the purpose of obtaining control, to be used to increase the return to the creditor's other position(s) in the capital structure.

Such a creditor's interest and behavior may vary depending on where the value of the firm lies. If all of the value of a firm can be transferred to the senior secured creditor through control of a junior class, the secured creditor may not have to share with junior creditors. Indeed, it is not unusual for a secured creditor to privilege its secured claim above its interest as an unsecured creditor and use its deficiency claim in a way that may actually harm the other unsecured claimants.[121] Similarly, landlords (who are not secured creditors, but share an ability to recover specific property) may prefer

---

115. This is distinct from purchasing a put option prepetition on the debt itself.

116. *See, e.g.*, Dish Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 106–08 (2d Cir. 2010); Tex. Hotel Sec. Corp. v. Waco Dev. Co., 87 F.2d 395, 400–01 (5th Cir. 1936).

117. *Dish Network Corp.*, 634 F.3d at 87, 106–08.

118. *Id.* at 104–08.

119. *See supra* notes 85–88 and accompanying text.

120. *See* Hu & Black, *Debt, Equity and Hybrid Decoupling*, *supra* note 30, at 683–84.

121. *See generally* Wells Fargo Bank, N.A. v. Loop 76, LLC (*In re* Loop 76, LLC), 465 B.R. 525 (B.A.P. 9th Cir. 2012) (considering when it is appropriate to separately classify a secured creditor's deficiency claim).

to recover the leased premises from the debtor in order to relet the property at a higher market price than to ensure the debtor's continued viability, which would improve the possibility of a recovery on their unsecured breach of lease claims, but might continue to lock them in to a below-market lease.

6. Investment in Multiple Affiliates

A similar problem arises in cases involving multiple related debtor entities.[122] A creditor might have an interest in more than one affiliated debtor firm. In such a case, the creditor might be willing to sacrifice a return on its investment in one entity in order to achieve a greater recovery for its investment in another entity under a joint Chapter 11 plan. Given that not all creditors in either entity will be similarly invested, there is an inherent misalignment of interests.[123]

F. Problems Created by Separating Economic Interest from Governance Rights

Thus, there are numerous ways in which a creditor can go short in bankruptcy and take a *Schadenfreude* position. Since creditors exercise formal governance rights in bankruptcy and have informal power when the debtor is in distress, they can throw their weight around—like a bully. When a conflict of interest is linked to governance power, the creditor has a strategic incentive to use that power, not just to take from others, but to reduce the value of the firm.[124]

As we will discuss below, this linkage is particularly troubling in bankruptcy because of: (1) fragmentation; and (2) transparency. With regard to fragmentation, blocking positions proliferate in bankruptcy (at least as

122. Most large firms structure themselves as a pyramid of holding companies and subsidiaries. While tort and trade creditors are typically creditors of only one legal entity with such structures, there will often be a tax liability-sharing agreement among the entities within the firm, and financial creditors typically receive cross-guaranties from most domestic entities within the firm structure. In some situations, there will be multiple debtor entities with the same creditors, but these creditor entities may not have equal interests in all of the debtors.

123. This situation existed in telecommunications company Adelphia's bankruptcy. There were 230 affiliated debtor entities with some overlapping creditors. ACC Bondholder Grp. v. Adelphia Commc'ns Corp. (*In re* Adelphia Comm'cns Corp.), 361 B.R. 337, 341–42 (S.D.N.Y. 2007). Five groups of creditors were deputized to litigate various intercompany claims, fraudulent transfer actions, and other inter-debtor causes of action. *Id.* at 343–45. Four of the creditor groups negotiated a settlement at the expense of the other creditor group (the "ACC Bondholder Group"), which objected to the settlement. *Id.* The ACC Bondholder Group was not unified, however—some of its members purportedly had claims against other debtor entities and so were in favor of the settlement because on net they did better. *See id.* at 364–67. *But see In re* Adelphia Comm'cns Corp., 368 B.R. 140, 222 (Bankr. S.D.N.Y. 2007).

124. *See* Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (*In re* Ion Media Networks, Inc.), 419 B.R. 585, 588–89 (Bankr. S.D.N.Y. 2009) (noting that a distressed debt investor's "motivations are easy enough to recognize. It has been using aggressive bankruptcy litigation tactics as a means to gain negotiating leverage or obtain judicial rulings that will enable it to earn outsize returns on its bargain basement debt purchases . . . .").

compared to solvent firms), and, because debt is often trading at a considerable discount, these blocking positions can be purchased on the cheap. With regard to transparency, the existing regime for disclosing creditor's potential control positions is rudimentary at best. As a result, when a control position is combined with an undisclosed short, the creditor becomes a Trojan Horse creditor.[125]

1. Current Mechanisms

Concern about use of leverage to reallocate value is not new, and we will discuss the Code's response in more detail below. Disputes have arisen about whether secured creditors' deficiency claims can be classified together with other unsecured creditors[126] and whether an (under)secured creditor can sit on an unsecured creditors' committee.[127] Indeed, the Bankruptcy Code already recognizes the problem and provides for it in two contexts.

First, the Code regulates the retention of professionals by the bankruptcy estate. Professionals, such as attorneys, who assist in the governance of the debtor during the bankruptcy, can be retained only if they are "disinterested" and "do not hold or represent an interest adverse to the estate."[128] Thus, to the extent that a professional is itself a creditor or equity holder, the retention is prohibited,[129] and if a professional had a material financial position in a competitor of the debtors, that would also preclude retention. Likewise, if the professional had previously served as an officer or director of the debtor, retention is forbidden[130]—the *estate* might well have claims against the professional on account of that prior service, and the professional would be conflicted in counseling the estate about prosecution of such a claim. The disinterestedness requirement for professionals is designed to ensure that those parties who assist in the governance of the estate are not exercising their influence for their personal benefit at the expense of the estate.

---

125. *See supra* text accompanying notes 29–30.

126. *See, e.g.*, *In re* Marlow Manor Downtown, LLC, 499 B.R. 717, 720–21 (Bankr. D. Alaska 2013), *aff'd*, Marlow Manor Downtown, LLC v. Wells Fargo Bank (*In re* Marlow Manor Downtown, LLC), No. AK-14-1122-JuKiKu, 2015 WL 667543, at *9–10 (B.A.P. 9th Cir. Feb. 6, 2015) (holding separate classification of unsecured deficiency claim improper); *see also* Boston Post Rd. Ltd. P'ship v. FDIC (*In re* Boston Post Rd. Ltd. P'ship), 21 F.3d 477, 483 (2d Cir. 1994) (holding separate classification of unsecured deficiency claim from unsecured trade claims improper); Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir. 1992); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1280–81 (5th Cir. 1991); *In re* 18 RVC, LLC, 485 B.R. 492, 497 (Bankr. E.D.N.Y. 2012); *In re* SM 104 Ltd., 160 B.R. 202, 220 (Bankr. S.D. Fla. 1993); *In re* Bjolmes Realty Tr., 134 B.R. 1000, 1003 (Bankr. D. Mass. 1991); *In re* Aztec Co., 107 B.R. 585, 587 (Bankr. M.D. Tenn. 1989).

127. *See, e.g.*, *In re* Walat Farms, Inc., 64 B.R. 65, 70 (Bankr. E.D. Mich. 1986); *In re* Glendale Woods Apartments, Ltd., 25 B.R. 414, 415 (Bankr. D. Md. 1982).

128. 11 U.S.C. §§ 101(14), 327(a) (2012).

129. *Id.* § 101(14)(A).

130. *Id.* § 101(14)(B).

Second, concerns about conflicted creditors are reflected in the context of the Code's overlooked "Lesser Vote"—the vote for the election of a Chapter 7 trustee.[131] The only moment when creditors exert governance influence in Chapter 7 is when they vote to elect the Chapter 7 trustee. The Bankruptcy Code provides that a creditor may vote for a candidate for trustee only if the creditor "does not have an interest materially adverse, other than an equity interest that is not substantial in relation to such creditor's interest as a creditor, to the interest of creditors entitled to such distribution" and "is not an insider."[132] No such provision exists in Chapter 11, where there is not normally a trustee appointed and where equity holders and insiders are not automatically disqualified from all voting.[133]

The advent of robust trading in claims and the increased sophistication of credit derivatives warrants a reexamination of the assumption that there are sufficient mechanisms available under current law to police conflicts of interest and to insure equitable distribution of a firm's value. That assumption, for the reasons we discuss above, is untenable in the face of modern capital markets.[134] It is now necessary to consider how bankruptcy law might ensure the alignment of a creditor's economic rights and control rights in the present environment.

2. Fragmentation Concerns

First, we should elaborate on the fragmentation and transparency problems created by the separation of economic interest from governance rights (or to put it the other way around, by the linking of a conflict of interest to governance rights). As Michael Heller has pointed out, fragmentation problems arise when the proliferation of veto rights makes it impossible for common owners to cooperate towards a mutually beneficial outcome.[135] An economic "short" may seek to sabotage a workout and encourage a bankruptcy to trigger payment on a derivative that is contingent on a

131. *Id.* § 702.

132. *Id.* § 702(a)(2)–(3).

133. Chapter 11 disqualifies insiders from one of its two votes. While insiders' votes count for purposes of § 1129(a)(8), they do not count for § 1129(a)(10).

134. *See supra* Sections II.E.2–.3.

135. Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1186–87 (1999); Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 680 (1998) [hereinafter Heller, *The Tragedy of the Anticommons*]. Fragmentation also interacts with transparency. *Compare* Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1, 3–7 (2000) (arguing that because property rights affect the rights of third parties, transparency is essential, and therefore, complex and divided forms of property should be discouraged), *with* Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. LEG. STUD. S373, S374–75 (2002) (asserting that the problem of division and transparency can be remedied through verification systems).

bankruptcy filing or other default.[136] Similarly, a claimant with a short position may seek to block confirmation of a bankruptcy plan in order to force liquidation, or may be willing to bargain aggressively in ways that may disrupt the administration of the case due to its hedged or inverted economic interest.[137] The "short" thus benefits from the misfortune of the debtor.

When governance rights in bankruptcy trade at a discount, it becomes cheaper for a short to become a Trojan Horse and bring about the misfortune it desires. As such, the ability to separate economic interest from governance rights can create or exacerbate coordination problems at both the workout stage and at the plan confirmation stage.[138] Too much liquidity can, thus, create tragedies of both the "commons" and the "anticommons."[139] Where the right to use an asset is held in common, claimants trying to grab too large a share can lead to destruction of an existing asset. This is a tragedy of the "commons." Where creation or preservation of a common asset—in this case a firm's reorganization or going concern value—is subject to multiple or fluid "veto rights," such as claimants drifting in and out of blocking positions, the result can be to frustrate the coordination necessary to create a common benefit. This is the tragedy of the "anticommons." As we will discuss below, this is particularly problematic in bankruptcy, where, by design, the Code gives a variety of claimants legal and practical veto rights over the reorganization—considerably more than exist when a company is solvent, though also somewhat less than that claimant might have outside of bankruptcy against an insolvent firm.[140]

Coordination problems can emerge naturally as a product of the liquidity of claims. For example, a debtor may work out a deal with one key creditor,

---

136. *See* Complaint, *supra* note 61, ¶ 3.

137. *See supra* text accompanying notes 59–65. In theory there is also a mirror image problem of the excessively "long" investor. In its most basic form, this is the problem of vendors and employees. Their interest in the debtor is not limited to the amount of their prepetition claim, but is likely driven by their hope of getting future business from the debtor.

The excessive long problem extends to investors, however. For example, an investor might own both the equity of the debtor and the equity of a key supplier of the debtor's. Such an investor might be happy for the debtor to assume excessive risk in order to keep the debtor providing business to its other investment. Conversely, if the debtor is a key supplier of a firm in which the investor is also invested, the investor might want to keep the debtor operating in order to ensure a supply to the other firm. We do not address this issue here because the governance problems that have presented themselves in bankruptcy have all been from short positions, not excessive long positions.

138. Janger, *supra* note 24, at 53–56 (discussing coordination issues at the plan confirmation stage). *See generally* Baird & Rasmussen, *supra* note 107 (discussing coordination problems in Chapter 11 bankruptcy).

139. *See generally* Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243 (1968) (describing the tragedy of the commons); Heller, *The Tragedy of the Anticommons*, *supra* note 135 (describing the tragedy of the anticommons).

140. The Bankruptcy Code is designed to facilitate collective governance by limiting the rights of holdouts. However, as we will discuss below, even in bankruptcy, "holdout" creditors have considerably more leverage than "dissenting" shareholders.

only to have that creditor sell its claim to a new party. Where the purchaser of the claim is a *Schadenfreude* investor—an economic short—the purchaser's goal may be to obstruct *any* agreement. The debtor and other creditors have no way of knowing this or of remedying the informational problem prior to bankruptcy and, under current law, even in bankruptcy.[141] Alternatively, the claims may find themselves in the hands of a holdout, willing to destroy the debtor to leverage a larger share of the pie. Worse yet, false signaling and coordination problems may interact and reinforce each other. For example, while the liquidity of claims is generally thought to improve the amount of information in the case, by setting a value for the debt,[142] it may be being used to accumulate a control position on behalf of a short.

3. Transparency Concerns

A second broad concern is false signaling (i.e., transparency). Concealed or disguised short positions impose informational costs on other investors. To participate in a bankruptcy, stakeholders are only required to disclose their "claim" or "interest," not what they paid for it, and not whether they have engaged in any hedging behavior. Therefore, it is difficult for other claimants to evaluate whether, for example, an unsecured creditor's behavior is driven by their interest in maximizing their economic interest as an unsecured creditor, or for some other reason.

This false signaling is particularly troublesome in bankruptcy cases. Bankruptcy law recognizes that it may not be rational for an individual unsecured creditor to put much effort into monitoring a case. The gains from monitoring or otherwise participating will be shared pro rata with all unsecured creditors, but the costs of monitoring are borne by the individual monitoring creditor. The hope in bankruptcy law is that the smaller creditors will free ride on the information provided by the behavior of larger creditors. Thus, the Bankruptcy Code provides for an official committee or committees of unsecured creditors funded by the bankruptcy estate.[143] The idea is that the larger, more sophisticated creditors will serve on these committees and that the smaller creditors will piggyback on their efforts. The committee members are made whole, because the direct pecuniary costs of committee service are paid by the estate.[144] Because official committee members serve in

141. Creditors will sometimes use both pre- and post-petition restructuring support agreements (also known as lock-up agreements) to attempt to bind themselves and others to supporting plans that meet particular characteristics, see Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COMM. L. (forthcoming 2019), but these devices do not ensure that parties to the agreements are in fact long or that they do not subsequently acquire short positions.

142. Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. FIN. & COM. L. 23, 26–27 (2009).

143. 11 U.S.C. § 1102 (2012).

144. *See id.* §§ 330, 1103.

a representative capacity, however, they are subject to fiduciary duties that limit their right to engage in self-interested behavior.[145] Fiduciary duties, however, are an imperfect protection against false signaling because they are less than crystalline and are imperfectly enforced.[146] Moreover, not all signaling is done by committee members. Small creditors may choose simply to follow the lead of creditors with larger positions that are not committee members (perhaps because they do not wish to be subject to trading restrictions).

In short, the purchase of a control position or a combination of control and blocking positions creates the power to obstruct, which may be reinforced by the lack of transparency. Also of significance, these "control" positions may have financial value that is separate and distinct from the distributional rights they represent. If control rights can be traded separately from economic rights, the ability of certain claimants to realize value on the control premium raises serious concerns about the "equitable distribution of [a] firm['s] value."[147]

G. DISTRESSED DEBT TRADING AND GOVERNANCE

It is now commonly understood, even by non-specialists, that debt of insolvent and bankrupt firms continues to trade, even after the debtor has filed for bankruptcy. This is not an unusual feature of bankruptcy regimes, but the governance effects (as distinct from the distributional effects) are more dramatic in the United States, where there is generally no formal fiduciary or administrator charged with administering the debtor, and the estate is overseen by a debtor-in-possession.[148] There is a significant market for "distressed debt."[149] Some of the investors in this market (sometimes derided as "vulture funds") are merely making a prediction about the likely return on the firm's debts.[150] Others, however, may be investing in a "governance play."[151] As we have discussed above, debt traders are not

145. Committee members are also subject to trading bars because they are privy to substantial non-public information about the debtor. Robert P. Enayati, Note, *Undermining the Trading Wall: The BAPCPA's Affront on the Creditors' Committee's Duty of Confidentiality in Chapter 11 Bankruptcies*, 21 GEO. J. LEGAL ETHICS 703, 706 (2008).

146. John A. E. Pottow, *Fiduciary Duties in Bankruptcy and Insolvency*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW (Evan J. Criddle et al. eds., forthcoming Apr. 2019). *See also generally* Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321 (2007) (proposing an alternative doctrine in which a corporation in bankruptcy would not owe a higher duty to creditors than shareholders).

147. *See* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 679.

148. *See* LEVITIN, *supra* note 39, at 358–59 (noting that "[i]n Chapter 11, the default mode is for existing management to remain in place and to operate the debtor as a 'debtor-in-possession' (DIP)" and that "[i]n many countries outside the United states, a trustee is the default setting for all insolvencies").

149. *See* Levitin, *supra* note 29, at 76–77.

150. *Id.* at 89, 95.

151. *See id.* at 95.

necessarily investing purely in economic return. They might be seeking to purchase the company (sometimes called a "loan-to-own" investor); for insolvent firms, debt markets are part of the market for corporate control.

It is also common for the price of a company's stock to change, and with it, the price of purchasing control over a firm. Corporate raiders look for bargains. When a stock's price falls, it may make a firm a takeover target because the control rights can be purchased at a relatively cheaper price. As we have shown, however, the motives may not be so benign. The investor might be the owner of a competitor, or might in some other way be an economic short.[152]

These aspects of the market for corporate control do not distinguish distressed debt markets from equity markets (though the fact that debt is in bankruptcy shifts the locus of regulation from securities regulation and state corporate law to federal bankruptcy law). Control rights trade at a premium, and all of these phenomena (including empty voting) exist in equity markets and are relatively unregulated.[153]

In this section, we challenge the understanding that trading of governance rights after insolvency, and particularly after filing for bankruptcy, requires no more regulation than trading in equities outside of bankruptcy. In our view, there are additional dynamics and policies that come into play on the event horizon where fixed claims without governance rights (debt) turn, effectively, into variable claims with governance rights (stock). The practicalities of this transformation are not well understood, and its implications are not adequately theorized. In this section, we sketch out some important differences. First, the fact that debt trades at a discount may create bargain price control blocks, but more importantly, bankruptcy-specific aspects of the plan confirmation process multiply the number of such "bargain blocking positions," and mandate different legal treatment of governance rights in bankruptcy.

1. The Event-Horizon—Insolvency

A key difference between the governance of a firm in bankruptcy and governance of a solvent company is that bankruptcy governance straddles an indistinct but nonetheless crucial event horizon—insolvency. When a debtor enters the zone of insolvency, debt begins to act like stock. Fixed claimants become variable claimants, and the former owners of a firm are potentially playing with other people's money. This is a financial, rather than a legal "event horizon." Financial markets deal with the possibility that this might happen in a variety of ways—by discounting the price of debt securities, increasing interest rates, and, as mentioned above, selling credit derivatives.

152. *Id.* 95–96.

153. *See* Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 629; Hu & Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership*, *supra* note 30, at 345.

But when the *risk* of insolvency becomes the *fact* of insolvency, there are legal consequences as well. This adds considerable complexity to distress situations, and it is important not to oversimplify.

Different legal regimes deal with this event horizon in different ways. Most countries force the immediate legal recognition of insolvency, and trigger the immediate financial realization on the value of the firm. For example, in the United Kingdom, the law of wrongful trading imposes additional duties in the zone of insolvency, and may require the debtor to commence insolvency proceedings upon financial insolvency.[154] Civil law jurisdictions impose criminal liability on officers and directors if they do not commence insolvency proceedings in a timely fashion.[155] This keeps things simple. Upon commencing insolvency proceedings in virtually every other jurisdiction outside the United States, governance is lodged in a fiduciary, and in many (though not all) of those jurisdictions, the job of the fiduciary is to liquidate the firm.[156]

This is not the rule in the United States.[157] There is no requirement that an insolvent firm commence a bankruptcy proceeding, nor is a bankruptcy proceeding predicated on a finding of insolvency.[158] Even once a proceeding is opened in the United States, Chapter 11 is designed to allow for the delay of financial realization of the firm's value. Nonetheless, there is a congeries of legal doctrines under U.S. law that confirm that the nature of the debtor/creditor relation changes upon insolvency.[159] Because realization of value is delayed, however, the governance situation is considerably muddied. As we have discussed above,[160] the filing of bankruptcy expressly transfers governance power to creditors. This means that, at least in the United States, financial insolvency creates an expectation, even before a debtor files for bankruptcy, that when one purchases debt one is purchasing an ownership interest. Dollars become shares of ownership. Indeed, one may even be purchasing debt with the goal of becoming the owner of the firm, and/or with the expectation of exercising the attendant governance rights in the event of a bankruptcy filing.

---

154. *See, e.g.*, Grant v. Ralls [2016] EWHC (Ch) 1812, [2016] B.C.C. 581 [582] (Eng.).

155. For a helpful discussion of the duties of officers and directors when a firm is in the zone of insolvency, see UNITED NATIONS COMM'N ON INT'L TRADE LAW, UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW: PART FOUR: DIRECTORS' OBLIGATIONS IN THE PERIOD APPROACHING INSOLVENCY 9 (2013), http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf.

156. *Id.*

157. Some states do recognize a cause of action against corporate officers and directors for "deepening insolvency." *See, e.g.*, Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347–48 (3d Cir. 2001) (applying Pennsylvania law); Forman v. Salzano (*In re* Norvergence, Inc.), 405 B.R. 709, 758–759 (Bankr. D.N.J. 2009) (applying New Jersey law).

158. *See* 11 U.S.C. §§ 109, 301 (2012).

159. Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 711–14.

160. *See supra* Section II.C.

At first glance, this may seem unremarkable. The genius of markets is that once control rights shift from one class of securities to another it should be reflected in market prices. But it's not that simple. Control does not work the same way in bankruptcy as it does outside. The legal governance regime shifts upon filing of a bankruptcy petition, where corporate law voting rules are replaced by the plan confirmation process and by the practical dynamics of a Chapter 11 case.

2. Control Mechanisms in Insolvency and Bankruptcy

Perversely, creditors in bankruptcy may have more powerful governance rights than shareholders. Classification of claims and voting rules create multiple opportunities to create blocking positions. Even secured creditors (still fixed claimants with respect to their collateral) can exercise a limited veto.[161] Furthermore, a variety of additional policy concerns come into play in the vicinity of insolvency—shifting fiduciary duties, distorted valuations, concerns about equality of distribution and hence value allocation, and concerns about the timing of realization of various rights. In this section, we give those concerns additional consideration and suggest that they may require a rethinking of the allocation of governance rights in bankruptcy.

The transition for creditors from passive investors to claimants with control rights begins before the filing of bankruptcy. Upon default (either of payment or through a covenant default), creditors get the right to pull the plug on the debtors' operations. This power is actually more extreme than the shareholder's right to vote on important corporate decisions. The unsecured creditor can seek a judgment. Any steps to execute on that judgment, by levying, or recording the lien against real property starts a 90-day preference avoidance clock.[162] This lights the bankruptcy fuse, so to speak. Creditors can join in filing an involuntary bankruptcy petition,[163] and secured creditors can commence self-help repossession and foreclosure. Outside of bankruptcy, almost everybody has a veto power over a consensual workout or restructuring; holdout and other coordination problems abound.[164] In the absence of Chapter 11, insolvency triggers a winding up and realization for creditors.

---

161. This point is not immediately obvious. Why would creditors get greater governance rights in bankruptcy than a shareholder would outside of bankruptcy? The reasons are complicated. But the key point is that outside of bankruptcy, the creditor has the right to insist on payment in full. That ability to insist on payment in full creates a holdout veto that bankruptcy seeks to manage—not through majority voting of shares, but through class voting, which works differently.

162. *See* 11 U.S.C. § 547 (allowing avoidance of preferential transfers to or for the benefit of non-insiders made within 90 days before the commencement of the bankruptcy).

163. *Id.* § 303.

164. *See, e.g.*, Bratton & Levitin, *supra* note 46, at 1604.

Chapter 11 limits these draconian rights in order to preserve value through a collective solution. Practical power is traded for more formal, but equally important, governance rights. The quid pro quo is complicated. In return for limitation on their non-bankruptcy veto rights, creditors are given an assurance of a baseline entitlement (best interests and cramdown) and of equitable/equal treatment.[165] As such, the governance rights accorded to creditors should be tailored to accomplish these goals.

Creditors' governance rights in bankruptcy are, nonetheless, considerably greater than the relatively modest powers of shareholders to vote on directors and to approve extraordinary corporate transactions. Once the debtor is in bankruptcy, unsecured creditors have the power to object to non-ordinary course transactions[166] and to vote on the plan,[167] and they may be able to obtain a blocking position depending on classification.

Voting rights in bankruptcy are not as simple as shareholder rights. Bankruptcy voting is by class,[168] and creditors are separately classified for a variety of reasons.[169] Only classes whose claims are impaired get to vote, and plan confirmation requires an affirmative vote by dual majorities either in all impaired classes or in at least one impaired class excluding insider votes (in which case the plan is then subject to additional substantive restrictions).[170] For an impaired class of creditors to accept a plan requires acceptance of the plan by over one-half of the number of claims in the class and at least two-thirds of the dollar amount of the claims in the class.[171]

In other words, control of a class for acceptance requires a higher threshold than at corporate law (generally a simple majority of shares). Conversely, blocking is easier: achieving a one-third (plus $1) interest in terms of face amount in a class of claims (or one-half in number of claims) confers a limited right to block a plan.[172] The fact that blocking a plan requires a lower threshold of control than accepting a plan is particularly important given that creditors who are net short of a debtor are likely to want to block a plan. Outside of limited statutory requirements, the debtor initially has the exclusive right to propose a plan,[173] so a short is unlikely to push for plan acceptance, at least initially.

---

165. 11 U.S.C. § 726(b) (denoting pro rata distribution within class); *id.* § 1122 (asserting that classes must contain only similar creditors); *id.* § 1123(a)(4) (providing for equal treatment within classes); *id.* § 1129(a)(7) (applying the best interests test); *id.* § 1129(b) (asserting the "fair and equitable" requirement of cramdown).

166. *Id.* § 363(b)(1).

167. *Id.* § 1126.

168. *Id.* § 1126(c)–(d).

169. *Id.* § 1122 (providing classification standards).

170. *Id.* §§ 1126(f), 1129(a)(8), 1129(a)(10), 1129(b).

171. *Id.* § 1126(c).

172. *See id.*

173. *Id.* § 1121(b)–(c).

Secured creditors may not foreclose immediately when the bankruptcy is filed, but they may be able to lift the automatic stay and subsequently foreclose.[174] They may also be able to assert control over the debtor's cash through negotiations over the use of cash collateral, and the ability to block post-petition financing.[175] Similarly, they too have a limited right to block a plan through voting if impaired.[176]

The Bankruptcy Code trades a creditor's practical veto and exit rights for a voice on how to realize value—that is, in the firm's governance. In doing so, they create myriad ways in which a creditor can obstruct a plan. Most of these are by design. In many cases, however, these blocking positions can create anticommons and other coordination problems. Worse yet, modern claims trading markets may fundamentally alter the landscape, particularly when linked to derivatives.

3. Insolvency, Claims Trading and the Control Premium

Claims against insolvent entities trade at a discount from face amount. This makes sense given the reduced probability of a return. But, as noted above, they can still carry with them a control premium. Part of the value of the claim lies in the entitlement to a distribution that it represents, but when linked to a control position, part of the value lies in the ability to steer the case, or hold it hostage. This power may allow the claimant to demand a premium as part of its distribution, use its leverage to benefit its position in another class, or capitalize on a short position.[177]

As the price of debt changes, so does the price of control. This is not intrinsically problematic. In equity markets, for example, changes in the price of stock do not change the governance rights associated with that share. As a result, the cost of gaining control rises and falls with the price of the stock. As we have noted above, governance and veto rights function differently in bankruptcy. Obstruction is easier, sometimes by design, sometimes not.[178] It therefore merits consideration whether the power to block a plan ought to be limited when claims are purchased at a steep discount.

First, where debt is trading at a steep discount, control rights or veto rights may be purchased on the cheap. This is problematic in the first instance because it may make it too easy to purchase "holdout" power. This holdout power can be used by the claims purchaser to seek to extort a disproportionate amount of the value of the firm from other creditors. Worse yet, when linked to the ability to create "empty" or short positions linked to control, the result may not just be reallocation of value, but its destruction.

---

174. *Id.* § 362(d).
175. *Id.* §§ 363(c), 364(d).
176. *Id.* § 1126.
177. *See supra* Section II.F.3.
178. *See supra* Section II.G.2.

These differences between solvent companies and firms in bankruptcy are, in our view, sufficient to justify consideration of a bankruptcy specific approach to conflicts of interest, holdouts, and specifically, Trojan Horse creditors.

But there's more; claims trading allows for the trading of veto rights, and hence the power to hold out. Vetoes have value, and make some votes more valuable than others when traded. This, in and of itself, implicates the Bankruptcy Code's principle of equal treatment. Control rights are a mechanism for firm governance, not an asset of a particular creditor. If anything, they are an asset of the class of creditors. But, by definition, control rights cannot be traded equally, as they reflect a power to veto or bind an action desired by other members of the same class. We develop this complication in the next section.

III. CLAIMS TRADING—EQUAL TREATMENT, REALIZATION, AND GOVERNANCE RIGHTS

Because claims trading enables a market in control rights in bankruptcy, the filing of a bankruptcy petition produces a governance problem that bumps into the fundamental bankruptcy policy of equal treatment for similar creditors. This is a second and distinct governance distortion caused by claims trading.

A. EQUAL TREATMENT

In a recent article, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, one of us (Janger) and Melissa Jacoby explored at length the meaning of the term "equity," as used in state law and in the Bankruptcy Code.[179] We explained that the filing of a bankruptcy petition operates as a form of "realization."[180] Liquidation in bankruptcy operates as a realization of value, and distribution according to the legal status of the claimants on the petition date. The genius of Chapter 11 is that it allows realization of the firm's value to be delayed, where doing so is in the best interest of the estate. However, the quid pro quo is that the principle of equal treatment will be respected, and it is, thus, a basic principle of bankruptcy that similarly treated creditors should be treated similarly.[181] However Chapter 11 creates a problem. Reorganization over time does not necessarily affect all types of claims in the same way. Encumbered assets may increase or decrease in value during the case, or be sold. The value of the firm may increase, through operations or asset appreciation, or it may decline. It is, therefore, not obvious how to manage the principle of equal treatment over time.

---

179. *See generally* Jacoby & Janger, *Tracing Equity*, *supra* note 4 (discussing equity in bankruptcy law).

180. *See id.* at 682–709.

181. *See* 11 U.S.C. § 726(b) (requiring pro rata treatment for creditors of similar priority); *id.* § 1122 (explaining that only similar claims may be classified together); *id.* § 1123(a)(4) (requiring equal treatment for all claims in a class); *id.* § 1129(b) (prohibiting unfair discrimination in cramdown).

In *Tracing Equity*, Jacoby and Janger explain that the Code gives effect to equal treatment over time by splitting the process of "realization" in two —fixing the relative position of claimants on the petition date ("Equitable Realization"), but determining the value of those claims at a variety of later dates ("Value Realization").[182] The Bankruptcy Code treats the filing of the bankruptcy petition as an "equitable realization"; the baseline for equal treatment is established on the date of the bankruptcy petition. For unsecured creditors, the relative pro-rata position of claims as of the petition date is enforced through the disallowance of claims for unmatured interest.[183] Similarly, the relative positions of asset-based (secured) claimants and unsecured claimants with regard to firm value are fixed on the petition date through the discontinuation of floating liens and equitable limitations placed on a secured creditors' interest in proceeds.[184] Thus, increases in firm value attributable to operations are distributed pro rata among the unsecured creditors, while asset based priority claims are tied to assets owned on the petition date. For secured creditors, this means that the pool of encumbered assets (collateral) is fixed on the petition date, as is the value of those assets. That value is entitled to adequate protection, for downside purposes, but any appreciation is measured at the time the asset is actually sold, or upon the effective date of the plan, whichever is earlier.[185] In other words, for a secured creditor, their allowed secured claim is realized for downside purposes on the petition date, but for upside purposes, upon disposition of the asset.

B. CONTROL, COLLATERAL AND EQUAL TREATMENT: THE PROBLEM OF CREDIT BIDDING

Up until now, we have been looking at situations where a claims trader attempts to purchase the "fulcrum" security to gain governance rights. The idea of the fulcrum security is a corporate governance principle based in corporate finance. The idea is that the junior-most class of claims that is "in the money" (that is to say, eligible for a distribution) should control the firm's governance because it is the residual claimant. Increases in value redound to its benefit, and declines in value occur at its expense. Bankruptcy law generally respects this view, and as a result, the focus of our governance concern has been on the purchase of junior debt claims.

There is another claims trading context that implicates the equality of distribution. Secured credit is both more and less powerful as a governance device. On the one hand, the secured creditor receives a distributional priority with regard to the value of its collateral in the form of an allowed

182. Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 688, 694.

183. 11 U.S.C. § 502(b)(2).

184. *Id.* § 552(a) (explaining the discontinuation of floating liens); *id.* § 552(b) (discussing the effect of a security interest postpetition); *see* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 706.

185. *See* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 688.

secured claim. As a result, the secured claim is usually separately classified, and therefore votes in its own class. In addition to having the right to vote its claim as a member of a class, however, it also has governance rights that arise as a result of its lien on particular assets. In particular, if the assets are being sold as part of the plan or in a sale under Section 363 of the Code, the secured creditor generally has the right to credit bid its claim,[186] meaning that secured creditor can offset its claim against its bid in a 363 sale, effectively making the secured creditor's debt the price to beat at the sale.[187] The right to credit bid was recently reaffirmed by the Supreme Court,[188] but courts have subsequently explored the limits of that right in a way that mirrors our concerns.[189]

The problem arises when an undersecured creditor who does not have a lien on all of the assets of the debtor seeks to credit bid at a going concern sale of substantially all of the debtor's assets. If the gap between the value of the assets and the amount of the secured creditor's debt is large enough, the credit bid may allow the secured party to purchase the firm at a substantial discount.

To illustrate, suppose that a secured creditor has a lien on many, but not all of the debtor's assets. Those assets are worth $10 million, if liquidated by themselves, and secure a $16 million debt. The debtor's other assets, not subject to the lien, are worth $2 million if liquidated by themselves. If the debtor were sold as a going concern, however, it would be worth $15 million.

In this case, should the secured creditor be allowed to credit bid for $16 million (the face amount of its debt), or merely $10 million (the realizable value of its collateral)?[190] If the secured creditor can credit bid $16 million, it will win the auction because no other party would rationally bid higher than $15 million. The result, then, would be to allow the undersecured creditor to capture $5 million of value not tied to its collateral (the realizable value of unencumbered assets plus the bankruptcy-created going-concern sale value) and to which it has no priority entitlement.

---

186. 11 U.S.C. § 363(k). Credit bidding may be restricted "for cause." *Id.*

187. We note here that credit bidding in bankruptcy is technically different than credit bidding in a state law foreclosure. State law foreclosure sales will by definition be of only a creditor's collateral, not other non-collateral assets. LEVITIN, *supra* note 39, at 42. In contrast, a bankruptcy sale may include assets that extend beyond a creditor's collateral package.

188. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 649 (2012).

189. We also note the possibility of debtor in possession financing agreements, which are approved by court order, 11 U.S.C. § 364, contractually requiring the DIP lender's right to credit bid be preserved. We believe such a contractual limitation should be void as against public policy. *See id.* § 364(a)–(f).

190. The language of § 363(k) does not definitely resolve this issue because it refers to property that is subject to a lien that secures an "allowed claim" and the offset of "such claim", without clarifying if this the claim referenced is just the allowed *secured* claim or the entire allowed claim, particularly if there has not been a determination of the value of the creditor's collateral yet. *See id.* § 363(k).

This concern is not theoretical. In *Free Lance-Star*, a potential buyer of the debtor, a newspaper, purchased the senior lenders claim, including its liens.[191] The goal of the claim purchaser was to use its ownership of the secured debt to exercise control over the bankruptcy and to use the right to credit bid to purchase the company in a 363 sale.[192] How the court remedied this problem will be discussed below.

C. CLAIMS, THE CONTROL PREMIUM, AND EQUAL TREATMENT

The lesson of this Article, *so far*, is that control positions, created by liens, as above, or by owning a blocking (one-third of a class) or accepting (two-thirds of a class), have value. A claims purchaser will pay extra for a block of claims that come with the power to influence the case—to become a bully or a Trojan Horse. But a question remains. How should the value of a control premium be allocated? In the previous sections, we established that those rights should not be exercisable on behalf of someone whose interest conflicts with the estate or members of the claimant's class.[193] But even when the interest of the holder aligns with the estate, how should the value of "control" be distributed to members of the relevant class?

Before one can answer, one must first distinguish pure "economic exit" from a sale where part of the price includes a "control premium." There is really no basis for objecting to pure economic exit. If an investor thinks that a claim, or the debtor, is undervalued, basic market principles suggest that selling the claim should be allowed. By contrast, the reasons are not so strong where the price of a claim includes a control premium. In order to see why, it is helpful to list the various reasons that "control" might have value, over and above the economic value of a claim. We can identify the following reasons:

- Claimants might hold an interest elsewhere in the capital structure and wish to maximize the value of that claim at the expense of the holders of claimants in a particular class.
- Claimants might wish to capture value of an asset synergy, for example an adjoining landowner wishing to put together an assemblage, or a related firm looking to increase market share.
- Claimants might have a legitimate disagreement about how best to maximize the value of the debtor or the distribution to the class.

The first motivation, based on our previous discussion, is aimed directly at violating equality of distribution as these Claimants increase their distribution at the expense of the rest of the class or another class. The second

191. *In re* Free Lance-Star Publ'g Co. of Fredericksburg, 512 B.R. 798, 800 (Bankr. E.D. Va. 2014).

192. *See supra* text accompanying notes 186–87.

193. *See supra* Sections II.C–.E, II.F.1, II.G.3.

rationale is more ambiguous. The asset synergy has positive value, but the control premium would allow the owner of the synergy to use its governance rights in the debtor to capture that value at the expense of the estate (and other creditors). In other words, both of these reasons for exiting are candidates for limitation of governance rights, either through separate classification or limitation of voting rights.

Only the third rationale reflects an honest disagreement about how to maximize the distribution to the class. For this limited class of situations alone, there is not a concern about equality of distribution. The question then becomes how to distinguish such honest disagreements from hold-out behavior. In our view, the best way to solve both of these problems is by preventing the sale of control rights at the time of exit. We will explain how this is done below.

D. THE PRICE OF THE CONTROL PREMIUM AND EQUAL TREATMENT

Even for claims purchases in the third category—honest disagreement about how to maximize value—the principle of equal treatment is implicated. During the course of a case, the price of debt may change—and so will the price of the control premium.

At first glance that would not appear to be problematic. In equity markets, for example, the market for corporate control relies on the fact that share valuation will determine when takeovers will happen. Similarly, if we are willing to tolerate economic exit, then the changing price of the debt will affect the distribution that selling creditors get depending on the time they exit. But, where a control premium is involved, there is a different problem. The opportunity to capture the premium is not available to the entire class, and again, if the price changes over time, the relative distributions will change.

Moreover, the control premium is not evenly distributed across all class members. The holders of the first one-third (plus $1) of the amount of a class of debt to tender their claims can "sell" a blocking position." So can the holders of the second one-third (plus $1), albeit to someone else. The holders of the remaining one-third (minus $2) are left out in the cold. Conversely, the holders of two-thirds of the amount of a class of debt have the ability to sell the power to "accept." The remaining one-third are, again, left out in the cold, with no ability to block a plan through the vote.

This ability to distribute the value of a control premium unequally also violates the principle of equal treatment and allows one subset of the claimants to extract value from another. This potential inequality manifests upon insolvency. While there is no general legal commitment to equal treatment outside of bankruptcy, it is a baseline distributional principle that equality of treatment is measured as of bankruptcy day once the debtor

files.[194] The relative position of creditors should not change. The ability of a first mover to grab that premium at the expense of other similar creditors violates the principle of equal treatment. As bankruptcy law polices even pre-bankruptcy grabs by first movers,[195] *a fortiori* it does not brook post-bankruptcy grabs.

In sum, we are concerned that the trading of claims at a discount after insolvency can cause problems in two ways. First, it facilitates the accumulation of control and blocking positions that might be linked to shorts, resulting in *Schadenfreude* creditors becoming "bullies," and worse yet, Trojan Horse creditors.[196] Second, because this power can be traded separately from a claim's distributional rights, it allows for the reallocation of the control premium among similarly situated creditors after the case has been filed. As we will discuss below, while these two concerns are distinct, they can be remedied by a single family of remedies that we call, collectively, "mark-to-market" governance.[197] In the next two sections, we will describe the existing mechanisms for dealing with distorted governance incentives and show why they are inadequate. Then we will describe our preferred approach.

IV. EXISTING REMEDIES AND THEIR LIMITATIONS

To the extent that conflicts of interest and governance distortions caused by claims trading are to be solved by law, there are a number of possible approaches that might be tried in various contexts, individually, or in combination. They are: (1) mandating disclosure; (2) limiting the voting power of creditors to correct the mismatch between voting power and economic interest; (3) limiting the alienability of claims; and (4) limiting the creditors' distribution through subordination or disallowance. Each of these remedies is available to some extent within the Bankruptcy Code as currently written. Each also has certain limitations and possible unintended consequences. In this section, we address each separately.

A. *DISCLOSURE*

One proposed method for dealing with distorted governance incentives would be mandatory disclosure of economic interests.[198] Mandatory disclosure of hedges is the method currently used for addressing distorted

194. *See* 11 U.S.C. §§ 726(b), 1129(a)(7).

195. *Id.* § 547 (allowing for the "avoidance of preferential transfers" (quoting 11 U.S.C. § 547 note (Historical and Revision Notes: Legislative Statements)).

196. *See supra* Part II.

197. *See infra* Section V.B.

198. *See* Kevin J. Coco, Note, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 613 (proposing disclosure of hedges); Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 731–33; Hu & Black, *Debt, Equity and Hybrid Decoupling*, *supra* note 30, at 684–85.

governance incentives of originators, sponsors, and servicers of asset-backed securities.[199]

Under current Federal Rule of Bankruptcy Procedure Rule 3001, creditors must disclose (under penalty of perjury) the amount they are owed and assert that they are the person entitled to receive payment.[200] Creditors, however, do not need to disclose how much they paid to acquire the claim, whether they have assigned all or part of their right to receive payment to somebody else, or whether they have insured or otherwise hedged part of the risk.

Members of both official and unofficial or *ad hoc* committees[201] are subject to certain enhanced disclosure requirements under Federal Rule of Bankruptcy Procedure Rule 2019 as controversially amended in 2011.[202] These entities must disclose "the nature and amount of each disclosable economic interest held in relation to the debtor as of the date the . . . group or committee was formed," including the acquisition date by quarter and year for any interest acquired in the previous year.[203] "Disclosable economic interest" is defined broadly as "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest."[204] The Rule 2019 disclosure requirement is on-going,[205] and is backed up by a threat of sanctions, including refusing to hear the motions of the non-compliant entities, and invalidating any votes made by the non-compliant entities.[206] To ensure compliance, the disclosure requirement applies not only to the actual claim holders, but to any party that represents them, that is, to attorneys.[207]

Requiring disclosure is a partial solution to the conflicted creditor problem because it eliminates false signaling. Disclosure does not, however,

---

199. *See supra* notes accompanying Section II.B. The SEC Registration AB II disclosure requirements are backed up by both the threat of private class action litigation and public SEC enforcement. Bankruptcy lacks an analogous public enforcement mechanism.

200. *See* FED. R. BANKR. P. 3001.

201. An "*ad hoc*" committee is merely two or more creditors that pursue any motion or action jointly in the bankruptcy. *See* Richard J. Corbi et al., *New Rule 2019: Distressed Investors, What Are You Holding?*, AM. BANKR. INST. J., June 2011, at 14, 14.

202. FED. R. BANKR. P. 2019; *see also* Corbi et al., *supra* note 201, at 14 (noting the "vigorous debate" over the amendment of Rule 2019).

203. FED. R. BANKR. P. 2019(c)(2)(B)–(C).

204. *Id.* R. 2019(a)(1).

205. *Id.* R. 2019(d).

206. *Id.* R. 2019(e)(2).

207. *See id.* R. 2019(a) Committee's Note to 2011 Amendment (noting that "an attorney who is retained and consulted by a creditor or equity security holder to monitor the case, but who does not advocate any position before the court or engage in solicitation activities on behalf of that client, does not represent the creditor or equity security holder for purposes of this rule"). The implication is that an attorney who does appear before the court is subject to the rule's disclosure requirements if representing a group.

prevent a creditor with a conflict from obstructing a workout or from voting its claim to block a plan, nor does it eliminate the tension between fiduciary duty and self-interest that arises when the creditor is serving on a committee.

Moreover, as Rule 2019 disclosure requirements currently exist, they do not apply to most creditors. Rule 2019 applies only to "[g]roups, [c]ommittees, and [e]ntities" that represent multiple creditors.[208] Thus, there is no disclosure requirement for individual creditors, as long as they do not act in concert. As a result, courts lack the information necessary to police the actions of individual creditors.

For example, in Lyondell Chemical's bankruptcy, the court was powerless in the absence of mandated disclosure, despite the bankruptcy judge noting that a trade publication had reported that certain noteholders had undertaken actions to precipitate the bankruptcy to collect on their credit default swaps.[209] Judge Gerber lamented:

> I'm not in a position to make a factual finding as to the truth of this report; newspaper articles are hearsay, and the parties' (and the Court's) inability to know all of the facts as to this is one of the many manifestations of the opacity of the use of derivatives in bankruptcy cases.[210]

Finally, even if the Rule 2019 disclosure requirements were universal, the remedial provisions backing up the requirements are discretionary.[211]

B. LIMITING THE FRANCHISE

A second mechanism for addressing the decoupling of governance rights and economic interest is to limit those governance rights directly.[212] Again, there are existing mechanisms under current law: separate classification and designation. Both of these remedies capitalize on the fact that, under Chapter 11's plan confirmation process, governance rights are exercised as a member of a class, and classes accept or reject a plan based on specific supermajority rules.[213] Under Section 1122 of the Bankruptcy Code, creditors may only be classified together for voting purposes if their claims are "substantially

208. *Id.* R. 2019(b)(1).

209. Lyondell Chem. Co. v. CenterPoint Energy Gas Servs. Inc. (*In re* Lyondell Chem. Co.), 402 B.R. 571, 585 n.26 (Bankr. S.D.N.Y. 2009).

210. *Id.*

211. FED. R. BANKR. P. 2019(e) (authorizing, but not requiring various remedies for violations of Rule 2019).

212. *See* Patrick D. Fleming, *Credit Derivatives Can Create a Financial Incentive for Creditors to Destroy a Chapter 11 Debtor: Section 1126(e) and Section 105(a) Provide a Solution*, 17 AM. BANKR. INST. L. REV. 189, 189 (2009); Hu & Black, *Equity and Debt Decoupling and Empty Voting II*, *supra* note 30, at 735 ("[V]oting rights in bankruptcy may need to be based on net economic ownership instead of gross ownership of debt . . . .").

213. 11 U.S.C. § 1126(c)–(d) (2012).

similar."[214] Under Section 1126, a class of claims only accepts a plan if its members vote by "more than one-half in number" and "at least two-thirds in amount" to accept.[215] Finally, also under Section 1126, a vote may be "designate[d]" or disregarded if it is cast in bad faith.[216] Under these principles, a hedged claim might need to be classified separately from unhedged claims, or a creditor who is economically short might have its vote designated as cast in bad faith.

These tools have a lot to commend them. They largely eliminate the ability of a creditor to use voting rights to harm the estate for its own benefit. Disenfranchisement of conflicted creditors is also consistent with bankruptcy policy as reflected in other Code provisions. Section 702 of the Bankruptcy Code disenfranchises parties with "interest[s] materially adverse" to other creditors' as well as insiders from voting in the election of a trustee.[217] Section 1129(a)(10) disenfranchises insiders (who are presumed to have conflicting interests) from voting on "cramdown" plans, which may be approved with the consent of only a single impaired class of creditors.[218]

The principal weaknesses of both classification and designation lie in the difficulty of administering them. Separate classification solves the signaling problem caused by empty creditors without depriving the creditor of all its rights. While it may not be able to block confirmation by eliminating an impaired accepting class, it does leave the creditor with the ability to block consensual confirmation and force a cramdown. Indeed, separate classification may actually increase a conflicted creditor's ability to block a consensual plan because its claims will constitute a larger percentage, or even all, of the separate class.

---

214. *Id.* § 1122(a).

215. *Id.* § 1126(c). A class of equity interests accepts a plan by a vote of two-thirds of amount. *Id.* § 1126(d).

216. *Id.* § 1126(e).

217. *Id.* § 702(a)(2)–(3).

218. *Id.* § 1129(a)(10). Section 1129(a)(10) applies to all Chapter 11 plans, but for "consensual" plans under § 1129(a) it is subsumed in almost all cases by the vote required under § 1129(a)(8), which requires the acceptance of all impaired classes. *See id.* § 1129(a)(8). Cramdown plans under § 1129(b) still require the acceptance of a single impaired class under § 1129(a)(10), but dispense with the requirement of all impaired classes accepting under § 1129(a)(8). *Id.* § 1129(b)(1).

These tools are consistent with the Trust Indenture Act. The Trust Indenture Act is a federal securities statute governing SEC-registered debt securities. *See* 15 U.S.C. § 77aaa–77bbbb (2012). The Trust Indenture Act imposes restrictions on the restructuring of such debt securities with the purpose of forcing most restructuring into bankruptcy where it can proceed with under the watchful eye of the court subject to various procedural and substantive safeguards. *Id.* § 77ppp. While some of the Trust Indenture Act's restrictions are waivable only by individual security holders, others are waivable by various majority votes. *Compare id.* § 77ppp(b) (proscribing rights waivable only by individual security holders), *with id.* § 77ppp(a) (proscribing rights waivable by vote of majority of security holders).

Designation also solves the false signaling problem by identifying the creditor's conflict, but is quite harsh, in that it deprives the creditor of any voting rights whatsoever.[219] Both classification and designation are binary remedies with uncertain triggers. Both can therefore be over- and under-inclusive. As we will discuss below, another possibility might be partial designation—to mark a creditors' voting right down to its real economic interest in the debtor. In other words, a creditor that has hedged one-third of its risk might be allowed to vote only one-third of its claim.

A common attribute of all disenfranchisement mechanisms is that none of them work without a robust disclosure regime. Unless a creditor has disclosed its position, or another creditor has uncovered that position and disclosed it to the court, none of these remedies can be imposed. As a result, in order to work, it may be necessary to impose a general requirement that creditors with significant positions provide continuous disclosure of changes in their economic interest in the debtor. This is particularly true of the vote dilution mechanism we advocate below. However, the remedy we propose is also more nuanced and need not have a specific trigger, but can be applied continuously.[220]

C. *TRADING BARS*

A straightforward solution to most of these problems would be to simply bar trading in claims once a debtor has filed for bankruptcy. Trading bars already routinely exist for members of official committees, which are privy to extensive non-public information about the debtor.[221] In a number of cases, courts have also issued orders restricting and monitoring trading in order to preserve the estate's tax losses.[222]

Broad trading bars would have considerable secondary market effects both on the market in bankruptcy claims and on pre-petition distressed debt markets. The effect is likely to be ambiguous, however. On the one hand, would-be buyers and sellers would fear being trapped in an illiquid position in the event of bankruptcy, which would drive down the price of the debt, thereby ironically opening the door for *Schadenfreude* investors to purchase at a pittance. Alternatively, this risk might be priced into the debt *ex ante* and

219. The leading bankruptcy treatise posits that designation under § 1126(e) cannot be partial, but must be done *in toto*, but provides no caselaw support for the interpretation of the Code. 7 COLLIER ON BANKRUPTCY ¶ 1126.06[3] (Richard Levin & Henry J. Sommer eds., 16th ed. 2018).

220. We note that our proposed solution—like the existing tools—would apply only in bankruptcy. This means that none of them will limit the ability of a "short" to engage in obstruction prior to bankruptcy. Also, by diluting or limiting the governance rights upon bankruptcy, some claims may be more valuable outside of bankruptcy than in bankruptcy, and vice versa, though subject to the "shadow of bankruptcy."

221. *See* Levitin, *supra* note 29, at 75.

222. Paul D. Leake & Mark G. Douglas, *Trading Restrictions in Bankruptcy: Did the Seventh Circuit Up the Ante for Stock Trading Injunctions?*, 1 PRATT'S J. BANKR. L. 280, 285 (2005).

lead to more accurate pricing of debt and, perhaps greater cooperation by creditors on the eve of bankruptcy.

D. LIMITATION OF DISTRIBUTION

Finally, where a creditor has engaged in some form of bad behavior, there are existing mechanisms for limiting their distribution through equitable subordination or disallowance of a claim.[223] These remedies exist under current law[224] and are not based on conflicts of interest per se, but instead on the behavior that might result from such conflicts. As such, alone among the mechanisms discussed here, they can be used as a mechanism for punishing prepetition behavior that harmed the estate. The problem, however, is that these remedies generally have a high trigger, requiring fairly egregious facts.

E. PROBLEMS WITH THE CURRENT REMEDIES

While the existing remedies are all, to one degree or another, aimed at the right problems, they are not well adapted to the current trading environment and current modes of financing. Either they: (1) are blunt and overly broad instruments with undesirable collateral effects; (2) impose too high a trigger, so cannot address the pervasiveness of the problem; or (3) are unworkable because the current regime does not provide sufficient transparency.

In our view, the bluntness problem lies in the linkage between distribution and governance. The existing remedies are not well tailored to the governance problem that we have raised. For example, disallowance limits the claimant's distribution rights and governance rights, when the problem lies in governance alone. The same is true of this linkage when one reduces the allowed amount of a claim to the price for which it was purchased. This solves the governance problem, but undercuts the liquidity of claims.[225] Subordination, perversely, is more likely to affect distribution (by putting the claimant out of the money) than governance. The separately classified subordinated claim still votes, but it most likely will be separately classified,

---

223. 11 U.S.C. § 510(c) (referring to equitable subordination); *see also* Pepper v. Litton, 308 U.S. 295, 302 (1939) (discussing equitable subordination and disallowance).

224. The status of equitable disallowance under current law is somewhat unclear; some courts have authorized it. *See* Adelphia Recovery Tr. v. Bank of Am., N.A., 390 B.R. 64, 76 (S.D.N.Y. 2008), *adhered to on reconsideration*, No. 05 CIV. 9050(LMM), 2008 WL 1959542, at *3 (S.D.N.Y. May 5, 2008); *In re* Wash. Mut., Inc., 461 B.R. 200, 256 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229 MFW, 2012 WL 1563880, at *16–19 (Bankr. D. Del. Feb. 24, 2012). But equitable disallowance lacks express statutory authorization in contrast to equitable subordination. *See* Alan M. Ahart, *Why the Equitable Disallowance of Claims in Bankruptcy Must Be Disallowed*, 20 AM. BANKR. INST. L. REV. 445, 460 (2012).

225. As we will discuss later, our goal is to develop an approach where claims trade based on the economic value of the asset itself, rather than based on a control premium. The benefits of control are owned by all of the creditors.

which ironically increases its voting power because voting is done by classes, enabling the equitably subordinated creditor to force a cramdown determination by voting against the plan. Finally, complete designation deprives the stakeholder of all governance rights when they may still have a meaningful economic interest that deserves to be represented. Each of these remedies is inadequately tailored in that they tend to be "all or nothing." Moreover, they link and delink governance and distribution in ways that do not necessarily deal with the evil to be addressed.

The second problem with the existing remedies is that they are difficult to trigger. All of the existing remedies are viewed as extraordinary punishments for damaging creditor behavior, rather than routine adjustments to implement "one dollar, one vote." For example, equitable subordination requires both inequitable conduct and unfair advantage to the subordinated creditor or injury to other creditors.[226] Statutory disallowance generally requires the claim to be invalid under applicable non-bankruptcy law.[227] It is unsettled whether equitable disallowance remains a viable doctrine under the current Bankruptcy Code,[228] but if so, it would require seriously inequitable conduct. Designation requires bad faith.[229] In our view, misbehavior is beside the point because the signaling problem resulting from creditors holding exogenous interests exists irrespective of bad behavior.

A final problem with the existing approach is that there are insufficient mechanisms to ensure transparency. Existing Rule 2019 imposes some disclosure obligations on members of official committees and *ad hoc* committees,[230] but those obligations are limited, and can readily be avoided by eschewing committee membership. A generally applicable disclosure requirement would eliminate much of the false signaling, but it is also necessary to implement the more tailored approach that we will describe below.[231]

---

226. Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977).

227. 11 U.S.C. § 502(b)(1).

228. *Compare* Harbinger Capital Partners LLC v. Ergen (*In re* LightSquared Inc.), 504 B.R. 321, 339 (Bankr. S.D.N.Y. 2013) (holding that there is no equitable disallowance under the Bankruptcy Code), *with Adelphia Recovery Tr.*, 390 B.R. at 74, 80 (affirming bankruptcy court's denial of motion to dismiss claim for equitable disallowance), *and In re Wash. Mut., Inc.*, 461 B.R. at 258, 267 (denying motion to dismiss and concluding that bankruptcy court has the authority to disallow claim on equitable grounds), *vacated in part upon settlement of parties*, No. 08-12229 (MFW), 2012 WL 1563880, at *29 (Bankr. D. Del. Feb. 24, 2012).

229. 11 U.S.C. § 1126(e).

230. *See* FED. R. BANKR. P. 2019(b).

231. The situation we address relates to governance in bankruptcy, not post-bankruptcy governance. Bankruptcy Code § 1129(a)(5) addresses post-bankruptcy governance by requiring disclosure of who will be running the company after the plan is confirmed, while § 1123(a)(6) and 1123(a)(7) impose restrictions on the governance structure of reorganized businesses. *See* 11 U.S.C. §§ 1123(a)(6)–(7), 1129(a)(5).

The assumption for all of these remedies is that conflicts only matter if it can be proven that they were acted upon. Our concern is that these conflicts are pervasive, and misallocation of governance rights will lead to suboptimal decision-making. Certainly, such misallocation creates opportunities for advantage taking, gaming, and misbehavior that will occur far more often than it can be proven. Our goal, therefore, is to address the root cause, rather than the symptom.

V. MARK-TO-MARKET GOVERNANCE

The challenge of addressing the empty-creditor and control premium problems identified above is that they are not just a problem of *Schadenfreude* investors deliberately assembling net short positions in a bankruptcy or Trojan-Horse creditors trying to use control rights and leverage to alter the bankruptcy priority scheme. There are a wide variety of innocent creditor behaviors that have the effect of modifying the economic attributes of a claim. Hedging, assigning, or contracting about debt requires that the debt have consistent economic attributes. The dollar amount of an unsecured claim fixes the proportion of the class distribution that the creditor will receive. Any effective remedy to the empty creditor problem must leave the economic attributes of the claim intact. Otherwise bankruptcy would destroy the liquidity of those claims both in bankruptcy and before. To be clear, our starting point is to leave distributional rights undisturbed.

The challenge, however, suggests the solution. The attributes that must be preserved undiminished relate to the "economic" attributes of the claims, not to their "governance" attributes, or at least not to the governance attributes that grant power in excess of (or in conflict with) economic interest or that alter the relative distribution of governance rights after insolvency. The interaction between these two concerns is a bit complex, so we will illustrate both, and then discuss a common approach to solving them.

A. *DISTRIBUTION V. GOVERNANCE—AN ILLUSTRATION*

A key set of distinctions throughout this article has been between economic exit and purchasing control—between distribution and governance. The two interact in complicated ways that are not fully incorporated into the existing Bankruptcy Code. Distributional entitlements and voting rights travel together under current law, but it is not clear that they should. It is easy to demonstrate why the distributional rights associated with a claim should not be affected by assignment or hedging. Imagine that a creditor holds a $10 million unsecured claim. Assume that the likely distribution in the debtor's bankruptcy is predicted to be $1 million, payable in two years. The claimant may wish to convert that asset to cash immediately and might be able to sell it for the present value of $1 million two years from now (perhaps $850,000 in today's dollars). If the allowed amount of the claim is discounted to the consideration paid of $850,000, then the distribution on

account of the purchased claim would only be $85,000 (plus any resulting increase in the pro-rated dividend, which we will ignore for simplicity's sake), instead of $1 million. No purchaser would pay $850,000 for a distribution worth $85,000, so the claim would be rendered unsellable. Indeed, the entire secondary market in bankruptcy claims would collapse if claims were only allowed at their purchase price. Numerous cases have reaffirmed the principle that a purchased claim participates, for distributional purposes, at the allowed face amount of the claim.[232]

This does not mean, however, that it is not possible (or even desirable) to make similar adjustments to a claimant's *governance* rights. A discounting of governance rights will not render claims unsellable, unlike a discounting of distribution rights. To the extent the claim was purchased in order to obtain governance rights (or even the option of governance rights), discounting of those governance rights will render the claim less attractive to purchasers, but it will still retain its fundamental economic value. To the extent that governance power has economic value, that value will be retained for the benefit of the class. In other words, discounting of governance rights will reduce a claim's value, but the value of the claim lost will be the governance premium—the price of the power to distort the distribution to other creditors, not the entitlement based on the underlying economic rights.

Discounting governance rights will not reduce the overall distribution to creditors, and to the extent that it preserves the appropriate balance of governing power within the estate, it may actually produce an increase. This is because the discounting of governance rights can be used to maintain the alignment of economic interest among members of a creditor class and to preserve equality of distribution. To understand how, envision a bankruptcy case with four unsecured creditors, each with a $10 million claim. The current best guess at this stage in the bankruptcy is that unsecured claims will ultimately receive a 10% distribution.[233] Here's how things stand:

232. *See, e.g.*, *In re* Nortel Networks, Inc., 532 B.R. 494, 560 (Bankr. D. Del. 2015) ("[T]he price paid by a secondary purchaser has no impact on its substantive rights. . . . Were the Court to accede to the suggestion that secondary purchase prices are relevant, the effect on the distressed market would be devastating."). The one exception to this is that claims with original issue discount are allowed only at the amount paid, with the original issue discount treated as interest included in the allowed claim only to the extent that it is deemed to have matured pre-petition according to whatever amortization schedule is used. Tex. Commerce Bank, N.A. v. Licht (*In re* Pengo Indus., Inc.), 962 F.2d 543, 546–47 (5th Cir. 1992); LTV Corp. v. Valley Fidelity Bank & Tr. Co. (*In re* Chateaugay Corp.), 961 F.2d 378, 383 (2d Cir. 1992); Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 557, 585–86 (Bankr. S.D.N.Y. 2013); *In re* Solutia Inc., 379 B.R. 473, 486 (Bankr. S.D.N.Y. 2007).

233. For simplicity's sake, we ignore the question of when the distribution will take place, as it will affect the discounting of the distribution to present value. While timing often matters substantially to creditors, it is not essential for demonstrating our point.

- The first creditor loaned the debtor $10 million and, uncontroversially, stands to receive a pro rata distribution of $1 million based on a claim of that amount.
- The second creditor purchased a $10 million claim from the original lender for $1 million and also stands to receive a pro rata $1 million payout.
- The third creditor purchased a $10 million claim from the original lender for $1 million, but then entered into a swap transaction with a third party under which it was guaranteed a payment of $1 million because the swap counterparty would pay the creditor the difference between the amount the creditor received as a distribution, while the creditor would pay any amount received over $1 million to the swap counterparty.
- Finally, a fourth creditor purchased a $10 million claim from the original lender for $1 million, but also entered into three swap contracts under the same terms as the previous creditor such that it would be paid three times any decline in value, and would pay three times any increase in value of the purchased claim.

Each of these creditors (even the first two) has a different economic interest in the debtor's future.

The first creditor has $10 million of value at risk and will strive to maximize the return for its class in order to maximize its own return. Thus, the first creditor's interests are aligned with those of similarly situated unsecured creditors, and with the debtor to the extent that it is in a residual class of claims.

Whereas the first creditor sees itself as potentially losing $10 million, the second creditor sees only $1 million of potential downside risk. It too will seek to maximize the return for its class in order to maximize its own return, but it is likely to view various exit strategies in an entirely different light. On one level, this represents the "sunk cost" fallacy, namely that prospective investment decisions will be made based on past losses, rather than on maximizing future returns.[234] Today, both creditors have the same economic interest—a claim with a market value of $1 million—but they are likely to behave differently because of how their position is framed. Also, to the extent that the claim represents governance rights, these governance rights were purchased at a bargain price.

234. *See* Thomas Kelly, *Sunk Costs, Rationality, and Acting for the Sake of the Past*, 38 NOÛS 60, 61 (2004).

The third creditor, by contrast is an indifferent creditor, with no stake in the outcome of the case at all. It neither benefits from the debtor's gains nor is it harmed by the debtor's losses. It nonetheless has governance rights.

The fourth creditor is a *Schadenfreude* investor. The worse the debtor does, the greater the payments the fourth creditor will receive on its multiple swaps. The better the debtor does, the more it has to pay. Also note that the economic interests of the third and fourth creditors are not affected by whether they purchased the claim or were the original creditor. The difference in economic interest is created by the steps that they took to hedge.

1. Proportional Dilution for Hedgers and Shorts

For the indifferent investor and the *Schadenfreude* investor, the link between the governance rights and economic interest that forms the basis for creditor control rights is broken, or worse yet, inverted. The rationale for giving these creditors voting rights disappears. In these cases, while there is no reason to disturb the economic bet that the derivative transactions create (i.e., to subordinate the claim or disallow it), there is every reason to adjust the voting rights to reflect the economic reality of each creditor.

Accordingly, we propose that a creditor who has hedged some or all of its exposure should have its voting rights reduced proportionally so that its governance rights reflect its economic interest. Also, for reasons discussed below,[235] we believe that the bankruptcy policy of equitable treatment mandates that any control rights belong to the class, not to any individual class member. Therefore, claims purchased at a discount should have their governance rights allocated to reflect their basis, which also reserves the value of the any control premia to the class as a whole. We refer to this governance allocation as "mark-to-interest," which is the first component of a system we term "mark-to-market governance."

The conceptual underpinning of "marking-to-interest" is not particularly radical. Many governance schemes protect the integrity of the democratic process by policing an identity of interest. Political party primaries often, but not always, require membership in the relevant party.[236] Other voting

235. *See infra* Section V.A.2.

236. *See State Primary Election Types*, NAT'L CONF. ST. LEGISLATURES (June 26, 2018), http://www.ncsl.org/research/elections-and-campaigns/primary-types.aspx. The experience in open primaries is instructive, in that it generally reflects a party choice to seek the most broadly acceptable (centrist) candidate. Sometimes it works, as with the recent selection, in Mississippi of Senator Thad Cochran as the Republican senatorial candidate. When faced with a more conservative Tea Party challenger in the primary, Cochran reached across party lines to normally Democratic African American voters. *See, e.g.*, Ashley Parker & Jonathan Martin, *G.O.P. Senator Courts Blacks in Mississippi Primary Race*, N.Y. TIMES (June 20, 2014), https://www.nytimes.com/2014/06/21/us/politics/cochran-asking-blacks-to-rescue-him-in-republican-primary.html. The result was that the relatively more centrist candidate, Cochran, was selected. *Mississippi Election Results*, N.Y. TIMES (Dec. 17, 2014, 12:28 PM), https://www.nytimes.com/elections/2014/mississippi-elections. Even this was not without controversy, but open primaries also leave open a

mechanisms that limit franchise based on conflicts of interest include judicial recusal rules,[237] and most directly applicable, recusal rules for interested directors in corporate transactions.[238] Even shareholders are subject to antifraud rules that limit insider trading (reallocating firm value to insiders) and rules with regard to oppression of minority shareholder issues.[239] Thus, the issue should not be whether we are raising a valid governance concern, but about whether there is a means of regulation wherein the benefits exceed the costs.

2. Basis-Allocated Governance Rights: Preserving Equality of Distribution

Our second concern is more complicated, but it starts from the fact, noted above, that once a debtor becomes insolvent, the changing price of debt reflects a changing price of governance. In other words, the "one-dollar, one-vote" principle breaks down. As the price of distressed debt changes, so does the price of a blocking position or an accepting position. One day a blocking position could cost $100,000. The next day it could cost $200,000. The problem here is not just that the value of the blocking position fluctuates, but so too does its distribution.

The problem is most easily understood in reference to the stock of a solvent company. A "control premium" attaches to the valuing of having a controlling stake in the company—the value of the marginal share needed for control is more than the value of a regular share because it brings with it the control rights. Yet that marginal share cannot be acquired without also owning all of the shares short of the final share needed for control. The point here is that the value of the control premium is distributed unevenly among shareholders. A controlling block is worth more on a per share basis than a minority block of shares. And when a company is in play, the first shareholders to tender to a buyer seeking control can realize on the control premium. Once the buyer has achieved control, the later tendering shareholders will not receive the control premium for their shares.

The fact that the control premium is unevenly distributed among creditors creates a ratable distribution problem that does not exist in equity markets. Bankruptcy law seeks to lock in the relative positions of creditors as

possibility for abuse, with cross-over voters supporting the least palatable candidate in the other party's primary so as to improve their party's candidate's chances in the general election. *Id.*; Andy Schmookler, *Open Primaries: A Wrong Idea*, HUFFPOST (June 15, 2017), https://www.huffingtonpost.com/andy-schmookler/open-primaries-a-wrong-id_b_10471396.html.

237. 28 U.S.C. § 455 (2012); Liteky v. United States, 510 U.S. 540, 541–43, 556 (1994).

238. *See, e.g.*, NASDAQ, CODE OF CONDUCT FOR NASDAQ AND U.S. SUBSIDIARY BOARDS OF DIRECTORS 1–2 (2016), http://ir.nasdaq.com/static-files/ed2focd1-d9cf-432c-8da8-eof87c6d66f1 (effective November 1, 2018).

239. 17 C.F.R. § 240.10b–5 (2018). *See generally* F. Hodge O'Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1987) (describing common causes of shareholder disputes, efforts to suppress minority shareholders' interests, and ways to combat shareholder suppression).

of the petition date.[240] Uneven and shifting distribution of the control premium among members of a class, postpetition, changes the allocation of the value of governance rights over time. To the extent that these rights have value, exiting creditors may realize on that value, while remaining creditors will not.

The best way to think about this is to recognize that the control rights of a class belong to the whole class equally and are allocated to the class as a whole, rather than to any individual creditor. Again, having raised the problem, the question is how to fix it, and whether the fix is worth the cost.

B. THE PROPOSED SOLUTION

Conceptually, our proposed solution is simple. Where a creditor has "hedged" its interest, the voting rights should reflect its actual economic interest as it applies to the particular creditor class. And, where a creditor has sold its claim, the governance rights should be discounted to reflect the creditor's basis.

As discussed above, because claims can be purchased at a discount and because there are multiple blocking positions in bankruptcy, holdout power is greater in bankruptcy than outside.[241] A key goal of bankruptcy law is to limit such holdout power.[242] Outside of bankruptcy, individual creditors have the ability to veto any change to their debt obligations.[243] In bankruptcy, such obligations can be modified by a vote of other creditors.[244]

While we have referred to the adjustment of governance rights through the shorthand of "mark-to-market," that is not exactly what we are proposing. A literal marking of economic interest to market would allow a creditor to vote based on the market value of its claim (excluding the market value attributable to the voting rights). What we would propose, instead, is a solution that addresses hedgers and purchasers separately.

For hedgers, we propose marking their claims to their economic interest ("mark-to-interest"). This would entail a proportional dilution of voting rights based on the extent to which the creditor faces the full risk of its position. For example, if a creditor has hedged half its risk, its voting rights should be reduced by 50%.

For claims purchasers, we propose to mark their claim to their purchase price ("mark-to-basis"). This would entail allocating governance rights based on the purchase price, instead of the face amount of the debt (which would still be used for distributional purposes). If a creditor purchased a $2,000

240. One of us has developed the issue of equitable distribution of firm value extensively in a separate manuscript. *See* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 696–706.

241. *See supra* Part II.

242. *See* LEVITIN, *supra* note 39, at 791, 936.

243. Bratton & Levitin, *supra* note 46, at 1604.

244. 11 U.S.C. §§ 1123, 1126, 1129 (2012).

claim for $400, it should have voting rights associated with the $400 purchase price, instead of the $2,000 debt. The effect of using basis, rather than face amount is to allow for economic exit, while preserving the value of control for the class as a whole. Each time a creditor exits, its governance rights would be reallocated to the entire class.

Marking the claims governance rights to basis largely solves both the problem of underpaying for a control premium and the problem that the control premium is not distributed equally across the class. The solution is to discount the voting rights, but not the distributional rights related to a claim.

A numerical example illustrates the point. If, on the petition date, there were $100 in claims in a class, a blocking position would require $33 of claims and a control position would require $67 of claims. If, for example, one month into the case, claims were selling for 50¢ on the dollar, then $33 in claims could be purchased for $16.50. If the voting rights were marked to basis, however, $33 in debt purchased for $16.50 would convey only $16.50 in voting rights, but would still represent $33 in distributional rights. Accordingly, to amass a blocking position would require a purchase of $66 in face amount at a 50% discount. Whereas distribution rights are allocated by face amount, voting rights are allocated by basis.

The same marking-to-basis mechanism also largely (though not entirely) alleviates the problem of unequal distribution. If a claim is purchased at a 50% discount, then the voting rights would be split. Half of the voting rights would go to the purchaser who purchased for 50¢ on the dollar, while the remaining half would effectively be reallocated, pro rata, to all claimants according to their original economic interest.

Thus, with a class of $100 in claims, a claimant who purchased $66 in claims for $33 would end up with $66 of distribution rights—two-thirds of the distribution rights in the class—but it would receive only one-half of voting rights in the class ($33 of $66), reflecting the claimant's share of the total basis of the class's claimants.[245] Neither would have a control position, but

245. The dollar amount of voting rights can be conceived in three ways, all resulting in the same percentage allocation of voting rights. First, the claimant can be conceived as having $33 out of a total of $66 in voting rights, because $66 is the total basis for the class ($33 for the claimant plus $33 for the rest of the class). The result is one half ($33 of $66) of the voting power goes to the claim purchaser.

Second, we can think of there being a reallocation of the voting premium of one third of the total votes (representing the difference between the claimant's face amount ($66) and basis ($33)), so that the claimant would get $33 in votes + a 33% premium for a total of $44 and the other class members would get $33 in votes plus a 33% premium for a total of $44 in votes. The result again is one half of the voting power ($44 of $88) goes to the claim purchaser.

Third, the claimant can be conceived as having $50 out of a total of $100 in voting rights. This approach takes the $33 difference between the claimant's face amount ($66) and basis ($33) and reallocates it pro rata to all claimants (including the claim purchaser) on the basis of their basis. The claim purchaser receives one half of the reallocated voting rights ($17) for a total of $50, while the rest of the class receives one half ($17) for a total of $50. Yet again, the result is one half of the voting power ($50 of $100) goes to the claim purchaser.

both would have blocking positions and would have to deal with each other. Purchasing control would be even more difficult. It would be necessary for a purchaser to purchase four-fifths of the face amount of a class to obtain a control position of two-thirds of the votes.

In thinking about the impact of such an approach, it is important to consider what it accomplishes, and what it does not. Mark-to-basis principally limits the ability of a claims trader to purchase control rights at a discount and mark-to-interest limits the ability of a creditor to use those rights to the disadvantage of other similarly situated creditors while creating a benefit outside the creditor class. For example, a creditor with short options, marked to interest, could not use its voting rights to the advantage of its derivative position because its voting rights would be proportionally diluted. A creditor who purchased a position in a class at a discount, would still be able to vote its claims, but only to the extent of the amount paid. The logic for hedgers lies in preserving interest alignment. The logic for traders, again, lies in equal distribution of the monetary value of control.

C. SOME COMPLICATIONS

One complication for the proportional dilution rule is that hedging comes in many forms.[246] The principle of proportional dilution is more difficult to administer in situations where the value of control to the conflicting interest is more difficult to value. Three examples have been mentioned above: (1) secured creditors' deficiency claims or other creditors who have invested across the capital structure; (2) landlords; and (3) competitors.[247] An undersecured creditor will frequently have a large deficiency claim.[248] The right to vote that claim as a member of the unsecured creditor class may create significant opportunities for the senior creditor to capture value that it does not own. Imagine that two secured creditors have liens on assets of the debtor worth $3 million and claims of $10 million. The debtor has other assets worth $1 million, and unsecured creditors with claims of $3 million. The secured creditors have the power to control the unsecured creditor class through their unsecured deficiency claims. They could thereby vote to support a plan with an artificially low valuation that transferred ownership of the debtor to the secured parties while giving a very small cash

---

In any case, the claim purchaser only ends up with one half of the voting rights in the class. Mathematically there is no difference between disregarding the voting rights reflected by the difference between face and basis and redistributing them pro rata on the basis of basis, because the pro rata redistribution, by definition, does not affect the ratio of the numerator and denominator in the voting. For bankruptcy law purposes it makes no difference which calculation is used.

246. *See supra* Section II.A.

247. *See supra* Sections II.E.4–.6.

248. *See* 11 U.S.C. § 506(b) (providing for bifurcation of undersecured claims into a secured claim for the value of the collateral and an unsecured claim for the deficiency).

payout to the unsecured class. Similarly, a landlord may prefer to recover control of its space to recovering on a breach claim or receiving cure payments over time. Finally, a competitor might favor liquidation even if it is not value maximizing on its claim because the demise of a competitor would have considerable economic value.

Unlike the challenges of modern financial instruments and distressed debt trading, these conflicts are not novel. Indeed, they are the genesis of the existing remedies.[249] Separate classification of the deficiency claim means that the other unsecured creditors will still be able to accept as a class if they choose to. The deficiency class will not accept, and cram-down will be necessary, but this would be true even if the secured creditor alone were to vote no. The main difference is that if there is an objecting unsecured class, the absolute priority rule will apply, and equity will have to be wiped out.[250] As for the landlord or the competitor, designation of votes may be an adequate remedy, as the conflict of interest should be readily apparent. In each of these situations, the appropriate dilution may be difficult to calculate, and while the principle may be operating, existing remedies might be better suited to the problem.

In short, we would only apply our approach to hedgers and traders. It seems that proportional and relative dilution are remedies that work particularly well for hedged and/or traded claims, but for the other types of conflicts we have discussed, existing remedies may be sufficient.

A second complication arises when governance rights are discounted based on basis. The result of one claim's governance rights being discounted is that existing claimants may have their governance rights enhanced. Blocking positions may emerge where previously they did not exist. On the one hand, this seems unfair, but when applied in actual cases, it shows how the two prongs of mark-to-market governance work together by permitting economic exit and preventing the sale of a control premium. To the extent that a class has governance rights within a Chapter 11 case, that right belongs to the class, not one subset of creditors who choose to sell into a developing control block because the right exists only by virtue of the existence of the class. The effect of calculating governance rights based on basis is that the control premium is constantly reallocated among the existing creditors. Since the control premium cannot be purchased, each time there is a sale of a claim, any discounted control rights are reallocated to the other members of the class to be shared equally. This solves the equity problem. It also reinforces the importance of proportional dilution for hedgers. A purchaser who is purchasing an economic interest will have to rely on the other creditors to

249. *See, e.g.*, H.R. REP. NO. 95-595, at 411 (1977) (noting that the good faith voting requirement of 11 U.S.C. § 1126(e) is to address the situation of when a creditor holds claims in multiple classes).

250. 11 U.S.C. § 1129(b)(2).

exercise their rights on behalf of the class in a non-conflicted manner. As a result, robust disclosure and mechanisms to retain interest alignment would be a prerequisite to any claim's liquidity. While it might seem farfetched to think that investors would buy economic claims stripped of their voting rights, a number of recent tech offerings have included shares with no voting power.[251] The lack of voting rights has not been an impediment to marketing the shares.

D. PURCHASE OF SECURED POSITIONS

As noted above, the right to credit bid can be used by a secured creditor to capture value in excess of its secured claim. The *Free Lance-Star* case illustrates a means for solving this problem, which we call "mark-to-value." In that case, the court concluded, however, that the claims purchaser did not have a lien on all of the corporate assets, and hence on the corporation's enterprise value.[252] Accordingly, the court limited the creditor's right to credit bid to an amount based solely on the value of the assets on which it had a valid lien.[253] The effect was to limit the likelihood that the debt overhang would chill the bidding at the sale and to preserve for later resolution the question of how much of the firm's value was allocable to the secured creditor's claim.

The *Free Lance-Star* ruling has been quite controversial.[254] However, the court's action can be viewed as an elegant move to mark the secured creditor's claim to market. The secured creditor's strategy in *Free Lance-Star* was an attempt to lever the value of the liened assets into ownership and control of the company. In short, the claim purchaser seemed to think that the secured claim carried with it control rights and hence a control premium. The court's decision limited the governance rights (specifically, the right to credit bid) to the liquidation value of the creditor's collateral and preserved disputes about allocation of value for later.[255]

We believe that limiting a secured creditor's ability to credit bid to the amount of its allowed secured claim ("mark-to-value") is an important third component of a system of "mark-to-market governance." Indeed, as Janger has explained elsewhere, the principle is already required by Sections 506, 363(k) and 1129(b)(2)(A).[256] Sales procedures are an important part of governance

251. James Rufus Koren & Paresh Dave, *Snap Won't Give Shareholders Voting Rights. For That, It's Being Shunned by a Major Stock Index*, L.A. TIMES (July 28, 2017, 10:40 AM), https://www.latimes.com/business/la-fi-snap-russell-indices-20170727-story.html. Notably, bankruptcy law requires any plan of reorganization to include a provision in the charter of the reorganized debtor prohibiting such nonvoting equity securities. *See* 11 U.S.C. § 1123(a)(6).

252. *In re* Free Lance-Star Publ'g Co. of Fredericksburg, 512 B.R. 798, 807–08 (Bankr. E.D. Va. 2014).

253. *Id.* (discussing valuation methodology).

254. Tyler P. Brown et al., *Secured Lender's Credit-Bid Capped in Free Lance-Star*, 33 AM. BANKR. INST. J. *1, *3 (2014).

255. *In re Free Lance-Star*, 512 B.R. at 808.

256. Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589, 601–06.

in bankruptcy, and the ability to credit bid beyond the value of one's collateral confers the power to chill cash bids.[257] Just as any control premium belongs to a class, not an individual creditor, secured creditors should not be able to use their power over assets to distort the Bankruptcy Code's priority scheme including the relationship between asset-based and firm-based claims. Just as with hedgers and discount buyers, the problem of secured creditors attempting to credit bid on assets of the debtor firm that are not part of their collateral can be solved by preserving the "relative governance rights" associated with a claim, while leaving the distributional rights intact.

E. PRELIMINARY CONCLUSIONS

In sum, ensuring that creditors are given governance rights in accordance with their economic interest in the debtor and limiting their ability to use or accumulate control rights to harm the firm or distort the Code's distributional priorities is a theme that underlies a variety of existing remedies under the Bankruptcy Code. Separate classification, designation of votes, and subordination of claims are all existing tools in the court's repertoire.

In this Article, however, we have identified three contexts where modern claims trading demands novel remedies.

- First, the existing regime is inadequate and needs to be modified to account for the possibility of positions hedged with derivatives (mark-to-interest).
- Second, purchasing a claim at a discount from face amount may increase the power of holdouts and violates the bankruptcy policy of equality of treatment (mark-to-basis).
- And third, where secured creditors are involved, limiting the right to credit bid to the value of the collateral—already occurring in some cases—can be accomplished by applying Section 363(k) (mark-to-value).

Each context necessitates a recalibration of control rights to achieve a mark-to-market governance system that reflects bankruptcy's underlying principles of value-maximizing governance and equitable distribution. In the next section we describe how this might be done.

VI. IMPLEMENTATION

The value of any creditor's position in a bankruptcy case has two components: the economic rights to a distribution and the governance rights that help to determine how to maximize the value of the firm's assets. Claimants may attempt to use their governance rights to enhance their

257. *Id.*

distribution at the expense of other claimants or the firm by separating their economic rights from their governance rights. Claims trading also allows selling claimants to sell control linked shares at a premium, while allowing claims purchasers to purchase blocking positions at a discount. The goal of this Article is to reestablish the connection between the claimant's economic position and its governance rights through three practical approaches: (1) proportional dilution of voting rights for all creditors that are hedged; (2) discounting the governance rights of purchased claims to the claimant's basis; and (3) by limiting the secured creditor's right to credit bid to the estimated value of its collateral.

In our view there is statutory authority for a partial implementation of our approach under current law in the Code, though the infrastructure would need to be created at the beginning of a case by order, local rule, or amendment to the Federal Rules of Bankruptcy Procedure. In this section, we identify the limits of existing law and propose a practical approach to implementation mark-to-interest and mark-to-basis governance. In our view there is existing legal authority, under Section 1126 of the Bankruptcy Code, to designate shorts, though not, except perhaps under Section 105, to dilute partial hedges or claims traders. In our view, there is already authority, under Sections 363(k) and 506 to limit credit bidding to the allowed secured claim, as illustrated by *Free Lance-Star*.[258]

A. *IMPLEMENTING MARK-TO-INTEREST AND MARK-TO-BASIS*

For the partially hedged, or even indifferent creditor, it would be difficult to characterize a vote as case in bad faith under Section 1126(e). However, for a true *Schadenfreude* investor, where the interest of the investor and the firm have diverged, then bad faith can be inferred from the conflict of interest itself. Designation (or equitable subordination) seems an appropriate response, and one that could be implemented immediately. Our more aggressive proposals, we think, would require an amendment to the Code. That said, we do think that both a modest version, as well also our more robust version, could be implemented by the same procedural mechanism.

A mark-to-market regime, in both its forms, would require a more robust disclosure system than currently exists. As noted above, Rule 2019 currently requires *ad hoc* committee members and official committee members to disclose more about their economic position than just the face value of their claim.[259] They must also disclose when they purchased their "disclosable economic interest" in the debtor by quarter if it was purchased in the past year.[260] Disclosure of the nature and amount of the interest as well as the general time when it was purchased can serve as a rough proxy for disclosure

258. *See infra* Section VI.B.

259. *See supra* notes 201–02 and accompanying text.

260. FED. R. BANKR. P. 2019(c)(2)(B)–(C).

of the price paid for the interest; for example, it is feasible for parties to discover roughly what a total return swap on the debtor would have cost two quarters ago.

Mark-to-market governance would necessitate a similar type of disclosure to Rule 2019, but it would have to apply to all claimants.[261] Beyond the Rule 2019 disclosure content, for mark-to-market governance to work, such creditors would also have to disclose the consideration they paid for their claims, something that is likely to be fiercely resisted because it will enable outside observers to calculate the successfulness of different investors' strategies.

The timing of these disclosures is important. To the extent that Chapter 11 expects smaller creditors to free-ride by watching the behavior of larger creditors, the only way to avoid false signaling is to require periodic updating of these disclosures, including whenever there is a material change in their disclosable interest.

Most importantly, however, we would require a final disclosure at the time of a distribution under a plan, after governance rights have been exercised. This would allow the claims agent tabulating ballots to apply the mark-to-market principles to each claim. Finally, because claims may be traded even after voting, a creditor with a blocking position might vote against the plan, and then build a short position based on the knowledge of its vote. Thus, creditors who have voted on a plan should be required to make a certification as of the effective date of the plan that there has been no material change in its economic interest. If there has been a material change, then the court should have the power to recalculate the governing majorities, and, if necessary, revoke plan confirmation.[262]

---

261. Our concerns about non-voting governance rights do not extend to Chapter 7, where creditors exert minimal governance influence.

We recognize that there are practical complications in marking claims to market when those claims are held indirectly. For example, most secured loans are syndicated, with a single claim filed by the agent bank for the syndicate. Would the disclosure regime we propose apply to each syndicate member, or would it be aggregated? How would a reduction in voting rights for the agent bank in the bankruptcy because of individual syndicate members' positions be addressed within the syndicate's own internal voting structure? The same problem emerges for participations and securitizations—is the disclosure requirement on the agent bank or servicer? Or is it on the beneficial interest holders? And for bonds, would the duty be on the indenture trustee? If so, how would the disclosure requirement work given that the trustee likely knows only the names of the brokerages that hold the bonds in "street name" for the ultimate investors, who might themselves be funds with their own investors?

262. Federal securities law takes a different approach. The Williams Act requires public disclosure when a stockholder accumulates a significantly large position to be able to begin affecting governance rights. 15 U.S.C. § 78m(d) (2012). This disclosure requirement alerts other shareholders that they should demand a control premium when they sell their stock. The negative implication is that absent a Williams Act warning, stock is sold without control rights, meaning that the stock price is discounted to reflect the lack of control rights.

B. IMPLEMENTING MARK-TO-VALUE

For secured creditors, as noted above, the architecture we suggest has already been partially implemented in a number of cases using Section 363(k), and may be required by Sections 506 and 1129(b)(2)(A).[263] Section 363(k) allows the court to limit the power to credit bid at a bankruptcy sale "for cause."[264] In *Free Lance-Star,* and a similar case *Fisker Automotive Holdings*, secured creditors who purchased their claims had their right to credit bid limited to the amount they had paid for the purchased debt.[265] This did not, in either case, determine their distributional rights, but it did facilitate bidding by other parties at the auction by limiting the effect of the overhanging credit bid.

In both of these cases, however, the court's decision to limit the right to credit bid was accompanied by findings that the creditor had engaged in inequitable behavior.[266] Many commenters have taken the view that those two courts were relying on egregious inequitable behavior by the bidding creditors.[267] It is certainly true that the behavior of the secured creditors in both cases played a role. However, it was important to the court in *Free Lance-Star* that the bidding creditor did not have a perfected lien on all of the assets being sold, and, more importantly, the court was particularly upset by the way in which the creditor tried to leverage its lien rights into control rights. Indeed, that was the inequitable behavior identified, and the remedy was to mark the "control rights" to market.[268]

In our view, the lesson of *Free Lance-Star* and *Fisker* is broader than is commonly understood. Whenever a debtor is conducting an all asset sale, it is not by any means clear that the incumbent secured lender has a perfected lien on all of the firm's value.[269] As such, there will often be cause to limit the right to credit bid to the value of the secured creditor's lien—to mark the bids to market.

VII. CONCLUSION

In conclusion, modern trading technology increases the liquidity of debt, and this includes distressed debt. As such, debt now trades in a manner similar to equity securities. Because bankruptcy gives governance rights to creditors,

263. Janger, *supra* note 256, at 601–06.

264. 11 U.S.C. § 363(k).

265. *In re* Free Lance-Star Publ'g Co. of Fredericksburg, 512 B.R. 798, 807–08 (Bankr. E.D. Va. 2014); *In re* Fisker Auto. Holdings, Inc., 510 B.R. 55, 61 (Bankr. D. Del. 2014).

266. *In re Free Lance-Star*, 512 B.R. at 808; *In re* Fisker Auto. Holdings, 510 B.R. at 60–61.

267. *See, e.g.*, Nelly Almeida, *Credit Bidding Capped Again: The Fisker Factors Create a "Perfect Storm" in Virginia*, WEIL BANKR. BLOG (Apr. 22, 2014), https://business-finance-restructuring.weil.com/363-sales/credit-bidding-capped-again-the-fisker-factors-create-a-perfect-storm-in-virginia.

268. *See In re Free Lance-Star*, 512 B.R. at 808.

269. *See* Jacoby & Janger, *Tracing Equity*, *supra* note 4, at 727–28.

the empty voting problem that has been observed in modern mergers and acquisition practice appears to have migrated to the bankruptcy forum.

We believe that matching governance rights to economic interest is the proper way to align investment incentives such that firm value is most likely to be maximized by its stakeholders. Just because a rule is likely to be wealth maximizing does not mean that it will not be controversial. When the bankruptcy court in *Northwest Airlines* found in 2007 that the then current version of Federal Rule of Bankruptcy Procedure 2019 required an *ad hoc* group of creditors to make various disclosures, including the amount paid for any "claims or interests" in the debtor,[270] the reaction from distressed debt investors was quick and furious.[271]

There is no denying that disclosure obligations would lead to a loss of liquidity of bankruptcy claims. Some creditors would not want to be subject to a disclosure requirement both because of its administrative burdens and potential liability and because of the concern about revealing information about their trading strategies and success. Indeed, we recognize that the changes we propose may make certain trading strategies less profitable.

But even if our proposal has a chilling effect on the claims trading market, that should not be dispositive in terms of evaluating its merits. Claims trading has important benefits,[272] but those benefits are only realized if the market in which claims are traded are open and transparent and if governance rights are properly distributed. Our approach does not limit "economic exit." It merely reestablishes the link between governance rights and economic interest. Indeed, fixing this problem in bankruptcy helps limit the problem outside of bankruptcy. If misallocated control rights are lost in bankruptcy, they lose value outside of bankruptcy, so there is less incentive to engage in empty creditor behavior overall.

Mark-to-market governance on the basis of "one dollar, one vote" provides a mechanism for reducing the distortions that empty voting can cause in bankruptcy while preserving the benefits of the claims trading market as relates to purely economic rights.

---

270. *In re* Nw. Airlines Corp., 363 B.R. 701, 702–04 (Bankr. S.D.N.Y. 2007) (requiring disclosure); *In re* Nw. Airlines Corp., 363 B.R. 704, 706–09 (Bankr. S.D.N.Y. 2007) (making disclosure public). The pre-2010 version of Rule 2019 did not require disclosure of any "disclosable economic interest," but merely of any "claim or interest" in the debtor and the purchase price and date. FED. R. BANKR. P. 2019, committee's notes to 2011 amendment.

271. *See* Corbi et al., *supra* note 201, at 14.

272. *See* Levitin, *supra* note 29, at 72–74.