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CURBING THE EXPLOITATION OF PASSIVE CREDITORS IN CHAPTER 11 REORGANIZATION BY LEVERAGING THE OVERSIGHT ROLE OF THE UNITED STATES TRUSTEE

ADDISON PIERCE*

The Bankruptcy Reform Act of 1978 is beginning to show its age in ways similar to the forty-year-old code it replaced. In addition to being ill-suited to address changes in the underlying credit market, the current code is confronting the development of an entirely new market place—a market in claims trading. While some praise the enhanced liquidity, others take issue with the strains placed on the efficacy of bankruptcy. Rather than engaging in the normative debate, this Comment seeks to redress a clear drawback to the current system: the harm endured by passive creditors. Unlike those economically empowered to participate in the reorganization process, the passive creditor lacks the economic ability and incentive to play an active role. This position leaves the passive creditor’s ability to collect on its claim solely in the hands of another: the creditors’ committee. While this committee may have provided adequate protection in 1978, the credit market and its participants are very different today. Some argue that this issue is systemic and can only be addressed by replacing the current code; however, this Comment argues that something can be done short of this massive task. The challenge is as follows: if too little is done, passive creditors will continue to be exploited and if too much is done the whole market could be damaged. Recognizing this challenge, this Comment proposes that passive creditors can be afforded adequate protection by leveraging the oversight power of the US Trustee to ensure the proper functioning of creditors’ committees. Moreover, the recommendation of this Comment would enhance protection for passive creditor while remaining market neutral.

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INTRODUCTION

Bankruptcy is an attempt to prevent a tragedy of the commons. Without bankruptcy, “creditors would resort to self-help measures to collect debts owed to them” by a failed or failing organization (“the debtor”). The foreclosure and liquidation assets would favor the sophisticated over the

1. See Michael A. Heller, The Tragedy of the Anticommons: Property in the Transition from Marx to Markets, 111 HARV. L. REV. 621, 677 (1998) (“A tragedy of the commons can occur when too many individuals have privileges of use in a scarce resource. The tragedy is that rational individuals, acting separately, may collectively overconsume scarce resources.”).

passive and leave similarly situated creditors (similarly situated in right rather than ability to collect) in disparate positions. Moreover, this process would be swift and crude, as creditors would favor efficiency over care when seeking to recover their claims.

Instead, bankruptcy provides a safe haven for creditor and debtor alike by staying the liquidation process and allowing the debtor and its creditors to work together to maximize the value of the debtor’s remaining assets. Chapter 11 of the Bankruptcy Code (“Chapter 11”) takes this idea a step further. Rather than working to maximize the value of the remaining assets, Chapter 11 recognizes that more value may be realized by utilizing the going-concern value of the assets. Instead of liquidation and dissolution, the debtor continues to operate under the safe haven of Chapter 11, proposes a plan of reorganization, restructures its existing debt, and starts anew. Chapter 11 reflects the belief that the value of a business as a going-concern may greatly exceed the value of its assets sold individually and immediately.

In 1978, when the Bankruptcy Code (“the Code” or “the 1978 Code”) underwent its most recent overhaul, bankruptcy proceedings were

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3. See id. ("[B]ankruptcy protects the interests of creditors as a group.").
4. See id. (typifying the self-interested taking of assets by a creditor as “harming assets that would have accrued to other creditors").
6. See H.R. REP. NO. 95-595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179 (noting that unlike liquidation, “[t]he purpose of [Chapter 11] ... is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders").
7. See id.; see also Frederick Tung, Confirmation and Claims Trading, 90 NW. U. L. REV. 1684, 1689 (1996) (restating going-concern value, as the value of “the continuation of the debtor’s business” as opposed to the value of “dismemberment and piecemeal sale of the assets").
8. See Whitaker, supra note 2 ("[I]t may be in the best interests of society in general to allow the debtor to continue to operate, create a plan of reorganization, restructure its existing debt, and start [anew]."). But see 11 U.S.C. § 112 (2012) (providing the bankruptcy judge the authority to convert the case to Chapter 7 liquidation for cause, if for example, under (b)(4)(a) there is “substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation").
9. See, e.g., United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) (“By permitting reorganization ... Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if ‘sold for scrap.’” (citation omitted)).
straightforward. A corporation in reorganization maintained a relatively simple capital structure. A senior bank held a single note with a security interest in all of the debtor’s assets, and the unsecured claims were held by a group of “dispersed, but homogenous creditors that could adequately be represented by a committee, typically made up of a small group of the largest unsecured claim holders.” With this structure, the bank, the committee, and the debtor’s managers could all sit at the bargaining table and work out a reorganization plan.

Today, the simple structure has been replaced by a system of unprecedented complexity and sophistication. The credit markets that underpin the entire system have undergone substantial evolution. Single secured lenders have transformed into primary lenders who manage a web of syndicated loan parcels. In addition to changes in the underlying markets, the system is also confronting the creation of a market in bankruptcy claims. Professor Adam Levitin has characterized the development as one that:

has changed the cast of characters involved in bankruptcies. In addition to long-standing relational creditors, like trade creditors or a single senior secured bank or bank group, bankruptcy cases now involve professional distressed debt investors, whose interests and behavior are often quite different than traditional relational counterparty creditors.

As the market for claims trading grows, the pressure placed on Chapter

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12. See id. (describing the structure as “relatively simple”).
13. Id.
14. See id. (“Today, we no longer have a single bank and dispersed general creditors. Dozens of constantly changing stakeholders occupy every tranche, each pursuing its own agenda. Some seek long-term control of the business, while others are passive, short-term investors. Others may hold a basket of both long and short positions in multiple tranches and complicated hedges involving other businesses.”).
15. See id. and accompanying text.
16. See id.
17. See Adam J. Levitin, Bankruptcy Markets: Making Sense of Claims Trading, 4 BROOK. J. CORP. FIN. & COM. L. 67, 68 (2009) (emphasizing that “nothing has changed the face of bankruptcy in the last decade as much [claims trading]”).
18. Id.
19. See Adam J. Levitin, Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron, 2007 COLUM. BUS. L. REV. 83, 86 (noting that “[a]lthough the exact size of the corporate bankruptcy claims trading market is unknown, it was estimated to be in the hundreds of billions of dollars about a decade ago and has seen a prodigious growth in recent years”).
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11 is disconcerting. If the Code was passed with the relational creditor in mind, as this relationship erodes, so too does the Code’s ability to function.

Concurrent with the growth in this new market, is a lack of growth in the federal regulatory regime. The Federal Rules of Bankruptcy ("Federal Rules") have proven permissive to the practice of claims trading, and securities regulations have proven to be too narrow to reach the claims. Free from regulatory scrutiny, it seems almost unquestionable that claims trading will continue to grow at a steadfast pace.

The lack of regulation should not, however, be mistaken for approval. Scholarship on claims trading actually points to the opposite; that there is little agreement on the merits of the practice. Those who favor claims trading focus on the enhanced liquidity and efficiency of the market place. On the other side are those who argue that the net effect is negative and that claims trading is detrimental to the proper functioning of the Code. What is clear from this debate is that “claims trading has cross-cutting impacts on the bankruptcy process with a net impact that is

20. See Levitin, supra note 17 (explaining that this dynamic has placed the code under “tremendous pressure”).
21. See id.
22. See Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 AM. BANKR. INST. L. REV. 569, 572 (2002) ("[T]here is an active, functioning, and enormous (in terms of dollar amount) market in distressed claims that is not actively regulated.").
23. See FED. R. BANKR. P. 3001(e) (allowing claims to be freely alienated, save for fraudulent transfers).
24. See generally Drain & Schwartz, supra note 22, at 571 (finding that claims in a bankrupt corporation are not recognized as securities, rendering the securities regulations inapplicable).
25. See Baird & Rasmussen, supra note 11, at 659 (expanding on the concept that deregulated markets provide opportunities that highly regulated markets do not, implying that the lack of regulation will encourage growth).
27. See, e.g., Brockway, supra note 26 and accompanying text.
28. See, e.g., Miller & Waisman, supra note 26 and accompanying text.
indeterminate on the available evidence." \(^{29}\) Further, it means, "claims trading is not well-suited for broad policy reforms . . . [and] at this point, we can merely identify several modest features of the claims trading market that can be improved." \(^{30}\)

Recognizing claims trading as a "fundamental feature of bankruptcy," \(^{31}\) this Comment examines the relationship between claims investors and passive creditors, and argues that the Code is failing to serve the passive creditors in Chapter 11 proceedings.

Part II of this Comment examines the Bankruptcy Code with particular attention paid to Chapter 11. This Section briefly introduces the (a) foundation and purpose of bankruptcy. This Section then looks at (b) how these principals are served by the 1978 Code. Finally, this Section (c) examines how the same principals are being poorly served today due to (i) the evolution of the credit market and (ii) the growth in claims trading.

Part III examines how the current system is allowing for the exploitation of the passive creditors. This Section examines (a) the provisions in the Code that permit claims trading and (b) how these provisions undercut the principles of bankruptcy. This Section also examines (c) why this inequality should not go unchecked, and more specifically (d) why this inequality should draw concern.

Part IV then addresses the problems identified above by arguing that (a) creditors' committees have a duty to maximize returns for passive creditors. Further, this Section argues that (b) the United States Trustee ("Trustee") has a role in ensuring fulfillment of this duty. Finally, this Section (c) provides a means by which creditors' committees can fulfill their obligations.

I. CHAPTER 11'S RESPONSIVENESS TO EVOLVING CREDIT MARKETS AND THE RAPID GROWTH IN CLAIMS TRADING

To understand the harsh realities of the marketplace for passive creditors, and the extent of the challenges they face, this Section begins by introducing briefly (a) Chapter 11 bankruptcy as it was envisioned by the Code in 1978. From this foundation, this Section then examines (b) the market-forced evolution of bankruptcy as the Code faced unforeseen evolutions in the credit markets. Finally, this Section (c) examines how claims trading has exacerbated the problems brought by the evolution of the credit markets and how it has pushed Chapter 11 cases even further.

\(^{29}\) Levitin, supra note 17, at 70.

\(^{30}\) Id.

from bankruptcy's normative goals.

A. The Prevailing Goals of Chapter 11 Bankruptcy: Safe Haven for Debtors and Equality for Creditors

Many different bankruptcy codes have come and gone since the U.S. Constitution granted congressional authority to establish uniform bankruptcy procedures. What has remained is the impetus underlying the procedures. Michael Whitaker describes the prevailing polices and their foundation as follows:

Bankruptcy law attempts to ensure that all similarly situated creditors are treated equally. More importantly, it protects the interests of creditors as a group. Without bankruptcy law, creditors would resort to self-help measures to collect the debts owed to them. Each creditor would act in its own best interest, in the process taking or harming assets that would have accrued to other creditors. Bankruptcy law attempts to minimize this harmful behavior and to ensure that the value of the debtor's remaining assets is maximized for all creditors.

This account represents the prevailing characterization of bankruptcy in the United States and, generally, suggests two principal goals. First is the provision of a safe harbor for debtors. Upon filing a Chapter 11 petition ("petition"), the debtor is provided an automatic stay preventing, among other actions, the commencement or continuation of judicial proceedings. This allows the debtor to enter the next stages of bankruptcy largely intact, having avoided foreclosure on assets or enforcement of outstanding debts. The automatic stay in particular, along with other rights granted in the Code generally, provide means by which the debtor can seek safe haven


33. See Whitaker, supra note 2 ("The [same] need for and policies behind a federal bankruptcy procedure remain true today.").

34. Id.

35. See Tung, supra note 7 ("Bankruptcy law has two general aims: to provide relief to the debtor . . . and to treat all creditors equitably in distribution.").

36. See id.; see, e.g., 11 U.S.C. § 362(a)(1) (2012) (providing, under Chapter 11, an automatic stay preventing, among other actions, the commencement or continuation of judicial proceedings).


38. See id. at § 362(a) (stating that filing a bankruptcy petition operates as a stay applicable to, with limited exceptions, all entities).
The second principal goal of bankruptcy can be characterized as providing a means of establishing equality among creditors. By preventing foreclosure and immediate liquidation of assets, larger and more sophisticated creditors are limited in their ability to recover to the detriment of smaller, yet similarly situated creditors and those who file first are limited from depleting resources before those who file later can assert a claim.

While many different bankruptcy codes have come and gone, the underlying need for a uniform bankruptcy code persists. When financially distressed organizations approach the point of insolvency, bankruptcy provides a safe haven for the debtor, while ensuring equality among similarly situated creditors.

B. Chapter 11 and the 1978 Bankruptcy Code: Realigning the Code with the Goals

The formation of a new bankruptcy code in 1978 was in response to dramatic changes in the underlying credit market not envisioned by even the most recent amendments to the 1898 Code, the 1938 Chandler Act. Among the changes was the newly formed Chapter 11, geared to address reorganization cases more complex than those contemplated by the Chandler Act. At the time, a debtor maintained a capital structure often

39. See, e.g., id. at § 1121(b) (“Except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter.”). But see Supra text accompanying note 7 (discussing the power under section 112 to convert a case to Chapter 7).

40. See Tung, supra note 7; Supra text accompanying note 35; Patricia Rummer, Chapter 11: Haven for Megacases?, COM. L. BULL., July-Aug. 1988, at 12, 13 (“The equality of distribution concept inherent in bankruptcy proceedings means that all claimants get a chance to share in whatever funds are set aside for claims. It gives all the claimants a level playing field.”); see also § 362 (providing an automatic stay that prevents creditors from receiving any distributions before the entire class of claimants is established).

41. See Rummer, supra note 40, at 14 (discussing In re A.H. Robins Co., 846 F.2d 267 (4th Cir. 1988)) (discussing the inequality based on timing issue by way of reference to a debtor who feared that if it “had been required to pay a substantial number of claims in a brief period of time, its resources would have been exhausted, and claimants at the end of the line would have been left with nothing”).

42. See Whitaker, supra note 2; Supra text accompanying note 33.

43. See Robert J. Keach & Albert Togut, Commission to Explore Overhauling Chapter 11, 30 AM. BANKR. INST. J. 36 (2011) (“[I]n [1978], we said we need to revise the bankruptcy laws because the entire underlying credit economy in the business world had changed dramatically in the 40 years since the 1938 Chandler Act.”).

44. See id. (implying that changes in the underlying credit market necessarily resulted in cases that are more complex).
consisting of a senior bank holding a single note with a security interest in all of the debtor's assets, and a group of dispersed, but homogenous, unsecured creditors who could adequately be represented by a committee, typically made up of a small group of the largest unsecured claim holders.\textsuperscript{45} With this structure, the debtor, the bank, and the committee could all sit at the bargaining table and work out a reorganization plan.\textsuperscript{46} Albert Togut has characterized the \textit{classic reorganization} under the 1978 Code as:

one in which a distressed company [could] find protection in the safe harbor of Chapter 11, dispose of unprofitable parts of the business [via liquidation or sale], stabilize what remain[ed], operate for a short time to see that the core business [could] be profitable, propose a plan based upon the smaller, profitable core business, restructure its balance sheet pursuant to a Chapter 11 plan, and emerge as a healthy, albeit smaller, business enterprise.\textsuperscript{47}

This characterization demonstrates how the 1978 Code supported the goals of bankruptcy by providing equality for creditors and a safe haven for debtors. While still greatly exposed to the systemic uncertainty of bankruptcy, creditors were generally afforded adequate protection.\textsuperscript{48} The Code provides that the creditors, as a uniform class, have a place at the bargaining table and can influence the reorganization plan.\textsuperscript{49} In addition, as this class is represented by a committee, even those creditors who held valid claims but did not actively participate in the bankruptcy process reaped rewards as members of the homogeneous class of unsecured creditors.\textsuperscript{50} In short, this example illustrates the 1978 Code as providing a system in which the debtor can seek the protection of bankruptcy and the

\begin{thebibliography}{99}
\bibitem{45} See Baird & Rasmussen, \textit{supra} note 11; 11 U.S.C. § 1102(a)(1) ("[A]s soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims . . . ."); § 1102(b)(1) ("A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee . . . .").
\bibitem{46} See Baird & Rasmussen, \textit{supra} note 11 (noting that under the contemplated system, the parties "bargained with each other against a backdrop of well-developed norms").
\bibitem{47} Keach & Togut, \textit{supra} note 43.
\bibitem{48} See, \textit{e.g.}, Baird & Rasmussen, \textit{supra} note 11, at 656 (articulating that the creditors were not only represented by a committee, but that the committee had the ability to hire accountants, investment bankers, lawyers, and others, at the expense of the debtor, to help protect the class).
\bibitem{49} See \textit{id.} at 656–57 ("[A] debtor would be hard-pressed to confirm a plan of reorganization over the active opposition of the creditors . . . .").
\bibitem{50} See Baird & Rasmussen \textit{supra} note 11; \textit{Supra} text accompanying note 45.
\end{thebibliography}
creditors can be assured equal class treatment.51

C. Chapter 11 Today

Just as four decades of progress led to the demise of the Chandler Act of 1938, the 1978 Code is confronting seemingly insurmountable challenges. Two of the most pronounced, in the context of Chapter 11, are (i) the Code’s inability to keep up with drastic evolution of credit markets, and (ii) the Code confronting the creation of a market in claims trading.

1. Failing to keep up with Evolving Credit Markets

Similar to the pressures weighing on the Chandler Act before its replacement, the 1978 Code is beginning to reach levels of critical stress.52 Rich Levin, an attorney involved in shaping the 1978 Code, characterized the change at an American Bankruptcy Institute event and discussed how the same underlying need for revision has emerged today:

At the time in [1978], we said we need to revise the bankruptcy laws because the entire underlying credit economy in the business world had changed dramatically in the 40 years since the 1938 Chandler Act. At the same time, we said we knew that there would need to be a bankruptcy reform act of 2018, 40 years hence, because the entire credit economy and business world would change again. Now, it’s changed dramatically in 30 years, and I think we’re at that point . . . that the system needs to be rethought. It’s done very well keeping up with the dramatic changes in the underlying business and credit economy, but it’s stretched dramatically . . ., it’s not designed for the current economy, and it needs to be rethought.53

While legal scholars and practitioners continue to debate overhauling the 1978 Code, for now consider the principles envisioned in the 1978 Code, and how today’s underlying credit market and business world are undercutting the value added by the Code.54

When a corporation seeks Chapter 11 protection, no longer is there a single senior bank holding a single note with a security interest in all of the debtor’s assets.55 No longer is there a group of dispersed, but homogenous,

51. See Tung, supra note 7.
52. See Keach & Togut, supra note 43 (analogizing pressures on the Code before the 1978 overhaul and pressures on the Code today).
53. Id.
55. See Baird & Rasmussen, supra note 11 (comparing the 1978 credit market to today’s credit market).
unsecured creditors.\textsuperscript{56} Instead, the traditional bank loan has evolved into a complex lending product often characterized by a web of syndicated loan parcels.\textsuperscript{57} The traditional bank lender has transformed into a primary loan servicer charged with managing the loan on behalf of interested parties.\textsuperscript{58} The unsecured creditors are no longer a class of homogeneous investors but rather a mix of massive, sophisticated hedge funds and institutional investors and a minority of small, passive creditors.\textsuperscript{59} The evolution of the traditional bargaining parties makes the negotiation process vastly more complex.\textsuperscript{60}

Chapter 11, however, has strained without breaking under this increased pressure.\textsuperscript{61} If creditors' rights under Chapter 11 can be reduced to the idea that Chapter 11 not only promotes the interests of creditors as a group, but also ensures that similarly situated creditors are treated equally, the increased complexity has damaged the ability of Chapter 11 to serve these goals.\textsuperscript{62} The creditors' interests as a class are still protected by the automatic stay, and the provisions that allow for efficient distribution of assets still encourage greater capitalization on remaining assets, but where Chapter 11 begins to fall short is in terms of the parties in interest. The secured lenders, greatly expanded in number, maintain the ability to work with the debtor to seek the best return on their claims, but equality among them is questionable as each may have a different agenda.\textsuperscript{63} While Chapter 11 still recognizes that the value of a business as a going-concern may greatly exceed its liquidated value, the goal of Chapter 11 to ensure equal treatment among similarly situated creditors is becoming greatly underserved.

\textbf{2. The Added Pressures of Claims Trading}

Concurrent with the growth in the complexity of the parties involved in a Chapter 11 proceeding, is an evolution in the relationship among them.\textsuperscript{64} Without question, the claim a creditor holds against a debtor represents an

\textsuperscript{56} \textit{See id.}
\textsuperscript{57} \textit{See id.}
\textsuperscript{58} \textit{See id.}
\textsuperscript{59} \textit{See id.}
\textsuperscript{60} \textit{See Levitin, supra note 17; Supra text accompanying note 18.}
\textsuperscript{61} \textit{See Keach & Togut, supra note 43; Levitin, supra note 17, at 67, 110 n.241 (noting that the system has held up "surprisingly well").}
\textsuperscript{62} \textit{See Baird & Rasmussen, supra note 11, at 657 (describing the fitment of the new parties into the old system as awkward).}
\textsuperscript{63} \textit{See id. (explaining that "[r]ather than dispersed and homogenous, [creditors' agendas] are close at hand, well informed, and radically different from one another").}
\textsuperscript{64} \textit{See id. (lamenting the relationship as one that is disparate but served as if homogenous).}
economic right, regardless of its eventual valuation. During the bankruptcy case, "[a]s with most economic rights, claims enjoy a strong presumption of free alienability." This presumption alters the relationship among the creditors as envisioned by the Code. Rather than a dispersed, but homogenous class, claims trading allows unsecured creditors to be further reduced into any number of subclasses. Some are passive creditors who typically hold their claims by virtue of a holding trade debt preceding the filing and can be grouped as passive by a shared inability to participate in the bankruptcy proceedings. Others are massive claims holders hoping to assume control of the debtor by virtue of their large stake. Still others seek value absent any desire to manage the corporation. Far from homogeneous, the vast number of players in the bankruptcy process, combined with the free alienability of claims, has transformed bankruptcy into a market of its own. It is with this evolution that the particular problem addressed by this Comment arises: claims trading and the dilemma of the passive creditor.

II. EXPLOITING THE PASSIVE CREDITOR

While the debate as to the merit of claims trading will press on for some time, even those who can see the value-adding nature of claims trading can readily identify improvable areas. Drain and Schwartz describe one such area as the imbalance between passive and sophisticated creditors, noting that:

66. Tung, supra note 7, at 1687.
67. See Levitin, supra note 17.
68. See Baird & Rasmussen, supra note 11 and accompanying text.
71. See, e.g., Baird & Rasmussen, supra note 11, at 661 n.57 (describing investment firm ESL's purchase of Kmart out of Chapter 11 bankruptcy for nearly $1 billion; selling Kmart's undervalued real estate assets for $900 million; and ultimately prof[iting] over $3 billion from selling off Kmart properties all without long-term management aspirations).
72. See Levitin, supra note 17 (discussing the transformation of bankruptcy into a market-driven process; one that is "a robust market for all types of claims against debtors . . .").
73. See id. at 110 (asserting that improvements can be made, regardless of greater debates as to the merits of claims trading).
there is at least good anecdotal evidence that small unsophisticated sellers - trade creditors sometimes characterized as 'involuntary' participants because they did not buy their claims as investments but, rather, were stuck with their obligor's default - already are widely engaged in the distressed debt market and are taken advantage of.74

But is this a problem? Many heavily regulated markets allow for willing buyers and willing sellers to form disadvantageous agreements.75 For example, the securities market, one of the most heavily regulated marketplaces, confronts issues of fraud while still allowing instances of great unfairness.76 The issue, however, is that the logic that compares a market in claims to a market in securities, overlooks bankruptcy's anti-market approach.77 That is, the design of the Code is to protect the debtor from the market place.78 While participants in the securities market may be protected only from fraud, the protection brought by bankruptcy extends much further.79

To illustrate the problem facing passive creditors, this Section will first (a) look at claims trading as it relates to the code and to the passive investor. This Section will then (b) analyze how the process weighs on the ability of bankruptcy to meet the goals of providing equality to the creditors. Finally, this Section (c) will analyze provisions of the Code that seem operable in the context of claims trading, but are yet to be invoked.

A. The Bankruptcy Code and the Claims Trading Grift: Misuse, Abuse, or Something Else?

Perhaps what is most challenging about redressing the harm imposed on passive creditors is the Code's approval of the practice. Rather than misuse or abuse of the Code, claims trading is something else entirely. Consider first (i) how the Code permits the practice, and then (ii) how the trade is carried out.

74. Drain & Schwartz, supra note 22, at 572–73.
75. See, e.g., Chiarella v. United States, 445 U.S. 222, 232 (1980) (holding that under the U.S. Securities laws, "not every instance of financial unfairness constitutes fraudulent activity [actionable] under § 10(b)").
76. See id.
77. See Levitin, supra note 17, at 71 (finding that bankruptcy "protect[s] a firm from the forces of the market").
78. Id.
79. See, e.g., Drain & Schwartz, supra note 22, at 573 ("Bankruptcy has its own disclosure, voting and remedial regime that, although not a perfect overlap with the securities laws, largely negates the need to apply them.").
1. Permitting the Grift

Perhaps for good reason, claims trading is referred to by some as vulture investing. Like vultures, the investors circle above, waiting for the deeply insolvent corporation to fail before feasting on the remains. While the imagery may be useful for some, the modern level of sophistication in the marketplace enables the market for claims trading to form well before an organization files its petition for Chapter 11 protection. Sophisticated debt investors are best able to capitalize on the bankruptcy by purchasing claims when others, fearful of the unknown, are willing to sell at steep discounts. This fear is perhaps most pronounced right before the entity files for bankruptcy protection, as creditors weary of their payment priority might want out before any filing. Those who do not get out before filing must endure the process as set forth in the Code. So how does the Code regulate their activity?

The bankruptcy case begins with the filing of a Chapter 11 petition. The filing operates as a stay upon all collection actions, applicable to all entities. This stay covers, among other things, any attempt to "collect, assess, or recover a claim against the debtor that arose before the commencement of the case." This provision both protects the debtor from a wave of collection actions, up to and including foreclosures and repossessions, and protects the creditors from one another by limiting the

80. See, e.g., Brockway, supra note 26, at 655 ("Many view bankruptcy as the death of an investment, but to a keen-eyed vulture investor it is the birth of opportunity.").

81. See Drain & Schwartz, supra note 22, at 571 ("[V]ulture investing, which often occurs with an eye to obtaining a controlling interest in the reorganized debtor’s equity securities by means of acquiring bankruptcy claims . . ."); Henry T. C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. PA. L. REV. 625, 732 (2008) (describing a vulture investor as one who, “when a firm gets into financial distress . . . accumulate[s] large stakes in a debt class that [is] likely to be pivotal in the expected restructuring").

82. See Hu & Black, supra note 81 (articulating that investors begin forming positions “when a firm gets into financial distress”).

83. See, e.g., Brockway, supra note 26 (stating that: “[a] bankruptcy filing is also among creditors’ worst fears [as] [t]he value of their debt and the timing and amount of repayment is uncertain. Some creditors, especially those unfamiliar with bankruptcy, are willing to sell their claims against the bankrupt debtor for pennies on the dollar”); In re Chateaugay Corp., No. 86B11270, slip op. at 2 (Bankr. S.D.N.Y. Mar. 11, 1988) (order denying assignment) (reviewing a request for assignment of over 400 claims purchased at thirty three percent of their face value when purchaser planned to propose a plan paying one hundred percent of the claims face value after acquisition).

84. See Brockway, supra note 26, at 655; Supra text accompanying note 83.

85. See supra text accompany note 38.


87. Id. at § 362(a)(6).
The protection for the creditors, however, is limited to each creditor’s interaction with the debtor, and does not cover interactions among the creditors. While the Code once provided a means by which the bankruptcy judge could manage these relationships, the provisions have subsequently been gutted.

Federal Rule of Bankruptcy Procedure 3001 (“Rule 3001”) recognizes a creditor’s right to freely alienate his claim without judicial approval or oversight. As initially passed, former Rule 3001 required that the transferee file disclosure documents with the court regarding the terms of transfer and the consideration therefore. By requiring such disclosures, the bankruptcy judge could weigh in on the individual transactions. This process was considered by some to be frustrating the goal of market liquidity because many courts refused to authorize the transfer of claims until “adequate information” was provided. However, for a seller to be truly adequately informed, the seller would likely have to be informed of the details that make the deal worthwhile for the buyer. For buyers, whose edge in the transaction is detailed knowledge of the debtor, enhanced disclosure requires them to show their hand, resulting in sellers unwilling to part with their claims at profitable discounts.

Today, Rule 3001 requires only that the transferee provide evidence of the transfer to the court and that if the transferor does not object within twenty days the transfer is deemed settled. Thus, the court’s oversight role has been reduced from an ability to govern transfers to simply

88. See, e.g., Rummer supra note 40, at 14; Supra text accompanying note 41.
89. See § 362(a)(6) (limiting the ability for creditors to pursue the bankrupt firm, but not proscribing creditors from interacting with one another).
90. See FED. R. BANKR. P. 3001(e) advisory committee’s note (“Subdivision (e) is amended to limit the court’s role to the adjudication of disputes.”).
91. See id. (allowing for the free alienation of claims).
92. See Andrew P. Logan III, Note, Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2), 2 AM. BANKR. INST. L. REV. 495, 500 (1994) (“Former Bankruptcy Rule 3001(e) [] required disclosure of the ‘terms of the transfer’ and ‘the consideration therefor.’”).
93. See id. (finding that courts had the power to “refuse [] to authorize the transfer of claims”).
94. Id.
95. See, e.g., In re Allegheny Int’l, Inc., 100 B.R. 241 at 242–44 (Bankr. W.D. Pa. 1988) (seeking to remedy insufficient disclosure by imposing on the debtor “the duty of advising the potential assignor of the debtor’s estimate of the value of the claim . . . until such time as a new plan of reorganization and disclosure statement are filed”).
96. See Logan, supra note 92 (indicating that enhanced disclosure requirements imposed by the court were “frustrating the goal of providing a liquid market for the sale of claims”).
97. FED. R. BANKR. P. 3001(e)(4).
resolving disputed transfers.\textsuperscript{98} Critical to the amended rule is the absence of a requirement for the disclosure of terms or consideration.\textsuperscript{99} By withholding this information from the record, creditors who are willing to sell their claims have no indication of how similar claims have been valued and are deprived of the benefit of class participation.

In its accompanying note to the 1991 Amendment, the advisory committee noted that the purpose of the Rule 3001 Amendment is:

\begin{quote}
[T]o limit the court's role to the adjudication of disputes regarding transfers of claims. . . . This rule is not intended either to encourage or discourage post-petition transfers of claims or to affect remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.\textsuperscript{100}
\end{quote}

With this limitation placed in the Code, willing market participants are unprotected by the judiciary, unless there has been a fraudulent transfer.\textsuperscript{101} With this reduction in oversight, the rapid growth in claims trading is far from unexpected.

2. The Grift

If the bankruptcy Code and Rules allow for claims trading, and in fact have been altered to restrict judicial oversight of claims trading, how can the exploitation germane to the changes be objectionable? Consider the actual trade that occurs between a passive investor and a sophisticated debt investor.

As noted above, bankruptcy proceedings begin upon filing of a Chapter 11 petition.\textsuperscript{102} Then, the debtor must file with the court a list of creditors and a schedule of its assets and liabilities.\textsuperscript{103} This list will serve as a

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\textsuperscript{98} See Logan, supra note 92 ("[T]he [amended] Rule eliminates any requirement that the filings with the court reflect either the "terms of the transfer" or "the consideration therefor.").

\textsuperscript{99} See generally \textit{FED. R. BANKR. P. 3001} (failing to impose disclosure requirements).

\textsuperscript{100} \textit{FED. R. BANKR. P. 3001} (quoting the advisory committee's note to the 1991 Amendment to Subsection (e)).

\textsuperscript{101} See Logan, supra note 92, at 501 ("Thus, Rule 3001(e)(2) restricts the court's function with respect to transferred claims to resolving whether a disputed transfer has in fact been made by the transferor, by providing only the transferor with standing to object to the transfer of a claim.").

\textsuperscript{102} See supra note 37 and accompanying text.

\textsuperscript{103} See 11 U.S.C. § 521(a) (2012) (referring to a section entitled "Debtor's Duties," this section provides that "(a) the debtor shall (1) file (A) a list of creditors; and (B) unless the court orders otherwise (i) a schedule of assets and liabilities . . . ").
preliminary snapshot of what the debtor has in way of assets, what claims the debtor has recognized, and what claims are disputed, contingent, or unliquidated.\textsuperscript{104} Once this snapshot is filed with the court, those creditors who have been left out by the debtor will be given the opportunity to have their claims established by the court.\textsuperscript{105} In the case where a claim is challenged, by either the debtor or creditor, the court, after notice and hearing, will determine the value of the claims as of the date of filing.\textsuperscript{106} For passive creditors, this stage of the process can be inconsequential as their typical type of claim, if not already disclosed by the debtor, is easily established.\textsuperscript{107} Nevertheless, what does affect the passive creditors is the result of this process. Once these steps have taken place, the court will have produced a list detailing the outstanding creditors and the claims they hold.\textsuperscript{108} With this information, debt investors can begin to examine the claims currently held and begin to formulate investment strategies.\textsuperscript{109} For the passive creditors, this is where things get troublesome.

As the bankruptcy case progresses, investors will begin to solicit claims holders.\textsuperscript{110} The timing and valuation of these bids may vary wildly based on the investor’s acute knowledge of the case.\textsuperscript{111} When an investor locates a willing seller, the deal proceeds just as any transfer of right would. There are negotiations, purchase sale agreements, and, finally, a trade execution.\textsuperscript{112} The final step in the trade is the purchaser filing a Notice of

\textsuperscript{104} See FED. R. BANK. P. 3003(b)(1).

\textsuperscript{105} See § 501 (providing that a creditor may file a proof of claim, in a timely manner); FED. R. BANKR. P. 3001 (providing the specific requirements for establishing a proof of claim, noting that “[a] proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim”).

\textsuperscript{106} See § 502(b) (“[I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim.”).

\textsuperscript{107} See FED. R. BANKR. P. 3001 (providing the technical requirements for establishing a claim and allowing for an inference that trade debt should be easy to established the validity of, so long as adequately accounted for by the creditor); Harner, supra note 69 and accompanying text.

\textsuperscript{108} See § 521(a) (requiring a list to be filed with the court).

\textsuperscript{109} See Joshua Nahas, Trade Claims Primer, DISTRESSED DEBT INVESTING (Oct. 26, 2010), http://www.distressed-debt-investing.com/2010/10/trade-claims-primer_26.html (“For a sophisticated [ ] investor it is possible to begin negotiations to purchase a claim utilizing information [on the list].”).

\textsuperscript{110} See id.

\textsuperscript{111} See id. (“[F]actors may come into play . . . that require a re-pricing or cancellation of the trade altogether.”).

\textsuperscript{112} See id. (describing the entire process as determining validity of the claim; reconciling the value of the claim; establishing representations, warranties and indemnification provisions; and, executing the trade).
Transfer and Evidence of Transfer with the bankruptcy court.\textsuperscript{113} The transaction is little more than a purchase and sale of an economic right that is freely alienable. As a freely negotiated, arm's length contract, some say the transaction presents little concern.\textsuperscript{114} After all, the Federal Rules were amended specifically so that the filing of this notice no longer affords the court the opportunity to assess the merit of the trade.\textsuperscript{115} Rather, like most contract law, it only allows challenges in the case of fraudulent dealings.\textsuperscript{116} While it may appear that this should settle the matter, recall that, unlike most parties to a contract, one of the parties to the transaction here is a protected class.\textsuperscript{117}

\textbf{B. Claims Trading, Inequality, and Information Asymmetry}

One of the prevailing goals of bankruptcy is to provide equality for similarly situated creditors.\textsuperscript{118} Reaching equality, however, is a challenge considering the great asymmetry of knowledge between the inside-investors and the passive creditor. Any trade may have an institutional investor on one side of the table and a passive creditor on the other.\textsuperscript{119} The passive creditor knows only what it is out, that is, how much the claim was originally worth, with little ability to price the claim post-petition.\textsuperscript{120} Conversely, the investor is a professional with the ability to more readily ascertain value, and monitor the value on an ongoing basis.\textsuperscript{121} The investor

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{113} See \textsc{Fed. Bankr. R. P. 3001(e)(2)} ("[E]vidence of the transfer shall be filed by the transferee.").
\item \textsuperscript{114} See, e.g., \textcite{levitin17}, at 73 (listing among the benefits, "allow[ing] a creditor to 'cash out' at a certain price" (citation omitted)).
\item \textsuperscript{115} See \textcite{logan92}, at 501 ("Thus, Rule 3001(e)(2) restricts the court's function with respect to transferred claims to resolving whether a disputed transfer has in fact been made by the transferor, by providing only the transferor with standing to object to the transfer of a claim.").
\item \textsuperscript{116} \textsc{Fed. R. Bankr. P. 3001} (quoting the advisory committee's note to the 1991 Amendment to Subsection (e)) ("This rule is not intended to... affect remedies otherwise available under non-bankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.").
\item \textsuperscript{117} See \textcite{baird11}, at 656 (observing that the protection by the committee includes the right of the committee to hiring accountants, investment bankers, lawyers, and others as needed and at the expense of the debtor).
\item \textsuperscript{118} See \textcite{tung7}; \textcite{supra} text accompanying note 35.
\item \textsuperscript{119} See, e.g., \textcite{in re revere 85} (finding that passive creditors sold their claims to a sophisticated investor for twenty percent face value shortly before approval of a reorganization plan paying sixty percent).
\item \textsuperscript{120} See \textcite{supra} text accompany note 119; see \textcite{levitin17}, at 73 (characterizing "payouts [as] speculative").
\item \textsuperscript{121} See \textcite{levitin17}, at 73 (describing the sophisticated investor as one who can "take the time and effort to monitor the debtor . . . ").
\end{itemize}
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likely possesses the specialized knowledge to determine the probability of receiving any distribution under the plan of reorganization as well as the timeframe of payout. The result is an uninformed creditor being solicited exit opportunities at a price that discounts the value of the claim pursuant to the probability of payment, as well as the time value of money. On top of this discount, there is the added margin by the investor looking to build in as much gain as possible. The result is a sharply discounted price and virtually no policing mechanisms. What claims trading at this level amounts to then, is a passive creditor negotiating with an experienced investor, in a world free from disclosure requirements or judicial intervention.

The severity of this exploitation can be garnered by a look at what the former Rule 3001 would prevent, and what its absence today would likely allow, in the case of *In re Revere Copper & Brass, Inc.* In this case, Phoenix Capital Corporation ("Phoenix") negotiated the purchase of twenty-eight unsecured claims against the debtor. The relevant terms of the transfer called for the payment by Phoenix to the creditors of twenty percent of the claims face value. To passive creditors who have little information about the state of their claim, the sharp discount may be appealing as bankruptcy promises them nothing. Shortly thereafter, however, *The Wall Street Journal* reported that the near-approved plan of reorganization was going to pay sixty-five percent of face value. Relying on disclosure concerns, the court refused to approve the assignment, fearing the claims holders where not "advised of their rights and options." Today, however, the check provided by Rule 3001 has

122. See, e.g., *In re Revere Copper & Brass*, 58 B.R. at 2 (finding that the investor was able to determine the likely time and amount of payout when soliciting claims holders with offers of only a fraction thereof).
123. See id. at 2–3 ("One of the evils attendant upon a solicitation of assignment of claims for a cash payment such as is being made by Phoenix is that solicited creditors may be unaware of their rights and options and fall prey to the belief that bankruptcy inevitably will result in their receiving the proverbial 10 cents on the dollar or worse.").
124. See id.
125. See id.
126. Id. at 2–3.
127. See id. at 1 ("Our offer is to 20% of the face amount of any valid, uncontested, and unpaid claim.").
128. See id. at 2 (finding that "the assignor-creditors may indeed prefer the certainty of the 20% cash in hand" even after learning of the possibility of 65% at some eventual time).
129. See id.
130. Id. app. ("Revere Copper & Brass, Inc. . . announced a reorganization plan that would settle various creditors' claims by paying from 65 cents" on the dollar.").
131. Id. at 3.
been removed, and similarly situated creditors would likely be unprotected by the court. The gutting of Rule 3001 has left the passive creditor markedly unprotected by the judiciary.\textsuperscript{132}

\textbf{C. A Protected Class: The Role of Creditors' Committees}

The challenges faced by the passive creditor during a modern Chapter 11 seem insurmountable. The changes to Rule 3001(e) have left them unprotected by the courts, the evolution of the credit markets have pushed them out of a homogeneous class, and the growth in claims trading have left them exposed to predatory solicitation.\textsuperscript{133}

It is easy to rationalize the problem of the passive creditor as one of dereliction—the idea that, as with any economic right, it is up to the possessor to exercise his right to the fullest of his ability. From this point of view, fraud continues to be actionable, but general issues of fairness yield to free market notions of willing buyers and sellers dealing at arm's length.\textsuperscript{134} The issue however is not that of an individual passive creditor, but rather, of the class itself.

When the Code passed in 1978, bankruptcy proceedings were relatively simple.\textsuperscript{135} Upon filing, the debtor was afforded the safe haven of Chapter 11 and creditors were represented as a homogeneous class. Under the Code, appointment of the creditors' committee ensured similarly situated unsecured creditors were represented as a class.\textsuperscript{136} As noted, however, this area of the Code has been sufficiently damaged by the evolution of the credit markets and the gutting of Rule 3001.\textsuperscript{137}

As these markets continue to evolve, the class of unsecured creditors will continue to fracture, undoing bankruptcy's goal of equal treatment among

\textsuperscript{132}. See Logan, \textit{supra} note 92, at 501 (describing the limited judicial role as one that “simply requires the transferee to provide evidence of the transfer to the court”).

\textsuperscript{133}. See \textsc{Stephen G. Moyer}, \textsc{Distressed Debt Analysis: Strategies for Speculative Investors} 298 (2004) (typifying the transaction as one where “the buyer is trying to present the picture that he or she is 'the only sucker on the planet dumb enough to buy these things; if you miss this bid, the next buyer will pay less.' And the buyer may, in fact, drop his or her bid for a day or two and then increase it to reinforce the reality that he or she is the only buyer in the market”); \textit{see also supra} text accompanying note 123.

\textsuperscript{134}. \textsc{Fed. R. Bankr. P.} 3001(e) advisory committee’s note to the 1991 Amendment (“This rule is not intended ... affect remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.”).

\textsuperscript{135}. See Baird & Rasmussen, \textit{supra} note 11 and accompanying text.

\textsuperscript{136}. \textit{See supra} text accompanying note 45.

\textsuperscript{137}. See Logan, \textit{supra} note 92, at 501 (describing the limited judicial role as one that “simply requires the transferee to provide evidence of the transfer to the court”).
Similarly, without adequate class representation, the problem for each passive creditor becomes one of collective action. Commenting on the problem, Baird and Rasmussen write:

As a group, the unsecured creditors would have been better off by taking concerted action, but no one creditor was willing to take the laboring oar. The costs of participation fell on those who participated, but the benefits were distributed to all creditors. While for creditors as a group the best course of action was to participate in the reorganization discussions, for each individual creditor the rational thing to do was stay passive.

Nevertheless, does this collective action issue, combined with the lack of affirmative class representation leave the passive creditors with no other choice than to try to participate in the reorganization? Not necessarily.

Under the Code, as soon as practicable after the order for relief under Chapter 11, the U.S. Trustee shall appoint a committee of creditors holding unsecured claims. This committee is to be made up of the seven largest claims holders and is charged with providing access to information for creditors who are not appointed to the committee. Additionally, the committee is empowered to negotiate on behalf of the class and collect and process the information necessary to make informed decisions.

Under the Code, the duties placed on the creditors committee establish a fiduciary relationship between the committee members and the non-committee members for whom they purport to act. The fiduciary duty established includes the duty to maximize the return of the class as a whole. This is embodied by the committee’s unique place of power at

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138. See Levitin, supra note 17; Supra text accompanying note 18.
139. See Baird & Rasmussen, supra note 11, at 655.
141. Id. at § 1102(b)(1).
142. Id. at § 1102(b)(3).
143. See id. at §§ 1103(c)(2)-(3) (allowing for informed decisions under (c)(2) by providing that the committee may “investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan” and allowing for negotiation under (c)(3) which allows the committee to “participate in the formulation of a plan, advise those represented by such committee’s determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan”) 144. See In re Drexel Burnham Lambert Grp., Inc., 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992) (recognizing the existence of a fiduciary duty).
145. See Levitin, supra note 17, at 111 (“Arguably facilitating claims trading is part of creditors’ committees’ duties.”); see also In re Drexel Burnham Lambert, 138 B.R.
the bargaining table.¹⁴⁶ Braid and Rasmussen characterize this power as the unique ability to "extract concession from the debtor . . . as [the debtor] would be hard-pressed to confirm a plan of reorganization over the active opposition of the creditors' committee."¹⁴⁷

As claims trading continues to grow, and as Chapter 11 continues to go unrevised, the role of the creditors' committee will be of added importance to the passive creditors. The concern, however, is how well creditors' committees are actually serving their fiduciary roles. Unlike the players at the table in 1978, no longer are the committee members a homogeneous class.¹⁴⁸ The positions held today are incredibly complex and well outside of what the Code envisioned.¹⁴⁹ Committee members own debt up and down the tranches.¹⁵⁰ All are motivated by self-interest; for some that means holding the controlling stake post-bankruptcy, for others it may mean creating a credit event sufficient to trigger their credit default swaps.¹⁵¹ For Baird and Rasmussen this means, "the idea of a committee as the principal vehicle for mediating the interests of the general creditors as a group may no longer work."¹⁵²

D. Grifted, Now What?

When the Code was passed in 1978, the simplicity of the credit market yielded a rather simple solution for passive creditors: committee representation. As the markets have evolved however, the sophistication of passive creditors has not. With little readily ascertainable data about the entire claims trading market, it would be unfounded to suggest sweeping reform in light of this particular area of concern.¹⁵³ This is not to say,

¹⁴⁶. See Baird & Rasmussen, supra note 11, at 656–57 (finding that the debtor has reason to listen to a committee but not an individual).
¹⁴⁷. Id.
¹⁴⁸. Id. at 651; Supra text accompanying note 14.
¹⁴⁹. See Baird & Rasmussen, supra note 11, at 651; Supra text accompanying note 14.
¹⁵⁰. See Baird & Rasmussen, supra note 11, at 651; Supra text accompanying note 14.
¹⁵¹. See, e.g., Karl Denninger, GM: Bankrupt. UNLESS..., MARKET TICKER, (Apr. 1, 2009), http://market-ticker.denninger.net/archives/921-GM-Bankrupt,-UNLESSFalse.html (speculating that GM bondholders were refusing to negotiate with GM outside of bankruptcy because their bonds are backed by AIG credit default swaps that would pay in full if GM filed for bankruptcy).
¹⁵². Baird & Rasmussen, supra note 11, at 657.
¹⁵³. See Levitin, supra note 17, at 70 ("[C]laims trading is not well-suited for broad policy reforms. Instead, at this point, we can merely identify several modest features of the claims trading market that can be improved.").
however, that nothing can or should be done. What is clear, is that the welfare of the passive creditor has shifted from the creditors’ committee, who have a fiduciary duty to serve them, to the good conscious of investors, who have limitless motivation to exploit them. But all is not lost.

III. REAFFIRMING THE ROLE OF THE CREDITORS’ COMMITTEE

The harm imposed on passive creditors stems from an inability to value their economic rights. The inability to value their claim has been exacerbated by solicitations from third parties trying to purchase the rights at sharply discounted prices. At its inception, the Code would starve off this issue by affording equal class representation for claims holders and judicial oversight of claims purchasers. The problem being confronted today is how to improve the case of the passive creditor absent the original protections.

Even with the amendment to Rule 3001, the answer to the problems continues to be valuation. While disclosure to the court used to provide such, it did so in an onerous way that frustrated liquidity. While others have reached this very conclusion, there is little discussion of how to reach a balance between the desire for disclosure and market liquidity.

In proposing such a solution, this Section will discuss (a) why disclosure is key to protecting passive creditors. However, because mandatory disclosure of full terms would be too onerous, this Section will also argue that (b) proper utilization of the creditors’ committees presents a solution that balances the concerns. Then, this Section will (c) demonstrate how the creditor’s committee can fulfill its duty to the passive creditors. Finally, (d) this Section will discuss the inherent limitations of any solution to this problem and how they may be overcome.

A. The Solution: Improved Price Disclosure

The biggest advantage the claims investor holds over the passive creditor is knowledge. Even where the superior knowledge is not obtained

154. Baird & Rasmussen, supra note 11, at 657 (advancing that the committee may no longer work, meaning that passive creditors are at the mercy of the investors).
155. See, e.g., In re Revere Copper & Brass, Inc., 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985) (underscoring the fact harm stems from an inability to value a claim).
156. See supra text accompanying note 123.
157. See Baird & Rasmussen, supra note 11; Supra text accompanying note 48; Logan, supra note 92; Supra text accompanying note 155.
158. See supra text accompanying note 155.
159. See Logan, supra note 92; Supra text accompanying note 96.
160. See, e.g., Levitin, supra note 17, at 110–11 (finding that “the most immediate
illicitly, where a trade is “colored with superior knowledge... assignments are similar to contracts of adhesion.”161 The solution where the courts have found such knowledge disparities was the imposition on the debtor “the duty of advising the potential assignor of the debtor’s estimate of the value of the claim.”162 While this plan provided sufficient means for passive creditors to price claims, the plans were imposed before judicial oversight was eliminated by the amendment to Rule 3001.

While the means to impose this solution have been undone, the need for such a solution has not.163 In fact, with the growth in claims trading, the need has grown. A claim as a freely alienated right presents little concern, but what has become a concern is how freely these rights are being alienated. As the court noted in, In re Allegheny, massive disparities in knowledge have resulted in what are essentially contracts of adhesion, where one party dictates the terms while the other sits in fear of the “ten-cent-on-the-dollar” alternative.164 What would alleviate this cohesion is the means for a passive creditor to price its claim.165 The issue then, is how to achieve this without former Rule 3001.

B. Requiring the Creditors’ Committee to Serve as a Committee for the Creditors

With judicial oversight stripped away, passive creditors are protected by the Code only by way of the creditors’ committee. While the membership of the creditors’ committee has changed, its fiduciary role has not.166 Creditors’ committees have the duty to maximize returns for the class.167 This duty can be fulfilled only one of two ways: plan improvement, or exit opportunity improvement.168 If a passive creditor instead holds their claim until plan confirmation, no exploitation has occurred as the court has improvement that can be made of claims trading is improved price disclosure”).

162. Id. (imposing the duty only until a reorganization plan is reached and agreed upon).
163. See Levitin, supra note 17, at 110–11; Supra text accompanying note 160.
164. See supra text accompanying note 123.
165. See generally Whitaker, supra 2, at 339 (arguing that “mandatory disclosure” would allow “those wishing to receive cash for their claims [to] do so” for reasons including better valuation).
166. See Levitin, supra note 17, at 111 (describing the duty as one that is owed to the class “as it exists at any given time”).
167. See id. (“Arguably facilitating claims trading is part of creditors’ committees’ duties.”).
168. See id. (“[M]aximizing the return... could be accomplished either through working for a better plan or by providing their constituents with improved immediate exit opportunities.”).
necessary considered the stake of all claims holders in confirming the plan. The duty as it relates to passive creditors, then, is enhancing the exit opportunity. Rather than leaving this to the free will of the committee or to a third party, enhancing or reaffirming this duty should be accomplished by the U.S. Trustee.

The Code charges the U.S. Trustee with appointing the creditors’ committee, as well as the duty of monitoring the committee. When making appointments, the U.S. Trustee must confront issues such as “adequacy of representation” and safeguarding of the interests of the creditor class as a whole. When monitoring the committee, the U.S. Trustee must ensure, among other things, that “[e]ach committee upholds the interests of the creditor group it represents, such as unsecured creditors.”

The importance of U.S. Trustee’s role can hardly be understated. As claims trading grows and bankruptcy continues to evolve, the obligations and duties of the U.S. Trustee can be leveraged to ensure that modern Chapter 11 protects passive creditors. When the U.S. Trustee appoints members to the committee, he or she must ensure that, even in cases dominated by investors vying for control, the passive creditors are still provided for. This seems to be an impossible task as passive creditors realize a cost benefit in not participating in the reorganization. By their very nature, a passive creditor cannot sit on the committee and protect similarly situated class members. The remedy then, is to condition committee membership on requiring the facilitation of non-coercive exit opportunities for passive creditors.

Affirmative duties levied on committee members are far from novel. In In re Federated Department Stores, Inc., (“FDS”) the bankruptcy court considered the presumptively inappropriate committee membership of a

169. See supra note 140 and accompanying text.


173. See Zipes & Lambert, supra note 172, at 255 (“In practice, the United States trustee must resolve a variety of tensions that are inherent in the appointment process.”).

claims trader. Considering that committee members owe fiduciary duties to the class they represent, a member trading in claims would likely violate its duty. In FDS, rather than barring committee membership, the member was permitted to serve so long as it took steps to protect itself from breaching its duty. The court stated that the Movant: "will not be violating its fiduciary duties as a committee member ... by trading in securities of the Debtors ... during the pendency of these Cases, provided that Fidelity employs an appropriate information blocking device."

Since the FDS decision, the U.S. Trustee has appointed creditors subject to appropriate safeguards to ensure that they can fulfill their fiduciary duties.

Because the U.S. Trustee can contractually condition participation on a committee, the US Trustee should exercise this power by conditioning committee membership on the facilitation of non-coercive exit opportunities for passive creditors.

C. Facilitation of the Non-coercive Exit Opportunity

The harm claims trading imposes on passive creditors can be addressed by increased scrutiny of the U.S. Trustee. Rather than imposing such a requirement without providing guidance, the uncertainty of which could seize liquidity, it is important to establish what would constitute fulfillment of those duties. Because too much intervention for the sake of the passive creditors could seize market liquidity and prove detrimental to the process, it is important that the level of intervention be balanced.

Such balance can be struck by requiring that the creditors' committees play an active role in facilitating claims trading for the passive creditors. In practice, some committees have already taken steps in this direction. For example, the Official Unsecured Creditors' Committee in the Dana Corporation listed the contact information of claims purchasers on its website to help creditors it represented obtain maximum value for their claims. While this process fails to level the playing field in ways similar

176. See Zipes & Lambert, supra note 172, at 246 (discussing the appearance of impropriety that arises if a committee member engages in trading claims).
178. See Zipes & Lambert, supra note 172, at 246 (noting that the U.S. Trustee has imposed similar duties since the FDS decision).
179. See Levitin, supra note 17, at 110–11; Supra text accompanying note 160.
180. See Levitin, supra note 17, at 111 (noting that Dana's Official Unsecured Creditors' Committee listed the contact information of claims purchasers on its website to help the creditors it represented obtain maximum value for their claims).
to judicial intervention, it represents a step in the right direction.

What is key to the role of the creditors’ committees is that passive creditors be apprised of some ability to value their claim and to understand the trading process. A more limited role by a committee might include informing the passive creditors of the opportunity to trade and the general risk inherent in trading, while also providing periodic valuation of the most prevalent debt type. Protection that is more substantial is embodied by actively posting prices of known trades, along with providing contact information of parties interested in purchasing claims. This more active representation would allow a solicited claims holder to reach out to other registered purchasers to shop for a better offer.

What is critical to any approach employed, is not guaranteeing the best price, but narrowing the knowledge gap between buyer and seller, sufficient to make an assignment less coercive and more freely negotiated.

D. Limitations on Reform: U.S. Trustee Program Budget Constraints

The systemic limitation on any proposal that calls for enhanced governmental action is the necessarily enhanced costs. The U.S. Trustee Program operates in a self-funding manor, with fees collected deposited into the U.S. Trustee Program Fund (the “Fund”) for which offsetting collections are available to the U.S. Trustee as specified in Appropriations Acts. While the Fund currently operates at a surplus, the fiscal year 2014 budget proposal notes general fund instability related to fluctuations in bankruptcy filings. The current system contains two fees: a filing fee paid at the inception of chapter 7, 11, 12 and 13 cases; and a quarterly fee by chapter 11 debtors based on cash disbursement levels of the debtor. While the fee system has been sufficient for some time, enhanced duties by the U.S. Trustee appointed to a bankruptcy case may put pressure on this system.

Although the Fund currently operates at a surplus, the U.S. Trustee Program’s current fee structure could not likely support any rule changes that imposed more taxing duties on the Trustees. Funding constraints have

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181. See id. (one means of enhancing the exit opportunity would be by simply “informing claimholders of the possibilities of claim purchases and issues in the market”).


183. Id. at 6 (noting that offsetting collections from bankruptcy fees exceeded the program’s appropriations in all but fiscal years 2006, 2007, and 2008).

184. Id. (discussing the fluctuation from fiscal year 2013, drawing down the Fund by $7 million, to fiscal year 2014, contributing to the Fund a projected $35 million).

185. Id. at 10.
already limited the role of the program. Hiring freezes and vacancies due to attrition have left the program understaffed. Debtor audits and other operations of the program have been reduced or eliminated. If the solution to the exploitation of passive creditor turns on heightened scrutiny of committees by the U.S. Trustee, the solution necessarily turns on alterations of the fee structure of the U.S. Trustee Program. While the specifics of the needed changes to the fee structure are beyond the scope of this Comment, it is critical that heightened duties imposed on the U.S. Trustee be complimented by funding; be it alterations to the current fees or imposition of new fees.

CONCLUSION

Claims trading is a feature of the bankruptcy world that is here to stay. Much debate centers on its merit; trying to classify the practice as beneficial or detrimental. Regardless of that much larger debate, it is undeniable that there are ways in which it can be improved. Some have resolved that improvement of Chapter 11 demands replacing Chapter 11 as it has become “hopelessly flawed.” Others “resolve to a credo of markets correcting themselves.” In the meantime, much can be done to improve the harms endured under the current system without bearing on the liquidity of the overall marketplace.

One such harm endured is the exploitation of the passive creditor by sophisticated debt investors. The exploitation arises from the intersection of a dated Code and a modern credit market where the knowledgeable investment firms can exploit the unassuming passive investor. Adding to this dilemma is the deteriorating role of the creditors’ committee as a means to protect the unsecured creditors as a class because of

186. Id. at 9 (enumerating some constraints based on funding such as “imposing a hiring freeze, temporarily suspending debtor audit activities and later reinstating the audits at a reduced level, and by reducing or eliminating all other categories of expense.”)
187. Id.
188. Id.
189. See Baird, supra note 31, at 23 (“Long passed is the time when we could usefully debate whether claims trading in bankruptcy was a good or a bad thing. We should accept that it has become a fundamental feature of bankruptcy.”).
190. See supra note 26 and accompanying text.
191. See Levitin, supra note 17, at 110 (“If claims trading is to be a feature of the bankruptcy world (and this may very well be a good thing), there are ways in which it can be improved.”).
193. Levitin, supra note 17, at 110.
unprecedented growth in claims trading.

This is not to say that nothing can be done. While it would be premature to impose any sweeping regulation, the U.S. Trustee and creditors’ committees can still address the problems faced by the passive creditor. By looking to the fiduciary duty to maximize the value of the claims held by the unsecured creditors as a class, the committees can be required to facilitate claims trading for the class. This duty could be met in a number of ways, all of which revolve around the concept of an increased ability to value a claim. While a committee may not be willing to assume such a role voluntarily, enhanced oversight by the U.S. Trustee can contractually obligate the committees to begin working in this direction.

Reliance on the creditors’ committee is far from the ideal mechanism to protect passive creditors, but for the time being, it represents an achievable step in light of an unwillingness to make changes that are more sweeping.