ARTICLES

BANKRUPTCY BOUNDARY GAMES

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INTRODUCTION

A century ago, securities law and corporate reorganization were flip sides of the same coin. When a company sold stock and bonds to the public, an investment bank—usually J.P. Morgan or another of a small handful of dominant banks—underwrote the issuance with the help of its Wall Street lawyers.1 If the company later defaulted, the same Wall Street investment bank formed a committee to represent the investors who held the bonds or stock it had underwritten. It then negotiated over the terms of a reorganization with the company’s managers and with the banks that had underwritten other securities on their behalf.2 Equity receivership, as corporate reorganization was known then, was simply one facet of corporate and securities law.

The legislative reforms of the New Deal drove a sharp wedge between these two previously connected areas of law. The most significant blow was struck by the Chandler Act of 1938,3 which purposely ended the old equity receivership practice.4 In addition to displacing a debtor’s managers, the Chandler Act prohibited the investment banks and lawyers that had represented a debtor prior to bankruptcy from participating in the bankruptcy case.5 Within a few years, Wall Street corporate reorganization practice had largely disappeared. The main source of continuity between securities law and bankruptcy practice was the Securities and Exchange Commission (SEC), which was given a prominent role in corporate reorganization by the Chandler Act.6

During this same era, Congress also passed the nation’s two major securities acts, which put securities law on federal footing and laid the groundwork for what quickly became an immensely complicated area of

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1. The historical details in this paragraph and the next are treated at greater length in D AVID A. SKEEL, JR., DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001).

2. Id. at 63–69.


5. Chandler Act § 158(3).

law. The ever increasing complexity of securities law further reinforced its separation from the similarly complex bankruptcy process. As with the separation between bankruptcy and other related regulatory regimes, the isolation of bankruptcy from securities law has created boundary issues in areas where they overlap. The drafters of the Bankruptcy Code could have responded to the overlapping domains by: (1) overriding the securities law in order to promote bankruptcy principles, (2) allowing both sets of rules to apply, or (3) deferring to the securities laws. One can find evidence of each of these three approaches in the Bankruptcy Code.

First, with some issues, such as the securities law rules dealing with offerings of corporate securities, the drafters have concluded that bankruptcy law adequately addresses the concerns that animate the securities laws. For example, when a debtor issues new stock or debt in connection with a reorganization plan, the debtor is excused from complying with the requirements imposed by the Securities Act of 1933.9

The second stance, coexistence, is perhaps best illustrated by the antifraud provisions of the securities laws. Although Congress has enacted a welter of bankruptcy-specific antifraud laws, bankruptcy does not displace securities law antifraud provisions such as § 10(b)11 and Rule 10b-5 which prohibit insider trading and inaccurate disclosure.12 Consequently, securities law provisions intersect with the bankruptcy framework in an awkward fashion at times.13

This Article is concerned with the last of the three responses, deference to the securities laws. Regarding another set of issues, Congress has concluded that ordinary bankruptcy principles should give way where there is an area of overlap between bankruptcy and securities law. Thus, the normal operations of bankruptcy law for corporate debtors are suspended in

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7. The Securities Act of 1933 was one of the laws enacted during Franklin D. Roosevelt’s first hundred days; the Securities and Exchange Act of 1934, which established the SEC, followed a year later. See, e.g., JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 13 (1982).

8. For a detailed analysis of another boundary, the separation between bankruptcy and state corporate law, see David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471 (1994).


13. A particular issue is the application of Rule 10b-5 to the members of creditors’ committees. Institutions that actively trade are wary of serving on the committee for fear that privileged information they receive as committee members would expose them to insider trading liability if they bought or sold securities of the debtor during the case. The standard prophylactics are the use of a “Chinese Wall” and, more recently, so-called “Big Boy” letters. See, e.g., Daniel Sullivan, Comment, Big Boys and Chinese Walls, 75 U. CHI. L. REV. 533, 541–46 (2008).
order to effectuate other important principles, such as the smooth functioning of the securities markets.

In Parts I, II, and III of this Article, I consider three of these issues in turn: (1) the exclusion of brokerage firms from Chapter 11 reorganization, (2) the protection of settlement payments from avoidance as preferences or fraudulent conveyances, and (3) the exemption of derivatives from the automatic stay and other basic bankruptcy provisions. I begin each part by discussing the provision and the concern it was designed to address. I then identify and assess important unintended consequences of the provisions. For instance, investment banks Drexel Burnham (Drexel) and Lehman Brothers (Lehman) both evaded the brokerage exclusion when they filed for bankruptcy; the settlement provision has been invoked in several high profile contexts that do not fit neatly within the core cases for which it was designed; and the application of the special derivatives protections has magnified the very systemic risk concerns they were designed to alleviate.14

Part IV of this Article explores the implications of the awkward interaction between bankruptcy and securities law. I begin by speculating about how bankruptcy courts will handle each of these issues if Congress does not alter the current rules. I then consider how Congress might intervene in these areas to address some of the problems that have arisen. I focus extensively on the most complex of the issues, bankruptcy’s special protections for derivatives and other financial contracts. After surveying possible alternatives to the existing framework, I propose and defend two strategies for reform: the first and more novel approach would apply the stay in cases involving systemically important firms, but not in other cases; and the second proposal would impose the stay in all cases by removing the existing exemptions. The choice between these two approaches depends upon the overall structure of financial services regulation.

The frictions between bankruptcy and securities law have increased with the growth in financial innovation in the past several decades, but the wall of separation between these two areas is rapidly eroding at the same time. If the erosion translates to less deference to the securities industry and more careful oversight of the bankruptcy-securities law intersection by Congress, it may, despite the erratic history to date, justify cautious optimism about the future integration of these long estranged bodies of law.

I. THE BROKERAGE EXCLUSION FROM CHAPTER 11

Since its original enactment in 1978, the Bankruptcy Code has excluded brokerages from Chapter 11 based on a concern for the protection of customer accounts and a perception that the rules governing customer

14. For further discussion of these issues, see infra Parts I, II, & III.
accounts would make a Chapter 11 reorganization prohibitively complex. The drafters of the provisions seem to have contemplated that troubled brokerages would be liquidated in Chapter 7, and that the liquidation would be coordinated with the insurance scheme for brokerage customers established by the Securities Investor Protection Act of 1970 (SIPA).

With the benefit of twenty-twenty hindsight, we can see that the brokerage exclusion was designed particularly with the brokerages of the 1960s in mind: brokerages that were set up as simple partnerships, and generally provided brokerage and advisory services. The investment banking business had not yet been transformed by initial public offerings (IPOs) and the shift to proprietary trading as a major source of investment bank profits. Unlike their 1960s predecessors, most current investment banks have a complex capital structure consisting of multiple (sometimes hundreds or thousands) entities.

The two major investment bank bankruptcies since the implementation of the exclusion have shown that, at least in the current environment, the special rules are quite easily evaded. When Drexel filed for bankruptcy in 1990, it filed a Chapter 11 petition for its holding company and kept its brokerage subsidiary out of bankruptcy until it had time to move all of the customer accounts. Lehman used roughly the same strategy in 2008, putting its holding company in Chapter 11 and foregoing bankruptcy for its brokerage subsidiaries.

Lehman added a clever twist to the strategy used by Drexel. Lehman’s principal objective when it filed for bankruptcy was to quickly complete a sale of its brokerage operations to Barclays. However, there was one small problem with the sale. The power of the debtor to propose, and of the bankruptcy court to approve, sales free and clear of existing liabilities only

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17. See id. at 1271–72 (describing SIPA as a response to the brokerage failures of the late 1960s and early 1970s).
18. Alan D. Morrison and William J. Wilhelm, Jr. explain the shift to proprietary trading as a response to technological change that diminished the value of the tacit knowledge that had traditionally been investment banks’ stock in trade. ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 225 (2007). This, and the need for capital, made the traditional partnership structure less attractive than shifting to corporate form. Id.
20. See generally id. (discussing the Drexel and Lehman bankruptcies in more detail).
21. Id. (manuscript at 9).
extends to property of the bankruptcy estate. Because the brokerage subsidiary had not filed for bankruptcy, its assets were not part of Lehman’s bankruptcy estate. Thus, the assets technically were not subject to the bankruptcy court’s power to authorize a sale.

To square the circle, Lehman coordinated with the SEC to set up a Securities Investor Protection Corporation (SIPC) proceeding for its North American brokerage operations simultaneously with the sale of its brokerage assets to Barclays. The brokerage entered liquidation just soon enough to whitewash the assets on their way to Barclays. Objectors challenged this maneuver at the hearing on Lehman’s sale, arguing that the brokerage was never property of the bankrupt entity’s estate and, therefore, the bankruptcy court lacked the power to authorize a “free and clear” sale of the assets of any subsidiary that had not been put into bankruptcy. But the court overruled the objections and permitted the sale to go through.

The Lehman sale was a tribute to bankruptcy lawyers’ ingenuity in circumventing a framework that once made sense, but is anachronistic in the current investment banking environment. The sale to Barclays was in the best interests of Lehman and its creditors, as the value of Lehman’s brokerage operations would have vanished otherwise. If the bankruptcy laws permitted an investment bank to file for Chapter 11, the fancy footwork used to make the sale possible would have been unnecessary. The brokerage exclusion might be justified, despite this effect, if its original rationale that Chapter 11 would be a quagmire, but Chapter 7 meant an orderly unwinding, held true. But the Drexel and Lehman experiences suggest that investment banks are likely to be sold rather than reorganized.

24. Id.
25. See E-mail from Martin J. Bienenstock, Partner, Dewey & Leboeuf L.L.P., to David A. Skeel, Jr., S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School (Jan. 29, 2009, 13:58 EST) (on file with author).
26. Id. (describing the objection and the court’s dismissal).
27. Whether value in an absolute sense would have disappeared is not quite as clear. If the brokerage operations had independent franchise value as a unit, that value might have been undermined by delay. But if the value was simply a function of human capital of individual employees, the principal effect of delay might have been distributive, with Lehman losing their value and another bank gaining it without compensating Lehman. Relatedly, questions arose as to whether Lehman had obtained an adequate price, and Lehman also alleged that Barclays had fraudulently retained $5 billion in securities it was obligated to return. See, e.g., Michael J. de la Merced, Lehman’s Estate is Suing Over Unit’s Sale, N.Y. Times, Nov. 17, 2009, at B8. These spats go to the terms of the deal; they do not necessarily reflect a destruction of value and do not call into question the need for a prompt sale.
in a Chapter 11 proceeding, and that Chapter 11 is an effective venue for achieving this goal. In each case, the Chapter 11 filing proceeded in two steps: an effort to rapidly sell assets whose value was time sensitive, followed by a more leisurely disposition of the firm’s other assets.

In Part IV, I will consider the obvious implications of this experience. For present purposes, the principal point is that the brokerage exclusion has functioned quite differently than its drafters seem to have envisioned. Congress imagined that when investment banks filed for bankruptcy, they would be liquidated under the watchful eye of the SEC or a bankruptcy trustee. Both Drexel and Lehman sidestepped the trustee and used Chapter 11 rather than Chapter 7. As we shall see, the disconnect between ostensible purpose and actual use is a recurring pattern in the Bankruptcy Code’s securities-oriented provisions.

II. THE SPECIAL PROTECTION FOR SECURITIES SETTLEMENTS

In 1982, Congress added a special provision to the Bankruptcy Code in order to protect margin call or settlement payments made by or to brokers from being challenged as preferences or fraudulent conveyances. The intuition is that these are ordinary brokerage operations, not preferences or fraudulent conveyances, and that the possibility of avoidance in the event of a bankruptcy could seriously interfere with the internal functioning of the securities markets. A witness at the principal congressional hearing testified that:

If a firm or a clearing organization had to return margin payments received from a debtor when he had already transmitted those funds to others in the clearing chain, its finances could be seriously undermined to the point

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28. Although Drexel was eventually reorganized, most of its assets were sold prior to confirmation of the reorganization plan and the reorganized firm was a far smaller entity. See, e.g., Ayotte & Skeel, supra note 19 (manuscript at 12) (noting that the reorganized company, New Street Capital, would manage $450 million of Drexel’s junk bonds).

29. See, e.g., id. (manuscript at 9–15) (discussing the two cases).

30. See infra Part IV.B.1 (recommending removal of the brokerage exclusion).

31. See supra notes 16–17 (describing the desire to protect customers’ accounts and the perception that Chapter 11 would be too complex).

32. Originally enacted as 11 U.S.C. § 546(d), the protection is now codified at 11 U.S.C. § 546(e) (2006). Section 546(e) states that:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to . . . a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Id.
where it might also be driven into bankruptcy . . . . [W]hen these moneys flow through the clearing chain, they are disbursed in many different directions, and there really is no way of tracing where they have gone. Any other firm in the chain would stand to have its own capital exposed if there were an attempt to recover these moneys.33

Although the warning about ripple effect bankruptcies was no doubt exaggerated, the justification for protecting ordinary settlement operations is compelling. Payments to or from a broker to complete a trade, and for which the broker is simply a middleman, are not the kinds of transactions that the preference and fraudulent conveyance laws are designed to police. But Congress did not explicitly limit the protection in § 546(e) to this context. The provision itself states that a settlement payment made by or to one of a long list of market participants is protected. 34 “Settlement payment” is explicitly defined by the Bankruptcy Code, 35 but the definition is comically circular, repeating the term “settlement payment” six times. 36 As a result, the settlement payment protection can be seen—particularly if one is willing to squint—as applying to issues well outside the context for which it was ostensibly drafted. Two important examples illustrate the extent to which this potential has indeed materialized.

The first example is leveraged buyouts (LBOs). When a number of LBOs quickly failed in the 1980s, bankruptcy courts were faced with the question as to whether the financing of an LBO should be deemed a fraudulent conveyance, given that the company took on substantial debt in connection with the transaction but did not retain the proceeds of the loan. 37 If some of the LBOs were indeed fraudulent conveyances, who should be held responsible? In several prominent cases, courts held that the public shareholders of a debtor could not be forced to disgorge the money they

34. 11 U.S.C. § 546(e).
36. According to the definition set forth in the Bankruptcy Code, “The term ‘settlement payment’ means . . . a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.” Id.
received for their stock.\textsuperscript{38} The courts based their conclusions largely on the Bankruptcy Code’s settlement provision.\textsuperscript{39}

Several other cases have questioned this interpretation of the statute, refusing to apply the settlement provision to protect payments to shareholders in an LBO if the broker or other institution never had a beneficial interest in the payments. In \textit{Matter of Mumford}, for example, the Eleventh Circuit held that the involvement of the financial institution was not sufficient to invoke the safe harbor because “the bank here was nothing more than an intermediary or conduit.”\textsuperscript{40} The court explained that the “[f]unds were deposited with the bank and when the bank received the shares from the selling shareholders, it sent funds to them in exchange. The bank never acquired a beneficial interest in either the funds or the shares.”\textsuperscript{41}

The second battleground involving the settlement provision was Enron. Shortly before filing for bankruptcy in late 2001, Enron bought significant amounts of its commercial paper at prices well above the prevailing market rate in an effort to protect its credit rating.\textsuperscript{42} It also purchased more than 300,000 shares of its own stock from a swap counterparty and bought the notes of a Collateralized Loan Obligation (CLO) facility—again at above market rates—to satisfy obligations under those arrangements.\textsuperscript{43} After filing for bankruptcy, Enron challenged all of these purchases, arguing that the commercial paper transactions were in essence preferential payments of its commercial paper obligations, and that the stock and note transactions were constructively fraudulent since Enron paid appreciably more than the prevailing market value.\textsuperscript{44} In each case, the defendants argued that the purchases were settlement payments and, therefore, could not be avoided.\textsuperscript{45}

The peculiar dynamics of Enron’s plight, namely, its purchase of the paper in a desperate effort to fend off a catastrophic ratings downgrade, created a difficult tension between the settlement payment provision and bankruptcy’s preference and fraudulent conveyance provisions. In form, the

\textsuperscript{38} See, e.g., Lowenschuss v. Resorts Int’l, Inc. (\textit{In re Resorts Int’l, Inc.}), 181 F.3d 505 (3d Cir. 1999); Kaiser Steel Corp. v. Pearl Brewing Co. (\textit{In re Kaiser Steel Corp.}), 952 F.2d 1230 (10th Cir. 1991).

\textsuperscript{39} See \textit{In re Resorts Int’l, Inc.}, 181 F.3d at 516–17; \textit{In re Kaiser Steel Corp.}, 952 F.2d at 1240–41.

\textsuperscript{40} Munford v. Valuation Research Corp. (\textit{In re Munford, Inc.}), 98 F.3d 604, 610 (11th Cir. 1996).

\textsuperscript{41} Id.

\textsuperscript{42} See generally Enron Corp. v. J.P. Morgan Sec., Inc. (\textit{In re Enron}), 325 B.R. 671 (Bankr. S.D.N.Y. 2005).


\textsuperscript{45} \textit{Int’l Fin. Corp. (In re Enron)}, 341 B.R. at 455; J.P. Morgan Sec., Inc. (\textit{In re Enron Corp.}), 325 B.R. at 681–82; Bear Stearns Int’l Ltd. (\textit{In re Enron}), 323 B.R. at 863.
transactions were simply purchases of commercial paper, which look like new market transactions rather than payments to an existing creditor that would implicate the § 547 preference provision. Yet, their effect was to pay existing Enron creditors who would otherwise hold ordinary unsecured claims.

The bankruptcy judge finessed this tension, as well as the uneasy fit between the cases and the core context for which the settlement payment safe harbor was designed, by asking whether the payments were of a type that is “common within the securities trade.” If so, he concluded, the payments would qualify as settlement payments and come within the safe harbor. Although he concluded that the CLO note purchases clearly qualified and, therefore, dismissed Enron’s action in that case, the judge refused to dismiss Enron’s avoidance actions with respect to its commercial paper and stock purchases. In these two cases, the status of the payments was a factual issue that could only be resolved through a hearing or trial.

The Enron decisions further illustrate the uncertainty as to just how far the settlement safe harbor sweeps. Not only was the bankruptcy court unable to resolve two of the three cases prior to trial, but the court introduced what is arguably a third approach to limiting the boundaries of the settlement payment safe harbor. The judge’s concern for what is “common within the securities trade” is narrower than the sweeping protection afforded in several of the LBO cases, but potentially broader than the “mere conduit” approach used in other LBO cases.

Much as the transformation of investment banking has rendered the brokerage exclusion obsolete, so too have LBOs and financial innovation introduced unanticipated complexities into the interpretation of the settlement provision. Courts seem to be wrestling with the tension between the broad language of the safe harbor, which weighs in favor of protection,

46. See, e.g., J.P. Morgan Sec., Inc. (In re Enron Corp.), 325 B.R. at 677.
47. See, e.g., id.
48. Int’l Fin. Corp. (In re Enron Corp.), 341 B.R. at 459 (holding that Enron’s purchase of notes qualified as settlement payment); J.P. Morgan Sec., Inc. (In re Enron Corp.), 325 B.R. at 677 (holding that the question whether commercial paper purchases are protected by section 546(e) “is a factual issue requiring a trial”); Bear Stearns Int’l Ltd. (In re Enron Corp.), 323 B.R. at 859 (holding that Enron’s purchase of its own stock was not protected if it violated Oregon law).
49. J.P. Morgan Sec., Inc. (In re Enron Corp.), 325 B.R. at 677 (holding that the question whether commercial paper purchases are protected by section 546(e) “is a factual issue requiring a trial”); Bear Stearns Int’l Ltd. (In re Enron Corp.), 323 B.R. at 877 n.9 (whether a “void payment was commonly used in the industry” would “at minimum” require a “factual hearing”).
and the fact that the defendants in such cases are far removed from its core purpose of protecting middlemen in the securities settlement system.

III. THE SPECIAL TREATMENT OF DERIVATIVES IN BANKRUPTCY

A final example of bankruptcy’s effort to accommodate securities law is the special protection afforded derivatives and other financial contracts in bankruptcy. The earliest version of these provisions in the Bankruptcy Code was enacted as part of the original 1978 legislation, which exempted commodities and forward contracts from the automatic stay and other core bankruptcy provisions.\(^{53}\) Additional exclusions have been added at regular intervals, most recently in 2005 and 2006.\(^{54}\)

The amendments have been championed by the principal industry lobbying organization, the International Swaps & Derivatives Association (ISDA), and the U.S. Federal Reserve and Treasury.\(^{55}\) These groups argued that if derivatives were not completely protected from the automatic stay, a bankruptcy involving a firm with significant derivatives exposure could snarl the financial system.\(^{56}\) As a representative from the Federal Reserve System (the Fed) explained in a 1999 submission to Congress:

> [T]he right to terminate or close-out financial market contracts is important to the stability of financial market participants . . . and reduces the likelihood that a single insolvency will trigger other insolvencies due to the non-defaulting counterparties’ inability to control their market risk. The right to terminate or close-out protects [financial institutions] . . . on an individual basis, and by protecting both the supervised and unsupervised market participants, protects the markets from systemic problems of “domino failures.”\(^{57}\)


\(^{54}\) In 1982, Congress added the settlement protection discussed in the last part, as well as a protection for margin payments; in 1984, Congress provided special exemptions for repurchase transactions. Id. at 644. In 1990, Congress exempted swap transactions; and in 2005, Congress expanded the protections for repos and for netting. Id. Several of the exclusions were further expanded in 2006.

In addition to the automatic stay (and related provisions), the exclusions insulate derivatives and other financial contracts from bankruptcy’s preference and fraudulent conveyance provisions. In the discussion that follows, I focus on the exemption from the automatic stay because this exemption has garnered the most attention. But, the exemption from preference and fraudulent conveyance attack is also problematic.

\(^{55}\) Ayotte & Skeel, supra note 19, at 30.

\(^{56}\) Id.

Over the years, the testimony has been replete with similar warnings about “domino effect” and “ripple effect” failures unless financial contracts and securities transactions are protected from core bankruptcy provisions.58

Most bankruptcy lawyers and judges have little familiarity with the securities markets. As a result, they largely deferred to the testimony of bank regulators and the securities industry each time Congress considered new expansions of the derivatives protections. The testimony of Bruce Bernstein, a prominent bankruptcy lawyer speaking on behalf of the National Bankruptcy Conference (NBC) on a proposal to expand protection for repurchase transactions, is particularly striking in this regard. Bernstein stated that his “experience [in secured lending] has been that markets do have a way of adjusting to shocks or interpretations of relationships that do not necessarily go the way the market thinks they should have gone initially.”59 But, he disclaimed any expertise on the implications of the treatment of derivatives, stating that “I really am not expert enough, nor is my crystal ball clear enough, to be able to respond in any certain way,”60 and that “[t]he broad, economic policy arguments of these well-informed and highly respected institutions [the Fed and the Public Securities Association] . . . are, quite frankly, beyond the scope of the NBC’s expertise and its normal areas of inquiry.”61 Fifteen years later, NBC representatives did question the necessity of further expansion of the protections, but by then the die had long since been cast and the testimony had little impact.62

As with each of the issues previously considered, the derivatives protections have given rise to unintended consequences. In the case of derivatives and other financial contracts, the consequences stem less from subsequent market developments than from the provisions themselves. Whereas the provisions originally sought to protect particular parties, they now extend to the entire market for derivatives and other financial

58. See generally id.
60. Id.
61. Id.
62. Bankruptcy Reform Act of 1999 Hearing (Part III), supra note 57, at 177 (prepared statement of Randal C. Picker, Leffmann Professor of Commercial Law, University of Chicago Law School, on behalf of the National Bankruptcy Conf.) (“There is no indication that the absence of such cross-product netting features has led to widespread difficulties or systematic disruptions in the financial markets for such products. In addition, master netting could deprive a debtor of much-needed cash collateral . . . .”). See also id. at 46–58 (statement of Kenneth N. Klee, Professor, University of California Los Angeles School of Law, on behalf of the National Bankruptcy Conf.).
Counterparties to a debtor that files for bankruptcy are exempt from the automatic stay, permitted to invoke any termination clause, and are protected from bankruptcy’s preference and fraudulent conveyance provisions.

Prior to the recent financial crisis, several commentators pointed out that permitting counterparties to terminate is at least as likely to create systematic problems—by inviting runs in the event of financial distress—as to counteract them. Regulators’ responses to the recent crisis seem to confirm these criticisms. The decision to bail out Bear Stearns, rather than to allow it to file for bankruptcy, stemmed at least in part from the perceived consequences of default and termination for the repo and derivatives markets. According to a column in the New York Times, “[f]ears of so-called counterparty risk arising from credit default swaps on the books of Bear Stearns . . . were central to the investment bank’s unraveling in March [2008] and the rescue engineered by the Federal Reserve Bank of New York and JPMorgan Chase.” The onset of AIG’s financial distress six months later triggered a simultaneous wave of collateral demands that forced the government to choose between a massive bailout and allowing it to file for bankruptcy. Largely because of the perceived effect on the credit default swap market, the government opted for a bailout whose cost is estimated at $180 to $200 billion as of this writing. Whether an AIG default would have cascaded through the financial system, as regulators feared, is subject to vigorous debate, but regulators clearly did not trust counterparties’ exemption from the bankruptcy stay to neutralize potential systemic effects.

The experience of Lehman, the one major derivatives player that was allowed to file for bankruptcy, suggests that bankruptcy professionals may

63. I borrow this characterization from an insightful article by Morrison & Riegel, supra note 53.

64. See, e.g., 11 U.S.C. § 362(b)(7) (exempting repos from stay), § 559 (exempting repos from invalidation of ipso facto clauses), § 546(f) (exempting repos from avoidance) (2006).


67. Id.


69. Id. at 974.
respond by creatively interpreting the exclusions to reduce counterparties’ ability to exit. Although counterparties of trades with Lehman affiliates that had not filed for bankruptcy should have been able to terminate their contracts and retrieve the collateral securing them, Lehman successfully argued that the collateral, which consisted of various financial assets, had been commingled with the holding company’s general accounts, and, therefore, were subject to the automatic stay. Based on this claim, Lehman retained control of the assets.

Particularly with major players in the derivatives markets, the recent stress test of the special exclusion of derivatives and other financial contracts from core provisions of the Bankruptcy Code raises serious questions about the wisdom of the exclusions.

IV. IMPLICATIONS OF THE BOUNDARY GAMES

With each of the issues we have considered, Congress has concluded that, as between the securities markets and the normal operations of the bankruptcy laws, bankruptcy should give way and the markets should prevail. In each case, the special protection has proven problematic. Debtors have sidestepped the requirement that broker-dealers file for Chapter 7 rather than Chapter 11; the settlement protection afforded the securities markets has been the subject of increasing uncertainty; and during the recent crisis, the special treatment of derivatives was a problem rather than a solution. This section considers the future of these provisions. I begin by speculating about implications in the absence of any legislative intervention. I then consider how Congress might alter the existing rules to more effectively manage the boundary between bankruptcy and the securities markets.

A. MANAGING THE GROWING TENSIONS

The increasing friction at the boundary between bankruptcy law and the securities markets is not accidental. Each of the special protections affected relatively few cases when it was first enacted. But with the transformation of investment banking and the explosion of financial innovation, the securities markets, traditional corporate enterprise, and bankruptcy have become increasingly intertwined. Despite the recent financial crisis, this tendency will surely continue.


71. Id.
The exclusion of investment banks from Chapter 11 has been rendered largely (but not completely) irrelevant by the shift in banks’ corporate structures and their use of Chapter 11 for holding companies and non-brokerage affiliates. As we have seen, the principal limitations of the strategy stem from the limits on the ability of the brokerage itself, because it is not in bankruptcy, to take advantage of provisions such as § 363. Given the benefits to both the debtor and its creditors, courts are likely to continue authorizing sales of brokerage assets.

With the settlement safe harbor and derivatives exemptions, the provisions are now drafted so broadly that the market transactions may continue to prevail over the automatic stay and other core bankruptcy provisions. Several commentators have recently defended the breadth of the provisions, predicting that they will reduce uncertainty by curbing bankruptcy judges’ discretion to protect some transactions but not others.

This prognosis may well be correct since it accords with the general Congressional strategy of insulating these markets from ordinary bankruptcy rules. But the breadth of the provisions will magnify the frictions they cause, as the provisions increasingly crop up in contexts in which they were not intended to apply. These frictions will be further exacerbated by doubts as to whether the special derivatives protections are justified, and by the widespread use of derivatives by ordinary businesses. Indeed, after agonizing whether a small business debtor’s commodity contract with a natural gas supplier should be characterized as a swap, and thus, exempt from bankruptcy’s avoidance provisions, a bankruptcy judge recently refused to construe the exemptions broadly “[b]ecause the contract [was] not clearly within the definition of swap agreement the court will not upset the priority scheme of the Bankruptcy Code by affording the transfers under the contract the protections afforded to swap agreements and swap participants.”

If the prediction that bankruptcy courts will balk at giving the derivatives exclusions their full reach in some cases is correct, it raises two possible concerns. The first is the costs of uncertainty. When bankruptcy courts have raised questions about financial innovations that were thought to be insulated from bankruptcy, the decisions have often had an immediate,

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73. See, e.g., Morrison & Riegel, supra note 53, at 641.
74. Natural Gas Distributors, L.L.C. v. Smithfield Packing Co., Inc. (In re Natural Gas Distributors), 369 B.R. 884, 900 (Bankr. E.D.N.C. 2007), rev’d, 556 F.3d 247 (4th Cir. 2009). As of this writing, this decision has been reversed by the Fourth Circuit and remanded to the bankruptcy court for further consideration. Id.
75. See Morrison & Riegel, supra note 53, at 644.
negative market impact. If bankruptcy courts do not effectively distinguish between cases where the special protections are or are not warranted, the uncertainty costs could be still higher.

The second concern is not entirely distinct from the first, but has a different focus. The bankruptcy rules are designed to effectively resolve the financial distress of a particular debtor, and bankruptcy judges’ decisions tend to reflect this orientation. This approach generally works well, but it may prove problematic if a decision that maximizes the value of the debtor’s assets could have costly spillover effects on parties outside the bankruptcy. As we have seen, concerns about spillover effects, especially systemic risk, are a recurrent theme in the legislative history of the special protections for financial contracts. If bankruptcy judges do not fully take spillover effects into account, and if the risk of these effects is real, the exercising of judicial discretion by courts could benefit debtors and their creditors while inflicting broader damage on the markets.

B. LEGISLATIVE REFORM

Bankruptcy judges and professionals have adapted to many of the problematic effects of the boundary rules we have considered. But the adaptations are invariably imperfect. Next, I explore how Congress could clarify the murky waters if lawmakers were inclined to intervene.

1. The Brokerage Exclusion from Chapter 11

As we have seen, parties have responded to the brokerage exclusion by working around it. Yet, their solution of putting affiliates, but not the brokerage, in bankruptcy is an imperfect proxy for Chapter 11. Technically, the brokerage cannot take advantage of benefits such as § 363. The brokerage exclusion could also interfere with the changes to bankruptcy’s treatment of derivatives (discussed below) since any derivatives held by a brokerage subsidiary that did not file for bankruptcy would not be protected. Although the exclusion once could be justified, it no longer serves any real purpose. Congress could appreciably simplify the bankruptcy process for investment banks by repealing the brokerage exclusion.

2. The Safe Harbor for Settlement Payments

The simplest solutions to the uncertainties created by the safe harbor for settlement payments would be either to explicitly limit the safe harbor to its

77. Supra text accompanying note 57.
original purpose of protecting securities middlemen in market transactions, or to broadly protect every transaction that takes place through the settlement system. But neither of these bright line approaches is particularly attractive. If only securities professionals were protected, ordinary market investors could find themselves subject to fraudulent conveyance or preference challenge due to the breadth of the bankruptcy avoidance provisions. Explicitly protecting all of these transactions, on the other hand, would shelter the recipients of problematic transfers due to the happenstance of a connection to the financial markets. The volume of transactions that now take place on the financial markets is so great that a blanket protection of them would afford protection to some that do not warrant it.

The current provision provides an escape valve because it does not protect transfers that amount to actual fraud. But unless fraud is construed liberally, the fraud exception is not broad enough to police potentially problematic transactions. One strategy for legislatively achieving a more workable middle ground would be to amend the safe harbor provision to provide differing levels of protection for market middlemen and other participants in the market. Lawmakers could provide blanket protection for market middlemen, absent fraud, while protecting investors and other participants unless they knew or should have known that they were the beneficiary of a preference or fraudulent conveyance. As bankruptcy old-timers will recognize, this standard echoes one of the requirements for avoiding a preference under the old Bankruptcy Act.

78. Interestingly, if Congress eliminated the safe harbor altogether, securities middlemen might well be protected by courts from preference or fraudulent conveyance attack. To the extent the middleman is simply a conduit for settlement payments, he is not really the recipient of a transfer.

79. The preference and constructive fraud provisions use a strict liability approach that does not take motive or knowledge into account—this is the principal source of their breadth. See 11 U.S.C. §§ 547(b), 548(a)(1)(B) (2006).


81. For an example of elastic interpretation of the fraud under § 546(e), see Gredd v. Bear Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.), 359 B.R. 510, 516–27 (Bankr. S.D.N.Y. 2007). In that case, the court concluded that the debtor, a hedge fund, had functioned as a Ponzi scheme, and thus that any transactions with the fund were potentially fraudulent. Id. at 518. The court also concluded that settlement payments to Bear Stearns, its prime broker, could therefore be challenged as fraudulent conveyances. Id. at 523–26. For an extensive critique of In re Manhattan Inv. Fund Ltd., see Peter S. Kim, Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying the Stockbroker Defense and the Good Faith Defense, 2008 COLUM. BUS. L. REV. 657, 676–79 (2008).

82. Under former section 60, the trustee was required to show that the recipient of an alleged preferential transfer knew or should have known the debtor was insolvent at the time of the transfer. Bankruptcy Act of 1898, Ch. 541, § 60, 30 Stat. 544 (repealed 1978). This requirement was criticized as making it too difficult to avoid preferences. See, e.g., Chaim J. Fortgang & Lawrence P. King, The 1978 Bankruptcy Code: Some Wrong Policy Decisions, 56 N.Y.U. L. REV. 1148, 1165–66 (1981) (describing the complaint).
Consider how this rule might function in an LBO. In many of these cases, insiders and large shareholders negotiate the terms of the buyout. If the debtor later files for bankruptcy and the trustee challenges the LBO as fraudulent, any brokers who handled the payments would be protected. The old shareholders also would be protected unless the trustee could show that they knew or should have known the transaction could be avoidable as a fraudulent transfer. The trustee might well be able to make this showing with respect to the insiders, but most likely not to the ordinary investor. Consequently, most ordinary investors would be protected.

The chief shortcoming of this approach is the difficulty in determining when the recipient knew or should have known that she was the recipient of a potentially avoidable transfer. But, given the cost of pursuing an avoidance action, a trustee or debtor-in-possession would rarely pursue these avoidance actions unless significant money was at stake and strong evidence existed showing that the recipient was aware that the payment she received was problematic.

3. Imposing a Stay on Derivatives and Other Financial Contracts

If lawmakers reform the current exemption of derivatives from the automatic stay, their most plausible strategies are to (1) adopt a transaction or product-based approach by exempting some financial contracts from the automatic stay but not others; (2) apply the automatic stay in the bankruptcy of some kinds of firms but not others; and/or (3) apply the automatic stay to all financial contracts, thus ending their special treatment. Next, I consider the intuition underlying each of the three approaches.

With respect to the first, the case for exempting some products is stronger than for others. Subjecting repos to the automatic stay might significantly interfere with the repo market, since repo loans are extended on a very short term basis. 83 The case for exempting credit default swaps, on the other hand, is weaker. 84 Under this approach, Congress would revisit

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83. On the other hand, if the repo creditor is fully collateralized, any harm from the stay should be limited. Gary Gorton has recently argued that repo financing is analogous to traditional deposit banking, and should be protected by a government guarantee analogous to deposit insurance. See, e.g., Gary Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007 (May 9, 2009) (unpublished manuscript at 4), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882&rec=1&srcabs=1436913. Although such a reform seems unlikely, if it were adopted it would further reduce the consequences of a stay for repo lenders.

84. Proponents of special treatment of swaps emphasize the standard systemic risk concern that preventing counterparties from terminating could cause “ripple effect” failures. Bankruptcy Reform Act of 1999 Hearing (Part III), supra note 57, at 172–73 (prepared statement of Oliver Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys.). They also argue that a party who depended on a swap for hedging purposes might have difficulty replacing the hedge and would run the risk of ending up with a duplicative hedge if the debtor later assumed its contract. Id. None of these contentions are especially persuasive, however. The counterparty itself can
each of the exemptions and remove the least compelling. In a sense, it would reverse the historic pattern of continuously expanding the special treatment of derivatives, and winnow down the protected list.

The second approach would distinguish among types of debtors, rather than focus on particular products. For instance, one commentator has recently argued that the automatic stay should apply if the debtor is not a financial institution, but counterparties should retain their exemption with financial institution debtors. The reasoning is that a derivative may be important to a nonfinancial debtor’s going concern value and, therefore, should be protected. A second proposal, which I have outlined briefly elsewhere, would draw a different line, distinguishing between ordinary and systemically important financial institutions. Under this proposal, the stay would apply only to systemically important institutions. This proposal draws on the experience of the recent financial crisis, which seems to confirm concerns that the absence of a stay could magnify the systemic effects of a large financial institution’s default.

The final approach would reverse the special protections altogether, based on a view that the arguments for exempting the derivatives and other financial contracts from bankruptcy no longer seem compelling. Exempting derivatives counterparties from the stay reduces their incentive to monitor the debtor and does not seem to provide a bulwark against systemic risk.

While each of these approaches has drawbacks, each proposal seems preferable to the existing framework. Let me briefly expand on the two that seem most compelling: the stay for systemically important institutions and the blanket stay. The proposal for a stay on systemically important institutions might proceed in two steps. First, the Fed would be instructed to minimize their risk through the simple expedient of limiting its exposure to any given debtor, for instance, and the counterparty often would be able to sell a duplicative hedge to a third party. Moreover, the uncertainty could be reduced under a rule that required the debtor to make prompt decisions on assumptions, much as bank regulators do in a bank insolvency.


86. See id.


88. See Sjostrom, supra note 68, at 962. The AIG “credit downgrade trigger[ed] additional posting obligations” on its credit default swaps. Id.

89. Lubben’s contention that derivatives held by nonfinancial entities should be stayed is sensible, but is subject to two limitations. See Lubben, supra note 84, at 3–5. First, and most obvious, it does not address the need for a stay in insolvencies involving nonbank financial institutions. Second, it could be circumvented. A financial institution that wished to evade the stay could interpose another financial institution between itself and the debtor.

90. For another, somewhat analogous proposal for singling out systemically important institutions, see Lee C. Buchheit & David A. Skeel, Jr., Some Bankruptcies are Worth It, N.Y. TIMES, May 19, 2009, at A25. Under this approach, lawmakers would provide for a transition
to designate the financial institutions it deems to be systemically important. As the regulator most concerned with systemic risk, and having conducted “stress tests” of the leading banks in early 2008, the Fed is the logical choice to determine which institutions are systemically important, and to do so in advance. Second, if a systemically important institution filed for bankruptcy, its derivatives and other financial contracts would be subject to the automatic stay.\footnote{In order to make the stay fully effective, Congress also would need to reverse the brokerage exclusion from Chapter 11, as discussed in Part IV.A. Otherwise, the stay would not protect any derivatives or other financial contracts held by the brokerage entity.}

The bankruptcy-plus-stay proposal for systemically important institutions would reduce the danger that an institution would dismember itself prior to bankruptcy in response to collateral calls, as AIG threatened to do, as well as reduce the threat that mass cancellation of contracts and collateral sales would drive down asset prices and increase the damage to other institutions. The proposal might also curb the perceived need for bailouts, give counterparties and creditors a greater incentive to monitor, and encourage the managers of a systemically important institution to plan for the possibility of bankruptcy, rather than trying to portray bankruptcy as a looming catastrophe in order to secure rescue funding.\footnote{See, e.g., Ayotte & Skeel, supra note 19; Skeel, supra note 87, at 25.} The most obvious concern with the proposal stems from its singling out of institutions that are systemically important. This special treatment could reward institutions that were given the “systemically important” designation, and perpetuate a status that creates serious distortions in the markets.\footnote{See, e.g., Peter J. Wallison, Too Big to Fail, or Succeed, WALL ST. J., June 18, 2009, at A17.} In practice, however, the proposal seems equally likely to discourage firms, rather than invite them, to attain “systemically important” status. Because the counterparties of a designated firm would be subject to the stay if the firm filed for bankruptcy, the proposal would increase counterparties’ incentives to deal with non-designated institutions if they wished to avoid the possibility of a stay in the event their counterparties encountered financial distress. The incentive to deal with non-designated institutions could help to erode the dominance of the derivatives industry by a handful of financial institutions.

The other strategy, a blanket stay on derivatives and other financial instruments, avoids the line drawing concerns created by approaches that apply the stay to some firms but not to others. The chief objections to the stay, as we have seen, stem from the consequences of preventing counterparties from exiting their contracts.\footnote{See supra text accompanying note 57.} The value of the contracts and of any collateral is extremely volatile. Accordingly, counterparties could be
damaged by the uncertainty as to whether the debtor will assume or reject their contract, and the cost of re-hedging contracts that the debtor rejects could be devastating if the contract is substantial.

Although these are legitimate concerns, they must be weighed against the very substantial benefits of the stay. The prospect of a stay would give counterparties an added incentive both to carefully monitor the debtor and to avoid overexposing themselves to a single counterparty. Moreover, the costs of the stay could be reduced by assessing the value of the collateral as of the date of the bankruptcy filing and by setting tight deadlines on the debtor’s decision to assume or reject the contract.

Between the limited and blanket stay, the determination as to which is preferable depends importantly on the nature of financial regulation. The case for a stay that targets systemically important institutions is strongest in a regulatory regime that singles out systemically important firms for distinct treatment.95 There are many reasons for concern about such a regime. For example, the perception that some firms are too big to fail is likely to distort capital markets, as lenders favor the firms that are thought to be protected. If the regulatory framework does make such distinctions, however, the targeted stay could curb the incentive to acquire systemically important status to some extent. In a regime that does not single out systemically important firms, a blanket stay is likely to be most compelling. It has the virtue of simplicity, and does not introduce the boundary issues that would arise with a distinction between systemically important and other institutions. Both approaches are, however, preferable to the current exemption from the bankruptcy stay.

CONCLUSION

The securities market exclusions from core provisions of the bankruptcy laws have an awkward history. In each case, lawmakers swept with a broad brush, giving a wide berth to the operations of the securities markets, and they did so at a time when the special treatment was quite uncontroversial. Nearly everyone was happy to leave the markets alone. With the rapid evolution of the markets in the past several decades, however, the provisions are no longer on the periphery of the bankruptcy process, and they have given rise to a steady stream of unintended consequences. Debtors have sidestepped the brokerage exclusion from Chapter 11, the settlement safe harbor has been invoked in contexts well

outside the transactions it was originally designed to protect, and the exemption from the stay for derivatives and other financial contracts performed much differently than advertised when Bear Stearns, Lehman and AIG failed.

In addition to speculating about the future of these provisions as bankruptcy judges continue to apply them under new or unanticipated conditions, I outlined possible legislative responses to each. The case for reversing the exclusion of brokerages from Chapter 11 seems straightforward and compelling. It also seems clear that Congress should reverse course on its relentless expansion of special protections for financial contracts, although the best strategy is debatable. The case for a legislative rewrite is weakest for the settlement safe harbor, but here too reform might reduce the current confusion.

Although the current treatment of the provisions we have considered is marked by evasion and confusion, there are grounds for encouragement going forward. The penchant for broad exclusions has been tied in important respects to the sharp line between securities law and bankruptcy law dating back to the New Deal. Largely unfamiliar with the securities markets, bankruptcy lawyers and judges generally accepted the doomsday claims of banking regulators and securities industry interest groups like ISDA, who insisted that Armageddon would ensue in the absence of special protections. However, the line between securities markets and bankruptcy is rapidly eroding. This development, coupled with the harsh light the recent financial crisis has cast on the earlier claims about the virtues of unregulated derivatives markets, make it more likely that these issues will be addressed in a balanced and better integrated fashion.
THE BANKRUPTCY EXCHANGE

Douglas G. Baird*

The bankruptcy forum has become a marketplace for claims. Those who made the loans are far removed from the players that sit at the negotiating table in the modern corporate reorganization. Instead of stock being traded on the floor of an exchange, claims are traded in bankruptcy court. Investors become residual owners of firms outside of bankruptcy by buying stock. Inside of bankruptcy they do it by buying debt. In both cases, it is a world of professional traders, arbitrageurs, and corporate raiders.

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. But it is naive to think that this new market, the bankruptcy exchange, should be unregulated. All markets are regulated. Whether one is a merchant who seeks to sell wool in the twelfth century or a farmer who wants to sell grain in the nineteenth, being subject to regulation is inevitable.

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* Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School. This paper was presented at a symposium on securities regulation and claims trading organized by the Brooklyn Journal of Corporate, Financial & Commercial Law on February 27, 2009. The ideas grow out of my long and continuing work with Robert Rasmussen. I am most grateful to Michael McMahon for assistance and the Sarah Scaife Foundation, the Lynde and Harry Bradley Fund, and the John M. Olin Foundation for support.

1. See Stuart C. Gilson, Investing in Distressed Situations: A Market Survey, FIN. ANALYSTS J., Nov.–Dec. 1995, at 8; Adam J. Levitin, Jr., Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron, 2007 COLUM. BUS. L. REV. 83, 86 (2007) (“Although 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.”).

2. See Michelle M. Harner, The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing, 77 FORDHAM L. REV. 703, 703 (2008) (“Activist institutional investors traditionally have invested in a company’s equity to try to influence change at the company. Some of these investors, however, are now purchasing a company’s debt for this same purpose.”); see also Michelle M. Harner, Trends in Distressed Debt Investing: An Empirical Study of Investors’ Objectives, 16 AM. BANKR. INST. L. REV. 69, 70 (2008) (“Professional distressed debt investors . . . . are purchasing positions in multiple tranches of the debtor’s capital structure, obtaining seats on the statutory committee of unsecured creditors and even acting as the debtor’s post-petition lender.”).

3. See, e.g., Munn v. Illinois (In re Munn), 94 U.S. 113, 135–36 (1877) (upholding state regulation of the storage and sale of grain); see also Richard O. Zerbe, Jr., The Origin and Effect of Grain Trade Regulations in the Late Nineteenth Century, 56 AGRIC. HIST. 172, 172 (1982) (“Business transactions of every sort take place within a regulatory context in the sense that there is a framework of law, custom, or culture which provides rules and structure to transactions.”).
without regulating it. Simply providing that it is open on Wednesdays, but not Saturdays, is a form of regulation that works to the advantage of some and to the disadvantage of others. The Chicago Board of Trade is the paradigm of a free market, but it is also among the world’s most heavily regulated. Elaborate rules establish who can trade, what can be sold, when trading can occur, and under what terms.  

Regulation of the bankruptcy exchange is similarly inescapable. Every decision in a bankruptcy case affects the bankruptcy exchange, for better or worse. Scheduling a date for a cramdown hearing has the effect of putting an exercise date on an option contract. Whether intended or not, every decision a bankruptcy judge makes affects trading on the bankruptcy exchange. The question is not whether there should be regulation, but what form it should take.

In this Article, I review the first principles that should be at work in regulating the bankruptcy exchange. Part I examines the features and the virtues of a well-functioning market and connects them to the trading of claims in bankruptcy. Parts II and III look more narrowly at the role the disclosure rules play. Disclosure rules are a crucial feature of the playing field in this market as in any other. At the medieval fair, goods for sale had to be on public display. On the Chicago Board of Trade, traders must, under some circumstances, disclose their trading positions (though only to the exchange, not to their contracting opposites). All markets have disclosure rules, and the bankruptcy exchange should not be an exception. Part II focuses on the disclosures needed for the rest of the bankruptcy process to work effectively, independent of the exchange itself. Part III focuses on the role that disclosure plays in ensuring a well-functioning market in bankruptcy claims. This part of the Article is the most tentative, because while one can set out basic principles, it is too soon to provide many clear lessons about the costs and benefits of maintaining transparency in the trading of bankruptcy claims.

I. THE WELL-FUNCTIONING EXCHANGE

Those who establish an exchange, whether medieval prince, Chicago merchant or bankruptcy judge, try to ensure that the market works while advancing their own agendas, whether it is raising taxes, promoting business, or rehabilitating firms. The rules that govern well-functioning markets share three features worth underscoring. First, they allow those who want to sell to do so at low cost and at a price that reflects the value of

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6. See CHICAGO BOARD OF TRADE RULEBOOK, R. 561.
the assets that are being traded. Second, they ensure that assets will move to those who value them the most. Third (and less noted), they try to take best advantage of the information that a well-functioning market aggregates. The price generated in such a market contains more reliable information than what you can find in the report of any expert. Even those who do not themselves trade can benefit from this information.

When a market is liquid, that is, when many are able to trade at low cost, the price at which assets are sold is likely to reflect its true value. This in turn attracts trade and lowers costs. Quite apart from transaction costs, someone who is confident that a market is working can worry less about strategic behavior. Moreover, the average trader can sell at the current price without doing elaborate research. The research is unnecessary as the information it would uncover is already embedded in the market price. Trading done by those who already have the information in a liquid market has this effect.

The ordinary, uninformed outsider can invest in the stock market by acquiring a diversified portfolio and be confident that, at least over the long run, she will enjoy a market return on her investment. A well-functioning bankruptcy exchange serves a similar function. Unsophisticated small creditors, whether they are suppliers, tort victims, or small investors, can opt out of the bankruptcy process early and liquidate their claims.

One must, of course, make an important caveat: To say that a well-functioning bankruptcy exchange has these virtues is not to say that claims trading in any particular bankruptcy works well. When the market for claims is thin, inaccessible, or laden with transaction costs, the prices at which claims trade may have no relationship to their true value. While a well-functioning market brings an enormous benefit to tort victims, one that works poorly can be worse than none at all. The unsophisticated creditors who trade, receive far less for their claims than they are worth. They are not knowledgeable enough to know that they should hold on to their claims.

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7. See, e.g., Justin Wolfers & Eric Zitzewitz, Prediction Markets, 18 J. ECON. PERSP. 107, 113 (2004) (evidence illustrates that the Hollywood Stock Exchange has been almost as accurate as experts in picking Oscar winners).
8. Id.
9. See id.
10. See Fischer Black, Noise, 41 J. FIN. 529, 532 (1986).
13. For the classic analysis of claims trading, see Chaim J. Fortgang & Thomas Moers Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 CARDOZO L. REV. 1 (1990). For an early and forceful exposition of the virtues of disclosure, see Joy Flowers Conti,
Of course, one cannot expect prices to track true values precisely, even in the most well-functioning market. As a matter of theory, it is simply not possible for the two to match. The prices on an exchange can reflect information only if those who possess it are able to profit by trading on it. They have to believe there is a gap between the true value and the market price or they will not have an incentive to trade. Quite apart from theory, experience has taught us that prices are inevitably noisy. Fischer Black’s test for whether a market was working well was whether an asset trades at a price that is within fifty percent of its true value.

In short, while searching to improve its regulation, one should not expect too much of the bankruptcy exchange. Even under the best of circumstances, prices on the exchange will be volatile. The best we can do is minimize the volatility and try to ensure that the price at which a claim is sold is an unbiased estimate of its actual value, where the price is as likely to be too high as too low.

A well-functioning market is one of the best ways to aggregate information. The best estimate of the price at which grain will sell next October is the price generated on the futures exchange today. Such knowledge is valuable not simply to the people who buy and sell on the exchange, but also to the farmer who must decide whether to plant wheat and to the bakery that must decide whether to expand. Indeed, markets are so effective at aggregating information that sometimes we create information markets solely for this purpose. For example, prediction markets do far better than any expert in predicting the outcome of the presidential election or the next winner of an Academy award.

It might seem that this feature of well-functioning markets could be harnessed in the bankruptcy process. Assume, for example, that a firm has creditors owed a total of $100 and all of it is unsecured. Let us also assume that the plan of reorganization will give one share of equity for each dollar of claim. The price at which each claim trades today multiplied by one hundred tells us how much the firm is worth.


14. See Black, supra note 10, at 531 (noise trading is necessary for the market to function). Indeed, Black showed that without such valuation uncertainty, securities markets could not even exist. Id. For him, a market was efficient if the price at which a security traded is somewhere between half and twice its true value. Id. at 533 (factor of two arbitrary values Black uses to define an efficient market).


One should, however, be quick to note the limitations of our ability to use or extract information from this market, even when it functions well. A judge cannot, for example, use the price at which claims trade to put a value on the firm. When the judge is putting a value on the firm, the price at which claims trade is not an estimate of the value of the firm, but rather a best estimate of the value the judge will place on it. If the judge follows the market price at the same time those who trade in the market are following the judge, they will simply be chasing each other’s tails.

Nevertheless, the bankruptcy exchange can still provide information. The bankruptcy judge and other players can usefully extract information from the prices at which claims trade. Among other things, they provide warning signals. Consider, for example, the case in which there is a hard cash offer for the firm and a plan of reorganization that the debtor has put forward. The judge must pick between the two. If the value of the firm derived from the bankruptcy exchange is less than the cash offer, one must at least ask whether the market is reflecting the possibility that the judge will accept that plan and that the plan is worth less than the hard cash offer. Of course, one must be confident both that the market is thick enough for prices to capture information and that the hard cash offer is indeed hard, but such information can be a useful signal.

The general features of a well-functioning market are understood. The basic idea is to encourage trade. The more fragmented the market and the more diverse the underlying assets that are bought and sold, the less likely the market will work effectively. The perennial challenge facing the Chicago Board of Trade is defining the underlying contract for the commodities that are bought and sold.18 If the definition of “corn” is too broad and allows for too much variation in the type of corn, sellers can act strategically and deliver corn of the low quality and still meet the contract. High-quality corn will become debased or disappear from the market altogether. But if “corn” is defined too narrowly, there will be too little trading. The price will not capture information as effectively and the contract itself can become subject to manipulation, such as the risk of a corner.19

The bankruptcy exchange also requires that claims be defined in a way that allows trading at low cost. The basic way in which the Bankruptcy Code treats claims does exactly this. The Bankruptcy Code converts all unsecured debts into a general claim against the firm, regardless of the

19. See id. at 127–32 (discussing corners on the Chicago Board of Trade in the nineteenth century).
debtor’s duration and interest rate. Debentures with different interest rates, different covenants and different maturity dates outside of bankruptcy trade become homogenized in bankruptcy, while many of their non-bankruptcy attributes are washed away. As any commodity becomes more fungible, it becomes easier to trade. Hence, facilitating claims trading ought to be counted among the justifications for this homogenization of disparate claims.

For the same reason, the widespread understanding that all claims with the same legal attributes must be put in the same class also facilitates trade. Some, including me, have criticized the rule on the ground that a supplier owed money and a bank might have radically different perspectives on a plan of reorganization. Hence, lumping them together might neglect the rights of some of the affected groups. But whatever benefit might arise from having multiple classes must be weighed against the cost to the bankruptcy exchange. The greater the diversity among the voting rights attached to claims, the thinner the market for them will be.

The need to ensure a well-functioning market in claims provides an additional justification for Justice Holmes’s opinion in *Sexton v. Dreyfuss*. In that case, Justice Holmes held that the attributes of every claim against the debtor are fixed at the time of the filing of the petition. The filing of the bankruptcy petition is a day of reckoning that “collapses all future probabilities to present values.” We take a snapshot of every claim on that day and the characteristics of the claim on that date remain throughout the case. No one can be made the holder in due course of a negotiable instrument after a bankruptcy petition is filed. A claim subject to

24. 219 U.S. 339 (1911).
25. *Id.* at 345. The principle has been reaffirmed many times over the decades. See, e.g., United States v. Marxen, 307 U.S. 200, 207 (1939) (“[T]he rights of creditors are fixed by the Bankruptcy Act as of the filing of the petition in bankruptcy.”); *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713, 715 (W.D. Mich. 1938) (“[T]he rights of creditors become fixed at the moment of bankruptcy and . . . they then acquire a right in rem against the assets.”); Swarts v. Siegel, 117 F. 13, 15 (8th Cir. 1902) (“The rights of creditors are fixed by the status of their claims when the petition in bankruptcy is filed.”).
27. A conspicuous exception arises if a creditor holding a claim engages in bad conduct during the bankruptcy case and thus subjects the claim to subordination. See 11 U.S.C. § 510(c)(1) (2006) (giving the bankruptcy court power to subordinate claims “under principles of equitable subordination”); see also Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d 692, 699–700 (5th Cir. 1977) (explaining the required conditions for equitable subordination).
28. A bankruptcy petition constitutes notice of the debtor’s default. Hence, “[o]nce the issuer of a negotiable instrument files a bankruptcy petition, no buyer of the instrument can be a holder
subordination at the moment the bankruptcy petition is filed should, by this logic, similarly remain subject to subordination no matter how many times it is transferred subsequently. The character of a claim should not change no matter who is holding it.

But while these longstanding bankruptcy rules facilitate the creation of the bankruptcy exchange, a number of new developments threaten to undermine it. As I have pointed out elsewhere, novel capital structures create an anti-commons problem. Instead of a firm with a dispersed group of holders of homogenous general claims against the firm, we increasingly see more complicated structures. There may be second liens and subordinated creditors in addition to general creditors. In a large case, secured creditors of a parent company may be structurally subordinated to the general creditors of the operating company subsidiary. A single bank is the record holder of a particular claim, but many individuals may hold the economic interest through total return swaps and other devices.

The fragmentation we see today may make it hard for a market in claims to come into being, even if everyone knows exactly who holds which claim. Forming a plan of reorganization is analogous to the problem facing the developer who wants to assemble a city block and build a skyscraper on it: The more dispersed and convoluted the various freehold and leasehold interests, the harder it is for the city block to be used effectively or a value to be placed on any of them. Bankruptcy is no different over this dimension.

in due course because the buyer will be on notice that the instrument is overdue.” LAWRENCE P. KING ET AL., 6 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 94.03[2][a][i] (Chaim J. Fortgang & Thomas Moers Mayer eds., 15th ed. rev. 2005).

29. This was vigorously and inconclusively contested in the Enron litigation. Enron Corp. v. Ave. Special Situations Fund II, L.P. (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005), vacated and remanded, 379 B.R. 425 (S.D.N.Y. 2007). The opposing argument is likewise premised upon the need to promote the trading of claims. One can argue that to promote the bankruptcy exchange, negotiability primes other considerations. Hence, doctrines such as equitable subordination should attach only to the party that engages in bad conduct, not to subsequent good faith purchasers. See Levitin, supra note 1, for a lucid discussion.


31. Id. (manuscript at 3–4).

32. See id. (manuscript at 25–28) (discussing second lien loans).

33. See id. (manuscript at 39).

II. DISCLOSURE AND THE BANKRUPTCY PROCESS

Before we reach the question of how much transparency is desirable or necessary to create a well-functioning exchange, we first need to recognize that there is some need for disclosure in order to ensure the smooth functioning of the bankruptcy process as a whole. The bankruptcy judge needs information about claims and those who hold them to administer the case effectively. A judge must make her decisions on the basis of what interested parties tell her. Advocates cannot engage in any misrepresentations, but they do not have to make the other side’s argument for them. To decide sensibly, the judge must take into account that she is listening to advocates and draw inferences from what they do and do not say.

In theory, the judge should be able to do this when multiple advocates are before her, as long as at least one of them has the incentive to disclose the relevant information. In contrast to many judicial forums, however, the bankruptcy judge is often forced to decide questions when only some of the interested parties are before her. Sometimes only the moving party is in court. Motions are filed and no one files an objection. “GNO” is the marginal note most often scribbled on the bankruptcy judge’s motion calendar—grant if no objection.

Deciding matters effectively in such an environment requires drawing inferences from what is being said and who is saying it. The bankruptcy judge is likely to look much differently at a motion to provide adequate protection blessed by a large general creditor, from the way she looks at it when the same creditor says nothing. She draws the reasonable inference that the order makes sense when someone who ultimately bears its costs supports it. She assumes that this party has reviewed the risks, even those that might not be readily apparent.

But drawing inferences from self-interested advocates may require knowing where the advocates are coming from, especially when only a limited number of them appear. When an investor who holds a general claim against the estate also holds an even larger slice of the secured debt, her willingness to bless the adequate protection order means much less. Hence, independent of what disclosures are needed to promote the bankruptcy exchange, it may make sense to require anyone who appears in front of the bankruptcy judge to disclose their position, regardless of whether they serve on a committee.

35. For an analysis of decision making in such contexts, see Paul Milgrom & John Roberts, Relying on the Information of Interested Parties, 17 RAND J. ECON. 18, 19 (1986).

36. Bankruptcy Rule 2019 requires certain disclosures from creditors serving on a committee other than the official creditors committee, but there is no general disclosure rule. FED. R. BANKR. P. 2019.
Disclosure, at least of a limited kind, may also be necessary because of the plan formation process. When the firm can be sold as a going concern, the plan of reorganization may involve little more than dividing the cash. But a going-concern sale does not always serve the interests of the stakeholders. Precisely because there is a liquid market in claims, those who are now participating in the bankruptcy process are already those who value the firm most highly. They prefer a reorganization in which they emerge as the owners of the business. They will receive less value from outsiders if they seek to sell the firm because they possess insider information. If they try to sell the firm, outsiders will infer that the private information they possess is bad. There is a standard “lemons” problem. They are better off negotiating among themselves rather than trying to sell it.

In such cases, negotiations are the lifeblood of the bankruptcy process, and the plan formation process is often complicated. The governing rules should make these negotiations easier. This may require disclosure, at least as to who owns what. It is hard to forge a consensual plan if you do not know with whom you should be bargaining. The general principle here is clear: The easier it is to find the stakeholders, the more likely a sensible plan of reorganization can emerge. The core idea here is a familiar one seen in many other environments. The better defined the property rights, the more valuable they are. Land becomes more valuable when its owner and its boundaries are easy to identify from public records. Quite apart from whether I want to buy or sell land, I can use my own land more effectively if it is easy for me to learn who my neighbors are. Put simply, knowing the identity of the holders of property rights is a key assumption of Coasean bargaining.

III. DISCLOSURE AND THE BANKRUPTCY EXCHANGE

Certain types of disclosure are necessary so that the market for claims functions effectively. The amount of disclosure needed to ensure a well-

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37. See George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488, 489–90 (1970). Akerlof suggests that used cars are sold for unusually low prices because buyers fear that their sellers are selling only because the car is a “lemon.” Id. Given that those with good cars cannot sell them for their true value, they are inclined not to sell them. Id. Therefore, the pool of cars put up for sale falls in quality, depressing the price even more. At the limit, the market can collapse completely. Id.


39. Potential distortions of the plan formation process lie at the heart of most critiques of Hu and Black, as well as Lubben, and the need they see for additional disclosure. See Henry T. C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. PA. L. REV. 625, 734 (2008) (“We believe that disclosure of coupled assets should become a routine part of bankruptcy proceedings.”); Stephen J. Lubben, Credit Derivatives and the Future of Chapter 11, 81 AM. BANKR. L.J. 405, 430 (2007).
functioning market is not obvious. All exchanges must have some mechanism for enforcing contracts and preventing fraud. Rules designed to ensure the solvency of those who trade on the exchange are also commonplace.40 By contrast, rules governing disclosure are far from self-evident and vary widely. Trade-offs are inevitable. Put in place too few disclosure obligations, and those who trade are forced into endless games of twenty questions. There is much information in possession of the seller that sophisticated buyers insist on knowing before they are willing to trade. But sellers will not answer every question and sophisticated buyers will not insist on it.41 Too many disclosure obligations discourage traders from gathering valuable information in the first place.42 Everyone else suffers because the prices do not take account of the information and thus do not reflect the underlying value of the asset. Perhaps because of this tension, clear benchmarks have not emerged.43

Consider the following case:44 The geologists for a mining company discover a vast mineral deposit on farmland in Canada. After the discovery, the company decides to repurchase a large amount of its own stock. Two disclosure issues present themselves. First, does the mining company have to disclose the existence of the mineral deposits to the Canadian farmers when they seek to acquire the mineral rights? Second, does it have to disclose the existence of the mineral deposits to the Wall Street investors when it tries to repurchase the stock? The answer to both questions under existing law is plain. The firm is free to hire intermediaries and buy up the mineral rights from the naïve farmers without disclosure as long as it does not engage in lies or misrepresentations,45 but it must disclose the existence


41. The proliferation of “big boy letters” evidences that sophisticated parties do not insist on complete disclosure, even when they know that their contracting opposites possess material, nonpublic information. See Daniel Sullivan, Comment, Big Boys and Chinese Walls, 75 U. CHI. L. REV. 533, 537 (2008).


44. The facts in this illustration are based on SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

45. See Laidlaw v. Organ, 15 U.S. 178, 195 (1817) (holding that contracting party had no duty to disclose material fact – in this case, the end of the War of 1812 to a stranger on the other end of the bargain); Harris v. Tyson, 24 Pa. 347, 359 (1855) (“A person who knows that there is a mine on the land of another may nevertheless buy it.”).
of the deposits to the sophisticated investors before it proceeds with its plan to repurchase the stock.\textsuperscript{46} Whether either disclosure rule makes sense or whether there is a sensible way to justify the different duties has long been a source of controversy with respect to commercial transactions generally and the trading of securities.\textsuperscript{47} But the example itself shows both the range of approaches and an absence of obvious overarching principles.

Other things being equal, disclosure of information is good. One wants the price to reflect underlying values, but only if the information about the underlying value is known can it be incorporated into the market price. Yet, the issue is more complicated than it first seems. The need for disclosure in a liquid market is far less than it appears. Indeed, when the markets are thick enough, information can remain private and still be reflected in the market price. The trading activity of those with knowledge drives the price. It is enough that those with knowledge trade (and are known to trade). In equilibrium, the information that only knowledgeable insiders possess becomes embedded (with some noise) in the market price.\textsuperscript{48}

Consider the simplest case, in which outsiders can observe the trading behavior of someone who is known to possess inside information and can see the price at which this trader is indifferent between buying and selling, but nothing else. Imagine ten black boxes with an identical, but undisclosed amount of cash inside. One person in the room is allowed to look inside each box before it is sealed. The boxes are then offered for sale. The person who has looked inside the box will buy any box that is offered for less than twenty dollars and willingly sells to anyone who offers more than twenty dollars. What happens next? Even those who have never looked inside the box will be willing to buy them, and they will be able to sell them to others who have never looked inside. And in all cases the price will be about twenty dollars. Everyone will buy and trade at a price that reflects the inside information that only one person possesses. Someone who entered the room and bought a box would buy it at a price that reflected its true value. When the market is otherwise sufficiently liquid, disclosure requirements are not merely unnecessary, but are affirmatively harmful. We need to give the one person the incentive to look inside the box and then be in a position to profit when the price rises just above or falls just below twenty dollars. Disclosure mandates reduces the incentive to gather information in the first place and also reduces the incentive to trade on it.\textsuperscript{49}


\textsuperscript{47} See Kronman, supra note 42.


\textsuperscript{49} See, e.g., MANNE, supra note 42, at 159, 165–66.
Returning to the example of the mining company, if the legal regime forced the company to disclose what it knew about the mineral deposits before acquiring the mineral rights, it might never have spent the money hiring geologists to look for the deposits in the first place. Consequently, the minerals might never have been discovered. Rules aimed at ensuring transparency can actually create a less efficient market, one that is less liquid and in which prices fail to reflect underlying values. Both those with and without information are left worse off.

For the trading of claims in bankruptcy, the lesson is a subtle one. On its face, there does not seem to be anyone in the position of the mining company and its team of geologists. Nor does it seem that the disclosures that are sometimes required—such as the price at which a hedge fund acquired a claim—have much to do with the underlying business.\(^{50}\) Regardless of whether such disclosures do any affirmative good, they do not seem to do any harm. Indeed, attaching importance to the price at which someone bought a claim (which vulture investors routinely do) seems to be an example of the sunk-cost fallacy.\(^{51}\) If two investors have the same information about an asset, both should be willing to sell it at the same price, regardless of how much they paid for it. Both should maximize the value of whatever they hold today.

The amount originally invested in an asset is a sunk cost. It should not be part of the decision calculus. In deciding how much to bet in a poker game, the number of chips in the pot that once were yours is irrelevant; once the money is in the middle of the table, it no longer belongs to you.\(^{52}\) Good poker players (including many vulture investors who assert that the amount they paid for their claims matters enormously) know that you must ignore what you have bet and instead calculate the cost for you to continue playing against the value of the entire pot.\(^{53}\) A bankruptcy claim seems to be the same. You make the decision that promises to give you the most for your claim, regardless of whether you bought at twenty or at forty. You


\(^{51}\) For a discussion of the sunk cost fallacy, see Thomas Kelly, Sunk Costs, Rationality, and Acting for the Sake of the Past, 38 NOÛS 60, 61 (2004) (“[I]t is widely agreed that honoring sunk costs is obviously and clearly irrational, and that doing so is, without exception, to be avoided. In economics and business textbooks, the tendency to honor sunk costs is treated as an elementary fallacy.”).

\(^{52}\) Annie Duke, The Sunk Costs of Trading, FIN. SPREAD BETTING – A TRADER’S GUIDE, http://www.financial-spread-betting.com/Sunk-cost.html (last visited Nov. 1, 2009). In poker lingo, the ratio of how much a bet is relative to the pot size is known as a player’s “pot odds.” See id.

\(^{53}\) Id. For further discussion on pot-odds, see MASON MALMUTH, ED MILLER & DAVID SKLANSKY, SMALL STAKES HOLD’EM: WINNING BIG WITH EXPERT PLAY 27–31 (Two Plus Two Publishing L.L.C. 4th prtg. 2009).
want the highest possible price, regardless of how much you paid for it. But appearances may be deceiving. Investors do not share the same information, and, as noted, we have to be careful about requiring the disclosure of private information that is costly to gather. One of the most sensitive pieces of information for any trader is her reservation price, as it reduces all of her private information to a single number. One of my best clues about how much you value an asset is the information that you, a sophisticated seller, bought the asset a minute ago for twenty dollars and are willing to sell it now for twenty-one dollars. I do not need to ask you anything about your private information as long as I can find out the price at which you are willing to buy and the price at which you are willing to sell. Claims in bankruptcy are no different from any other asset. Requiring a vulture investor to disclose the price at which she buys and sells a claim reveals her own estimate of its underlying value. At the limit, such a disclosure duty might have the same effect as a general duty to disclose.

Disclosure brings with it a second cost as well. As mentioned earlier, firms in financial distress, especially today, possess capital structures that are badly fragmented. The bankruptcy exchange provides a mechanism that allows those who trade to consolidate the different pieces and make the ownership claims simpler and more coherent. Disclosure obligations can make this harder. The challenge is analogous to the one facing the real estate developer mentioned in Part I of this Article.54 Suppose the developer wants to reassemble an entire city block.55 Disclosing the plan in advance invites hold-outs who will refuse to sell simply to capture some of the benefits the developer hopes to earn by reunited fragmented pieces of land.56 One can argue that those who try to acquire substantial positions in the fulcrum security of a firm in Chapter 11 should be able to do so free of disclosure obligations.57 We should allow investors to build positions, just as we allow those who try to assemble city blocks not to reveal what they are doing. All standard critiques of the Williams Act apply with full force in the bankruptcy context.58

54. See discussion supra p. 29 and note 34.
55. See sources cited supra note 34.
56. Id.
57. Exactly what disclosure obligations exist under current law are not clear. Unanswered are even such basic questions as whether bankruptcy claims are “securities” within the meaning of securities laws. See Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 AM. BANKR. INST. L. REV. 569 (2002). Also unclear is the equitable power to fashion regulations inside of bankruptcy analogous to Rule 10b-5. See 17 C.F.R. § 240.10b-5 (2008).
These objections to disclosure obligations, however, rest on the assumption that the underlying market is liquid. When the amount of trading that takes place in a given market is small, all bets are off. Distortions are possible. Prices may not reflect underlying values. For example, prices can rise or fall, not because of any underlying change in the true value of the firm, but because of an information mirage. A single trader mistakenly believes that another is trading on the basis of private information. She believes that the other has looked inside the black box when she has not. A third trader observes the first two trades, assumes that the second is not making a mistake, and draws an even stronger inference. An information cascade develops from just a small misstep.

When markets are illiquid, one must also worry about manipulation. A trader known to have private information would appear at an exchange and conspicuously sell. Others would infer that the private information was bad news and would sell as well. The price would fall. At this point, confederates of the insider would begin to amass a huge position at the now artificially low price. When the private information becomes public information, the price rises far above the original level. The informed trader and his confederates enjoy an even larger profit than they would have had if he relied on his information without manipulating the market simultaneously.

In the case of commodities contracts in the nineteenth century, the manipulation of most concern was the corner. A trader would secretly amass a huge portion of a particular contract (such as No. 2 soft red winter wheat for March delivery). At the same time, the trader would go long on the same commodity with short sellers. When the time came to deliver the wheat, the short sellers would not be able to acquire it because the trader would keep it off the market. The short sellers as a group would battle each other over the small amount that was actually available and the price would skyrocket.

The crucial, and largely unexplored, question is whether manipulations are possible on the bankruptcy exchange. Manipulation does not arise merely because a trader who knows an asset is undervalued tries to amass a large position at a low price. A trader who does this will, by virtue of her trading activity, raise the price. The trading activity pushes the price in the right direction. The price is never distorted in the sense that the trading

60. See CRONON, supra note 18, at 127–32.
61. Id. at 127.
62. Id.
63. Id.
64. Id.
brings the market price closer to its true value. While the bankruptcy judge might need disclosure to do her job effectively or distort the plan formation process, disclosure is not necessary to ensure that the market functions effectively merely because someone is trading on the basis of inside information. But one can imagine investors acquiring different positions in different tranches with a view to misleading others and turning things to their advantage.

In addition to the possibility of market manipulations, we need to worry about the way in which dispersed private information can undermine the liquidity of a market. One can imagine environments in which multiple parties possess private information, but none of them has an incentive to disclose what they know, even though each would be better off if everyone disclosed what they knew. Put differently, we face a collective action problem in which the individual benefits of disclosure are small, but the benefits of disclosure to the group as a whole are large. We face a trade-off between discouraging those with information from trading on it and ensuring that the market is sufficiently transparent that people will be willing to trade on it. It is axiomatic that the fewer the players, and the less active the trading, the less confident we can be that this will happen.

Existing theories of market design do not offer many lessons about the liquidity/transparency trade-off.65 It may be that for the moment the best we can do is focus on the concrete. It may be possible to be more pointed in asking what information the judge needs to decide the questions before her and what information the parties need to know to be able to negotiate with each other, while at the same time being aware of the costs of disclosure, even of things that seem both irrelevant and innocuous. Making this balance and exercising discretion wisely is yet another burden we must place on the modern bankruptcy judge.

IV. CONCLUSION

The bankruptcy forum has gone through dramatic evolution since the adoption of the Bankruptcy Code in 1978. It is no longer a sleepy place where traditional lenders and entrenched managers try to come to terms. In implementing the Bankruptcy Code, the modern bankruptcy judge creates a marketplace from scratch every time a large case is filed before her. Especially in a world of illiquidity, parties will assert—with greater or lesser degrees of credibility—that the judge’s decision to impose one set of rules or another will destroy either the firm or the marketplace for its securities. Insisting on coherent rules can make life hard for those who

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65. See Ruben Lee, What is an Exchange: The Automation, Management, and Regulation of Financial Markets 247 (1998) (“In sum, . . . it is . . . still difficult to draw robust conclusions from the literature concerning the effects or the merits of transparency.”).
make the most noise. In this world, the judge must resist the temptation to gravitate towards the decision that provides the easiest way to end the case. The smoothest path is not necessarily the one that promotes either the bankruptcy forum or the bankruptcy exchange. Until coherent norms emerge, the bankruptcy judge must seek out, as best she can, the most sensible set of regulations—including disclosure rules. Discovering these will bring the greatest rewards over the long run.
THE COSTS OF LIQUIDITY ENHANCEMENT: TRANSPARENCY COST, RISK ALTERATION, AND COORDINATION PROBLEMS

Edward J. Janger

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

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

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

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


8. See discussion infra Part II.
create a market for, a particular type of asset.¹ Often overlooked, however, when such liquidity enhancing doctrines are created, is that, historically, there has been a quid pro quo for the protection (good faith); these doctrines have been created sparingly; and they are narrowly tailored to facilitate particular types of transactions. These limitations exist because liquidity enhancement has costs, both to the transacting parties, and, seemingly paradoxically, to the market itself.

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

¹ Miller, 97 Eng. Rep. at 401. Lord Mansfield is quite clear on this point, basing the holder in due course doctrine on the fact that bank notes function as money substitutes:

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

Id.
I. LIQUIDITY ENHANCEMENT

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

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

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

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

14. Id.
15. Id. cmt 1–4.
16. § 2-403.
17. Id.
23. U.C.C. § 3-301 (2002).
these requirements the effect is powerful and surprising. A negotiable instrument is nothing more than a paperized debt obligation. The maker/issuer of a promissory note promises to pay the note according to its terms to a person entitled to enforce the note.24 The drawer/issuer of a check or draft instructs a third party to make payment on the instrument, and promises to pay the item according to its terms if it is dishonored.25 Up to this point, negotiable instrument law has merely made contractual obligations assignable. It has not altered the content of those rights. The holder of the instrument has no greater rights than the original payee or their transferor. The holder in due course doctrine, however, goes further. It gives a person who purchases the instrument for value and without notice of any competing claims against the instrument, or defenses on the underlying obligation, the right to enforce the note regardless of whether the obligor had valid defenses that could have been asserted against the original payee.26 Moreover, the holder in due course “owns” the instrument free of any claims from competing owners.27

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

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

26. U.C.C. § 3-305(a), (b) (2002).
27. § 3-305.
29. See supra text accompanying note 9.
30. Official Comment 2 to 3-104 explains that preventing surprise due to freedom from defenses is one of the reasons that “words of negotiability” are a requirement for the applicability of Article 3, and hence of the holder in due course doctrine. U.C.C. § 3-104 cmt. 2 (2002).
claims and freedom from defenses advantage the buyers and sellers of goods and negotiable instruments over the owners of goods and the issuers of negotiable instruments.

**B. NEW SCHOOL – STRUCTURED FINANCE**

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

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

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32. MARCIA STIGUM & ANTHONY CRESCENZI, STIGUM’S MONEY MARKET (4th ed. 2007).
34. See id. at 135 (explaining the use of special purpose vehicles “to separate the receivables from risks associated with the originator”).
35. Id.
36. Id. at 135–36.
37. Id. at 136–37 (discussing the impact of debt securities ratings on investor behavior).
38. The role of AIG in issuing bond insurance and credit default swaps is now well understood. See Adam Davidson, How AIG Fell Apart, REUTERS, Sept. 18, 2008, http://www.reuters.com/article/2008/09/18/sp-usmar5972272080918/articleOne?id=USMAR5972272080918&sp=true. One of the reasons that the Federal Reserve felt that it could not let AIG fail was that the evaporation of the credit default insurance policy would have constituted a default on many thousands of securitization facilities and would have
or tranching is used to give certain securities a distributional preference over others. Like the “freedom from defenses” that accompanies a holder in due course, these credit enhancements free the purchaser of the asset from the need to worry about the soundness of the underlying obligation.

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

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

C. NEW SCHOOL – CLAIMS TRADING AND CREDIT DERIVATIVES

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


national/national_story.php?id=29443.


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

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

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

II. THE COSTS OF LIQUIDITY ENHANCEMENT

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

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

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

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

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

**A. TRANSPARENCY OF THE ISSUER/ORIGINATOR/SELLER**

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

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

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

B. RISK ALTERATION

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

48. Id.
49. Id.
50. Janger, Muddy Rules, supra note 42.
To the extent that ABS purchasers receive even better treatment in bankruptcy than secured lenders, the externality associated with risk alteration is even more problematic. In this context, the exigencies of liquidity enhancement (freedom from claims) run smack into the bankruptcy policy of allowing debtors to use encumbered assets during reorganization. This, in turn, increases the risk faced by those employees, tort claimants, and other unsecured creditors who might benefit from a going concern reorganization.

C. DISTORTION OF MONITORING INCENTIVES

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

1. Conflict of Interest

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

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


55. Id. at 932.

56. Id.

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

2. Infeasibility – Transparency of the Investment

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

D. Agency Costs – “Empty Voting” in Bankruptcy

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

59. See SCHWARCZ, supra note 57.
60. See Scott, supra note 54, at 918.
62. See generally Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. ILL. L. REV. 775 (2005) (explaining that one share, one vote, does not make sense where hedging has separated the investor’s voting interest from his or her economic interest in the company).
monitoring incentives. But, the problem runs deeper than that in bankruptcy. In a reorganization case, debt claimants have governance rights.\(^6\)\(^3\) During the case, they have the power to object to non-ordinary course borrowing decisions, to non-ordinary course asset sales, to seek dismissal or conversion, and, more importantly, to vote on the plan of reorganization.\(^6\)\(^4\) When the holder of governance rights has a conflict of interest, the result is a principal/agent problem.

When a claim is repackaged and enhanced through the use of a credit default swap or other hedge, the voting rights may be divorced from the economic interest associated with the claim. In nonbankruptcy securities markets, derivatives trading may lead to the so-called “empty voting” problem, where a single investor may hold both an equity (stock) interest in a company and a short position against the same company.\(^6\)\(^5\) This hedge reduces the shareholder’s economic stake in the company. To make matters worse, the same shareholder may decide to “go short” by purchasing a greater amount of “insurance” than they hold stock. If they do this, the shareholder may actually benefit from a drop in the company’s shares value. They may, therefore, vote their shares against the company’s interest.\(^6\)\(^6\)

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

E. ANTICOMMONS PROBLEMS

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

\(^6\)\(^5\) Partnoy & Skeel, supra note 58, at 1034–35; Martin & Partnoy, supra note 62, at 778–79.
\(^6\)\(^6\) Recently, there has been speculation in the press that Chrysler bondholders may have refused to cooperate in the proposed out of court restructuring, at least in part, because they held credit default swaps issued by AIG. Ryan Grim, Confirmed: Barofsky Investigating Chrysler Bondholders, HUFFINGTON POST, May 6, 2009, http://www.huffingtonpost.com/2009/05/06/confirmed-barofsky-invest_n_197974.html.
derivatives might create these problems as well. 67 Worse yet, as discussed in Part III, this fragmentation, along with post-bankruptcy claims trading, may undercut the ability of debtors to cobble together a confirmable plan of reorganization.

F. ENDogeneity

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

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

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

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

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

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

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

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

III. WHEN LIQUIDITY AND REORGANIZATION POLICY COLLIDE

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

A. RULE 2019

A first example lies in the recent set of attacks on Federal Rule of Bankruptcy Procedure 2019. 79 Rule 2019 requires members of unofficial or ad hoc committees to disclose their holdings in the debtor. 80 As Judge Gropper pointed out in the Northwest case, this is a disclosure rule. 81 Because other creditors or interest holders may seek to free ride on the efforts of the Committee when deciding whether to support or oppose a plan of reorganization, Committee members are required to disclose their economic positions. 82 This is not an accident. Indeed, it is part of the logic

76. Id. at 24–42.
78. Id.
80. Id.
behind committees. Committee support of the plan of reorganization, it is hoped, will signal to the key constituencies that the plan is a good deal for similarly situated creditors.

This function is undercut when claimants who are not members of the Committee cannot discern the economic position of the members. However, it is quite possible that a member of an official or ad hoc committee may have purchased a claim at a discount or even hedged out the risk associated with its investment. Paradoxically, the holder of a claim may even reverse its economic position through the use of hedging and other strategies, such that it might benefit from the debtor’s failure to reorganize. Distressed debt investors, perhaps for this very reason, have objected vociferously to being forced to make this disclosure. They have argued that to do so will either shut down claims trading or force traders to avoid becoming members of a committee. Two courts have been convinced by this argument. A Texas court in In re Scotia Development, L.L.C. held that the disruption to the bond market would be too great to require committee members to comply with Rule 2019. By contrast, in In re Kaiser Aluminum, a Delaware case, committee members were required to disclose their positions but were allowed to do so under seal. Finally, and uniquely, Judge Gropper, in the Northwest case required the committee members to actually disclose their positions. The result was a firestorm, calling for repeal or amendment of the rule or reversal of the opinion.

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

83. Id. at 1420–21.
84. Id. at 1440.
85. Id. at 1435, 1443.
89. See Alexander, supra note 82, at 1421, 1424–27.
90. See id. at 1425, 1433, 1438–39.
92. Alexander, supra note 82, at 1416.
93. Id. at 1441–42.
different type, and not disclosed that position, such reliance may be misplaced.

B. CREDIT DEFAULT SWAPS, CLASSIFICATION, AND VOTING

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

C. BEYOND HOLDER IN DUE COURSE

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

Sure enough, when the issue was joined, Judge Gonzales subordinated Citibank’s claims.\textsuperscript{103} This then raised the question of whether the subordination of Citibank applied to the claims or whether the purchasers took free of the estate’s “subordination” claim against Citibank.\textsuperscript{104} Stripped to its bare essentials, the purchaser sought to be given the same treatment as

\textsuperscript{95} See supra text accompanying note 66.
\textsuperscript{97} Id. at 429.
\textsuperscript{98} Id. at 429.
\textsuperscript{99} Id. at 428.
\textsuperscript{100} Id. at 428–29.
\textsuperscript{101} Id.
\textsuperscript{102} Id.
\textsuperscript{103} Id. at 437.
\textsuperscript{104} Id. at 427–28.
a holder in due course. The bankruptcy court would have none of this and concluded that the subordination of Citibank ran with the claim and extended to the purchasers.105

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

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

CONCLUSION: CHAPTER 11 AS LIQUIDITY ENHANCEMENT

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

Modern advocates of liquidity appear to not care about the nature of the transaction or the holder of the claim. Neither do they consider the costs that might be incurred by granting protection. Indeed, whenever there is discussion of possibly curtailing the liquidity of claims after bankruptcy, the argument is that this effect would not be limited to the claims post-bankruptcy; it would also limit liquidity pre-bankruptcy.109 This may be true,
but it may not be relevant. On one level, Chapter 11 is a liquidity enhancing device all by itself. In the absence of Chapter 11, claims trading would stop with the declaration of bankruptcy or, at the most, upon the liquidation of assets. Bankruptcy would be a realization event. The existence of Chapter 11 and post-bankruptcy trading prevent the filing of a petition itself from operating as a realization event, from fixing the value of the claim. The claims continue to carry with them the value of a possible reorganization, and hence, increased value. To the extent that the possibility of a reorganization is actually liquidity enhancing, it stands to reason that liquidity regulation, or even limitation in the interest of bankruptcy reorganization, would not result in a deprivation of some inherent value held by the owner of the claim. When considering liquidity enhancement, it is appropriate, and indeed essential, to consider the costs that such enhancement might have for a debtor seeking to reorganize.
Professors Douglas G. Baird and Edward J. Janger have clearly and concisely spelled out why we need regulation of what Professor Baird calls “The Bankruptcy Exchange.” However, that is not necessarily to agree with Professor Baird’s contention that the bankruptcy judge has “established” the exchange in the same fashion that a medieval prince would organize a trade fair or that a group of merchants formed the Chicago Board of Trade. Nevertheless, today’s bankruptcy judge functions in an arena where claims trade constantly.

As Professor Baird demonstrates, not only do the bankruptcy judge’s decisions affect the trades, but the trades can affect the judge’s decisions as well. The concept that a judge’s decision in a case may affect the value of a claim is obvious. Although not as obvious, it is also true that trades may affect a judge’s decision. For example, in a recent case involving the valuation of a debtor for fraudulent conveyance purposes, the Third Circuit held that the value of a company’s stock in a market free of manipulation is virtually conclusive as to the solvency or insolvency of the enterprise.

Many other cases, including two of my own, have found that the value placed on an enterprise by a potential acquirer is highly probative when

* Allan L. Gropper is a United States Bankruptcy Judge for the Southern District of New York. These comments were presented at a symposium on securities regulation and claims trading organized by the Brooklyn Journal of Corporate, Financial & Commercial Law on February 27, 2009.


3. Id.

4. VFB L.L.C. v. Campbell Soup Co., 482 F.3d 624, 632–33 (3d Cir. 2007) (also called the “Vlasic Pickle case” as it involved the spinoff of that business). There, the court held that “[a]bsent some reason to distrust it, the market price is ‘a more reliable measure of the stock’s value than the subjective estimates of one or two expert witnesses.’” Id. at 633 (quoting In re Prince, 85 F.3d 314, 320 (7th Cir. 1996)); see also Statutory Comm. v. Motorola, Inc. (In re Iridium Operating L.L.C.), 373 B.R. 283, 293 (Bankr. S.D.N.Y. 2007) (the court stated that the public trading market “remains the best and most unbiased measure of fair market value and, when available to the Court, is the preferred standard of valuation”).
judging the opinions of competing expert witnesses. Professor Baird sums up the dangers of relying solely on trades in valuation disputes with the quip: “If the judge follows the market price at the same time those who trade in the market are following the judge, they will simply be chasing each other’s tails.” This is a good point to recall in the difficult area of valuation.

In any event, both Professors Baird and Janger convincingly demonstrate the importance of subjecting claims trading to some form of regulation. In particular, Professor Janger shows that liquidity enhancement has been overvalued in the bankruptcy context. Both professors correctly emphasize the importance and centrality of disclosure in any regulatory scheme. The bankruptcy judge is frequently asked to make decisions based on the views of the parties before him. Thus, when deciding whether to approve a compromise, the judge is directed to consider, among other things, “the paramount interest of the creditors and a proper deference to their reasonable views in the premises.” This is not to argue that we should simply accept the hue and cry of the majority, but as Professor Baird contends, we need to know who the creditors are. Trading in claims and fragmentation of interests make it particularly hard to determine who owns what and whose position should be accorded weight.

If we accept the need for regulation of this large and active market, two pressing questions present themselves: what type of a regulatory structure is required and what is its scope? Unfortunately, neither professor has answered that question; nor did any of the other participants in the Symposium. In light of the present administration’s determination to regulate so-called “exotic securities,” the need for an answer has become even more compelling in the months since the Symposium took place.

7. For example, he cogently examines the decision of the District Court in the Enron case holding that in the name of liquidity enhancement, equitable subordination defenses do not run with the claim where the claim is “assigned.” See Janger, supra note 1, at 55–56 (discussing Enron Corp. v. Springfield Assoc. (In re Enron Corp.), 379 B.R. 425 (S.D.N.Y. 2007), vacating, 340 B.R. 180 (Bankr. S.D.N.Y. 2006)). In order to extend the principle of liquidity enhancement, the court’s decision in Enron created a distinction between a sale and an assignment that has no basis in any law, including the Uniform Commercial Code, which does not distinguish between a sale and an assignment. See, e.g., N.Y. U.C.C. LAW §§ 1-201(32), 9-408 (McKinney 2001); see also N.Y. U.C.C. LAW § 9-404(a) (McKinney 2001); N.Y. GEN. OBLIG. LAW § 13-105 (McKinney 1963).
Derivatives and credit default swaps are usually included in the list of securities or instruments to be regulated, but there is no evidence to date that bankruptcy claims are on the agenda of the putative regulators.

In considering the kind of regulation and disclosure needed to make the bankruptcy process work properly, we must take account of the fact that we are writing on a fundamentally blank slate. There is virtually no regulation of the market for trading in bankruptcy claims at present, except for a few disclosure obligations discussed below. However, it is important to recognize that we have reached this point not because of a conscious decision to leave the market unregulated, but due to the absence of any decision.

There are many reasons why bankruptcy claims trading remains largely unregulated. While claims trading is as old as our nation,11 the explosion of claims trading that has taken place in recent years is unprecedented. Professor Baird suggests that the current market is in “the hundreds of billions of dollars.”12

There is also very little regulation in this area because the Bankruptcy Reform Act of 1978,13 for unknown reasons, omitted the provisions of §§ 21214 and 24915 of the former Bankruptcy Act of 1898,16 as well as former Bankruptcy Rules 10-21117 and 10-215(c)(4),18 which modified and supplemented them.19 Thereafter, the only rule that survived under the Bankruptcy Code, and that was construed as a substantive regulation of claims trading, was Bankruptcy Rule 3001(e).20 As adopted in 1983, Bankruptcy Rule 3001(e) left some room for the bankruptcy court to review vast market of exotic financial instruments known as derivatives, which fueled the global economic crisis and wounded some of the biggest names on Wall Street.”; see also Edmund L. Andrews & Louise Story, U.S. to Detail Plan to Rein in Finance World, N.Y. TIMES, Mar. 26, 2009, at A1; Zachary A. Goldfarb, Geithner Pushes Derivatives Plan; But He Warns Europe May Not Follow, WASH. POST, July 11, 2009 at A10.


19. Fortgang & Mayer, supra note 11, at 27–28. These provisions dealt principally with trading in claims by fiduciaries. Id.

the circumstances of the transfer of a claim.\textsuperscript{21} Originally, Bankruptcy Rule 3001(e) required that evidence of a claim transfer, together with evidence of the terms of the transfer, had to be filed with the bankruptcy court.\textsuperscript{22} The Rule also stated that “[i]f the court finds, after a hearing on notice, that the claim has been unconditionally transferred, it shall enter an order substituting the transferee for the original claimant, otherwise the court shall enter such order as may be appropriate.”\textsuperscript{23}

This Rule was largely ministerial. The filing of the required information with respect to the transfer disclosed the identity of the holder of the claim and the consideration paid. It also made clear the identity of the creditor for the purposes of voting and distribution.\textsuperscript{24} However, the Advisory Committee Note to the Rule indicated that some degree of court oversight was intended, when it stated:

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 the evils that may arise out of post-bankruptcy traffic in claims against an estate.\textsuperscript{25}

After the adoption of the amended Rule in 1983, decisions began to deal with the perceived “evils” of this “traffic”\textsuperscript{26} by entities that were not insiders or fiduciaries. One of the first cases was \textit{In re Revere Copper and Brass, Inc.}, where a trader had purchased claims at 20 cents on the dollar near the time the debtor publicly announced its intention to propose a plan that would pay 65 cents in cash.\textsuperscript{27} Although there were no objections to the notices of claims’ transfer under former Bankruptcy Rule 3001(e)(2), the court refused to grant routine approval to the transfers and required that the creditors be given more information and the right to rescind their sales.\textsuperscript{28}


\textsuperscript{22} \textit{Id.} The Rule excepted claims “based on a publicly traded note, bond or debenture” and thus preserved the unimpeded transferability of these securities. \textit{Id.} The Rule also set out different procedures for the transfer of claims for security and the transfer of claims before and after a proof of claim had been filed in court. \textit{See id.}

\textsuperscript{23} \textit{Id.}

\textsuperscript{24} \textit{See id.}

\textsuperscript{25} \textit{Id.} advisory committee’s note. The Advisory Committee Note cited several cases that illustrated such “evils,” all of which involved a breach of fiduciary duty by insiders or fiduciaries, including: \textit{In re Phila. & W. Ry. Co.}, 64 F. Supp. 738 (E.D. Pa. 1946); Monroe v. Scofield (\textit{In re Gallic-Vulcan Mining Corp.}), 135 F.2d 725 (10th Cir. 1943); \textit{cf. In re Latham Lithographic Corp.}, 107 F.2d 749 (2d Cir. 1939).


\textsuperscript{27} \textit{In re Revere Copper & Brass, Inc.}, 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985).

\textsuperscript{28} \textit{Id.}
Echoing the Advisory Committee Note to Bankruptcy Rule 3001(e)(2), the court wrote:

One of the evils attendant upon a solicitation of assignment of claims for a cash payment such as is being made by [the assignee] 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.29

Another case that illustrated the developing law was *In re Allegheny International, Inc.*,30 where the court, faced with an active trading market and incomplete public information on the status of the case,31 “echo[ed] the concerns expressed in *In re Revere Copper and Brass, Inc.*” 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.”32 The court expressed its concerns stating:

We do not believe that Congress intended the trafficking in claims such as has occurred in this case and others. Such concerns are evident from the 1983 Advisory Committee Note, although we recognize that the cases cited therein involved breaches of fiduciary duty . . . . Although this case does not involve inside knowledge, it is colored with superior knowledge, and thus the assignments are similar to contracts of adhesion. We hope that Congress will address these concerns in the future.33

Congress did not act to address these concerns positively. Rather, it responded to the *Revere* and *Allegheny* courts’ apparent concerns regarding the application of Bankruptcy Rule 3001(e) by amending it to remove any disclosure requirement pertaining to the price at which a transfer was made and expressly “limit the court’s role to the adjudication of disputes regarding transfers of claims.”34 The language in the prior Advisory Committee note relating to the “evils that may arise out of post-bankruptcy

29. *Id.* at 2.
31. *Id.*
32. *Id.* at 242–44. See also the court’s later decision in *In re Allegheny Int’l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).
33. *In re Allegheny Int’l Inc.*, 100 B.R. at 243. In *In re Ionosphere Clubs, Inc.*, involving the bankruptcy of Eastern Air Lines, the court found the *Revere* and *Allegheny* decisions inapposite, because the transferor and transferee were both sophisticated institutions with adequate information. *In re Ionosphere Clubs, Inc.*, 119 B.R. 440, 446 (Bankr. S.D.N.Y. 1990). The court canvassed the “evils” spawned by claims trading in large cases and expressed concern that the action of the parties there, in partially assigning claims, imposed on the debtors “the substantially increased burden associated with monitoring, administering and objecting to claims which have been filed against the estate.” *Id.* at 444.
traffic in claims was deleted and effectively overridden by the new Advisory Committee Note which stated that amended Bankruptcy Rule 3001(e) "is not intended either to encourage or discourage postpetition transfers of claims or to affect any remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim." In other words, the bankruptcy courts were told to keep out of the claims trading arena. Except in the few areas discussed below, and despite the enormous increase in bankruptcy claims trading since 1991, there have been no new decisions on the order of Revere or Allegheny.

Although there is no official report of the deliberations of the Rules Committee that recommended the amendments to Bankruptcy Rule 3001(e), it was suggested at the Symposium that the Committee may have viewed a ministerial rule like 3001(e) as being unable to deal with difficult and controversial policy issues, such as what a judge’s role should be in connection with the transfer of claims and what should be disclosed. The Rules Committee may have viewed the issues as appropriate for consideration by Congress, or perhaps the Securities Exchange Commission (SEC). Such a view is consistent with the express hope of the Allegheny court that Congress would deal with the issue. Nevertheless, after 1991, neither Congress, the SEC, nor any other group took up the task of addressing the issues of the judge’s role and the scope of appropriate disclosure concerning claims trading. The period from 1991 until 2008 was not conducive to the promotion of regulation in any sphere. As a result, there is virtually no regulation governing the market for bankruptcy claims.

This is not to say that there is no involvement at all by the bankruptcy courts that bears on some of the claims trading issues raised by Professors Baird and Janger. However, with the exception indicated below, most of the courts’ involvement has dealt with the effects of claims trading. The questions presented in such a situation often turn on whether a creditor has economic interests that are adverse to the class in which it votes.

37. The amendments became effective in 1991.
40. For example, the Bankruptcy Code provides that the court may, after notice and a hearing, invalidate the vote of "any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of" the Bankruptcy Code. See 11 U.S.C. §1126(e) (2006).
41. Some of the issues arising out of extensive trading in distressed debt are discussed in In re Adelphia Commc’n Corp., 359 B.R. 54 (Bankr. S.D.N.Y. 2006).
The sole exception to the absence of any regulation or rule-making is Bankruptcy Rule 2019. The rule originated in the 1930’s and in its current form requires the disclosure of certain information from informal or ad hoc committees of creditors. Until the decisions in the *Northwest Airlines* case in 2007, Rule 2019 was rarely enforced. The claims trading community responded negatively to the *Northwest* decisions, and it urged the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States to eliminate the Rule altogether. However, in July 2009, the Committee instead recommended the adoption of a revised Rule 2019 that preserves the principle of disclosure while meeting some of the traders’ principal concerns. While the current proposed revision deletes some of the required disclosures, it also strengthens the Rule by making it applicable to both official and unofficial creditor committees. As of August 2009, the revised rule has been published for public comment. The proposed amendments to Rule 2019 are a useful reference point as we approach the issue of regulation.

There was never a conscious decision that the enormous market in bankruptcy claims should not be regulated. In my opinion, it should be. Along with Professors Baird and Janger, the other participants in the Symposium have ably started the dialogue on this important issue. It is time that Congress turned its attention to it in a comprehensive fashion.

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42. FED. R. BANKR. P. 2019.
43. See id.
44. See *In re Northwest Airlines* Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007); see also *In re Northwest Airlines* Corp., 363 B.R. 704 (Bankr. S.D.N.Y. 2007). The decisions applied the disclosure requirements to an informal committee of security holders and refused to provide for the disclosure to be made under seal. *In re Northwest Airlines*, 363 B.R. 701; *In re Northwest Airlines*, 363 B.R. 704. (For full disclosure, these decisions were written by the author of this Comment).
47. Id.
The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code’s enactment in 1978. Claims trading has revolutionized bankruptcy by making it a much more market-driven process. The limited scholarly literature on claims trading, however, while recognizing its radical impact, has either focused on doctrinal issues or used claims trading as a touchstone for the “Great Normative Bankruptcy Debate” about whether bankruptcy should be a market process or a safe-harbor from the market. The result is that scholarly treatments of claims trading have operated with a high level of generality and scant evidentiary basis.

This Article argues that a more productive approach to claims trading must begin with a better understanding of its nuances. It shows that claims trading is a complex, multi-dimensional, and dynamic market with tremendous variation by timing, asset class, and trading motivation, and with different impacts on the bankruptcy reorganization process. Accordingly, the Article challenges the claim of Professors Douglas G. Baird and Robert K. Rasmussen that claims trading, along with other financial innovations, is detrimental to the bankruptcy process by creating an anticommons problem. The Article questions key assumptions underlying Baird and Rasmussen’s argument and suggests that rather than wreaking havoc on the bankruptcy process, claims trading might facilitate more efficient bankruptcy negotiations and help reorganizations.

In the abstract, however, claims trading’s net social welfare impact is indeterminate, and empirical examination is not possible because of the incomplete nature of claims trading disclosure requirements, which expose only changes in legal title, not economic interest. Given the complexity of the claims trading market and our limited knowledge of its operations and impact, regulatory approaches to claims trading should be narrowly targeted and noninvasive. A start would be to improve market efficiency by increasing unsophisticated creditors’ awareness of their claims trading options and by enhancing price disclosure to market participants through mechanisms like electronic quotation bulletin boards.
INTRODUCTION

The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code’s enactment in 1978. Claims trading has revolutionized bankruptcy by making it a much more market-driven process. Instead of serving as a forum for creditors to negotiate a restructuring of the debtor’s finances with the goal of limiting their losses, bankruptcy is now a general investment opportunity. The development of a robust market for all types of claims against debtors 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.

The changes wrought by claims trading have placed tremendous pressure on the bankruptcy reorganization structure set forth in Chapter 11 of the Bankruptcy Code, which was drafted with a relational creditor world in mind. Because of the changes that claims trading has unleashed on the bankruptcy process, it arouses passions unlike any other issue in the bankruptcy world. Yet, in spite of this, claims trading remains a poorly understood and little studied area of bankruptcy. Although there are a fair number of legal decisions that touch on aspects of claims trading, only a few squarely address the key policy issues involved. Exacerbating this problem, only a limited number of scholarly articles that discuss bankruptcy

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4. See, e.g., Enron Corp. v. Ave. Special Situations Fund II, L.P. (In re Enron Corp.), 340 B.R. 180 (Bankr. S.D.N.Y. 2006), vacated, Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.), 379 B.R. 425 (S.D.N.Y. 2007); Enron Corp. v. Ave. Special Situations Fund II, L.P. (In re Enron Corp.), 333 B.R. 205, 211 (Bankr. S.D.N.Y. 2005); Viking Assocs., L.L.C. v. Drewes (In re Olson), 120 F.3d 98, 102 (8th Cir. 1997) (under FED. R. BANKR. P. 3001(e), a court may not reduce the allowed amount of a claim to the amount paid by a claims buyer unless objected to by the transferor); Figter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Figter), 118 F.3d 635 (9th Cir. 1997); In re First Humancare Corp., 124 B.R. 87, 92 (Bankr. W.D. Mo. 1991) (claims purchase by debtor’s former management company to gain standing to file a plan to protect interest of the debtor was in good faith); In re Applegate Prop. Ltd., 133 B.R. 827, 836 (Bankr. W.D. Tex. 1991) (designating votes of an affiliate of the debtor that purchased a blocking position to thwart a creditor’s plan because it was done in bad faith); In re Allegheny Int’l, Inc., 118 B.R. 282, 289–90 (Bankr. W.D. Pa. 1990) (because of bad faith activities, the court designated votes of a claims purchaser who purchased to get a blocking position on a plan).
claims trading. The existing literature tends to focus on doctrinal issues created by claims trading, contains no discussion of the market mechanisms for claims trading and rarely delves into the differences among the varied trading practices that fall under the rubric of “claims trading.” Put another way, the limited literature on claims trading generally does not engage with claims trading’s realities.

Instead, claims trading is often used as a totem for a larger normative debate about bankruptcy: What interests should be served by bankruptcy policy? What relative weight should be placed on concerns of efficiency
and distributional fairness? Should bankruptcy merely be a procedural extension of the market or is it a safe-harbor from the market in which other values and interests are expressed? This Great Normative Bankruptcy Debate has focused on claims trading because it has been the leading factor in the marketization of bankruptcy.

This Article argues that it is unproductive to understand claims trading through the lens of the Great Normative Bankruptcy Debate. Burdening consideration of claims trading with the weight of this overarching policy debate has prevented a serious engagement with actual practice of claims trading. Instead, claims trading is frequently treated as a generic and stylized phenomenon, divorced from its more nuanced operation in practice.

This Article disaggregates the wide variety of investment practices that fall under the rubric of claims trading. It argues that claims trading is actually comprised of several overlapping and evolving markets that vary on dimensions of timing and asset class. These different markets have distinct mechanisms and distinct risks for buyers and sellers who are moved by a variety of motivations.

An examination of these markets shows that claims trading has cross-cutting impacts on the bankruptcy process with a net impact that is indeterminate on the available evidence. Accordingly, claims 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.

Part I of this Article connects the bankruptcy claims trading debate to the Great Normative Bankruptcy Debate and observes two problems that plague discussions of bankruptcy claims trading: a scant evidentiary basis and a high level of generality. Part II shows how claims trading is a multidimensional and dynamic market with tremendous variation by timing, asset class, and trading motivation. It demonstrates how some claims trading may be beneficial or neutral, while other trading activities are more problematic. This suggests that any regulatory approaches to claims trading should be narrowly targeted so as not to throw out the proverbial baby with the bathwater.

Part III considers an argument recently articulated by Douglas G. Baird and Robert K. Rasmussen (Baird and Rasmussen) that implicates claims trading, in general, along with other financial innovations, as detrimental to

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6. It is also possible to add in concerns of administrability. In the bankruptcy context, however, administrability is ultimately a question of efficiency and distribution. A case that is hard to administer takes longer and is more expensive, and the costs from the delay are borne by the residual claimant(s). For a discussion on the difficulty in identifying residual claimants, see Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341, 1342 (2004).
the bankruptcy process. Baird and Rasmussen point to claims trading as contributing to an anticommons problem that reduces the effectiveness of bankruptcy as a procedural tool for resolving the collective action problem of the race to the courthouse. Part III questions key assumptions underlying Baird and Rasmussen’s argument and suggests that rather than wreaking havoc on the bankruptcy process, claims trading may actually facilitate more efficient bankruptcy negotiations and help reorganizations. Part IV concludes with some suggestions for improving the claims trading market.

I. CLAIMS TRADING AND THE GREAT NORMATIVE BANKRUPTCY DEBATE

A. A TAXONOMY OF NORMATIVE VIEWS OF BANKRUPTCY

Over a decade ago, Douglas Baird mapped the world of bankruptcy scholarship as roughly divided into two loose camps: Traditionalists and Proceduralists. As Baird explained:

The [T]raditionalists believe that bankruptcy law serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise, if the protections that bankruptcy law provides were unavailable. By contrast, the [P]roceduralists deny that bankruptcy can work any special magic. Firms must live or die in the market. All bankruptcy can do is ensure that fights among creditors and other investors of capital do not accelerate a firm’s liquidation. For them, one does more harm than good by doing anything more to protect a firm from the forces of the market.

The division that Baird finds in the scholarship is also a different view of what bankruptcy’s relationship to the market process should be. Should bankruptcy be a part of or apart from the market? Is bankruptcy merely an extension of the market or a safe haven from it?

Ultimately, the camps diverge on the question of whether markets can be relied upon to produce optimal outcomes. Are markets always the answer? Traditionalists are more skeptical of markets than Proceduralists. Part of this skepticism is both expressed in and a function of how optimal outcomes are defined. Traditionalists, who often work on consumer bankruptcy issues, look at net social outcomes, while Proceduralists, who tend to focus on corporate reorganizations, focus on the firm, in keeping

7. Baird & Rasmussen, supra note 5 (manuscript at 6, 33).
9. Id. at 577–78.
10. There is a strange tension between the Proceduralist view of bankruptcy as a solution to a market failure due to a collective action problem and Proceduralists’ willingness to generally rely on a market they recognize as fallible.
with a long tradition of exclusively firm-focused corporate law scholarship.11 While many variations exist in these camps, it still remains a remarkably accurate intellectual cartography of the bankruptcy world.

B. NORMATIVE VIEWS OF BANKRUPTCY AND THE CLAIMS TRADING DEBATE

Baird’s taxonomy has remarkable explanatory power for understanding the debate about claims trading. Arguments being made against claims trading are very much Traditionalist arguments, while arguments being made for claims trading are Proceduralist arguments. For example, Harvey Miller, perhaps the leading practitioner advocate of the rehabilitation view of business bankruptcy, has argued that:

Distressed debt trading and changes in bankruptcy relationships have destroyed the symbiotic relationship of debtor and creditor . . . . Because Chapter 11 is premised upon a symbiotic relationship between debtor and creditor, it is becoming less effective in the context of distressed debt trading.12

Miller contends that the failure rate of large Chapter 11 cases is due in part to claims trading, as “distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments.”13 Similarly, Fredrick Tung has argued that claims trading upsets the community of interests involved in bankruptcy.14 Others have maintained that claims trading merely provides a mechanism for creditors to move in or out of this community.15 They argue that “distressed-debt investors generally have a salutary impact on the residual actor problem of bankruptcy by expediting business reorganizations and protecting going-concern enterprise values”16 or that “courts should encourage, rather than interfere with, the market in order to facilitate the significant benefits claims trading offers in bankruptcy.”17

In this light, it is worth considering the standard arguments about claims trading. These arguments in favor of claims trading are about efficiency and markets:

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13. Id. at 2016.
14. Tung, supra note 5, at 1718.
15. See, e.g., Levitin, Finding Nemo, supra note 5, at 87 (“The ability to sell bankruptcy claims provides an exit opportunity for creditors who do not wish to incur the hassle and expense of the reorganization process.”).
17. Rasmussen & Skeel, supra note 2, at 104.
1) Claims trading allows an exit for those creditors who want to cut loose from the bankruptcy process because of liquidity constraints,\(^{18}\) administrative hassle and expense,\(^{19}\) regulatory risk,\(^{20}\) to avoid an adversarial relationship with the debtor,\(^{21}\) or to establish a tax loss.\(^{22}\) There are significant risks, costs, and delays inherent in bankruptcies. Payouts are speculative and can take years to receive.\(^{23}\) Selling a claim allows a creditor to “cash out” at a certain price.

2) Claims trading permits an entrance to the bankruptcy process for those investors who want to take the time and effort to monitor the debtor and contribute expertise to the reorganization process.\(^{24}\)

3) Claims trading increases liquidity overall in capital markets and lowers the cost of credit as the option of avoiding the uncertainty of being a creditor in bankruptcy increases the risk tolerance of originating lenders.\(^{25}\)

4) Claims trading reduces transaction costs in the plan negotiation process by consolidating dispersed claimholders into a few large claimholders.\(^{26}\)

5) Claims trading reduces the administrative costs of bankruptcies by speeding up the reorganization negotiation process through consolidation of claimholders.\(^{27}\)

6) Claims trading creates a market for control in bankruptcy that might not exist absent a cramdown plan or a § 363 sale.\(^{28}\)

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18. \textit{In re} Kreisler, 546 F.3d 863, 864 (7th Cir. 2008) (“Claims trading allows creditors to opt out of the bankruptcy system, trading an uncertain future payment for an immediate one, so long as they can find a purchaser.”).


21. \textit{Id.}

22. \textit{Id.; see also} Goldschmid, \textit{supra} note 5, at 206.

23. Baird & Rasmussen, \textit{supra} note 5 (manuscript at 13).


7) Claims trading can result in a higher and/or quicker return for creditors because it imposes market discipline on debtors. If a reorganization is being run poorly, creditors will sell their claims, and the buyers will either push for a liquidation or attempt to take control of the reorganization.

Three more arguments not found in the literature might be added to the arguments above. First, claims trading ensures more efficient allocations of capital in the market by permitting entry and exit, which lets parties express their idiosyncratic valuations. Second, claims trading can facilitate reorganizations by bringing in parties who are willing and able to contribute the fresh capital needed to fund the reorganization process (Debtor in Possession (DIP) financing) and the newly reorganized company (exit financing). And third, claims trading may facilitate more sustainable reorganizations by enabling firms to emerge with lower leverage ratios.

Banks are generally prohibited from holding equity in non-financial operating companies. Therefore, bank creditors want their claims paid either in cash or in debt of the reorganized company. This either makes reorganization harder by requiring more cash on hand or adds to the debt burden of the reorganized firm, making the reorganization less sustainable and (all else being equal) increasing the likelihood of a refiling (a so-called Chapter 22).

Claims trading enables the replacement of bank creditors with hedge funds and private equity funds, which are able, and often eager, to take equity in the reorganized company. Thus, claims trading facilitates a shift in the composition of creditors that allows more flexibility in reorganizing and promotes more sustainable reorganizations.

These arguments emphasize efficiency gains both in bankruptcy and in the capital markets from claims trading. This contrasts with the arguments against claims trading, which raise countervailing efficiency concerns, as

29. Drain & Schwartz, supra note 5, at 575–76.
30. Thus, claims trading could result in a positive externality on creditors who do not trade but instead free-ride on the market discipline of the traders.
31. Bank holding companies are unable to hold equity in firms whose activities are not “so closely related to banking as to be a proper incident thereto.” 12 U.S.C. § 1843(c)(8) (2006); cf. 12 C.F.R. § 5.34(d)(2) (2009) (providing limitations on national banks’ operating subsidiaries).
32. Banks are more likely than hedge funds and private equity funds to have relationships with operating firms and originate loans.
33. For example, a hedge fund that purchases a claim at thirty cents on the dollar and gets paid out forty-five cents on the dollar in cash and new debt will likely be happy to take an equity piece as well and capture the potential upside of the firm (which is greater if the firm has manageable debt service).
34. Banks also prefer payouts in debt rather than equity in order to protect themselves in the event of a refiling and because debt would boost their earnings per share (EPS). EPS is not a relevant performance metric for hedge funds and private equity funds, so they are less driven by earnings.
well as concerns about procedural and distributional fairness, not just within the bankruptcy, but also to a larger community of interests:

1) Claims trading hinders bankruptcy plan negotiations by raising transaction costs of negotiation because the identity of creditors is churning, which makes it hard to lock in a deal.\(^{35}\) The delay imposes an externality on creditors who do not trade and reduces the value of the debtor’s estate.\(^{36}\)

2) Claims trading enables greenmail, insider trading, and other unfair practices that allow particular creditors to extract surplus rents.\(^{37}\)

3) Claims trading hurts unsecured creditors by making it harder to find creditors willing and able to serve on committees. Many creditors will not serve on committees because they wish to remain unrestricted for trading purposes, while others have purchased claims up and down the capital structure, and therefore, have conflicts of interest that preclude them from serving.\(^{38}\)

4) Claims trading encourages participation of creditors who value short-term returns on trades and quick monetization over the long-term value and viability of the debtor company.\(^{39}\) This can lead to deadweight loss through the destruction of going concern value and can lead to recidivism among debtors.\(^{40}\) The loss often has externalities on non-creditor community interests affected by bankruptcies.\(^{41}\)

5) Claims trading destroys the “symbiotic relationship of debtor and creditor” that is the premise of Chapter 11.\(^{42}\)

The arguments about claims trading roughly track the normative bankruptcy scholarship divide identified by Baird.\(^{43}\) Arguments in support of claims trading favor letting the market guide reorganizations, while the arguments

\(^{35}\) Baird & Rasmussen, supra note 5 (manuscript at 50).

\(^{36}\) The externality can include the loss of valuable net operating losses (NOLs) if the turnover in ownership is too high. See 26 U.S.C. § 382(f)(5) (2006).

\(^{37}\) Baird & Rasmussen, supra note 5 (manuscript at 50).


\(^{39}\) See, e.g., Miller & Waisman, Twenty-First Century, supra note 5, at 181; Miller, supra note 5, at 2016 (“distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments”); Harner, supra note 5.

\(^{40}\) Miller & Waisman, Twenty-First Century, supra note 5, at 182; Miller & Waisman, Is Chapter 11 Bankrupt?, supra note 5, at 153.


\(^{42}\) Miller, supra note 5, at 2014.

\(^{43}\) Baird, supra note 8.
against are skeptical of the market producing either efficient or fair results for the community of interests involved in a bankruptcy.

All of these arguments operate on a very high level of generality. The standard arguments about claims trading focus on whether claims trading should or should not be allowed. They are not arguments for regulating claims trading, but are instead arguments about it being either a positive or negative phenomenon.

This binary divide makes little sense, however. Are critics of claims trading really calling for an end to all claims trading or merely for some regulation of it? Are advocates of claims trading arguing for it to remain a virtually unregulated market, or simply arguing for claims trading to continue in some form? To date, no one seems to have called for an outright ban on claims trading. When pressed, proponents of claims trading will usually concede the need for some reforms in the market to curb such abuses as claims laundering, greenmail, insider trading, or to protect unsophisticated trade creditors.44

When confronted with claims trading as an actuality, rather than as a way for expressing normative views on bankruptcy policy, the binary arguments collapse into a spectrum of more regulation to less regulation. This spectrum, however, contains relatively few regulatory proposals. To the extent that arguments about claims trading are really about claims trading, rather than a normative vision of bankruptcy, it has a thin evidentiary basis which forces claims trading to be addressed in a highly generalized manner.45 These features limit the debate to being little more than an imperfect battleground for the Great Normative Bankruptcy Debate.

C. THE THIN EVIDENTIARY BASIS FOR THE CLAIMS TRADING DEBATE

The debate over claims trading operates on a limited evidentiary base. Arguments about claims trading are based on theory, common sense, and anecdote, but not data. Empirically, we know relatively little about claims trading. What is the volume of claims trades in number? In amount? What percentage of claims change hands? How frequently do claims trade? Who buys and who sells? How many discrete buyers are there? How many are prepetition creditors? Does trading result in a consolidation or dispersal of holdings and to what degree? How much variation is there by case? By asset class? By timing within a case? By type of debtor? How does the pricing change over time? How accurate of a predictor of plan payouts is

44. See generally Conti, Kozlowski & Ferleger, supra note 5, at 287, 296, 299 (discussing specific claims trading abuses and the need for reform through proper disclosure).

45. Notable exceptions are: Baird & Rasmussen; supra note 5; Drain & Schwartz, supra note 5; Goldschmid, supra note 5; Levitin, Finding Nemo, supra note 5; and Levitin, The Limits of Enron, supra note 5.
the claims market? And how does this all compare to distressed debt trading on the doorstep of bankruptcy?

No one has a handle even on the most elementary questions like the size of the bankruptcy claims trading market, either in terms of face value of claims trading hands or the volume of transactions. There is broad consensus that there is a large and growing market in claims. Academic articles place the market at hundreds of billions. One company attempting to create an exchange in trade claims estimates this piece of the market to be worth $75 billion. It is not clear what that number is actually measuring—total par value of claims, total amounts paid for claims, etc. Moreover, it is unclear how anyone could arrive at any number. The data simply does not exist.

The reason that we do not know the extent of the claims trading market is because it is largely invisible in court records. Claims trading is an over-the-counter (OTC) market, so there is no exchange that can provide information. The sole specific regulation of claims trading, Federal Rule of Bankruptcy Procedure 3001(e) (Rule 3001(e)), states that notice of claims trades be filed with the court, although no particular timeliness is required. The Rule 3001(e) filing requirement applies only when the actual claim changes hands, however, not when the beneficial interest represented by the claim changes hands. This means that many economic claims trades are not reported with the court.

In particular, two major categories of claims—bank debt and bond claims—do not show up in Rule 3001(e) filings. Bank debt is often syndicated; only the administrative agent for the syndicate (typically the lead bank) will file a claim in the bankruptcy. The syndicated interests (assignments or participations) might change hands, but it will not be reflected in a Rule 3001(e) filing.

46. See, e.g., Drain & Schwartz, supra note 5, at 569–70 (noting the “formation of numerous distressed debt funds with assets in excess of $1 billion” in 2002); Rasmussen & Skeel, supra note 2, at 101 n.71 (providing financial figures on claims trading); Tung, supra note 5, at 1685 (noting an estimate of the claims trading market “as high as $300 billion” in 1996).


48. There is a nascent attempt to create a claims trading exchange in the so-called Trade Receivables Exchange (T-REX), now part of Second Market. See Second Market, Bankruptcy Claims, http://www.secondmarket.com/markets/bankruptcy-claims.html.

49. Generally applicable laws on fraud and contract apply to claims trades, of course. See generally Drain & Schwartz, supra note 5. For certain types of claims, federal and/or state securities laws may apply as well.

50. See Groshong, supra note 5, at 642.

Trades in bank loans are also unlikely to be visible in Rule 3001(e) filings because the economic interest in the loan could be separated from legal title to the loan due to a total return swap (TRS). A bank loan TRS is an OTC derivative product in which a bank (the funding bank) agrees to swap the total return (all interest and fees) on a loan it funds (or has purchased) in exchange for periodic payments by the swap counterparty (typically a hedge fund) of LIBOR plus a spread. The bank thus ends its exposure on the loan for the duration of the swap (typically one year), but makes a profit on the difference between its own cost of funding the loan and the payments it receives from its swap counterparty.

In a TRS, the funding bank retains legal title to the loan and performs all ministerial acts, including filing of bankruptcy claims, but the economic interest in the loan is transferred to the swap counterparty. There are three potential TRS-related transactions that would not be visible. First, a TRS could expire postpetition. This would have the effect of transferring the economic interest in the loan back to the funding bank. Second, a TRS could be entered into postpetition on an existing loan (unlike a credit default swap). And third, the funding bank’s swap counterparty could assign its interest to another party postpetition. None of these transactions would be observable in Rule 3001(e) filings because legal title for the loan remains with the funding bank, even as the economic interest in the loan shifts.

For bonds, there will be only one claim filed per indenture, and it will be filed by the indenture trustee. Thus, there will be no Rule 3001(e) filings evident for trades in the debtor’s bond debt. Trades in claims for two large slices of the capital structure of bankrupt companies are simply invisible.

52. Philip Nisbet & Mark Herzinger, Bank Loan Total Return Swap Primer, in THE HANDBOOK OF LOAN SYNDICATIONS & TRADING 680, 684, 693 (Allison Taylor & Alicia Sansone eds., 2007). The size of the TRS market for North American bank loans is estimated to be $75 billion. Id. at 681, 693. Banks require their TRS counterparties to post collateral to cover counterparty payment risk, but the collateral is usually a fraction (a “haircut”) of the amount of the reference loan(s) for the swap. Id. at 681, 692–93. This means that TRS are actually a device for leveraged investing. In recent years, up to 10x leverage has been available. Id. at 698. To illustrate, consider a TRS on a $10 million bank loan. If the bank’s swap counterparty wanted to fund the loan itself, directly, it would need to tie up $10 million in the loan. The bank, however, might only require $1 million in collateral for a TRS. Thus, the counterparty will be able to achieve the return on a $10 million loan (minus LIBOR plus the spread) while only tying up $1 million. See id. at 697 (providing additional sample calculations). Of course, the swap counterparty is responsible for its payments regardless of the total return on the bank loan, so such leverage carries significant risks.

53. Id. at 684. Bank capital requirements do not require banks to hold specific risk-based capital for perfectly hedged assets in their trading books and counterparty risk can be covered by posting of sufficient collateral, which is part of the TRS transaction. O.C.C. Interpretive Letter No. 893 (Nov. 23, 1999), available at http://www.occ.treas.gov/interp/oct00/int893.pdf. Therefore, banks have extremely low costs of funding for loans hedged by TRS (which are perfectly matched hedges, so the difference between the swap counterparty’s period payments and the bank’s cost of funding—the bank’s profit of the TRS—is substantial).
The trades that are visible are primarily trades in unsecured trade debt. In large Chapter 11 cases (Mega-Cases), there is clearly an active market in such claims, as their case dockets are peppered with Rule 3001(e) filings. These trades will range from claims as small as a $40 claim by a locksmith (such a trade occurred in Footstar’s bankruptcy\(^{54}\)) to multi-million dollar claims,\(^{55}\) but many are relatively small, under $1,000.\(^{56}\) While it would be possible to undertake an empirical study of claims trading based on Rule 3001(e) filings, it would necessarily be incomplete, and there is good reason to believe that the market in unsecured trade and vendor claims looks different from the market in bond claims or bank debt.

To the extent that claims trading has received scholarly attention, it is in the context of Mega-Cases,\(^{57}\) yet there are many smaller business bankruptcy cases, ranging from small businesses that file under Chapter 13 to small cap, middle market, and even sizeable Chapter 11’s with publicly traded debt securities that are not Mega-Cases. We know almost nothing about claims trading dynamics in the medium and small business cases. For those small businesses in Chapter 13, the dynamics presumably resemble those of Chapter 13 consumer debtor cases. But for the smaller Chapter 11 cases, it is not clear how much claims trading there is or what its purpose is. Not surprisingly, given the epistemological limitations on any discussion of bankruptcy claims trading, the debate usually operates at a high level of generality, lumping all claims trading together.

The claims trading debate is hindered by this level of generality. At best, with a high level of generality, all we can say is that the net impact of claims trading is indeterminate.\(^{58}\) Unpacking the various practices that fall under the claims trading rubric is a necessary first step in advancing a more productive discussion about claims trading’s impact on bankruptcy. The following section considers some of the key variations in the claims trading market and their likely impacts on the bankruptcy process.

\(^{54}\) See Notice to transfer of Claim pursuant to rule 3001(e)(1) from A & Z Lock & Key to Revenue Management, In re Footstar, No. 04-22350 (Bankr. S.D.N.Y. June 22, 2004).


\(^{57}\) See, e.g., Levitin, Finding Nemo, supra note 5, at 89 (discussing Enron’s effect on bankruptcy claims trading); see generally Levitin, The Limits of Enron, supra note 5 (discussing the subordination that buyers of bankruptcy claims will be subjected to post-Enron); Kenneth M. Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts? 15 (March 2009) (Univ. of Penn. Inst. for Law & Econ. Research, Paper No. 09-05, Nw. Law & Econ. Research Paper No. 09-05, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639 (discussing Lehman Brother’s decision to file for bankruptcy and the effects on government intervention).

\(^{58}\) Levitin, Finding Nemo, supra note 5, at 89.
II. THREE-DIMENSIONAL CLAIMS TRADING

Claims trading is a multi-dimensional and dynamic market that encompasses trades in claims based on a variety of types of debts and trading motivations. The market varies on three dimensions: temporally, regarding when claims trading takes place; qualitatively, regarding what is traded; and motivationally, regarding trading strategies. As an initial matter, however, it is necessary to define claims trading. We often speak of “bankruptcy claims trading,” but what is it about a bankruptcy claim that distinguishes it from a regular debt claim? Answering this requires us to first consider the temporal dimension of claims trading.

A. THE TEMPORAL DIMENSION: ARE BANKRUPTCY CLAIMS A DISTINCT MARKET?

From a legal perspective, there are many possible distinctions between a bankruptcy claim and a regular debt. In an earlier work, I noted that the Bankruptcy Code’s definition of “claim” was arguably broader than what might be commonly thought of as a debt because it included disputed, contingent, and unliquidated payment obligations. I also noted that not all debts were enforceable in bankruptcy, that a bankruptcy claim carries rights with it that are distinct from those that are part of a debt, and that bankruptcy endows a claim with a relational aspect that does not exist in a debt. Filing for bankruptcy can also accelerate debts that have not yet become due outside of bankruptcy.

Although there is a legal distinction between a bankruptcy claim and a regular debt, they are both rights to use the legal system to collect value from another. The value of those rights depends on legal distinctions, such as whether the collection takes place through state law or federal bankruptcy law, whether or not a claim is ultimately allowable, and, if so, in what amount, with what priority, and with what voting rights. Buying or selling either a bankruptcy claim or a regular debt is a gamble on this constellation of risks, but the market is concerned about these distinctions.

59. 11 U.S.C. § 101(5)(A), (B) (2006) defines a “claim” as:

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.


61. Levitin, Finding Nemo, supra note 5, at 170.
only to the extent that they are meaningful markers of risk and value. Yet, the market import of legal distinction between bankruptcy claims and distressed debt depends on whether it is in a consumer or a business context.

### 1. Consumer Debt

Within consumer claims, there are a few submarkets, temporally. First, there is a market involving the resale of consumer debt as part of routine securitization transactions.\(^6^2\) Second, there is a market for delinquent debt of non-bankrupt consumers.\(^6^3\) Third, there is a market for consumer bankruptcy claims, many of which were previously delinquent.\(^6^4\) And fourth, there is a market in “zombie” debt that has been discharged in bankruptcy.\(^6^5\) These temporal submarkets are further divided by asset type. Although many claims buyers will deal in all types of consumer debt, there are some that specialize in credit card debt, mortgages, auto loans, student loans or medical debt.\(^6^6\)

The key temporal distinction, however, in consumer cases is the bankruptcy status of the obligor. There is a distinct market for bankruptcy debt from delinquent or regulatorily “charged-off” debt.\(^6^7\) This is due to the

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64. Moss, *supra* note 5, at 646.

65. This discharged debt is called “zombie” debt because there are still attempts to collect it even though it is legally unenforceable, making it a financial “undead.” Liz Pulliam Weston, “Zombie” Debt Is Hard to Kill, http://articles.moneycentral.msn.com/SavingAndDebt/ManageDebt/ZombieDebtCollectorsDigUpYourOldMistakes.aspx. Debtors will sometimes pay discharged “zombie” debt because they do not know that the debt is no longer enforceable; because they do not want to deal with the harassment of (illegal) debt collection; because of a sense of moral obligation to repay debts, regardless of their legal status; because they hope it will help their credit rating; or because repayment of the debt is a precondition for receiving new financing or other consideration. Some courts have held that the purchase or sale of discharged debt, leading to subsequent collection activity, can be a violation of the discharge injunction. See, e.g., *In re Nassoko*, 405 B.R. 515, 520–21 (Bankr. S.D.N.Y. 2009) (sale of discharged debt could provide basis for violation of discharge injunction); Gunter v. Kevin O’Brien & Assoc. Co. (*In re Gunter*), 389 B.R. 67, 73 (Bankr. S.D. Ohio 2008) (failure to inform the purchaser of the discharge is itself a violation of the discharge injunction); *In re Lafferty*, 229 B.R. 707, 714 (Bankr. N.D. Ohio 1998) (“The selling of accounts is a deliberate act to collect on a discharged debt.”); Walker v. M&R Dodge, Inc. (*In re Walker*), 180 B.R. 834, 844 (Bankr. W.D. La. 1995); *In re Roush*, 88 B.R. 163, 165 (Bankr. S.D. Ohio 1988) (“[T]he burden of establishing procedures adequate to minimize or eliminate this problem was upon the creditor.”); *In re Conti*, 50 B.R. 142, 146 (Bankr. E.D. Va. 1985) (“The IRS is not privileged to ignore the dischargeability of certain taxes because of the burden or inconvenience which it may cause.”). But see Finnie v. First Union Nat’l Bank, 275 B.R. 743, 746 (E.D. Va. 2002) (sale alone of discharged debt is not a collection action in violation of the discharge injunction).


67. Generally accepted accounting principles prohibit non-performing assets from remaining on a balance sheet but do not specify specific dates for which they must be “charged-off.”
differences in collecting bankruptcy claims and merely delinquent debt. A
creditor in a consumer bankruptcy case only has to file a proof of claim or
be listed on a debtor’s schedule, and, unless the claim is challenged or the
creditor objects to the plan, the creditor will receive its allocated payment
from the bankruptcy trustee. Generally, it is a passive investment process.

This contrasts with investing in delinquent, but non-bankrupt consumer
debt, which will usually payout only if there are active collection efforts,
such as dunning calls and letters. This is a much more labor-intensive
business model that results in very different pricing for bankruptcy and non-
bankruptcy consumer claims most clearly visible in the pricing of
unsecured debt in Chapter 13.

Because 93–96% of Chapter 7 cases are “no-asset” cases, most of the
consumer bankruptcy claims market is in Chapter 13 claims. $72.35
billion in consumer claims were sold in 2008. Around three-quarters of
the total market ($55.527 billion) was credit card debt, and Chapter 13
claims accounted for around a quarter of face value of the consumer debt
resale market. Whereas a dollar of credit card debt sells on average for
10–11 cents in a Chapter 13 case, it will only sell for 2–3 cents outside of
bankruptcy. Thus for consumer claims, there is a distinct bankruptcy
claims market based on different collection models.

The temporal pricing variations for different types of consumer debt
also inform an important debate issue in consumer finance about the effect
of bankruptcy recovery rates on the cost and availability of consumer credit,
especially to the riskiest consumers. In theory, if limits on dischargeability
resulted in greater returns for creditors, they would result in lower costs for
borrowers and/or greater credit availability, assuming perfectly efficient,
complete markets. The assumption of perfect or complete markets is

Banking regulation, however, requires that financial institutions “charge-off” non-performing debt
after a specified lapse of time: 180 days for open-end credit and 120 days for closed-end credit.
Uniform Retail Credit Classification and Account Management Policy, 64 Fed. Reg. 6655, 6657
(Feb. 10, 1999).

68. See 11 U.S.C. § 502(a) (2006). This provision applies to business bankruptcies as well. Id.
69. W. Clarkson McDow, Jr., Protecting the Integrity of the Bankruptcy System in Chapter 7
(last visited Sept. 15, 2009) (ninety-six percent of Chapter 7s in 2000 were no-asset cases); Dalí Jiménez,
(ninety-three percent of consumer Chapter 7s were no-asset cases).

70. See Credit Card Debt Sales in 2008, THE NILSON REPORT, Mar. 2009, at 10, 10
[hereinafter NILSON REPORT].
71. Id.
72. Id.
73. Id.
74. Id.
generally problematic, and there is mixed evidence on whether greater dischargeability actually affects the cost or availability of consumer credit. Given that the price of unsecured Chapter 13 debt is so much higher than the price of equivalent debt outside of bankruptcy, it raises the question of whether changes in bankruptcy law that would broaden the scope of the discharge and enhance the debtor’s fresh start in life would have adverse consequences on consumer finance markets. As long as the bankruptcy return (and hence the price of bankruptcy claims) is still greater than that of the equivalent debt outside of bankruptcy, policies that make bankruptcy more attractive to defaulted consumers should not affect consumer credit pricing. When faced with a defaulted debt, the relevant consideration for a creditor is the trade-off between state law and bankruptcy as collection methods (or restructuring the debt). In many cases, bankruptcy may be a more attractive option for creditors. State law collection, especially of unsecured debts, is ineffective because of limitations on garnishment and asset exemptions. Bankruptcy, on the other hand, requires payments to be made if there are nonexempt assets or disposable income.

2. Business Debt

In the business context, in contrast, bankruptcy claims do not constitute a distinct market from distressed debt, in part because the collection efforts involved do not vary significantly depending on bankruptcy. Historically, there was a distinct “bankruptcy claims” market that was thin and highly specialized. Claims traders bought claims only after a plan was proposed. They assumed only plan vote and feasibility risk, which was de minimis. The plan was a public document, and investors looked to pick up claims on the eve of the vote.

Over the past two decades, however, investors began buying claims earlier and earlier. Now, investors trade in distressed debt well before

77. See id. at 602 (suggesting that Chapter 13 cramdown would result in smaller losses than state law foreclosure for mortgages).
78. See id. at 644.
79. See id. at 579; see also 11 U.S.C. § 1325(b) (2006).
80. Levitin, Finding Nemo, supra note 5, at 92.
82. Id.
83. Id.
84. Id.
bankruptcy.\textsuperscript{85} Instead of distinct markets based on whether the obligor is bankrupt or not, there is a general distressed debt market with a variety of investment strategies based on timing.\textsuperscript{86} The segmentation that exists in the market is not based on bankruptcy status, but rather on asset class.\textsuperscript{87}

The lack of temporal distinction between bankruptcy and non-bankruptcy claims trading in the business claims context is important because it suggests that regulatory cost spillovers would be much more severe in the business claims context.\textsuperscript{88} Because business bankruptcy claims are part of a broader market in business debt obligations, regulation of bankruptcy claims trading would also affect activity elsewhere in the broader market. While there might be good bankruptcy policy reasons to regulate bankruptcy claims trading in particular ways, the policy analysis has to consider the impact on non-bankruptcy claims trades in a way that it might not in the consumer claims context.

\textbf{B. THE QUALITATIVE DIMENSION: MARKET SEGMENTATION BY ASSET CLASS}

\textbf{1. Consumer Debt}

The consumer claims market is entirely distinct from the business claims market. It has also been largely overlooked by the academic literature, other than in context of the Fair Debt Collection Practices Act, even though claims buyers represent an important class of consumer bankruptcy creditors, especially for credit card debt.\textsuperscript{89}

Most of the claims traded in consumer bankruptcy cases are in unsecured claims, especially credit card debt claims.\textsuperscript{90} Consumer claims trading also occurs primarily in Chapter 13 debt because almost all Chapter 7s are no-asset cases.\textsuperscript{91} As Guy B. Moss has noted regarding consumer Chapter 7s:

If the aim of the buyer is to realize on the upside potential of the claim based solely on the ultimate dividend payable from the estate, the prospects appear marginal. If, instead, the buyer’s aim is to realize on all or a significant part of the entire claim by attacking the debtor’s discharge or the dischargeability of the claim purchased by taking advantage of the debt reaffirmation provisions of the Bankruptcy Code, or by inducing voluntary payments after the discharge enters, the prospects are at best

\begin{itemize}
  \item \textsuperscript{85} Id.
  \item \textsuperscript{86} Id.
  \item \textsuperscript{87} Id.; see also Michelle M. Harner, \textit{Trends in Distressed Debt Investing: An Empirical Study of Investors’ Objectives}, 16 AM. BANKR. INST. L. REV. 69, 71 (2008).
  \item \textsuperscript{88} Levitin, \textit{Finding Nemo}, supra note 5, at 151–60.
  \item \textsuperscript{89} For a major exception, see Moss, supra note 5.
  \item \textsuperscript{90} See NILSON REPORT, supra note 70, at 10.
  \item \textsuperscript{91} McDow, supra note 69.
\end{itemize}
uncertain, in many respects fraught with risk, and, of course, subject to the potential costs of litigation. 92

Accordingly, the Chapter 7 consumer claims market is much more limited than the Chapter 13 market.

Consumer claims trading is a fairly concentrated industry, with ten firms holding over 80% of resold consumer debt (excluding sales that occur as part of securitization transactions) and a similar percentage for credit card debt. 93 Apparently, concentration is much higher for bankruptcy claims, as executives at eCast Settlement Corporation (formerly a Bear Stearns affiliate, now a JPMorgan Chase affiliate) estimate that eCast and two other major consumer debt buyers hold 70% of consumer credit card debt in Chapter 13 bankruptcies. 94 eCast and the other buyers purchase the credit card debt and occasionally other types of unsecured debt, such as auto loan deficiencies in bankruptcy cases, at 10–15 cents on the dollar depending on a variety of actuarial factors, including the judicial district, the judge and trustee, and account features. 95

Typically, in consumer cases there is only one trading moment in bankruptcy for any particular claim—a debt buyer purchases a claim and holds it through the case. In consumer cases, claims trading operates on a single basic strategy—buy low and get a higher payout. The risk of a lower than anticipated yield is mitigated through diversified investment in thousands of cases. 96

Because there is no voting in Chapter 7, 12, or 13 cases, the value of a claim is its payout value, but that payout value can be manipulated because a claim gives the claim holder standing to make motions as a party in interest. A motivated professional Chapter 13 creditor, like a claims buyer, might also strategically bring frivolous litigation to boost its payouts. Frivolous or not, on a one-off basis, it is simply not worthwhile to bring much litigation over a $3,000 or $8,000 claim. Consumer debtors, however, can rarely afford to litigate such matters. Thus, the threat of litigation, enhanced by the occasional noisy example, can result in greater payouts.

Consumer claims trading raises two key policy concerns. First, can the claims purchaser actually prove title to the claim and the requisite facts to support the claim? 97 And second, might claims trading be used to “laundrer” the claim? 98 The consumer debtor might have a claim against the lender that

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92. Moss, supra note 5, at 643 (internal citations omitted).
93. NILSON REPORT, supra note 70, at 10.
94. Telephone Interview with Mark Jackwicz, Executive Vice President & Kwang Thomas Choi, Executive Vice President, eCast Settlement Corp. (Sept. 11, 2008) (on file with author).
95. Id.
98. See Levitin, Finding Nemo, supra note 5, at 141.
could result in the claim being disallowed, equitably subordinated, or subject to setoff. The sale of the claim by the lender to a third party would prevent the consumer from prosecuting its action against the lender in the bankruptcy forum, preventing the consumer from having the debt disallowed, subordinated, or setoff, in the hands of the purchaser. The lender can thus “launder” the claim and monetize it based on its untainted value, while the buyer remains impervious to the consumer’s claims.

2. Business Debt

Business debt claims fall into roughly four asset classes: bond debt, bank debt, trade debt, and tort debt. Some investors will purchase claims in any and all classes, while others limit themselves to particular classes. These types of debt differ not only based on where they are in the capital structure, but also on the risks that a purchaser assumes.

a. Bond Debt

Claims based on bond debt are by far the most liquid type because bond debt is a commodity with relatively fewer risks attached to it than other asset classes. There is little risk about whether bond debt will be disallowed, subordinated, or subject to clawback actions. The validity and amount of the bonds are not in question and the bondholder and indenture trustee have no dealings with the debtor that would create equitable subordination grounds. Most bonds are unsecured, so there is no strong-arm risk. Moreover, because bond debt trades publicly, there is little counterparty risk involved in the trades because of the use of large financial institutions as broker-dealers; there is no question whether the party that is selling the claim actually owns it. There is minimal diligence involved in a bond debt trade, and the identity of counterparties is typically not known, making more serious diligence impossible.

There is also typically a rough symmetry of sophistication between parties in bond debt trades. Most corporate bonds are owned by financial

100. For a discussion of claims washing in the business bankruptcy context, see Levitin, Finding Nemo, supra note 5, at 145 and Levitin, The Limits of Enron, supra note 5, at 404. The consumer context may raise different equities and policy concerns than the corporate context even though there is but “one Code to rule them all.” See J.R.R. Tolkein, The Lord of the Rings, Part One: The Fellowship of the Ring 55 (Ballentine Books 1965) (“One ring to rule them all. . .”).
102. 11 U.S.C. §§ 502(b), (d), 510(c) (2006).
103. The so-called “strong-arm” provision of the Bankruptcy Code, 11 U.S.C. § 544(a) (2006), permits the trustee to avoid most liens that are unperfected at the time of a bankruptcy filing.
institutions, not by individual investors. Accordingly, bond debt trades do not raise concerns of sophisticated investors fleecing naïve mom-and-pops.

b. Bank Debt

Bank debt is commonly syndicated, participated, or both and, trades in slices, rather than whole loans. The syndications now are written with an eye to trading, a contrast from past practice, when bank loan syndications were often restricted to banks, out of concerns about the different accounting rules and non-banks’ ability to make further advances to the debtor.

Bank debt bears more risks for a claims purchaser than bond debt because it might be subject to disallowance due to clawback actions. Bank debt is almost always secured, but a lien might turn out to be unperfected and subject to avoidance. There is also risk of equitable subordination for misbehavior by the bank.

On the other hand, bank claims provide a purchaser with information and leverage that is not available to a bondholder. Bank loans typically have various reporting covenants beyond what exist in bond indentures. The access to the information is hugely valuable to an investor. Thus, bank debt is particularly attractive, especially to purchasers pre-bankruptcy, who will end up with a large informational advantage on the market.

Bank debt also provides a claims purchaser with far more leverage over the debtor, especially before bankruptcy. There are many more covenants in bank loans, which make defaults more likely, but which offer the purchaser of bank debt the possibility of forbearance fees, additional security, or

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105. Harner, supra note 5, at 712 (reporting that banks are “increasingly syndicating commercial loans or selling their loans once a company experiences financial distress”); see also Marc Bennett, Buying and Selling Bank Debt, HEDGE FUND NEWS, May 2003, http://hedgefundnews.com/news_n_info/article_detail.php?id=287 (describing how banks trade “pieces” of troubled loans, and how participation may be used as an alternative to, or a step toward, the full assignment of bank debt).
110. BUSINESS WORKOUTS MANUAL §16:50 (2d ed. 2002) (“[A] bondholder may find itself without access to important information. The reporting requirements imposed by most indentures are substantially less comprehensive than those required under a typical bank loan agreement. . . .”); see also Henry S. Miller, Emerging Issues in Workouts & Bankruptcies 2004 – PowerPoint Slides, in EMERGING ISSUES IN WORKOUTS & BANKRUPTCIES 2004 WHAT YOU NEED TO KNOW!, at 99, 108 (PLI Comm. L. & Practice, Course Handbook Series No. A0-00KZ, 2004) (“Covenants are generally less restrictive than first lien or bank loans.”).
111. See Harner, supra note 5.
forcing the debtor into bankruptcy by denying forbearance. Thus, the holder of bank debt, even if it is participated or syndicated, has greater influence over the relationship with the debtor than does a single bondholder. Additionally, because bank debt is usually sold in large denominations, if a seller breaches its sale warranties to the buyer, a lawsuit is economically viable and can likely cover the damages. Like bond debt, bank debt is almost always held by a financial institution and trades between sophisticated investors on both sides of the transaction.

c. Trade Debt

Trade debt offers even more challenges to a claims purchaser than bank debt. The counterparty risks, and therefore, the diligence requirements, are much higher. The defenses that a debtor might raise against a bank loan are fairly limited: There might be counterclaims against the bank or equitable subordination issues, but the validity of the loan itself is relatively easy to ascertain. This is not the case with trade debt.

For example, a vendor might have breached its contract with the debtor in any number of ways. The vendor might have delivered the debtor an insufficient quality or quantity of merchandise, failed to deliver it on time or failed to perform the services promised. Any of these breaches could provide the debtor with defenses to the enforcement of the contract, but would be quite difficult for a claims purchaser, with no right to inspect the debtor's books and records, to diligence. There might also be setoff rights based on other dealings between the vendor and the debtor, including other discrete contracts. A purchaser of trade claims has much greater uncertainty about how much, if any, of the claim will be allowed, and every trade claim presents distinct risks.

While the purchaser can protect itself via representations and warranties from the seller, many trade debt claims are in denominations that make litigation over misrepresentations on the sale uneconomic. This depresses the market for smaller trade claims, which is already limited because of the higher ratio of transaction costs to value, and because small claims are of little interest to buyers who are looking to gain influence over a plan. The market in smaller trade claims attracts buyers primarily looking to capture a

112. This might be done to trigger a loan credit default swap or total return swap on the loan. It might also be done as part of a loan-to-own strategy.
113. Levitin, Finding Nemo, supra note 5, at 152–53.
114. Id. at 175.
115. Levitin, The Limits of Enron, supra note 5, at 414 (explaining, post-Enron, the higher relative value of loan participation claims to trade claims resulting from their lower relative risk).
116. There are methods of mitigating this risk. For example, a cautious purchaser might purchase small claims only after the debtor schedules them and bases the purchase price on the scheduled amount of the claim, rather than on the amount listed on the proof of claim filed by the seller.
spread, since small trade claims will probably be classified as convenience claims and likely paid in full.\footnote{See Levitin, The Limits of Enron, supra note 5.} This means small claims are unlikely to have a vote on a plan,\footnote{See 11 U.S.C. §§ 1122(b) (permitting creation of convenience class), 1126(f) (unimpaired classes are deemed to have accepted a plan) (2006).} which makes them unattractive to buyers looking to gain control over a plan.

While trade debt offers investors many more diligence challenges than bond or bank debt, it also offers some advantages. Bondholders and bank lenders must lay out 100 cents to get a $1 allowed claim.\footnote{Many bonds have an original issue discount (OID), meaning the purchase price at issue is less than the face value that the issuer will have to pay to redeem the bond upon maturity. OID is generally treated as a form of unmatured interest in bankruptcy. See, e.g., Chateaugay Corp. v. Valley Fid. Bank & Trust Co. (In re Chateaugay), 961 F.2d 378, 380–81 (2d Cir. 1992) (unaccrued OID on unsecured debt treated as unmatured interest); In re Solutia Inc., 379 B.R. 473, 486 (Bankr. S.D.N.Y. 2007) (unaccrued OID on secured debt treated as unmatured interest).} Therefore, their “cost” of a claim is 100%. To the extent that the claim is sold for less than 100 cents on the dollar, there is an economic loss to the bondholder or bank lender.

A trade claimant, in contrast, likely has a much lower “cost” for its claim. If the trade claimant’s markup on the goods it sold to the debtor was 50%, then the trade claimant will come out ahead economically (but not necessarily in accounting), by selling at 54 cents on the dollar. Additionally, trade creditors are more likely to place a premium on liquidity than bank lenders or bondholders, all of which means they are likely more willing to sell at lower prices.\footnote{See Andrew Africk, Comment, Trading Claims in Chapter 11: How Much Influence Can be Purchased in Good Faith Under Section 1126?, 139 U. PA. L. REV. 1393, 1399–1400 (1991).} For a vulture fund looking to purchase unsecured debt in a bankruptcy, an allowed trade claim is just as good as an allowed bond claim, but the likely price spread produces an attractive arbitrage opportunity.

Trades in trade claims raise concerns about sophisticated traders taking advantage of ingénue vendors. It is important to remember that trade creditors include both incredibly sophisticated parties with extensive bankruptcy experience (e.g., Fortune 500 companies like OEM auto manufacturers) as well as sole proprietorship small businesses with no prior bankruptcy experience.

d. Tort Debt

Finally, there is a much smaller market for tort claims.\footnote{Janover, supra note 81.} Most investors are not interested in tort claims, in part because of the issues of

\begin{itemize}
\item[117.] See Levitin, The Limits of Enron, supra note 5.
\item[118.] See 11 U.S.C. §§ 1122(b) (permitting creation of convenience class), 1126(f) (unimpaired classes are deemed to have accepted a plan) (2006).
\item[119.] Many bonds have an original issue discount (OID), meaning the purchase price at issue is less than the face value that the issuer will have to pay to redeem the bond upon maturity. OID is generally treated as a form of unmatured interest in bankruptcy. See, e.g., Chateaugay Corp. v. Valley Fid. Bank & Trust Co. (In re Chateaugay), 961 F.2d 378, 380–81 (2d Cir. 1992) (unaccrued OID on unsecured debt treated as unmatured interest); In re Solutia Inc., 379 B.R. 473, 486 (Bankr. S.D.N.Y. 2007) (unaccrued OID on secured debt treated as unmatured interest).
\item[121.] Harner, supra note 5, at 716.
\item[122.] Janover, supra note 81.
\end{itemize}
proof involved in disputed claims and because champerty issues are particularly salient in the personal injury context.123

3. Deal Mechanics and Documentation

Deal documentation and deal mechanics vary for claims depending on asset class. Bond debt and equity trade in bankruptcy just as it did outside of it (although exchange-traded equity will be delisted and trade OTC on the Pink Sheets), and with the same documentation.124 The same securities laws will apply in bankruptcy as outside, which presents another variation in asset class.125

A claim’s status under securities laws affects its attractiveness to investors.126 Federal securities laws will apply to bond claims and certificated equity interests, which sometimes trade as penny stocks.127 State securities laws might, in some cases, extend to bank or trade claims, as state law definitions of securities can be broader than federal law.128 Some investors are happy to comply with securities regulation regimes, while others do not want to be subject to it.129 This is another factor encouraging buyers toward bank and trade debt and away from bonds.

Bank debt trades OTC using standardized documentation from the Loan Syndication and Trading Association (LSTA), a trade association of syndicated loan broker-dealers.130 Large investment banks serve as the broker-dealers in this market, but a number of smaller firms such as Imperial Capital, Cantor Fitzgerald, The Seaport Group, and Pressprich & Co. also compete. Because bank loans are not treated as securities for federal law, the broker-dealers are not subject to federal broker-dealer regulation, including the duty of fair dealing and the 10b-10 trade confirmation rule.131

Broker-dealer pricing depends on the size of the transactions and the liquidity in the claim type, but is typically in the range of a couple basis

124. See Drain & Schwartz, supra note 5, at 570 (although exchange-traded equity will be delisted and trade OTC on the Pink Sheets).
125. Id. at 606, 609.
127. See Drain & Schwartz, supra note 5, at 606, 609.
128. See, e.g., O HIO REV. CODE ANN. § 1707.01(B) (LexisNexis 2009) (defining security as including “interim receipts, interim certificates, promissory notes, all forms of commercial paper, evidences of indebtedness . . . any instrument evidencing a promise or an agreement to pay money . . .”)
129. See Drain & Schwartz, supra note 5, at 571–73.
130. Huber & Young, supra note 51; Siegel, Part I, supra note 5, at 567–68.
points on each trade. There is no direct contact between the buyer and the seller, and they receive separate trade confirmations. Thus, it is impossible to know if the broker-dealer is acting as a dealer engaged in a price arbitrage itself (trading for its own account and pocketing the spread between the buyer’s offer and the seller’s price) rather than as a broker (a fiduciary agent with compensation limited by contract).

Trade debt can also go through a broker-dealer, but its initial sale often involves direct contacts between the buyer and seller. As soon as schedules of claimholders or proofs of claims are filed, firms that specialize in buying trade claims rush to send offers to claimholders. As the website of Argo Partners, a firm that specializes in trade claims, explains:

If you have received a letter from Argo Partners offering to purchase your claim, you are listed in papers filed in the bankruptcy court as a creditor in a bankruptcy proceeding. The letter you received extends an offer to buy your claim in exchange for the amount stated.

To accept our offer, simply complete the Assignment Agreement and return it via mail, email or fax. Payment for your claim will be made pursuant to the terms of the offer letter you received. Argo Partners will file the necessary documents to effectuate the transfer with the U.S. Bankruptcy Court.

Documentation for trade claims is far from standardized, although there have been moves made in that direction. In 2002, a number of specialists in trade claims formed a Trade Claims Buyers Association (TCBA) with the goal of standardizing “the assignment, transfer and payment for such claims. This would not only clarify procedures among competitors in the trade claims market but, most importantly, would also act to bring additional confidence to creditors wishing to sell their claims.”

It is unclear how much progress has been made in adoption of standardized procedures and documentation for trade claims. Trade claims can be subject to a range of contract defenses. Therefore, contracts for the purchase of trade claims typically have mechanisms to adjust for a disallowance, reduction or offset. Sellers often want to negotiate these terms carefully, which precludes standardization.

132. Beranek & Jones, supra note 27, at 78.
133. Only equity securities are subject to Securities Exchange Commission Rule 10b-10’s mark-up disclosure requirement. See 17 C.F.R. 240.10b-10 (2005).
134. Janover, supra note 81.
135. These specialists are often looking to later resell to other distressed debt investors who do not want to engage in the direct-to-vendor contact.
The differences in the asset classes of bankruptcy claims suggest that different types of regulation are necessary. Trade claims, for example, might require regulation with a greater eye to protecting sellers because of differences in sophistication. The differences in the asset classes also suggest that there should be different rules about transient liability with claims.

For example, consider the sorely confused district court ruling in Enron, the most important claims trading case to have emerged in recent years. The issue before the district court was whether a claim could be equitably subordinated or disallowed in the hands of a purchaser for malfeasance done by the seller unrelated to the claim. The district court held that the answer depended on whether the claim was “sold” or “assigned,” a novel distinction that flew against the long-standing interchangeability of these terms in legal practice.

A rule that equitable subordination or disallowance follows a claim might make sense if there was a highly negotiated transfer, such as a trade claim with opportunities for the buyer to conduct diligence on the seller or negotiate warranties. It makes little sense, however, for a claim based on a bond, where counterparty diligence is impossible, as is the ability to negotiate separate warranties absent knowledge of the counterparty’s finances. While it is true that Enron involved bank debt, which has a more complicated situation because it trades on standardized forms, there is a greater ability to negotiate terms and conduct diligence of the immediate seller (but not of upstream transferors) of bank debt. A rule that makes sense for one asset class of claim might not for another.

140. Id. at 427–28.
141. Id. at 448–49.
143. See Levitin, Finding Nemo, supra note 5, at 93.
C. THE MOTIVATIONAL DIMENSION: TRADING STRATEGIES

1. Sellers

A claims trade requires both a seller and a buyer, of course, but it is important to recognize the differences in their respective motivations, as well as the impact of their activity. Claims sellers have a variety of motivations. Parties want to get out of bankruptcy cases for a variety of reasons including liquidity constraints, administrative hassle, conflicts of interest with current customers (including the debtor), and expense or regulatory risk. Others wish to sell their claims to lock in a profit, limit a loss, or benefit from a tax advantage.144

Additionally, there might be some creditors who want to get out of the bankruptcy case because they have done something nefarious that would cause the claim to be disallowed or subordinated in their hands and are looking to “launder” their claim through the sale.145 Unless there are grounds for an independent action against them for their conduct, once they cease to be a creditor in the bankruptcy, they have little to lose.146 Despite the celebrated Enron case,147 there is no evidence that this practice is widespread. Most likely, the vast majority of claims sellers are simply looking to disengage from the bankruptcy with no bad faith motivation.

Preserving exit opportunities for creditors is important because it affects the availability and cost of capital to all businesses, especially riskier ones. To the extent that creditors are worried about being trapped into a bankruptcy, it will reduce their willingness to lend, resulting in less credit availability and/or higher costs. This, in turn, might force marginal borrowers into bankruptcy.148

Bankruptcy claims are the residual capital market, and as such are intimately linked with upstream markets. While the workings of this relationship depend on the ease of non-bankruptcy debt collection, there are

144. In some cases, a party will be both a buyer and a seller in sequence. This might be simply because the party wishes to monetize on its trading gains. But it can also be a loss mitigation strategy. The ability to sell gives claims purchasers a fallback in case their investment strategy does not go as planned. This fallback option is only available, however, in cases where there is sufficient liquidity in claims that an investor will not fear being locked into its position.


146. In the business context, unlike the consumer context, there may well be funding for such an independent action.


148. See Levitin, Finding Nemo, supra note 5, at 89.
indelible connections between bankruptcy markets and non-bankruptcy markets; with business debt, they are largely seamless.

From a policy perspective, however, it is very easy to view bankruptcy as a world in and of itself. The problem is that bankruptcy is not an end in and of itself, but a part of the market regulation system. It is an easy trap for those who work solely in the bankruptcy realm to focus only on the bankruptcy effects of claims trading (and often only through the prism of the case at hand); it is harder for them to see the indirect effects of claims trading on capital markets, much less the causal links. Nonetheless, evaluations of claims trading must account for the larger net social welfare impacts including liquidity.

To the extent that we believe there is value to protect in the exit opportunity from claims trading, it also means that we have to protect sufficient entry opportunities, as every claims trade requires a buyer and a seller. While claim purchases raise several problematic strategies, purchases are necessary for sales and vice versa.

2. Buyers

Claims buyers are a more complicated group than sellers. Every claims trader is looking to buy low and sell high, but beyond that, it is hard to generalize when and what, much less why, they are buying. Some of their activities are quite innocent while others raise serious policy concerns.

Some claims purchasers buy before the bankruptcy petition is filed, some at the beginning of the case, and some towards the end. For example, there are investors who look to purchase at low prices either when a business is failing or early in the bankruptcy and ride through the case until payouts are fairly certain. These investors might be hoping to buy at 30 cents on the dollar and get a payout at 70 cents on the dollar. Perhaps if they waited another six months, the payout would be 74 cents on the dollar, but the additional 4 cents on the dollar for six months might not be a worthwhile return for the time value of the investment.

Other investors might not want to assume the risk that exists in the early days of a case when the fate of the debtor is much less certain, but they would gladly purchase at 70 cents on the dollar at the end of the case to get a payout of 74 cents on the dollar six months later.

Some buyers focus on a particular asset class, while others buy up and down the capital structure, using one class of debt as a hedge on another. As for why they are buying, several different types of claims trading may be observed, at least in Mega-Cases.

149. See Harner, supra note 5, at 716.
150. Coco, supra note 5, at 617.
As with consumer bankruptcies, there are simple passive arbitrageurs looking to make a spread between the price they pay for a claim and the ultimate payout, discounted for some time value.151 These buyers do not appear in court and are not active in the case. They are also often eager to purchase very small claims because these claims will likely be classified as convenience claims, which are frequently paid in full.152 Similarly, there are arbitrageurs who are not looking to make their spread based on the ultimate payout in the case, but rather as broker-dealers, earning a commission or markup on the claims.153 These passive investment types of activity are, by themselves, harmless, except to the extent claims trading volume overall is a problem.154

Also, there are arbitrageurs, typically activist investment funds, who are active in the case, appearing in court, taking part in plan negotiations, and litigating to improve their payouts.155 These purchasers contribute to the reorganization process both through their expertise and ability to fund the reorganization, either through DIP lending or exit financing.156 These funds buy in because they want to impact the restructuring strategically.157 Sometimes this is simply with an aim to increase the payout. Other times it is because they see bankruptcy as an acquisition strategy.

Claims purchasing can also be a takeover strategy. There are claims purchasers who look to acquire the so-called “fulcrum security”—the class(es) of claims that will be paid with equity in the reorganized firm.158 Investors can purchase debt claims and end up as owners of the reorganized firm. This strategy is another type of arbitrage, because it uses claims trading as a way to acquire the reorganized debtor at a discounted price. Sometimes buyers will aim for the fulcrum security after a bankruptcy filing, but often they will get involved pre-bankruptcy, as part of a loan-to-own strategy with a distressed company.159

There is reason to believe that bankruptcy might allow for cheaper acquisitions than outside of bankruptcy. First, there is uncertainty as to

151. Fortgang & Mayer, Trading Claims, supra note 5, at 5.
153. Beranek & Jones, supra note 27, at 77.
154. See infra Part III.
155. See, e.g., Harner, supra note 5, at 731.
156. Id. at 734–36.
157. Harner, supra note 87, at 70 n.3, 95; Tung, supra note 5, at 1686.
158. Press Release, Kirkland & Ellis L.L.P., Seminar Grapples with Hedge Funds’ Influence (Apr. 10, 2007), http://www.kirkland.com/sitecontent.cfm?contentID=230&itemId=6927 (explaining “some funds don’t want to make investments in the fulcrum security, the debt instrument most likely to convert to equity ownership in restructuring”).
159. Second lien debt is particularly popular as a potential fulcrum that also provides leverage to force a bankruptcy. See Gordon L. Su, Bankruptcy Implications of Second Lien Loans 1 (unpublished manuscript), available at https://www.turnaround.org/cmaextras/Paper—Bankruptcy Implications.pdf.
where in the capital structure the fulcrum security will lie. There might be reduced demand for what turns out to be the fulcrum security, and hence a lower price.

Second, bankruptcy claims can be acquired very quietly. There is no equivalent to the Williams Act provision requiring a public filing if a shareholder acquires more than 5% of a company’s securities. As a result, a purchaser might avoid paying the control premium. This is not necessarily a problematic strategy from a policy perspective, but the ability to arbitrage regulatory regimes to gain a bargain raises the specter of companies being pushed into bankruptcy to facilitate cheaper takeovers that impose costs on other creditors and shareholders.

There are also claims traders who use claims as a method of shorting reorganizations. An entity might purchase bankruptcy claims because it is short on a reorganization due to another investment (such as an investment in a competitor), because it wishes to force an asset sale, or because they are competitors of the debtors. The purchaser’s incentive in plan confirmation voting is to delay or block confirmation, and force a liquidation.

From a bankruptcy policy viewpoint, this looks quite bad, but it needs to be considered as part of the larger debate on shorting, which is essential for market discipline. The possibility of parties being short in reorganizations is typically part of the parties being long in other investments. By the same token, a party that is long on a bankruptcy reorganization might have hedged it with a short position on a competitor or index. If parties are to be encouraged to be long on reorganizations, they might need to be short elsewhere, and if shorting is acceptable outside of bankruptcy, it should be so in bankruptcy. Trading strategies that seem distasteful when viewed solely in a bankruptcy context can have a more neutral tone when the interconnectedness of bankruptcy markets to other markets is considered.

162. See, e.g., Arturo Bris et al., Efficiency and the Bear: Short Sales and Markets Around the World, 62 J. FIN. 1029, 1072 (2007) (finding “a negative association between short sales restrictions and the diffusion of negative information into prices”); José Scheinkman & Wei Xiong, Overconfidence and Speculative Bubbles, 111 J. POL. ECON. 1183 (2003) (short sales constraints can be a cause or a necessary condition for asset bubbles and excessive volatility); Eli Ofek & Matthew Richardson, DotCom Mania: The Rise and Fall of Internet Stock Prices, 58 J. FIN. 1113 (2003) (short sales constraints result in stock prices failing to fully incorporate information); Charles M. Jones & Owen A. Lamont, Short-Sale Constraints and Stock Returns, 66 J. FIN. ECON. 207 (2002) (demonstrating that stocks that are expensive to short have high valuations, but low returns, indicating that they are overpriced).
Additionally, there are claims purchasers who are seeking to acquire information about the debtor’s operations and assets. The information might be valuable to a competitor of the debtor or to a party interested in purchasing a specific asset. Courts have begun to be more careful about this and restrict trading of parties with access to information, despite a very open-ended disclosure provision in the Bankruptcy Code.

Finally, there are greenmailers who accumulate enough claims of a particular impaired class to block plan confirmation. Greenmailers play on hostage value, using this blocking position to extract a greater payout in a plan of reorganization for their class of claims or to get bought out. The goal of the blocking position is not to force a better plan overall, in which the greenmailer will benefit, but to have value reallocated from other creditors to the greenmailer, either in the form of a direct buyout from the parties that have a strong interest in plan confirmation or via a shift in plan distributions.

To the extent the greenmailer uses bankruptcy’s procedural requirements as a mechanism to extract value from other parties, it is an abuse of the process that undermines essential policy goals of efficiency and fairness and should be cause for vote designation or even equitable subordination. But determining whether an investor obtained a blocking position for greenmail purposes or to push an alternative vision of a reorganization could present difficult evidentiary challenges. Greenmail seems to be more a possibility to be dreaded and suspected than a clearly identifiable practice.

Claims trading strategies are not exclusive. A claims purchaser could be seeking the fulcrum security, but find itself with a simple dollar for dollar spread or a blocking position. Alternatively, an attempt to gain a blocking position might be unsuccessful, but a fallback would be making a simple spread. While a basic typology of claims trading is possible, we do not know how neat these categories are in practice.

The foregoing discussion of claims markets and claims trading underscores that claims trading is comprised of dynamic, multi-motivational, and overlapping sub-markets, which raise distinct policy

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164. See 11 U.S.C. § 1102(b)(3) (2009) (“A committee . . . shall (A) provide access to information for creditors who . . . (i) hold claims of the kind represented by that committee; and (ii) are not appointed to the committee.”); see also Enayati, supra note 163.

165. A plan of reorganization must be approved by creditors “hold[ing] at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors,” 11 U.S.C. § 1126(c) (2006), and, if it is not a cramdown plan, by those requisite majorities for every impaired class, 11 U.S.C. § 1129(a)(8), (b) (2006).

166. Lipson, supra note 161, at 6.

167. Id.
concerns. Some claims trading is beneficial, and some is value eroding. The key value added elements of claims trading are that it allows an exit for parties (which can have upstream effects on market liquidity, capital availability, and the cost of capital) and that it allows entrance to parties that can bring in the expertise and financing to speed along a reorganization. In other words, claims trading can help with efficient allocations of capital in the market. In order to preserve the essential exit opportunities, there must be sufficient entrance opportunities and vice-versa. Thus, greater liquidity in claims trading would appear to be beneficial to the bankruptcy process.

Yet, it is possible that distinctions in claims trading do not matter because the key issue is the impact on the bankruptcy process of trading volume (in terms of number of trades) and the creditor churn it produces. This issue is considered in the following section.

III. ANTICOMMONS, EMPTY CORES, AND THE COMING OF THE ANTIBANKRUPTCY

In a forthcoming article, Baird and Rasmussen, articulate a sharp argument that implicates claims trading in general, along with other financial innovations, as detrimental to the bankruptcy process.168 Baird and Rasmussen argue that changes in finance in recent years, including claims trading, the entry of distressed debt investors into the bankruptcy world, and the rise of derivatives, have created an “anticommons” problem in bankruptcy.169 An anticommons problem exists when there are too many rights holders with the ability to exclude others from using a resource and none with the exclusive right to use the resource.170 The result is that the resource is underused.171

The collective action problem posed by the anticommons problem is particularly troubling, because an essential function of bankruptcy is to mitigate collective action problems. Bankruptcy can become a tragedy of the anticommons if the existence of too many claimants frustrates the formation of a plan that would maximize the value of the bankrupt firm’s assets. If a sufficient coalition for a value-maximizing plan cannot be formed, the firm’s assets may not be put to their best use. As Baird and Thomas Jackson have explained in their seminal works, bankruptcy is designed to deal with the collective action problem of creditors competing

168. Baird & Rasmussen, supra note 5.
169. Id.
171. Id.
for a common pool. Unremedied, the collective action problem will often result in a loss of value of the bankrupt firm relative to an orderly process.

Bankruptcy is thus, in the Proceduralist view, a legislative correction of a market failure. The marketization created by financial innovation, including claims trading, undermines some of the procedural correction by substituting the transaction costs of a collective action problem caused by fragmented and shifting creditor identities for the collective action problem of the common pool.

Baird and Rasmussen observe that in the current bankruptcy world, “ownership interests are fragmented and conflicting. This is quite at odds with the standard account of corporate reorganizations—that it solves a tragedy of the commons, the collective action problem that exists when general creditors share numerous dispersed, but otherwise similar, interests. Bankruptcy has become antibankruptcy.”

Today, Baird and Rasmussen argue that coalitions are more difficult to form because of the multiplicity of parties and the difficulty for parties in assessing each other’s true economic interests. For the Proceduralist view of bankruptcy, this is an eschatological scenario that we might term “the Coming of the Antibankruptcy.”

The anticommons problem Baird and Rasmussen identify is due to what game theory terms the problem of an “empty core”—a status in which multiple parties “cannot reach a stable agreement with each other because some other agreement always exists that some parties prefer . . . [causing the parties to] defect from any tentative agreement that might be made and hence none ever is.” For any group of three or more parties, there are multiple possible coalitions, including singleton coalitions. A party will opt to join a coalition only if that coalition offers it at least as much as any other coalition. A core constitutes the set of possible coalitions from which there will not be defection. The core can be empty, have one possible outcome, or many. If there is a nonempty core, it will include a Pareto

173. See infra Part I.B.
174. Baird & Rasmussen, supra note 5 (manuscript at 6).
175. Id. (manuscript at 4).
177. Baird & Rasmussen, supra note 5 (manuscript at 5 n.11).
178. Id.
179. Lester G. Telser, The Usefulness of Core Theory in Economics, 8 J. Econ. Persp. 151, 154 (1994).
180. Id. at 152.
optimal outcome, in which it is not possible to make any party better off without making at least one party worse off.  

In bankruptcy terms, for a core to be nonempty, the proposed coalition must offer a better deal (a plan) to a sufficient number of claimants (the votes needed for confirmation) than any of the other deals that those claimants could get. If there are too many competing deals, there might not be a stable equilibrium for forming a plan. Hence, the core would be empty; a Pareto optimal outcome would not exist. Thus, in bankruptcy, there is competition among multiple possible coalitions including numerous potential alternative reorganization plans, liquidation (via a Chapter 11 plan or a conversion to Chapter 7, which will occur if a sufficiently large coalition cannot be formed), and the sale of the claim. As seen by Baird and Rasmussen, there is an anticommons problem when stable coalitions cannot be formed due to an empty core.  

Baird and Rasmussen’s argument has an important implication for claims trading policy because it suggests that claims trading has an overall negative impact on bankruptcy. To be sure, Baird and Rasmussen make no argument about claims trading’s net impact outside of bankruptcy, but their argument draws into question the utility of claims trading.

Does bankruptcy really suffer from an anti-commons problem due to an empty core? If so, is that a function of claims trading or other changes in finance? Baird and Rasmussen’s story is one of financial innovation leading to increasingly fragmented ownership by parties whose interests lead them away from the traditional patterns of bankruptcy negotiation coalitions. The result is that there are more possible competing coalitions and thus a greater chance of an empty core.

While Baird and Rasmussen’s story is quite compelling, it relies on two questionable assumptions: First, that claimholdings are actually more

181. Id. at 156. Presumably, Kaldor-Hicks efficiency is the better metric for core theory because of the possibility of negotiations.

182. We can also add to all of these alternatives variations from investment strategies outside of the bankruptcy that will shift the value of deals.

183. Baird & Rasmussen, supra note 5 (manuscript at 4–5).


185. See Baird & Rasmussen, supra note 5 (manuscript at 12–19).

fragmented than in the past, and second, that this is causing more problems in forming coalitions, resulting in suboptimal outcomes.

A. HAVE CLAIMHOLDINGS BECOME MORE FRAGMENTED?

Baird and Rasmussen’s fragmentation story is about bank debt, not claims trading or derivatives. As they explain, syndication and second lien loans have resulted in a fragmentation of interests in secured bank debt. Claims trading and derivatives play a role in this story because they mean that creditor identities have changed and that their interests are opaque. The traditional creditor structure of a single senior secured bank, bondholders, and trade claimants, all of whom are long on the reorganization, has been replaced with multiple secured parties. In addition bond and trade claims are held by constantly shifting distressed debt investors who may or may not be long on the reorganization and who might have holdings throughout the capital structure. The result is that historical patterns of reorganization negotiations no longer hold. These historical patterns had an anchoring effect on negotiations that reduced the allure of alternative coalitions; bankruptcy negotiations had a stylized choreography that made them work. Today, there is no anchoring and negotiation chaos ensues.

Baird and Rasmussen’s fragmentation story assumes a factual situation that has a limited anecdotal evidentiary basis and for which there are reasons to doubt. Are there more parties involved in a bankruptcy now than in the halcyon days of corporate reorganization when banks were banks, trade was trade, bondholders were passive, and everyone was long on the reorganization? Quite possibly, but we don’t actually know.

Fragmentation is not a new phenomenon in bank lending, as large bank loans have been syndicated since at least the 1980s. The number of large banks has declined because of consolidation in the banking space, but

187. Id. (manuscript at 6).
188. Id. (manuscript at 22–23).
189. Id. (manuscript at 2–4, 21–22).
190. Id. (manuscript at 2–3).
191. Id. (manuscript at 2–5).
192. Id.
193. Allison A. Taylor & Ruth Yang, Evolution of the Primary and Secondary Leveraged Loan Markets, in THE HANDBOOK OF LOAN SYNDICATION AND TRADING 21, 23 (Allison Taylor & Alicia Sansone eds., 2007); see also Baird & Rasmussen, supra note 5 (manuscript at 22).
194. For example, instead of Manufacturers Hanover, Chemical Bank, Chase, BankOne, and JPMorgan, there is now just JPMorgan Chase. The total number of depository institutions declined from 13,853 at the end of 1992 to 8,099 as of September 30, 2009. See Federal Deposit Insurance Corporation, Statistics on Depository Institutions, http://www2.fdic.gov/sdi/index.asp (to obtain the aforementioned numbers: follow “Retrieve Reports” hyperlink, then follow “Run Report” hyperlink for “Standard Report #4,” then set report date and follow “Update Report” hyperlink and note total reporting institutions).
they have simply been replaced by investment funds, including actively managed structured investment vehicles (such as Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs)) as members of the bank group. The fragmentation story depends on whether syndication is more common in current years than in the past, whether syndicates now have more members, and whether the syndicate members are now more active investors. The potential membership in syndicates has definitely grown as syndication agreements have become less restrictive, but that does not mean that there are more parties involved in any particular syndication.195 Rather, less restrictive syndication agreements are more likely a reflection of the development of a secondary market in leveraged loans, which more than doubled in volume from 1998 to 2005.196 We simply do not know whether there are more parties holding a stake in the bank debt in today’s median large bankruptcy than in 1990.197 It is likely, however, that syndicate members include more active members, such as distressed debt funds, and their agendas may be quite different from that of the lead bank.

B. IS THE EMPTY CORE A (NEW) PROBLEM?

Assuming that Baird and Rasmussen are correct about fragmentation, did financial innovation, including claims trading, produce an empty core problem? Again, there are reasons to think otherwise. Assuming for the time being that there is in fact an empty core problem in bankruptcy, the causal link with financial innovation is tenuous.

Bankruptcy always features an anticommons issue and always has a potential empty core problem. The nature of bankruptcy is that there are multiple claims on the estate. Some have the potential to exclude others from confirming a plan, but typically no single claimant can impose an outcome on all of the others. Anticommons is the nature of bankruptcy, but it is not always a tragedy.

Possible empty core problems are endemic to bankruptcy. An empty core problem can exist with as few as three claimants. Indeed, Baird and Rasmussen’s illustration of an empty core in bankruptcy does not involve fragmented interests, claims trading, or derivatives.198 Instead, it is a potential problem present in any multi-party negotiation. Short of unanimous plan votes, the core is by definition “empty” because some

195. See Baird & Rasmussen, supra note 5 (manuscript at 22).
196. Taylor & Yang, supra note 193, at 25–27.
197. Baird and Rasmussen do not discuss the securitization of bank debt, but this is a factor that could cut both ways in terms of number of parties with a voice in the reorganization, and which could add in a level of agency issues. See generally Baird & Rasmussen, supra note 5.
198. Id. (manuscript at 47–48).
creditors have, through their vote, expressed that they prefer a different arrangement.

The Bankruptcy Code is designed to deal with these problems. It does not require unanimity of creditors. Instead, it allows for somewhat flexible classification and requires dual majorities in each class for consensual plan confirmation.199 It also allows for nonconsensual cramdown confirmation in which only a single impaired class needs to accept the plan for confirmation.200

There are also contractual mechanisms that can be used to counteract the problems created by the churn in creditors.201 Debtors “may negotiate provisions in its pre-petition credit agreements which restrict the lender’s trading of its claims.”202 Alternatively, a debtor can employ lock-up agreements that commit signing creditors to vote for the debtor’s plan, place restrictions on their trading or require them to use their best efforts to see the plan confirmed.203 Lock-ups can be done in out-of-court restructurings or prepackaged plans without court approval.204 Lock-ups can also be done with the court’s approval of a stipulation that settles a creditor’s claim in exchange for the creditor agreeing to vote for the plan.205

The way a lock-up agreement operates to restrict trading may be seen from the Plan Support Agreement (the Agreement) filed with the court in the Freedom Communications Bankruptcy.206 The Agreement committed the debtor and certain creditors to “cooperate with each other in good faith and shall coordinate their activities in connection with (a) the implementation of the Restructuring and (b) the pursuit of the Restructuring and confirmation and consummation of the Plan.”207 The Agreement applied to all claims purchased in the future by its creditor signatories,208

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199. The Bankruptcy Code requires two-thirds in claim amount, over one-half in number of claims. 11 U.S.C. § 1126(c) (2006).
201. There are transaction costs to these mechanisms. Lock-up via stipulation is costly and might be hard to do on a wide-enough scale to sufficiently mitigate the effects of claims trading; many parties do not want to sign lockup agreements, and even when they are possible, they come with transaction costs. That said, the costs of any such contractual solutions are not borne by the debtor per se but by the residual creditor(s). Accordingly, there is little reason that a debtor should not utilize them.
202. Groshong, supra note 5, at 640. This takes some foresight, however, when negotiating a credit agreement, and most debtors do not borrow with an expectation of bankruptcy.
203. Id. at 635.
205. Groshong, supra note 5, at 635.
207. Id. at 2.
208. Id. at 10. Section 9 of the Agreement provides:
and prohibits the sale of claims by the signatory creditors unless the purchaser agreed to be bound by the Agreement or received the debtor’s consent. The existence of devices like lock-up agreements, and pre-petition credit agreements indicates that empty cores might not be creating the havoc in Reorgland that Baird and Rasmussen fear.

The question then is whether financial innovations over the past couple decades, including claims trading, have increased the likelihood of an empty core. Increased fragmentation of interests would increase the number of parties involved in a negotiation, and thus mean that there are more conditions that must be satisfied. Therefore, if the number of parties involved in bankruptcy negotiations has increased, there is a greater likelihood of an empty core. If Baird and Rasmussen are correct about fragmentation, this will add to the risk of an empty core, although the question of magnitude of impact remains.

The impact of claims trading on the core is uncertain. Economist Lester G. Telser has noted, “[t]he larger the number of traders, the smaller is the range of outcomes without deadweight losses.” The number of coalitions that can be formed in any situation, \( q \), is \( 2^n - 1 \), where \( n \) is the number of parties involved. Thus, an increase in the number of parties involved \( (n) \) increases the number of possible coalitions \( (q) \) exponentially.

\[
q = 2^n - 1
\]

\( n \):

- Nothing in this Agreement shall be deemed to limit or restrict the ability or right of a Consenting Lender to purchase or take assignment of any additional Secured Lender Claims (“Additional Claims”) against or interests in any Debtor or any affiliate of any Debtor; provided, however, that in the event a Consenting Lender purchases or takes assignment of any such Additional Claims or other interests after the date hereof, such Additional Claims or other interests shall immediately upon such acquisition become subject to the terms of this Agreement.

\( \text{id.} \) (emphasis in original).

209. \( \text{id.} \) at 11. Section 10 of the Agreement provides:

(a) Except as set forth in Section 10(b), each Consenting Lender hereby agrees that . . . it shall not sell, transfer or assign all or any of its Secured Lender Claims, as the case may be, or any option thereon or any right or interest (voting, participation or otherwise) therein (each, a “Transfer”) without the prior written consent of Holdings.

(b) Notwithstanding the foregoing, any Consenting Lender may Transfer any or all of its respective Secured Lender Claims, provided that, as a condition precedent, the transferee thereof agrees in writing, in the form attached hereto as Exhibit B, to be bound by the terms of this Agreement.

(c) Any Transfer of any Secured Lender Claim that does not comply with the foregoing shall be deemed void \textit{ab initio}.

\( \text{id.} \)

210. Telser, \( \text{supra} \) note 179, at 152.

211. \( \text{id.} \)
Claims trading has cross-cutting effects on $n$, and thus, on $q$. On the one hand, claims trading increases the number of possible coalitions because every possible claims purchaser is an additional party. The ability to trade a claim means that every claimholder has the possibility of forming a coalition with each possible claim purchaser. In most cases, however, this will result in only linear, rather than exponential growth in the number of possible coalitions, because most claims trades are exclusive, bilateral coalitions.\textsuperscript{212} That growth will depend on the number of potential distressed debt investors, which is limited because the sunk research costs of investing in any case will, at some point, outweigh the benefits of diversification. This limits the number of investments a distressed debt investor can pursue. While we cannot be sure of the magnitude, claims trading adds an alternative coalition to the mix that increases the chance of a nonempty core.\textsuperscript{213}

Yet claims trading can also reduce the chance of a nonempty core. The number of participants in the bankruptcy negotiation process is not static. The number of claimholders can be divided or consolidated. The key question is not the total number of parties ever involved in the bankruptcy, but the lowest number involved at any given instant in the case before a plan vote, since that instant represents the point when there would be the least chance of an empty core and the best chance of a deal, all else being equal. Claims trading can help consolidate the number of claimholders, which would decrease the number of potential coalitions exponentially and thereby decrease the chance of an empty core.\textsuperscript{214}

Does claims trading reduce the number of claimants, and, if so, how quickly? These are currently unanswered empirical questions. But until we can answer them, we cannot know the net effect of claims trading on the lowest number of parties involved in a bankruptcy case at any point prior to plan confirmation voting. At the very least, there is anecdotal evidence that

\textsuperscript{212} There is also the possibility of a multiparty coalition with another claimant and/or multiple claim purchasers. In that case, the number of coalitions would go up exponentially, but claims trading usually involves bilaterally negotiated trades. The transaction costs for multilateral trades are too high. For simplicity, let us assume there are the same number of potential purchasers for each of the claimants.

In practice there will not be, but it does not affect the principle that claims trading has a linear, rather than exponential effect, on the number of coalitions. For example, if there are five claim holders, there will be thirty-one possible coalitions. But if there are 3 possible purchasers for each of their claims, there will be 15 more possible coalitions for a total of 46, not 224 more for a total of 255. Thus, if $T$ is the number of potential claims purchasers, the possibility of claims trading increases the number of coalitions by $n^T$. Therefore, $q=2^n-1+ (n^T)$.

\textsuperscript{213} A casual perusal of some Mega-Case dockets indicates that there are usually no more than a dozen purchasers of trade claims. The point is not to pinpoint an exact number, but to provide a sense of the order of magnitude being in the tens, not the hundreds or thousands.

\textsuperscript{214} Drain & Schwartz, supra note 5, at 575–76.
claims trading is not causing a rampant empty core problem. As one leading practitioner has noted:

The complication today is not claims trading. We’ve dealt with it for years and there are many ways to lock in votes notwithstanding later trades of the voted claims. It is very rare that the group that negotiates with the debtor calls up in the middle of negotiations and says it no longer owns the claims and you must find the new owners. In fact, I’ve never seen that happen. When a minority of negotiating creditors have sold their positions, the new owners have always followed through on the deal under negotiation. In fact, they purchased their claims because they approved of the deal being discussed.215

It is not unreasonable to theorize that claims trading reduces the number of parties involved and thereby facilitates negotiation.216 Perhaps the Yeatsen gyre is narrowing, not widening.217 If this is correct, then Baird and Rasmussen’s view about the effect of financial innovation on large business bankruptcies is upside down.218 Rather than financial innovation creating a collective action problem that undermines the procedural goal of bankruptcy, namely resolving a different collective action of the race to the courthouse, financial innovation is creating a solution to a collective action problem that is endemic to the multiparty nature of bankruptcy. Claims trading might help resolve the anticommons problem, rather than exacerbate it.

Such a theory is consistent with two measures of bankruptcy negotiations. First, cramdown plans, where a broad negotiated deal could not be reached, continue to remain relatively rare.219 And second, as figure 1 below shows, the duration of large public bankruptcy cases has fallen for the past three decades.220 If there is an empty core problem associated with financial innovations in the past decade or two, bankruptcy cases should have started to take longer because creditor churning leads to interminable negotiations. Durations drop, regardless of whether one controls for the

215. E-mail from Martin J. Bienenstock, Partner, Dewey & Leboeuf L.L.P., to Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center (Sept. 7, 2009, 23:58 EST) (on file with author).
216. Consolidation of claims is analogous to the impact of vertical integration on empty core problems. See Telser, supra note 179, at 160–62.
217. See Yeats, supra note 184, at 187.
218. Baird & Rasmussen, supra note 5 (manuscript at 31–43) (arguing that financial innovations have hindered the coalition building necessary for reorganizations).
219. Douglas G. Baird & Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L.J. 1930, 1932 (2006) (noting rarity of insistence on absolute priority). To be sure, these are perhaps suboptimal plans, but there is no good way to verify this.
220. There is remarkably little discussion in the academic literature about why durations of bankruptcy cases have dropped. See Skeel, supra note 28, at 922, 928 (suggesting that speed might be a function of management incentive packages and financing agreements).
type of outcome (sale of substantially all assets, conversion, plan confirmation, etc.), whether a prepackaged plan was involved, or whether it was a Delaware case. To be sure, there are other reasons why case durations might be falling that could overwhelm the visible effect of an empty core problem, but it is hard to see evidence of an empty core problem at least with this metric.

Figure 1: Duration of Large Public Bankruptcy Cases


Jiang et al. argue that hedge fund involvement in bankruptcies, which is heavily related to claims trading, is associated with longer case duration. Jiang et al., supra, note 24, at 22. Their findings are not credible for two reasons. First, their methodology significantly undercounts hedge fund involvement in bankruptcies because it is only able to track hedge fund involvement when hedge funds hold legal title to bankruptcy claims. See generally id. Accordingly, they are unlikely to have observed hedge fund involvement in bankruptcy claims via loan syndications (where the agent bank holds title to a claim), total return swaps on loans (where the swap protection seller holds title to a claim), and bond claims (where the debt is held in street name). Second, they are only able to observe hedge fund direct holdings and trades for which Rule 3001(e) filings were made. See id. As a result, they observe minimal hedge fund involvement in prepackaged bankruptcies, where there is little trading in the claims post-petition. The hedge fund involvement they do observe is in non-prepackaged cases, which have longer duration. Thus, their finding that hedge fund involvement in Chapter 11 increases case duration is driven by the limitations on the ability to observe hedge fund involvement in bankruptcy overall, and especially in prepackaged bankruptcies.

222. See Lynn M. LoPucki, Web BRD Lynn M. LoPucki’s Bankruptcy Research Database, http://lopucki.law.ucla.edu/index.htm (to obtain the numbers in the graph above: submit a query for each year, use the default settings for “cases,” then select “duration in days” and “disposition” for each year) (note, the graph above was created by the author using data downloaded from the LoPucki database).
In fact, claims trading might well be responsible for faster case resolution, because it serves as a mechanism to assess risk and brings in parties with a willingness to supply fresh capital to support the reorganization. Claims purchasers are vigilant about the progress of the case in a way that an original lender with deal fatigue is not, because the claim is their business opportunity, rather than an attempt to salvage a bad situation. Thus, a pair of studies has found that the presence of distressed debt investors in Chapter 11 cases increases overall value. Absent the ability to trade, distressed debt investing would be sharply curtailed because of lack of entry and exit opportunities for investors. Moreover, the investment funds that purchase claims often supply the capital for the reorganization through the DIP loan (if they purchased claims pre-petition) and exit financing. The factors contributing to the increased speed of large Chapter 11 cases have yet to be systematically explored, but increased access to capital for bankrupt companies due, in part, to claims trading, might well play an important role.

C. WHAT IF THE CORE IS EMPTY?

It is possible, however, that the Bankruptcy Code is simply not designed well enough to deal with the anticommons and empty core problems. The Code might be obsolete. If so, what is to be done? Is there any way to make deals stick?

223. Hotchkiss & Mooradian, supra note 24, at 401 (finding that “vulture investors add value by disciplining managers of distressed firms”); Jiang et al., supra note 24, at 32 (noting that the “prevalence of hedge funds contributes to the trend toward a more management-neutral restructuring process, and is viewed by the market as enhancing the overall value of bankrupt firms”). To be sure, Jiang et al. summarily conclude that claims trading itself does not enhance value. See Jiang et al., supra note 24 (manuscript at 31). This conclusion rests on a regression of reorganization value against the presence of distressed debt investors (as identified by the authors), controlling for whether the debt was purchased post-bankruptcy or not. See id. at 17. This regression does not provide a good measure for the value of claims trading, however, because liquidity is a major consideration for any investor, and without the ability to sell a bankruptcy claim, many investors would never invest in distressed debt in the first place. Therefore, claims trading must be credited with some of the benefits that Jiang et al. find stemming from the presences of distressed debt investors who purchased their holdings before bankruptcy. See id. at 19.

Irrespective of the interpretive problems with Jiang et al.’s regression, its outputs are likely specious because they are based on an unrepresentative data sampling. Jiang et al. are able to observe only trades in which legal title is transferred. See id. at 17, 30. As a result, they are unable to observe most of the trades in bank and bond debt. Accordingly, their data is unrepresentative of claims trading as a whole, and cannot support conclusions about claims trading’s impact. More generally, the data problem means that they are not capable of tracking the full range of distressed debt investor activities in bankruptcy, which casts doubt on all of their findings.

224. One factor that might have driven quicker resolutions is increased liquidity in the market generally, as it enables a viable threat of a sale of the bankrupt company or its principal assets as an alternative to a negotiated plan of reorganization. In the current market, the lack of liquidity is also contributing to shorter case durations as companies lack the funds for a lengthy reorganization process.
Core theory’s solution for a problem of an empty core caused by too many possible coalitions is to restrict the number of possible coalitions. As Telser has written, “[r]estricting the number and composition of coalitions can result in a nonempty core with respect to those coalitions that are legal.” In claims trading terms, this would mean restricting claims trading volume or participants or lowering plan voting thresholds. Restricting the number of possible coalition, however, does not guaranty Pareto optimality. If coalition possibilities are over-restricted, results may be suboptimal. As Telser has noted:

There is always a set of legal coalitions giving Pareto optimality, and we can [as an abstract theoretical matter] calculate which coalitions to allow that can give the maximal amount of competition consistent with Pareto optimality. Allowing more than this number causes the core to vanish, and allowing less may not give Pareto optimality.

Thus, core theory suggests that there is a delicate balance between allowing too much claims trading and not enough. What that equilibrium is (or equilibria are), however, is unknown in real world conditions. This is an empirical question, but given the state of data on claims trading, we cannot begin to answer it.

There is reason to question, as a positive matter, Baird and Rasmussen’s story of financial innovation having a severely negative impact on the bankruptcy process. But if they are correct, their suggested reforms are relatively moderate given the problem they diagnose. Baird and Rasmussen do not even broach the possibility of limiting the use of any of the innovative financial products they outline. Instead, they focus on finding offsetting negotiation facilitation mechanisms.

As they astutely note, negotiation is the lifeblood of bankruptcy, and bankruptcy judges should be given the tools to facilitate negotiated agreements. Accordingly, they raise some possible tools: limiting the number of potential coalitions through greater plan exclusivity, applying...
plan solicitation restrictions more leniently, reducing the number of priorities, or giving bankruptcy judges a “nuclear option” to force a sale as a method for focusing bargaining.

Baird and Rasmussen rightly recognize that these methods either create more problems than they solve or are likely too weak to meaningfully facilitate negotiations. Nonetheless, they resign to a credo of markets correcting themselves, an odd display of faith in markets given the story they have told of government correcting one market failure—the race to the courthouse—through bankruptcy’s collective procedure, only to have the market generate another market failure.

Capitalism is, as they note, “still very much a work in progress,” but that is cold comfort if we are faced with the Coming of the Antibankruptcy. If the landscape for reorganizations is as dire as Baird and Rasmussen believe, salvation will lie only in the Second Coming, a New Bankruptcy Code, written against a backdrop of fragmented interests, claims trading, and empty cores, rather than attempting to jury-rig the current Bankruptcy Code, which was written for a different era of finance. For bankruptcy agnostics and nonbelievers, however, we might think about some modest reforms to improve claims trading markets.

**IV. CONCLUSION: IMPROVING CLAIMS TRADING**

Claims trading has revolutionized the bankruptcy world, but no one can say for sure whether it is for the better or worse. While claims trading may well cause problems in the reorganization process, there is a general resignation to its continued existence. 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. Some issues, like improved disclosure of economic interest in claims, are unlikely to be easily resolved, but there are other more readily achievable and less controversial reforms.

The most immediate improvement that can be made of claims trading is improved price disclosure. Because bankruptcy claims trade on the OTC market, there is limited pricing information; a creditor cannot easily gauge

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235. Id. (manuscript at 50).
236. Id. (manuscript at 51).
237. Id. (manuscript at 52–53).
238. Id. (manuscript at 49–50).
239. Id. (manuscript at 54).
240. Id.
241. The Bankruptcy Code was written against a different financial markets backdrop, but it has stood up surprisingly well. The critical stresses on the Bankruptcy Code for business bankruptcy are not those created by claims trading, but rather those created by the automatic stay exceptions for certain financial contracts, 11 U.S.C. § 362(b)(6), (7), (17), (27) (2006), and the disparity in creditor protections for sales, 11 U.S.C. § 363 (2006), and plan confirmations, 11 U.S.C. §1129 (2006).
242. See supra p. 75.
what the market price for its claim is. There might not be comparables, and
even if there are, there is no central source to see pricing. At best, a creditor
might receive several solicitations around the same time and be able to
compare them. Absent the ability to easily cross-check against comparables,
it is difficult for a creditor to evaluate an offer to purchase its claim.

Inefficiency adds to the allure of the claims trading market because it
can create profitable arbitrage opportunities, such as between trade claims
and bond claims—both unsecured debt with the same place in the capital
structure, but potentially priced quite differently. There is little likelihood
that the market will correct this problem. If the claims market were fully
efficient, there would be only minimal profit margins. This means that the
repeat market participants—dealers and attorneys—have little incentive to
make the market more efficient. An exchange would provide the best price
disclosure mechanism, but bankruptcy claims, particularly trade claims, are
ill-suited for an exchange. They are insufficiently standardized and are too
illiquid. There is too much claim-specific diligence required because of
counterparty risk for trade-claims to ever be exchange traded the way shares
of IBM are.

One possibility would be an electronic quotation bulletin board, like the
Pink Sheets or OTC Bulletin Board, where market makers post recent bids
and asks, providing potential buyers and sellers with some sense of the
market. Some steps have been taken in this direction, although it remains to
be seen if it is a viable model. For such a system to work, however, there
would need to be dedicated market makers in particular bankruptcies. It is
not clear whether claims brokers would want to assume that role.

A more feasible alternative would be to utilize creditors committees as
a platform for facilitating claims trading, whether by simply informing
claimholders of the possibilities of claim purchases and issues in the market
or by posting information on claim trade prices when available. A move in
this direction can be observed in the bankruptcy of Dana Corporation.243
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.244

Arguably facilitating claims trading is part of creditors’ committees’
duties. If creditors’ committees are responsible for maximizing the return
for their constituents as they exist at any particular time, that could be
accomplished either through working for a better plan or by providing their
constituents with improved immediate exit opportunities.

These are not separate possibilities—if plan payouts look better, the
price for claims should go up. And claims trading could derail plan

244. See Dana Corp. Official Unsecured Creditors Committee,
confirmation and add delay, which might drive down the price of claims for remaining constituents. Nonetheless, creditors’ committees should start to consider what role they have in increasing the value of their constituents’ claims, be it through a plan or through a trade. Creditors’ committees may not be the ideal mechanism for improving market efficiency by enabling claims sellers to comparison shop among buyers’ offers, but they represent the most easily achievable step in that direction.

Bankruptcy law will always straddle market and communitarian tendencies, but the Great Normative Bankruptcy Debate about what bankruptcy should be is of little use in formulating policy on claims trading realities. Instead, by examining claims trading for what it is—a diverse collection of practices and markets—rather than as a meme for normative ideas, we can better understand how claims trading affects bankruptcy and determine which claims trading practices should be encouraged.
A CRITICAL ANALYSIS OF THE BANKRUPTCY CODE’S EXCEPTION TO DISCHARGE FOR DEBTS ARISING FROM WRONGFUL CONDUCT

INTRODUCTION

While bankruptcy is intended to relieve the honest debtor, the Bankruptcy Code (the Code) prevents the discharge of debts in certain situations where the debtor’s actions are less than ethical. 

Section 523(a)(6) of the Code does not allow a debtor to discharge any debt “for willful and malicious injury by the debtor to another entity or to the property of another entity.” The case law concerning the interpretation of § 523(a)(6) is not clear and in 2007, the Federal Bankruptcy Court for the Northern District of Illinois noted a circuit split over the requirements for the dischargeability of intentional breaches of contract in bankruptcy proceedings. The bankruptcy court noted that there is disagreement between the circuits over whether § 523(a)(6) requires tortious conduct for a debt to be nondischargeable. While the text of § 523(a)(6) clearly requires a willful and malicious injury, the Ninth and Fifth Circuits are divided as to whether tortious conduct is required for an intentional breach of contract to be nondischargeable. In the Ninth Circuit, for a breach of contract “to be excepted from discharge under § 523(a)(6) . . . [it] must be accompanied by some form of tortious conduct that gives rise to willful and malicious injury.” The Fifth Circuit, however, “holds that any breach of contract is nondischargeable as a willful and malicious injury if the debtor either intended to injure the other party to the contract by breaching it or if injury

3. § 523(a)(6).
4. Tortious conduct is “[a]n act or omission that subjects the actor to liability under the principles of tort law.” BLACK’S LAW DICTIONARY 337 (9th ed. 2009).
5. § 523(a)(6).
6. Wish Acquisition, L.L.C. v. Salvino, 373 B.R. 578, 588 (Bankr. N.D. Ill. 2007), aff’d, No. 07-C-4756, 2008 U.S. Dist. LEXIS 3918 (N.D. Ill. Jan. 18, 2008). In addition to the split between the Ninth and Fifth Circuits, the Tenth and Sixth Circuits are also split through unreported decisions. Compare In re Best, 109 F. App’x 1 (6th Cir. 2004) (tortious conduct is necessary for a debt to be nondischargeable under § 523(6)(a)) with Sanders v. Vaughn (In re Sanders), No. 99-6396, 2000 U.S. App. LEXIS 5763 (10th Cir. Mar. 29, 2000) (tortious conduct is not necessary for a debt to be nondischargeable under § 523(6)(a)).
7. Petralia v. Jercich (In re Jercich), 238 F.3d 1202, 1206 (9th Cir. 2001) (internal quotation marks omitted).
to the other party was substantially certain to result from the breach; tortious conduct is not required.8

Part I of this note will begin with an overview of the circuit split and its origination out of the United States Supreme Court’s decision in Kawaauhau v. Geiger.9 This overview will commence with a discussion of Geiger, then analyze the competing interpretations developed by the Ninth Circuit’s In re Jercich decision,10 and the Fifth Circuit’s In re Williams decision.11 Part I will conclude with a brief explanation of Wish Acquisition, L.L.C. v. Salvino,12 a bankruptcy case that noted the circuit split. Part II of this note discusses the role of state regulation in the application of federal bankruptcy law, specifically the § 523(a)(6) exception. Part III will conclude the note with an analysis of the relevant issues and a recommendation that the Ninth Circuit rule be adopted to resolve the circuit split. The Ninth Circuit rule should be adopted because it is more protective of debtors, more in line with the legislature’s intent concerning the Bankruptcy Code, and is less susceptible to abuse by creditors or debtors.

I. CIRCUIT SPLIT

The Supreme Court’s decision in Geiger gave rise to a circuit split because the case merely addressed the issue of whether reckless or negligent conduct could lead to a debt being nondischargeable.13 The Court did not address the issue of what kind of intentional conduct was necessary to invoke the § 523(a)(6) exceptions.14 Since the Court did not address what constitutes a “willful and malicious injury” under § 523(a)(6), the Ninth and Fifth Circuits developed competing interpretations.15 In 2007, the Bankruptcy Court for the Northern District of Illinois addressed the circuit split and determined that the Ninth Circuit’s rule requiring tortious conduct for a debt to be nondischargeable under § 523(a)(6) should be applied in the Seventh Circuit.16

A. KAWAAUHAU V. GEIGER

The circuit split recognized in Salvino arose out of competing interpretations of the Geiger decision that determined the scope of § 523(a)(6).17 The Court held that “a debt arising from a medical

8. Salvino, 373 B.R. at 588 (citing Williams v. Int’l Bhd. of Elec. Workers Local 520 (In re Williams), 337 F.3d 504, 510 (5th Cir. 2003)) (internal quotation marks omitted).
10. 238 F.3d 1202.
11. 337 F.3d 504.
12. 373 B.R. 578.
14. Id.
15. See In re Jercich, 238 F.3d at 1206; In re Williams, 337 F.3d at 510.
17. See generally Geiger, 523 U.S. 57.
malpractice judgment, attributable to negligent or reckless conduct,” was dischargeable under § 523(a)(6) because the plaintiff was not the victim of a willful or malicious injury. This suit arose when a plaintiff had her right leg amputated below the knee after receiving treatment from her doctor for a foot injury. The jury found the defendant liable for malpractice, and he attempted to avoid the judgment by petitioning for bankruptcy. In response to the defendant’s bankruptcy petition, the plaintiff requested that the bankruptcy court hold the malpractice judgment nondischargeable because the judgment originated from a willful and malicious injury and was thus a debt excepted from discharge under § 523(a)(6).

The bankruptcy court initially determined that the defendant’s conduct was willful and malicious since his “treatment fell far below the appropriate standard of care.” The district court affirmed the bankruptcy court’s determination that the debt was nondischargeable, but the appellate court reversed and determined that the malpractice debt was dischargeable. The court of appeals reversed the district court’s determination because the § 523(a)(6) exception from discharge “is confined to debts based on what the law has for generations called an intentional tort.” Ultimately, the United States Supreme Court affirmed the judgment of the court of appeals and determined that willful, in the context of § 523(a)(6), modifies injury, “indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury.” The Court justified a narrow reading of the statute by asserting that if Congress had intended to “exempt debts resulting from unintentionally inflicted injuries,” explicit language to make that meaning clear would have been used. Further, the structure of the statute mirrors that of intentional torts, in that “[i]ntentional torts generally require that the actor intend ‘the consequences of an act,’ not simply ‘the act itself.’” If the Court adopted a broad reading of § 523(a)(6), it would have expanded the scope of the statute to cover many situations where “an act is intentional, but injury is unintended,” including a knowing breach of contract or a car accident. This type of broad reading would be incompatible with the established notion that “exceptions to discharge

18. Id. at 59.
19. Id.
20. Id. at 59–60.
21. Id. at 60.
22. Id.
23. Id.
24. Id. (internal quotation marks omitted).
25. Id. at 61 (emphasis in original).
26. Id.
27. Id. at 61–62 (quoting RESTATEMENT (SECOND) OF TORTS § 8A cmt. a (1964)).
28. Id. at 62.
should be confined to those plainly expressed."

Finally, if the Court adopted a broad understanding of willful and malicious it would have rendered § 523(a)(9), which exempts debts from injuries or deaths arising from drunk driving to be discharged, superfluous. Based on these factors, the Court unanimously determined that § 523(a)(6) should be interpreted narrowly, so that the statute only applies to a deliberate or intentional injury.

In deciding Geiger, the Supreme Court clearly established that § 523(a)(6) exempted only deliberate or intentional injuries, and does not cover intentional acts that result in injury. However, the Court did not address the issue of whether the debtor’s conduct must be tortious to be exempted under the statute. Both the Ninth and Fifth Circuits address this issue, but are split on whether the debtor’s conduct must be tortious in addition to willful and malicious for a debt to be nondischargeable.

**B. PETRALIA V. JERCICH**

After the Supreme Court in Geiger addressed one aspect of the § 523(a)(6) exception, the Ninth Circuit addressed the issue of whether tortious conduct is required to invoke the exception. Its decision is the basis for the Salvino decision. The dispute in Jercich arose when Jercich, the owner of a real estate company, failed to pay one of his employees as required under an employment contract. The employee sued Jercich seeking damages. The state court found in favor of the employee and while the appellate decision was pending, Jercich filed for bankruptcy. The employee initiated proceedings to except the judgment from discharge under § 523(a)(6).

Ultimately, the bankruptcy court found for Jercich and determined that the debt was dischargeable. The bankruptcy appellate panel affirmed the bankruptcy court’s decision because “where a debtor’s conduct constitutes both a breach of contract and a tort, the debt resulting from that conduct does not fit within § 523(a)(6) unless the liability for the tort is independent of the liability on the contract.” The appellate panel determined that since

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29. Id. (quoting Gleason v. Thaw, 236 U.S. 558, 562 (1915)) (internal quotation marks omitted).
30. Id.
31. Id.
32. Petralia v. Jercich (In re Jercich), 238 F.3d 1202, 1203–04 (9th Cir. 2001).
33. Id. at 1204.
34. Id.
35. Id.
36. Id.
there was not a tort independent from the contract, the debt was not exempt from discharge under § 523(a)(6).\(^{38}\)

The Ninth Circuit reversed the appellate panel and held “that to be excepted from discharge under § 523(a)(6), a breach of contract must be accompanied by some form of tortious conduct that gives rise to willful and malicious injury.”\(^{39}\) In order for a breach of contract to become tortious conduct it must “violate[] an independent duty arising from principles of tort law.”\(^{40}\) Jercich’s nonpayment of wages to the employee when he had the ability to do so was tortious conduct because it violated California law.\(^{41}\) The Ninth Circuit determined that the “deliberate or intentional injury” standard established by the Supreme Court in Geiger necessitates tortious conduct, in addition to a “willful and malicious injury,” for a debt to be nondischargeable under § 523(a)(6).\(^{42}\)

C. WILLIAMS V. INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS LOCAL 520

While the Ninth Circuit determined that tortious conduct was required for a debt to be deemed nondischargeable under § 523(a)(6),\(^{43}\) the Fifth Circuit rejected the tortious conduct requirement and instead limited its inquiry to a determination of whether the debtor’s conduct was willful and malicious.\(^{44}\) The Fifth Circuit held in Williams “that for a debt to be nondischargeable, a debtor must have acted with objective substantial certainty or subjective motive to inflict injury.”\(^{45}\)

The conflict in Williams arose out of a violation of a collective bargaining agreement and a subsequent agreement between an electrical contractor and a union for electricians. Williams, the electrical contractor, hired electricians for a commercial project who concealed their union affiliation and went on strike.\(^{46}\) After being unable to hire non-union electricians, Williams entered into a collective bargaining agreement with the Union.\(^{47}\) Finding trouble with the union electricians, Williams, in violation of the collective bargaining agreement, hired non-union electricians.\(^{48}\) In response to the violation, the Union initiated a grievance

\(^{38}\) Id.

\(^{39}\) In re Jercich, 238 F.3d at 1206 (internal quotation marks omitted).

\(^{40}\) Id. (quoting Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460 (Cal. 1994)).

\(^{41}\) Id. at 1207.

\(^{42}\) See id. at 1205.

\(^{43}\) Id.

\(^{44}\) See Williams v. Int’l Bhd. of Elec. Workers Local 520 (In re Williams), 337 F.3d 504, 510 (5th Cir. 2003).

\(^{45}\) Id. at 508–09 (citing Miller v. J.D. Abrams, Inc. (In re Miller), 156 F.3d 598, 603 (5th Cir. 1998)) (internal quotation marks omitted).

\(^{46}\) Id. at 507.

\(^{47}\) Id.

\(^{48}\) Id.
against Williams. The dispute was resolved when Williams agreed to use only union electricians for commercial projects. The new agreement was subsequently violated and the Union sought damages from both Williams’ original violation of the collective bargaining agreement and his later violation of the new agreement. Williams then filed for bankruptcy, and the Union sought to have the debts under the collective bargaining agreement and the subsequent agreement excepted from the discharge under § 523(a)(6).

The bankruptcy court determined that the debts under the collective bargaining agreement were nondischargeable because they “arose from willful and malicious injury.” After the judgment was affirmed by the district court, the Fifth Circuit reaffirmed the bankruptcy court’s determination that tortious conduct is not required for a debt to be nondischargeable. In rejecting the requirement of tortious conduct, the circuit court condensed the test for a willful or malicious injury “into a single inquiry of whether there exists either an objective substantial certainty of harm or a subjective motive to cause harm on the part of the debtor.” This test requires that “a debtor must commit an intentional or substantially certain injury in order to be deprived of a discharge.”

Though the Fifth Circuit affirmed the bankruptcy court’s determination that tortious conduct is not required for a debt to be nondischargeable under § 523(a)(6), it did not fully affirm the decision of the bankruptcy court. The Fifth Circuit reversed the bankruptcy court’s determination that the damages resulting from Williams’ violation of the collective bargaining agreement were nondischargeable. Williams may have acted intentionally in hiring non-union electricians, but he was not intending to harm the Union through this action; he was acting to finish the project and to save his business. The Union did not introduce any evidence that when Williams breached the collective bargaining agreement he “was substantially certain

49. Id.
50. Id.
51. Id.
52. Id. at 508.
53. Id.
54. Id. at 510.
55. See id. at 510 (citing Texas v. Walker, 142 F.3d 813, 823 (5th Cir. 1998)).
56. Id. at 509 (citing Miller v. J.D. Abrams, Inc. (In re Miller), 156 F.3d 598, 603 (5th Cir. 1998)) (internal quotation marks omitted).
57. Id.
58. Id. at 510.
59. Id. at 513.
60. Id.
61. Id. at 510.
the Union would sustain a blow to its prestige and its ability to uphold its contracts.\textsuperscript{62} Since there was no showing that Williams intended or was substantially certain to cause injury to the Union through his violation of the collective bargaining agreement, the debt was dischargeable.\textsuperscript{63}

The circuit court also affirmed the bankruptcy court’s determination that Williams’ violation of the agreement led to nondischargeable damages.\textsuperscript{64} It is well established that “[f]ailure to obey a court order constitutes willful and malicious conduct, and a judgment against a defiant debtor is excepted from discharge.”\textsuperscript{65} Since Williams failed to follow the court order, his conduct was at least substantially certain to cause injury to the Union and therefore the damages resulting from his breach of the agreement were nondischargeable.\textsuperscript{66} This ruling interprets \textit{Geiger} to mean tortious conduct is not required to invoke the \textsection{523}(a)(6) exception to discharge, and instead only requires conduct that was intentionally undergone, or substantially certain, to cause injury.\textsuperscript{67}

\section{D. \textit{Wish Acquisition, L.L.C. v. Salvino}}

The Ninth and Fifth Circuit’s debate concerning the requirement of tortious conduct in the \textsection{523}(a)(6) exception has influenced other courts not within their jurisdiction. For example, in \textit{Wish Acquisition L.L.C. v. Salvino}, the Bankruptcy Court for the Northern District of Illinois sided with the Ninth Circuit’s determination that tortious conduct was required to invoke the \textsection{523}(a)(6) exception.\textsuperscript{68} In this case, Salvino, the debtor, owed Wish Acquisition (Wish), his former employer, debts that were nondischargeable under \textsection{523}(a)(6) for the intentional breach of his employment contract.\textsuperscript{69} The conflict arose after Wish acquired Salvino’s medical practice and the practice subsequently defaulted on its loans.\textsuperscript{70} When Wish acquired the practice, it entered into an employment contract with Salvino which provided that Wish would “forgive all but $1.5 million of Salvino’s personal guaranty of the bank loan” in exchange for Salvino’s medical services.\textsuperscript{71} Salvino, before filing for bankruptcy, breached his employment contract by seeking other employment, making him liable to repay the $1.5

\begin{footnotesize}
\begin{enumerate}
\item Id. at 511.
\item Id.
\item Id. at 513.
\item Id. at 512 (citing PRP Wine Int’l v. Allison (\textit{In re Allison}), 176 B.R. 60, 64 (Bankr. S.D. Fla. 1994)).
\item Id. at 513.
\item See id. at 509.
\item Id.
\item Id. at 582.
\item Id. at 583.
\end{enumerate}
\end{footnotesize}
million under a liquidated damages provision in the employment contract.\textsuperscript{72} The court determined that Salvino’s debts were dischargeable because Wish was unable to show that Salvino’s intentional breach of contract resulted in a willful and malicious injury.\textsuperscript{73}

In deciding this case, the bankruptcy court adopted the Ninth Circuit’s rule that “the willful and malicious injury exception [of § 523(a)(6)] applies only to claims arising from tortious conduct, not from simple breaches of contract.”\textsuperscript{74} The first reason the court gave in deciding to adopt the Ninth Circuit rule requiring tortious conduct was due to the use of the phrase “willful and malicious injury” in § 523(a)(6).\textsuperscript{75} Using the terms “willful and malicious” implies that the exception is limited to tortious conduct.\textsuperscript{76} Therefore, “only debts arising from the sort of conduct that the common law discourages by punitive damages” would be nondischargeable.\textsuperscript{77}

Second, the court stated that before § 523(a)(6) was enacted, there was a willful and malicious injury exception from the discharge of debts that applied only when tortious conduct was present.\textsuperscript{78} Since Congress enacted § 523(a)(6) with the willful and malicious standard, the court presumed that Congress meant to continue the practice of limiting the application of the exception to tortious conduct.\textsuperscript{79} Third, the court concluded that if a broad understanding of willful and malicious conduct was adopted under § 523(a)(6), it would include debts generally discharged in bankruptcy.\textsuperscript{80}

Finally, the court reasoned that if all intentional breaches of contract were nondischargeable under § 523(a)(6), then it would come into conflict with § 365 of the Code.\textsuperscript{81} Section 365 encourages, in certain circumstances, intentional breaches that will generally harm the other party.\textsuperscript{82} Therefore, if § 523(a)(6) did not require tortious conduct, the Code would punish conduct that it encourages elsewhere.\textsuperscript{83}

In this case, Salvino’s breach of his employment contract was not a willful and malicious injury under § 523(a)(6) since the breach itself was not tortious.\textsuperscript{84} Salvino owed Wish $1.5 million,\textsuperscript{85} but this money was

\textsuperscript{72} See id. at 582–84.
\textsuperscript{73} Id. at 581.
\textsuperscript{74} Id.
\textsuperscript{75} Id. at 589.
\textsuperscript{76} Id.
\textsuperscript{77} Id. (internal quotation marks omitted).
\textsuperscript{78} Id.; see also In re Barton, 465 F. Supp. 918, 924 (S.D.N.Y. 1979) (limiting willful and malicious injury “to cases sounding in tort, not in contract”).
\textsuperscript{79} Salvino, 373 B.R. at 590.
\textsuperscript{80} Id.
\textsuperscript{81} Id. at 591.
\textsuperscript{83} Salvino, 373 B.R. at 591.
\textsuperscript{84} Id.
\textsuperscript{85} Id. at 586–87.
contract debt and did not arise from an independent violation of tort law.\textsuperscript{86} The breach was not tortious because the contract was a private agreement and an intentional breach of contract does not give rise to liability under tort law.\textsuperscript{87} Additionally, since § 523(a)(6) is not based on contract principles and instead is grounded in tort law, “[i]t is designed to compensate the injured party for the injury suffered while not allowing the debtor to escape liability for a willful and malicious injury by resort to the bankruptcy laws.”\textsuperscript{88} Since the purpose of § 523(a)(6) is to compensate an injured creditor, “the appropriate measure for non-dischargeability under § 523(a)(6) is an amount equal to the injury caused by the debtor rather than any other sum owed by the debtor on a contractual basis.”\textsuperscript{89} Though Salvino’s conduct was intentional, his breach of the contract was not tortious and therefore his debt was dischargeable under the Code.\textsuperscript{90}

While the Supreme Court in \textit{Geiger} managed to clarify one aspect of the § 523(a)(6) exception, the Court failed to answer the question of whether tortious conduct is a prerequisite for a debt to be nondischargeable under the section. This failure has led to competing interpretations by the Ninth and Fifth Circuits that have affected other areas of the law. The differing interpretations of § 523(a)(6) by the Ninth and Fifth Circuits of whether tortious conduct is required for a debt to be nondischargeable has resulted in state and federal common law having conflicting roles in understanding the exception.

II. BANKRUPTCY LAW WITHIN THE FEDERAL AND STATE STATUTORY LANDSCAPE

Since the Ninth and Fifth Circuit rules require differing reliance on state and federal common law, it is necessary to place § 523(a)(6) in the broader legal context and understand the competing authority of federal and state governments in establishing bankruptcy standards. The Code occupies a unique place in American jurisprudence in that it is federal law that allows the states to establish competing interpretations, especially concerning exemptions.\textsuperscript{91} Though bankruptcy law does allow for some state regulation,\textsuperscript{92} when there is a conflict between the federal and state laws,

\begin{footnotes}
\begin{enumerate}
\item See id. at 592.
\item Id.
\item Friendly Fin. Serv. Mid-City, Inc. v. Modicue (\textit{In re Modicue}), 926 F.2d 452, 453 (5th Cir. 1991) (internal quotation marks omitted).
\item Id.
\item See \textit{Salvino}, 373 B.R. at 592.
\item For examples of such exemptions, see New York’s personal property exemption statute and Texas’ personal property exemption statute. N.Y. C.P.L.R. 5205 (McKinney 2009); TEX. PROP. CODE ANN. § 42.001 (Vernon 2007).
\item See, e.g., 11 U.S.C. § 522(b)(3)(A) (2006) (defining property as “any property that is exempt under federal law . . . or state or local law that is applicable on the date of the filing of the petition . . .”).
\end{enumerate}
\end{footnotes}
federal law will govern. 93 The federal government has authority to regulate bankruptcy as outlined in the Bankruptcy Clause, which gives the federal government the authority to enact "uniform [l]aws on the subject of [b]ankruptcies throughout the United States." 94 Despite this clear provision, there has been some debate over the proper scope of federal authority in bankruptcy.

A. DEFINING THE TRADITIONAL ROLE OF STATE LAW IN BANKRUPTCY DETERMINATIONS

Despite the fact that the Constitution clearly establishes the federal government as having authority concerning the enactment of uniform bankruptcy laws, the individual states have always had a role to play in bankruptcy. 95 In Butner v. United States, the Supreme Court explicitly recognized the role of the states in bankruptcy determinations. 96 The Court advocated limited federal authority in bankruptcy cases by representing the legal truism that unless there is conflicting federal regulation, state law governs. 97 The Supreme Court espoused and established the notion that state bankruptcy laws are only preempted when there is actual conflict with the federal regulation provided by the Code. 98 The dispute in Butner centered on competing claims for rents collected between the filing of bankruptcy and foreclosure between a bankruptcy trustee and a second mortgagee. 99 When the Supreme Court granted certiorari, it did not intend to determine whether the state law was properly applied. 100 Instead, the Court was concerned with whether the federal statutes that govern the administration of bankrupt estates were correctly interpreted. 101 Since state law defines and creates property interests, unless there is "some federal interest [that] requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." 102 The Court sought to ensure the uniform treatment of property within a state, regardless of whether the suit was in federal or state courts, "to reduce uncertainty . . . discourage forum shopping, and . . . prevent a party from receiving 'a windfall merely by

93. U.S. CONST. art. VI, cl. 2.
95. See, e.g., Tower Grove Bank & Trust Co. v. Weinstein (In re Hallenberg-Wagner Motor Co.), 119 F.2d 120, 122 (8th Cir. 1941) (“In this circuit the law is settled that the construction of mortgages is governed by local state law.”).
97. See id. at 54.
98. Id.
99. Id. at 49.
100. Id. at 51.
101. Id.
102. Id. at 55.
reason of the happenstance of bankruptcy.” 103 The Court in Butner held that “the federal bankruptcy court should take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued.” 104

Since Butner was decided, 105 there has been movement in the federal bankruptcy courts to rely on federal common law for definitional purposes to ensure uniformity among the states. 106 The basic premise of Butner holds true, but its scope has been limited to a definitional role, with the federal courts increasingly relying on federal common law, rather than state law, to settle any ambiguities in the Code. 107

B. THE SHIFT TO USING FEDERAL COMMON LAW TO DEFINE TERMS THAT ARE AT ISSUE

While not directly contradicting the truism found in Butner, the Court in United States v. Craft shifted away from the dominance of state definitions in the application of federal bankruptcy law, and instead focused on using federal common law to define relevant terms. 108 In Craft, the Court was concerned with “whether a tenant by the entirety possesses ‘property’ or ‘rights to property’ to which a federal tax lien may attach.” 109 The Court determined that the tenant by the entirety possessed “property” or “rights to property” for the purposes of federal law, and while the state may make a different choice concerning state creditors, that choice is not binding on federal courts. 110 Instead, federal courts should “look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, [and] then to federal law to determine whether the taxpayer’s state-delineated rights qualify as property or rights to property within the compass of the federal tax lien legislation.” 111 Craft did not completely reject the truism found in Butner, but instead, merely

104. Id. at 56.
105. The decision in Butner has been superceded by the new bankruptcy code, however “Butner’s core principles remain ‘good law,’ as it has been re-articulated by the High Court since the advent of the Bankruptcy Code.” See In re Pruitt, 401 B.R. 546, 564 (2009).
106. See United States v. Craft, 535 U.S. 274, 278–79 (2002) (“State law determines only which sticks are in a person’s bundle. Whether those sticks qualify as ‘property’ for purposes of the federal tax lien statute is a question of federal law.”).
107. See id. at 288 (state law definition of property rejected in favor of a definition from federal common law); see also Rousey v. Jacoway, 544 U.S. 320, 330 (2005) (state law is not even mentioned in the analysis when the Court is filling in blanks in the Bankruptcy Code).
109. Id. at 276.
110. Id. at 288.
111. Id. at 278 (quoting Drye v. United States, 528 U.S. 49, 58 (1999)) (internal quotation marks omitted).
represented a movement toward the establishment of a federal common law defining the scope of the Code.\textsuperscript{112}

\section*{C. THE EXPANSION OF FEDERAL COMMON LAW IN DETERMINING THE APPLICABILITY OF BANKRUPTCY LAW}

Expanding on the conception of a federal common law for definitional purposes as envisaged by \textit{Craft}, the Supreme Court later firmly established that the question of whether a debt is dischargeable is a separate federal inquiry that should take place in bankruptcy court, not earlier in state court when the nondischargeability of debts is not at issue.\textsuperscript{113} In \textit{Archer v. Warner}, the Warners agreed to pay the Archers in order to settle a fraud claim.\textsuperscript{114} However, after the Warners missed their first payment, they filed for bankruptcy.\textsuperscript{115} The Archers claimed that the Warners’ debt was nondischargeable because it was for money obtained by fraud.\textsuperscript{116} The bankruptcy court, district court, and the court of appeals denied the Archers’ claim and determined that the debt was dischargeable.\textsuperscript{117} The Supreme Court reversed stating that “the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt.”\textsuperscript{118} \textit{Archer} definitively settled the issue that the bankruptcy court can weigh all evidence by looking beyond the record of state court proceedings when determining whether a debt is nondischargeable.\textsuperscript{119} Yet, in \textit{Rousey v. Jacoway}, the Court did not expand on the notion of a federal common law existing for definitional purposes as \textit{Archer} did. Instead, \textit{Rousey} is merely a recent example of federal common law being applied to a bankruptcy exemption.\textsuperscript{120} The Court in \textit{Rousey} asked “whether debtors can exempt assets in their Individual Retirement Accounts (‘IRAs’) from the bankruptcy estate pursuant to § 522(d)(10)(E).”\textsuperscript{121} The § 522(d)(10)(E) exemption allows a debtor to remove his right to receive “a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor” from the bankruptcy estate.\textsuperscript{122} The bankruptcy court, the bankruptcy appellate panel, and the court of appeals determined

\begin{thebibliography}{99}
\bibitem{Craft} See id. at 288.
\bibitem{Archer1} Id. at 317.
\bibitem{Archer2} Id. at 317–18.
\bibitem{Archer3} Id. at 318.
\bibitem{Archer4} Id.
\bibitem{Rousey} Id. at 320–21 (quoting Brown, 442 U.S. at 138) (internal quotation marks omitted).
\bibitem{Rousey1} See id. at 321 (citing Brown, 442 U.S. at 138–39).
\bibitem{Rousey3} Id. at 322.
\end{thebibliography}
that the debtors’ right to payment did not meet all of the statutory factors. Therefore, the IRAs were not exempt from the bankruptcy proceedings.\textsuperscript{123} The Supreme Court reversed and determined that IRAs could be exempted from the bankruptcy estate under § 522(d)(10)(E).\textsuperscript{124}

In the context of this note, \textit{Rousey} is not important for the decision itself, but rather for how it was reached. When the Court determined that the exemption applied, the Court did not consider state law, relying on an analysis grounded in federal common law.\textsuperscript{125} Specifically the Court noted that the Code did not define the relevant terms, and looked “to the ordinary meaning of [those] terms” within the federal common law instead of state law.\textsuperscript{126} \textit{Rousey} illustrates the scope of the \textit{Archer} expansion by demonstrating that the application of federal common law extended beyond the applicability of bankruptcy law in general and instead is applicable in defining exemption terms.

\section*{III. APPLICATION OF PRINCIPLES IN DECIDING THE CIRCUIT SPLIT}

Though the Ninth and Fifth Circuits’ interpretations necessitate different roles concerning the incorporation of federal and state common law into § 523(a)(6), the differing reliance on either federal or state common law does not make either interpretation fundamentally unsound. However, the Ninth Circuit rule is superior because it is more protective of debtors, is supported by the legislature’s drafting intent, and is not subject to abuse by creditors or debtors.

\subsection*{A. NINTH CIRCUIT RULE AND THE ROLE OF STATE AND FEDERAL COMMON LAW}

The Ninth Circuit rule concerning the nondischargeability of debts under § 523(a)(6) is a fundamentally sound statutory interpretation, but, since tortious conduct is not defined within the Code, there is conflict over whether state or federal common law should define the term.\textsuperscript{127} Depending on which standard is adopted, different conduct will be excepted from discharge under the Ninth Circuit rule. If courts apply the truism from \textit{Butner}, state law will define what constitutes tortious conduct.\textsuperscript{128} However,

\begin{thebibliography}{9}
\bibitem{123} \textit{Rousey}, 544 U.S. at 324–25.
\bibitem{124} \textit{Id.} at 326.
\bibitem{125} See \textit{id.} at 327–32 (analyzing whether the debtor’s right to payment meets the requirements of the § 522(d)(10)(E) exception without invoking, or even mentioning state law, and instead relying on a purely federal analysis).
\bibitem{126} \textit{Id.} at 330.
\bibitem{128} \textit{Butner v. United States}, 440 U.S. 48, 54 n.9 (1979) (“[S]tate laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress.”).
\end{thebibliography}
if the courts apply the reasoning found in *Craft* or *Archer*, the courts will look to federal common law to define tortious conduct.\textsuperscript{129}

While the Supremacy Clause of the United States Constitution would generally govern this conflict of competing interpretations, a determination of what constitutes tortious conduct is an activity generally left to the states.\textsuperscript{130} Traditionally, states have been granted the authority to establish tort law because the determination of what constitutes tortious conduct is representative of a public policy decision to regulate.\textsuperscript{131} In addition to tradition, defining what conduct is tortious should be left to the states so as to ensure the uniform application of bankruptcy law by both state and federal courts within a state. This will reduce uncertainty over what conduct is exempted, discourage forum shopping by debtors and creditors, and prevent a party from being benefited because the action is a bankruptcy proceeding.\textsuperscript{132}

Furthermore, the federal definition of “tortious conduct” is inappropriate in the application of § 523(a)(6) because unlike *Craft*, there is no predefined common law since the Code does not define the term tortious conduct.\textsuperscript{133} And while *Archer* may expand on the federal definitional power found in *Craft*, it does so by requiring a federal inquiry in bankruptcy court when the dischargeability of debts in bankruptcy is at issue.\textsuperscript{134} This inquiry does not require the application of state or federal common law to define a term, but merely ensures that bankruptcy courts weigh all of the evidence when determining if a debt is nondischargeable.\textsuperscript{135} Defining what constitutes tortious conduct must be done on the state level in order to ensure that local interests are represented in a uniform manner within the state.\textsuperscript{136} In turn, this will necessitate reliance on the *Butner* Court’s decision to incorporate state tort law into the Code.

Following the *Butner* Court’s rationale may be disconcerting because it could lead to a different application and analysis of claims grounded in bankruptcy on a state-by-state basis. For example, in the hypothetical state


\textsuperscript{130} HENRY COHEN & VANESSA K. BURROWS, FEDERAL TORT REFORM LEGISLATION: CONSTITUTIONALITY AND SUMMARIES OF SELECTED STATUTES, CRS REPORT FOR CONGRESS (July 7, 2008), available at http://www.law.umaryland.edu/marshall/crsreports/crsdocuments/95797_07072008.pdf (“Tort law at present is almost exclusively state law rather than federal law.”).

\textsuperscript{131} See *Retherford* v. AT&T Commc’n, 844 P.2d 949, 974 (Utah 1992) (“The common law of tort expresses public policy . . . .”).

\textsuperscript{132} *Butner*, 440 U.S. at 55.

\textsuperscript{133} 11 U.S.C. § 523(a)(6) (2006); see *Craft*, 535 U.S. at 283 (explaining that the language of 26 U.S.C. § 6321 is broad and shows congressional intent to reach all the property a taxpayer may have).

\textsuperscript{134} See *Archer*, 538 U.S. at 321.

\textsuperscript{135} See id.

\textsuperscript{136} See *Butner*, 440 U.S. at 55.
of Guntopia, suppose there is a law exempting all responsibility for harm caused by firing a gun on one’s own property. The Ninth Circuit rule, under the *Butner* standard, would allow someone who damaged another’s property, with a gun used on their own property, to avoid the debt.\(^{137}\) While this is an extreme example, it illustrates that reliance on the *Butner* standard could result in disparate treatment among the states for determining whether debts can be discharged in bankruptcy. Ultimately, this concern does not amount to much when one looks at how the Ninth Circuit rule has been applied. For example, in the *Jercich* decision, the court looked to California law to determine whether the nonpayment of wages by an employer was tortious conduct.\(^{138}\) Though adoption of the Ninth Circuit rule could lead to confusion over whether state law or federal common law defines tortious conduct, the traditional exertion of power by the state, coupled with the general adoption of state standards by the bankruptcy courts, means that the state law definition of tortious conduct would be adopted.

While the requirement of tortious conduct being read into § 523(a)(6) could lead to conflict between state and federal law, the *Butner* truism effectively limits that conflict even when viewed in light of the expansive federal common law established by *Craft* and *Archer*.

**B. FIFTH CIRCUIT RULE AND THE ROLE OF STATE AND FEDERAL COMMON LAW**

Unlike the Ninth Circuit rule, the Fifth Circuit rule found in *Williams* invites the adoption of federal common law to define the terms. The Fifth Circuit rule requires that the “debtor must have acted with objective substantial certainty or subjective motive to inflict injury.”\(^{139}\) This test relies on definitional terms that can be uniformly adopted among the states, and therefore, there are no negative consequences with the adoption of a federal standard. The requirements of “objective substantial certainty” and “subjective motive” can be easily defined by federal common law so as to ensure uniformity in the application of bankruptcy law.\(^{140}\) Similar to the

\(^{137}\) The injury to property that would occur from an individual firing a gun on their own property would be dischargeable under § 523(a)(6) even if the individual acted in a willful and malicious manner because the state has determined that the individual’s conduct is not blameworthy. See 11 U.S.C. § 523(a)(6) (2006).

\(^{138}\) See *Petralia v. Jercich* (*In re Jercich*), 238 F.3d 1202, 1207 (9th Cir. 2001); see also *Jett v. Sicroff* (*In re Sicroff*), 401 F.3d 1101, 1105 (9th Cir. 2005) (looking to California state law to determine that the libelous statements made by the debtor were tortious conduct making the damages nondischargeable under § 523(a)(6), amended by, No. 03-15610, 2005 U.S. App. LEXIS 5919 (9th Cir. Apr. 11, 2005).

\(^{139}\) *Williams v. Int’l Bhd. of Elec. Workers Local 520* (*In re Williams*), 337 F.3d 504, 509 (5th Cir. 2003) (citing *Miller v. J.D. Abrams, Inc.* (*In re Miller*), 156 F.3d 598, 603 (5th Cir. 1998)) (internal quotations omitted).

\(^{140}\) The reason these terms can be adopted easily on a federal level is because they are terms of art that are used in a consistent manner among the states. The term “objective substantial certainty” is applied in the same manner by the Fifth Circuit and in a bankruptcy court in Ohio.
rationale by the Court in Rousey, the terms found in the Fifth Circuit test can be easily defined by looking to the ordinary meaning of those terms.\(^{141}\) In addition to Rousey, the Court in Archer established that federal common law could be used to define terms in bankruptcy.\(^{142}\) The adoption of federal common law to define the terms found in the Fifth Circuit test is appropriate because of the uniform nature of the terms and the interest in establishing uniform application of the law among the states.

While the Fifth Circuit rule embraces the modern trend of using federal common law in interpreting the Code, there is concern that the test is not fundamentally sound since it conflates the willful and malicious requirement. The Fifth Circuit, relying primarily on the Supreme Court’s reasoning in Geiger, determined that § 523(a)(6) creates an implied malice standard, and that “[a] debtor acts with implied malice when he acts with the actual intent to cause injury.”\(^{143}\) While it is possible that the Fifth Circuit could rely on the vagueness of the statute to justify its implied malice standard, since the fact that the statute reads “willful and malicious” could be interpreted as meaning that the injury be both willful and malicious, the statute could also be disjunctive and refer to a “willful injury” or a “malicious injury” as being adequate for an exception from discharge. However, the conflation misconstrues both the nature and the plain language of the Geiger decision, which did not address whether the doctor’s conduct was malicious and merely focused on whether the doctor caused a willful injury to the patient.\(^{144}\) Furthermore, as the Ninth Circuit has noted, conflating the willful and malicious standards of § 523(a)(6) contravenes established precedent.\(^{145}\) Since the Supreme Court did not address the malicious requirement in Geiger, the Fifth Circuit has

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See, e.g., Berry v. Vollbracht (In re Vollbracht), 276 F. App’x. 360, 361 (5th Cir. 2007) (defining “objective substantial certainty” as an objective test where the court looks at whether the debtor’s actions were at least substantially certain to result in injury); J. Bowers Constr. Co. v. Williams (In re Williams), 233 B.R. 398, (Bankr. N.D. Ohio 1999) (the “objective substantial certainty” test was applied in an objective manner where the court looked at whether the debtor’s actions in withdrawing funds from a joint savings account were intended to cause injury to the plaintiff). In addition to the consistent treatment of “objective substantial certainty,” the term “subjective motive” is also treated in a consistent manner amongst the various states. See, e.g., Berry, 276 F. App’x at 362 (“subjective motive” is used to determine whether the debtor’s intentional actions were intended to cause harm to the plaintiff); Branch Banking & Trust Co. v. Powers (In re Powers), 227 B.R. 73, 76 (Bankr. E.D. Va. 1998) (the “subjective motive” test “requires [courts] to focus on the subjective intent of the debtor to determine whether the injury was intended or unintended”). This is in contrast to “tortious conduct,” a term that the individual states have vested interests in defining. See Biner, 440 U.S. at 55.

143. In re Williams, 337 F.3d at 509 (quoting In re Miller, 156 F.3d at 606) (internal quotations omitted).
misconstrued that case’s interpretation of § 523(a)(6) by conflating the willful and malicious standard into a single test.\textsuperscript{146}

The fact that the Ninth Circuit rule relies on state common law to define tortious conduct, and the Fifth Circuit rule relies on federal common law to define its terms does not affect the soundness of the rules. Though there could be some concern that the Ninth Circuit rule is an example of judicial rule making, this concern is unfounded because its interpretation can be reconciled with the statute’s legislative history and the rules of statutory construction.\textsuperscript{147} On the other hand, there is serious concern that the Fifth Circuit’s conflation of the willful and malicious injury requirement into a single test comes into conflict with the Supreme Court’s decision in Geiger and established precedent. Though this conflict does not make the Fifth Circuit rule fundamentally unsound, it does make the Ninth Circuit rule more attractive.

C. PROTECTIVE OF DEBTORS

In addition to the Ninth Circuit rule being a more attractive rule for constructionary reasons, the Ninth Circuit rule is also more protective of debtors. It is well established in the United States that the purpose of bankruptcy is “to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.”\textsuperscript{148} The fresh start afforded to the honest debtor gives the debtor “a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”\textsuperscript{149} However, the policy for relief in bankruptcy being accorded to the honest debtor is not absolute and “the fresh start [policy of the Code] does not extend to an \textit{in rem} claim against property but is limited to a discharge of personal liability.”\textsuperscript{150}

\textsuperscript{146} It is possible, however, that the Supreme Court has implicitly approved of the Fifth Circuit’s condensing of the malice and willful requirements, since the Court denied certiorari to \textit{Miller v. J.D. Abrams, Inc. (In re Miller),} 156 F.3d 598 (5th Cir. 1998), the case that established the implied malice standard. See \textit{Miller v. J.D. Abrams, Inc. (In re Miller),} 526 U.S. 1016 (1999). Nevertheless, this result is a stretch and is reading too much into the Court’s decision to deny certiorari. United States v. Carver, 260 U.S. 482, 490 (1922) (“The denial of a writ of certiorari imports no expression of opinion upon the merits of the case . . . .”). Even though the Fifth Circuit rule misread\textsuperscript{\hspace{1pt}}s the Court’s decision in Geiger by conflating the willful and malicious requirements, it is not clear that the rule is not fundamentally sound since Geiger merely focused on what constituted an intentional injury and did not address what constituted a malicious injury. See Geiger, 523 U.S. at 61.

\textsuperscript{147} See infra the subsequent discussion concerning the role of legislative history and the rules of statutory construction in Part III.D.


\textsuperscript{149} Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

While it was clear as early as 1915 that the purpose of the Code was to give the honest debtor a fresh start, before the enactment of the Code reform in 1978 secured creditors were able to abuse the system at the debtors’ expense. The Bankruptcy Reform Act of 1978 took steps to prevent abuse by creditors and the wide-sweeping changes resulted in the Code having a pro-debtor bias. Yet, many of the amendments to the Code after 1978 have been passed to level the playing field, and even in some instances, favor creditors in bankruptcy. Despite “the policy winds hav[ing] turned angrily from the dew-dropping pro[-]debtor south to the frozen bosom of the pro[-]creditor north,” the fundamental purpose of the Code remains the same: to give the honest debtor a fresh start.

The Ninth Circuit rule is more protective of debtors and is more lenient in allowing them to discharge their debts in bankruptcy proceedings. As shown in *Jercich* and *Salvino*, the Ninth Circuit rule only prevents debts from being dischargeable when the debtor has intentionally and maliciously caused injury to the creditor through tortious conduct. By requiring tortious conduct in addition to a malicious and willful injury, the Ninth Circuit rule makes it harder for debtors to have their debts declared nondischargeable. In addition to being protective of debtors, the requirement of tortious conduct involves a determination of the debtor’s “honesty,” or his blameworthiness, thus making the rule congruent with the purpose of bankruptcy. For example, in *Jercich*, the debtor was “dishonest” because he breached California public policy in failing to pay the wages of one of his employees and therefore his debt was nondischargeable, while the debtor in *Salvino* was “honest” because an intentional breach of an employment contract was not a violation of Illinois public policy. The Ninth Circuit rule serves the fundamental purpose of


153. See id. at 1064.

154. *Id.* (for example, see 11 U.S.C. § 522(f)(3) (2006), which was originally added in 1994, and strongly favors creditors at the expense of debtors).

155. *Id.*


158. *See, e.g.*, *Salvino*, 373 B.R. at 592 (although Salvino falsely represented the fact that he intended to work for Wish, his breach of contract was not tortious).


160. *In re Jercich*, 238 F.3d at 1206–07.

bankruptcy by protecting honest debtors and preventing dishonest debtors from discharging their debts.\textsuperscript{162}

On the other hand, the Fifth Circuit rule that combines the willful and malicious injury requirement into a single determination of whether the debtor “acted with objective substantial certainty or subjective motive to inflict injury” is not protective of debtors.\textsuperscript{163} By conflating the willful and malicious requirements, the Fifth Circuit rule requires a single determination of whether a debtor’s conduct can be nondischargeable. In addition to the rule being easily satisfied, the Fifth Circuit rule does not make any attempt to distinguish between an honest and dishonest debtor.\textsuperscript{164} By failing to incorporate any degree of blameworthiness into the determination, the Fifth Circuit rule is as likely to allow a dishonest debtor to discharge her debts as to prevent an honest debtor from doing so.

While the Fifth Circuit rule provides debtors some protection by requiring intentional action on the part of the debtor, the Ninth Circuit rule is more protective by having multiple elements and a determination of blameworthiness through the requirement of tortious conduct. The Ninth Circuit rule is better because it is more protective of debtors in general, and more importantly, it makes an effort to protect honest debtors in accordance with the purpose of the Code.

D. INTENT OF THE LEGISLATURE

Besides being more protective of debtors, the Ninth Circuit rule is more in line with the intent of the legislature and the rules of statutory construction. Concerning the passage of amendments to the Code, “[w]hen Congress amends the bankruptcy laws, it does not write on a clean slate.”\textsuperscript{165} This means that modifications to the Code do not replace established case law; instead, amendments are understood in light of previous interpretations except where the common law is explicitly overruled.\textsuperscript{166} Further, when there is a dearth of discussion concerning a modification to existing case law in the legislative history, the Supreme Court has been reluctant to interpret an amendment to the Code that contradicts a pre-Code practice.\textsuperscript{167} In practice, when a provision of the Code “is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the

\textsuperscript{162} See In re Jercich, 238 F.3d at 1206.
\textsuperscript{163} Williams v. Int’l Bhd. of Elec. Workers Local 520 (In re Williams), 337 F.3d 504, 509 (5th Cir. 2003) (citing Miller v. J.D. Abrams, Inc. (In re Miller), 156 F.3d 598, 603 (5th Cir. 1998)) (internal quotation marks omitted).
\textsuperscript{164} See, e.g., Red v. Baum (In re Red), 96 F. App’x 229, 231 (5th Cir. 2004). Despite the fact that the debtor’s act of running a car into a crowded bar constituted tortious conduct, the court did not address the debtor’s blameworthiness in holding his debt nondischargeable and instead focused on whether the debtor’s actions were objectively certain to cause harm. Id.
\textsuperscript{167} Dewsnup, 502 U.S. at 419.
statute.168 But, when interpreting a provision of the Code that is open to some interpretation, the court may look to legislative history and the pre-
Code practice.169

Section 523(a)(6) may not be facially ambiguous, but given the divergent treatment among the circuits, it is necessary to look at earlier practice and the legislative history to determine whether tortious conduct is required.170 Looking at the practice of the judiciary before § 523(a)(6) was added to the Code, the Ninth Circuit rule is more in line with past practice. Before § 523(a)(6) was codified in 1978, § 17(a)(8) of the Bankruptcy Act of 1898 had a willful and malicious injury exception from discharge that applied only where there was tortious conduct.171 By voluntarily reenacting the willful and malicious injury requirement for nondischargeability from the old § 17(a)(8) into § 523(a)(6), it is safe to assume that Congress intended to continue limiting the application of this exception to tortious conduct.172 This assumption comes from the fact that “Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change.”173 Since the language of the old bankruptcy exception found in § 17(a)(8) is the same as the current language found in § 523(a)(6),174 unless there is contrary language in the legislative history the requirement of tortious conduct will continue unabated.175 Additionally, when a common law principle is firmly established, like the requirement of tortious conduct to invoke the willful and malicious injury exception, “the courts may take it as given that Congress has legislated with an expectation that the principle will apply except when a statutory purpose to the contrary is evident.”176

Looking to the legislative history, the Ninth Circuit rule is congruent with established rules of statutory construction. The legislative history of § 523(a)(6) merely discusses that the Supreme Court’s ruling in a prior case had been overruled.177 Therefore, “willful” means intentional or

169. See id. at 246.
170. See id.
172. See id. at 590.
174. Salvino, 373 B.R. at 589 (“[B]efore the enactment of § 523(a)(6) in the 1978 Bankruptcy Code, a ‘willful and malicious injury’ exception from discharge was set out in § 17(a)(8) of the Bankruptcy Act of 1898, and was applied only in situations of tortious conduct.”).
176. Id. (quoting Isbrandtsen Co. v. Johnson, 343 U.S. 779, 783 (1952)) (internal quotation marks omitted).
177. In the legislative changes concerning § 523(a)(6), the only change mentioned is that the Supreme Court case Tinker v. Colwell, 193 U.S. 473 (1902), was overruled. See S. REP. NO. 95-989, at 79 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 5865.
deliberate. However, there is nothing in the legislative history suggesting that the scope of the § 523(a)(6) exception has been expanded to cover claims of malicious and willful injury that do not involve an independent tort action. Further, when discussing the modifications to § 523 generally, the legislative discussion makes no mention of § 523(a)(6), and where there is no discussion it is likely that the pre-Code practice is still applicable. Since there is no discussion in the legislative history of modifying § 523(a)(6) to cover claims of malicious and willful injury that do not involve an independent tort action, the Ninth Circuit rule should be adopted.

It is necessary to look at the pervasiveness of past practice and legislative history to determine whether the prior practice is still the current rule under the Code, because the modification of the Code does not occur on a clean slate. Past practice will govern unless there is clear intent either in the statute or in the legislative history to overrule the past practice. When Congress adopted the language of § 17(a)(8) without modifying it or discussing changes, the case law requiring tortious conduct for a debt to be nondischargeable still governed. Since the Fifth Circuit rule does not require tortious conduct and the Ninth Circuit rule does, the Ninth Circuit rule is more harmonious with the rules of legislative history and statutory construction.

E. ABUSE BY THE DEBTOR AND THE CREDITOR

Beyond being more protective of debtors and more in line with legislative intent, the Ninth Circuit rule cannot be as easily manipulated by either party for an unfair advantage while the Fifth Circuit rule can be easily abused by a creditor. While the underlying purpose of the Code, in allowing the honest debtor to start afresh, is pro-debtor, bankruptcy does not unduly favor debtors at the expense of creditors. Given this dichotomy, it becomes necessary to interpret the Code in such a manner that creditors do not lose their rights but debtors are protected in accordance with the purpose of the Code. Although it is true that the balancing of debtors and

178. S. REP. NO. 95-989, at 79.
179. See id. (does not mention modifying the statute to no longer require tortious conduct).
181. See Dewsnup v. Timm, 502 U.S. 410, 419 (1992) (Without discussion in the legislative history, the Court has been reluctant to adopt an interpretation of the Bankruptcy Code that would "effect a major change in pre-Code practice . . . .").
183. See Dewsnup, 502 U.S. at 419.
creditors' rights in an equitable manner can result in abuse of the system, the
fact that bankruptcy is an alternative avenue for the vindication of legal
debtors' rights exacerbes the possibility of forum shopping. 187

Since “[t]here is no virtue in giving parties an incentive to engage in
forum shopping for its own sake,” it becomes necessary to establish
exception rules that do not encourage pursuing an action in bankruptcy over
other legitimate legal avenues. 188 One method of limiting forum shopping in
bankruptcy is to ensure that debtor/creditor rights outside of bankruptcy
match those rights within bankruptcy. 189 By keeping the rights in
bankruptcy and alternative legal avenues congruent, the ability of parties to
misbehave is severely limited. 190 This method is superior to granting judges
discretion to police the conduct of parties since judges are human, and
therefore, prone to error. 191 By establishing congruent policies in and out of
bankruptcy, courts can limit forum shopping and other abuses by parties.

The Ninth Circuit rule limits opportunities to forum shop by ensuring
that legal rights that are protected outside of bankruptcy are protected
during bankruptcy proceedings. By exempting tortious conduct from
discharge, the Ninth Circuit rule establishes a bankruptcy policy grounded
in legal rights. This congruent policy in the context of § 523(a)(6) ensures
that violators of public policy are held responsible for the harm they
cause. 192 By ensuring that violators of public policy are responsible for the
harm they cause no matter what the legal proceeding, the Ninth Circuit rule
does not provide an incentive for the debtor to enter into bankruptcy and
gives the creditor no reason to force the debtor into bankruptcy. 193 Since the
Ninth Circuit rule ensures congruence between rights in and out of
bankruptcy, the rule is appropriately classified as a neutral rule into and out
of bankruptcy. 194

Though the Ninth Circuit rule ensures congruent analysis of conduct,
there is concern that in practice a dishonest debtor might be able to abuse
the rule to avoid his obligations to his creditor. For example, allowing the
doctor in Salvino to avoid the debts arising out of his intentional breach of
contract seems to be an abuse of the Code, since it allows a dishonest debtor

187. See id. at 824–27.
188. Id. at 827.
189. See id. at 822.
190. See id. at 821 (when a party has an incentive to misbehave controlling their conduct is
inherently difficult, but eliminating that incentive makes that party easier to police).
191. Id. (“Allowing someone to gamble with someone else’s money is always a bad idea, even
when a conscientious judge is looking over the gambler’s shoulder.”).
192. See, e.g., Petralia v. Jercich (In re Jercich), 238 F.3d 1202, 1207 (9th Cir. 2001) (Jercich
was unable to avoid damages owed through non-payment of wages to his employee even though
he filed for bankruptcy).
193. See Baird, supra note 186, at 827 (“There is no virtue in giving parties an incentive to
engage in forum shopping for its own sake.”).
194. The Ninth Circuit rule is appropriately classified as a neutral rule into and out of
bankruptcy since it does not encourage forum shopping by either the debtor or the creditor.
to swindle his creditor and escape his obligations.\textsuperscript{195} Despite the doctor’s dishonesty, his conduct is more correctly classified as an intentional breach of contract done to offset further economic loss.\textsuperscript{196} The doctor’s conduct may have been underhanded, but it was merely a breach of an agreement between private parties and did not implicate the public policy concerns underlying tort law.\textsuperscript{197} Since Salvino did not violate any public policy in breaching his contract,\textsuperscript{198} he is not blameworthy, and therefore is an honest debtor who is entitled to protection under the Code.\textsuperscript{199}

By requiring tortious conduct for a debt to be nondischargeable under § 523(a)(6), the Ninth Circuit rule is firmly grounding willful and malicious injury in tort law. By doing so, the Ninth Circuit is ensuring that each challenge to the dischargeability of debts under § 523(a)(6) will be decided on a case-by-case basis after a careful weighing of objective standards that does not allow either the debtor or the creditor to use bankruptcy to their own advantage at the expense of the other party.\textsuperscript{200}

In contrast, the Fifth Circuit rule is not neutral concerning forum shopping and has the effect of encouraging creditors to force debtors into bankruptcy. This incentive results from the lack of a requirement of tortious conduct in the determination of whether a debt is nondischargeable because of a willful and malicious injury.\textsuperscript{201} Without the tortious conduct exception, creditors who lack a valid tort claim, or whose judgment would be limited in normal proceedings, have an incentive to push debtors into bankruptcy to ensure payment. This incentive results because the Fifth Circuit rule is easily satisfied and is sufficiently broad to cover a wide range of misconduct, including intentional breaches of contract.\textsuperscript{202} For example, under the Fifth Circuit rule, Salvino would have been unable to discharge the debts resulting from the breach of his employment contract since he intended, or was substantially certain, to injure the creditor.\textsuperscript{203} A creditor under the Fifth Circuit rule would have the incentive to force a debtor like Salvino into bankruptcy, so as to limit his remedies and ensure a prompt judgment for payment.

\begin{footnotesize}
\textsuperscript{196} See id.
\textsuperscript{197} See Retherford v. AT&T Commc’n, 844 P.2d 949, 974 (Utah 1992) (“The common law of tort expresses public policy, the scope of which is not generally determined by reference to privately contracted obligations.”).
\textsuperscript{198} Salvino, 373 B.R. at 592.
\textsuperscript{200} See, e.g., Salvino, 373 B.R. at 588–92; Petralia v. Jercich (In re Jercich), 238 F.3d 1202, 1206–09 (9th Cir. 2001) (examples of analysis under the Ninth Circuit rule on a case by case basis), cert. denied, 533 U.S. 930 (2001).
\textsuperscript{201} See Williams v. Int’l Bhd. of Elec. Workers Local 520 (In re Williams), 337 F.3d 504, 510 (5th Cir. 2003).
\textsuperscript{202} See Salvino, 373 B.R. at 590.
\textsuperscript{203} See id. at 578.
\end{footnotesize}
The Ninth Circuit rule is neutral as to the issue of forum shopping because it ensures equal treatment of parties in and out of bankruptcy proceedings, thus ensuring that neither party will seek the bankruptcy arena in search of a windfall.\textsuperscript{204} In contrast, the Fifth Circuit rule does not mandate similar application of the law within bankruptcy and other legal proceedings resulting in an incentive for creditors to engage in forum shopping.\textsuperscript{205} The Ninth Circuit’s rule is superior to the Fifth Circuit’s approach because, instead of merely giving judges additional authority to police abuses, it eliminates incentives to engage in forum shopping.\textsuperscript{206}

CONCLUSION

The Ninth Circuit rule requiring tortious conduct for a debt to be nondischargeable should be universally adopted since it is more protective of debtors, more consistent with the legislative history of the statute, can be reconciled with the rules of statutory construction, and is less likely to result in forum shopping by both the debtor and the creditor. As Bankruptcy Judge Wedoff notes in \textit{Salvino}, the use of the phrase “willful and malicious injury” suggests that the exception is limited to tortious conduct, that the legislative history seems to necessitate a finding of a tortious conduct requirement, that without a tortious conduct requirement the exception would become too broad and contravene the purpose of the Code, and that there would be conflicts between clauses of the Code if tortious conduct was not required.\textsuperscript{207} Interpreting § 523(a)(6) to require tortious conduct is more protective of debtors because it is more difficult to satisfy and is harmonious with the overarching purpose of the Code.\textsuperscript{208} This interpretation is also more consistent with the intent of the legislature because past practice and the rules of statutory construction necessitate a finding that tortious conduct is required to invoke the willful and malicious injury exception.\textsuperscript{209} The Ninth Circuit rule will result in less forum shopping by either party as it ensures the equal application of law whether the action is a bankruptcy proceeding or not.\textsuperscript{210} Since the fundamental purpose of the Code is to allow the honest debtor to start afresh\textsuperscript{211} and the Ninth Circuit clearly fulfills that function, it should be universally adopted throughout the United States.

\textsuperscript{204} See Baird, supra note 186, at 825.
\textsuperscript{205} See id. at 818 (“In a world in which workers enjoy a special priority only in bankruptcy, creditors will strive to resolve their differences outside of bankruptcy.”).
\textsuperscript{206} Id. at 821.
\textsuperscript{207} See Salvino, 373 B.R. at 589–91.
\textsuperscript{208} See Williams v. U.S. Fid. & Guar. Co., 236 U.S. 549, 554–55 (1915) (the purpose of bankruptcy is to allow an “honest debtor” to “start afresh”).
\textsuperscript{210} See Baird, supra note 186, at 822.
\textsuperscript{211} See Williams, 236 U.S. at 555.
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HOW TO BUFFER YOUR WAY OUT OF A SCRAPE: POTENTIAL ABUSE OF THE CARTOON NETWORK V. CABLEVISION DECISION

INTRODUCTION

As subscribers to Cablevision Systems Corporation’s (Cablevision) cable service are stuck in rush hour traffic or delayed at the doctor’s office, a frightening thought might suddenly occur to them: they may miss the new episode of CSI: Crime Scene Investigation, Aqua Teen Hunger Force, or Lost airing that night. Fortunately, most digital television viewers can breathe a collective sigh of relief. The rise of cable television programming distribution has brought with it new technologies that allow users to record television programming and store these shows for viewing at a later time. The use of digital playback technologies, such as Digital Video Recorder (DVR) systems and Video on Demand (VOD) services, has so pervaded

1. Cablevision Systems Corporation is a telecommunications and media company that provides various information and entertainment services. About Cablevision, http://www.cablevision.com/about/index.jsp (last visited Oct. 19, 2009). “Cablevision’s portfolio of operations includes a full suite of advanced digital television, voice and high-speed Internet services, publishing and interactive media, world-renowned entertainment showplaces, professional sports teams, and popular national and regional programming networks.” Id.

2. Cablevision provides programming and original content to hundreds of millions of American consumers through its “[iO] Interactive Optimum-brand” digital cable service. Id.


6. From May 2007 to May 2008 alone, the number of viewers watching programming through the use of technology with some form of playback-viewing capabilities rose 35.7%, from an estimated 46,632,000 viewers to almost 63,265,000 viewers. The Nielsen Company, Nielsen’s Three Screen Report 2, 4 (2008) [hereinafter Nielsen’s Three Screen Report] (stating that as of May 2008, fourteen percent of all TV tuning in primetime in households with Digital Video Recorders (DVR) was through playback of stored programming).

7. PCMag.com, Encyclopedia Definition of: DVR, http://www.pcmag.com/encyclopedia_term/0,2542,t-DVR&i=42147,00.asp (last visited Oct. 22, 2008). A Digital Video Recorder, “[a]lso known as a ‘personal video recorder’ (PVR) or ‘hard disk recorder,’ a DVR is a consumer device” that digitizes broadcast or cable TV onto a hard disk using MPEG-2 compression. Id. It allows the viewer to pause at any time and continue to play or record a program for viewing at a later date like a VCR. Id. The DVR can also be set to periodically record favorite shows whenever broadcast. Id.

8. VOD service is provided on an individual customer basis, whereby a cable operator receives licensed programming at a central facility and stores it on computer servers so that individual customers may view selected programming at any time through the use of a cable
the broadcasting industry that the viewing habits of the modern television spectator have been drastically changed. Consumers may now watch the programs they enjoy without the time constraints of real-time viewing. These services even allow viewers to pause a television show they are currently watching to go have a snack or run an errand, and then subsequently resume their program with the option of skipping past any television commercial advertisements they may find unappealing. Despite the advantages these technologies provide to consumers, the Remote Storage Digital Video Recorder (RS-DVR) system developed by Cablevision as a digital playback system has caused a great commotion amongst those in the media and entertainment distribution industry. The prospect of this product’s broad commercial rollout has spurred a large number of content providers of movie and television programs to jointly bring a copyright suit against Cablevision.

On August 4, 2008, the Second Circuit handed down its long-awaited decision in Cartoon Network L.P. v. CSC Holdings, Inc., announcing that Cablevision’s RS-DVR system would not infringe upon the exclusive reproduction rights held by owners of copyrighted programming.


9. See generally Nielsen’s Three Screen Report, supra note 6. Today, “25% and 35% of U.S. homes have DVR and [VOD] respectively. As the number of homes with the ability to time shift [their programming] increases, we should expect that people will have more choice of television programming available to them and more choice in when to watch.” Id. at 4.

10. See supra text accompanying note 7.

11. See Brian Stelter, A Ruling May Pave the Way for Broader Use of DVR, N.Y. TIMES, Aug. 5, 2008, at C8, available at http://www.nytimes.com/2008/08/05/business/media/05adco.html (Craig E. Moffett, an analyst at Sanford C. Bernstein & Company, said the Cablevision ruling could have “seismic implications across the media landscape” which could lead to “a huge increase in the number of viewing hours per day potentially subject to ad-skipping.”).

12. The RS-DVR system allows cable customers to “record [television] programming on central hard drives” without the use of stand-alone DVRs. Cartoon Network L.P. v. CSC Holdings, Inc., 536 F.3d 121, 124 (2d Cir. 2008), cert. denied sub nom. CNN, Inc. v. CSC Holdings, Inc., 129 S. Ct. 2890 (2009). Cablevision stores and maintains these hard drives at a “remote” location. Id. Customers may then receive playback of those programs “through their home television sets, using only a remote control and a standard cable box equipped with the RS-DVR software.” Id.

13. Id. at 124.

14. Id.

15. Id.

16. Id. at 140.
Although the ruling is being hailed by some as a victory for both innovation\(^{17}\) and consumers,\(^{18}\) this note argues that the court misapplied prior case law\(^{19}\) and ignored the importance of these content-providers’ exclusive rights to control the usage and distribution of their copyrighted work.\(^{20}\) The Second Circuit employed a short-sighted analysis in categorizing data “buffers”\(^{21}\) as transitory carriers of data streams that do not produce infringing “fixed copies”\(^{22}\) of copyrighted works.\(^{23}\) The decision will likely increase future litigation over whether copyright infringement has occurred when data is quickly overwritten\(^{24}\) or obtained through the use of buffers.

\(^{17}\) Gigi Sohn, President of Public Knowledge, a Washington, D.C. based public interest advocacy organization dedicated to promoting the public interest in access to information, called the decision a “great victory for innovation.” Glen Dickson, Court Says Yes to Network DVR, BROADCASTING & CABLE, Aug. 4, 2008, http://www.broadcastingcable.com/index.asp?layout= talkbackCommentsFull&amp;talk_back_header_id=6547155&amp;articleid=CA6584154.


\(^{19}\) Namely, the application of MAI Systems Corp. v. Peak Computer, Inc., 991 F.2d 511 (9th Cir. 1993), and its progeny; as well as the application of the line of cases following Religious Technology Center v. Netcom On-Line Communication Services, 907 F. Supp. 1361 (N.D. Cal. 1995).


\(^{21}\) A **Buffer** is:

> [A] reserved segment of memory used to hold data while it is being processed. In a program, buffers are created to hold some amount of data from each of the files that will be read or written. In a streaming media application, the program uses buffers to store an advance supply of audio or video data to compensate for momentary delays.


A work is “fixed” in a tangible medium of expression when its embodiment in a copy or phonorecord, by or under the authority of the author, is sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration. A work consisting of sounds, images, or both, that are being transmitted, is “fixed” for purposes of this title if a fixation of the work is being made simultaneously with its transmission.


In an already complex battlefield of legal issues, the court’s holding places an even heavier burden on determining where the line between direct and contributory copyright infringement liability should attach. The court’s reasoning in reaching this decision has further divorced liability for direct copyright infringement from intermediary content providers by solely attaching this legal responsibility to consumer end-users.

In order to justify its decision, the Second Circuit, dangerously extended the view regarding Internet Service Providers (ISPs) and Bulletin Board Systems (BBSs) as passive owners of contributory infringement systems by applying it beyond the realm of the Internet.

The court’s emphasis on the transitory duration of the copyrighted works’ embodiment in the buffers, as well as the role of the buffers in preventing the copies from being impermissibly “fixed” in avoidance of direct infringement, may have an impact on a topic debated vigorously on a global scale: facilitating the process of “screen-scraping” to aggregate data for use on a third-party website. While employing screen-scrappers to obtain facts and statistics from third-party websites is not typically held to be an illegal practice in the United States, many courts consider it to be an unethical business practice.

25. Cartoon Network, 536 F.3d at 130 (stating that data is not “fixed” in buffers for more than a transitory duration where the data resides in such a buffer for no more than 1.2 seconds before being overwritten).


27. An Internet Service Provider is “an organization that provides access to the Internet. Connection to the user is provided via dial-up, ISDN, cable, DSL and T1/T3 lines.” PCMag.com, Encyclopedia Definition of: ISP, http://www.pcmag.com/encyclopedia_term/0,2542,t=ISP&i=45481,00.asp (last visited Oct. 4, 2008).

28. A BBS is “[a] computer system used as an information source and forum for a particular interest group. A BBS functions somewhat like a stand-alone Web site, but without graphics. However, unlike Web access via one connection to the Internet, each BBS had its own telephone number to dial up.” PCMag.com, Encyclopedia Definition of: BBS, http://www.pcmag.com/encyclopedia_term/0,2542,t=bulletin+board&i=38485,00.asp (last visited Oct. 19, 2009).

29. Cartoon Network, 536 F.3d at 124.

30. Id. at 127.


32. Screen-scraping (or “scraping”) is the process of acquiring data displayed on screen by capturing the text manually with the copy command or via software. Web pages are constantly being screen scraped in order to save meaningful data for later use. In order to perform scraping automatically, software must be written that is recognized specific data.

This note is divided into five parts. Part I highlights the differences between stand-alone DVR systems and Cablevision’s RS-DVR system. Part II describes the court’s key holdings in the Cartoon Network case, namely finding that the use of buffers in the RS-DVR system to produce reproductions of a “transitory duration” are not capable of infringing directly. Part II also explains the court’s conclusion that it is end-users, and not the cable provider, that supply the volitional conduct necessary for direct copyright infringement liability. Part III examines the court’s misguided logic in allowing systems employing buffers to escape culpability as direct infringers, and proceeds to describe the dangers of extending the Netcom volition test beyond the relative confines of Internet services. Such judicial methodology allows for an adequate inquiry into who is making the unauthorized copies without exploring why. Finally, Part IV and V demonstrate how the Second Circuit’s decision may aid providers of screen-scraping programs to avoid direct infringement liability by utilizing buffers to engage in the questionably unethical practice of data extraction and aggregation. This note concludes by stressing the need to reign in the court’s jurisprudential view granting the nearly blanket status of buffers as a non-infringing technology.

I. ARE ALL DIGITAL VIDEO RECORDERS CREATED EQUAL?

A. HOW DVRS WORK

In order to better understand the court’s erroneous reasoning in this case, it is essential to understand the basics of how a standard “set-top DVR” device works in contrast to how Cablevision’s RS-DVR system operates. Basically, set-top DVR devices, or Personal Video Recorders (PVRs), are in-home consumer machines that allow cable subscribers to record programming, store the copied program on the internal hard drive, and play it back at a later time at the user’s request. These devices operate much like a Video Cassette Recorder (VCR) does with videotapes.


34. Set-top DVR devices are cable boxes, often offered by cable operators themselves, that have DVR digital playback technology embedded within them. Turner’s Memorandum of Law, supra note 4, at 6.

35. Id.

36. Id.

37. Id.
But how does one’s favorite episode of “The Simpsons” get from the content provider to a consumer’s DVR box for playback? Television signals used to be sent primarily in analog broadcast form, transmitted as a series of continuous waves. In order to provide more channels of programming to subscribers, programming distributors have increasingly moved towards the use of digital cable broadcasting that delivers these encoded signals in digital form. One major difference between broadcast television and cable transmission is that under the digital cable delivery system, traditional analog signals are converted into compressed digital signals and transmitted to cable subscribers.

The delivery of these digitized data streams begins with content owners sending feeds (data streams containing the shows that we know and love) to one of the cable provider’s central facilities, which aggregates all the programming feeds into one large stream of data. After the real-time cable television programming (or “linear network programming”) is sent from the content providers to a cable operator, the cable company instantaneously transmits the programming feed directly to subscribers. It is important to note that the program data is only converted into packets of data at the central facility so that programs may be tagged with “program identifiers,” which in turn allow the subscribers’ cable boxes to decode the signal when received. Because this data passes through the cable company’s hardware pursuant to negotiated and statutorily-mandated licensing agreements between the content owners and the cable provider.


40. Id.

41. Compressed analog signals are analog signals that have been digitized and compressed spatially, taking up less bandwidth per channel, as well as temporally. Michael Miller, How Home Theater and HDTV Work 28 (Greg Wiegand et al. eds., Michael Troller Illustrator, 2006). This type of compression allows cable companies to transmit 10 digital channels into the same bandwidth (6 MHz) of one traditional analog broadcast channel. Id.

42. Id.

43. Twentieth Century, 478 F. Supp. 2d at 610–11.

44. Turner’s Memorandum of Law, supra note 4, at 3.

45. Id. at 5.

46. Twentieth Century, 478 F. Supp. 2d at 610.

47. Miller, supra note 41, at 29.

48. Twentieth Century, 478 F. Supp. 2d at 610. This type of content distribution, as well as content supplied to cable operators for use in VOD services, is governed by licensing affiliation agreements entered into between suppliers of copyrighted programming and the cable operators broadcasting this material. Turner’s Memorandum of Law, supra note 4, at 4.
no unlicensed copies are made or stored while the data is being aggregated and encoded at this central facility.\textsuperscript{49}

Once the encoded signal reaches a consumer’s PVR tuner,\textsuperscript{50} the signal is sent to both an internal hard drive to record and store programming, and an MPEG-2\textsuperscript{51} decoder to convert the signal back to analog so that the signal may be sent to the television\textsuperscript{52} for the subscriber’s viewing pleasure. The television watcher at home determines which shows to record and sets the PVR accordingly through the use of an on-screen programming guide.\textsuperscript{53} This data is stored on the internal hard drive, similar in operation to a hard disk on a personal computer,\textsuperscript{54} and the recorded material remains available for the cable subscriber to play back at any time.\textsuperscript{55}

\textbf{B. THE RS-DVR SYSTEM’S UNIQUE OPERATION}

Cablevision’s RS-DVR system provides digital video playback through a different means than that employed by standard PVRs.\textsuperscript{56} The RS-DVR system allows customers to record cable programming on hard drives housed and maintained by Cablevision at a central location without the use of a set-top PVR box.\textsuperscript{57} All that is required of consumers to play back recorded content through a home television set is the use of a standard cable box equipped with RS-DVR software and a remote control.\textsuperscript{58}

These systems diverge at the point when the various broadcast television and cable channels, which provide programming content, transmit their television programs as signals to cable companies such as Cablevision.\textsuperscript{59} Instead of adhering to the typical process of aggregating all

\footnotesize{\textsuperscript{49} Under this type of system, all transmission activities are governed by licensing agreements between the cable company and the providers of the copyrighted programs. Turner’s Memorandum of Law, supra note 4, at 5. \textsuperscript{50} MILLER, supra note 41, at 29. \textsuperscript{51} MPEG stands for Moving Pictures Experts Group. PCMag.com, Encyclopedia Definition of: MPEG, http://www.pcmag.com/encyclopedia_term/0,2542,t=MPEG&i=47295.00.asp (last visited Oct. 19, 2009). An MPEG is “an ISO/ITU standard for compressing digital video. Pronounced ‘em-peg,’ it is the universal standard for digital terrestrial, cable and satellite TV, DVDs and digital video recorders (DVRs).” Id. MPEG-2 provides broadcast quality video and is used as the compression standard for DVD information, as well as digital television. Id. \textsuperscript{52} Jonathan Strickland & James Bickers, \textit{How DVR Works}, http://electronics.howstuffworks.com/dvr1.htm (last visited Oct. 19, 2009) (discussing how a basic digital video recorder receives television signals). \textsuperscript{53} MILLER, supra note 41, at 167. \textsuperscript{54} Id. \textsuperscript{55} Twentieth Century Fox Film Corp. v. Cablevision Sys. Corp., 478 F. Supp. 2d 607, 612 (S.D.N.Y. 2007), rev’d in part, vacated in part sub nom. Cartoon Network L.P. v. CSC Holdings, Inc., 536 F.3d 121 (2d Cir. 2008), cert. denied sub nom. CNN, Inc. v. CSC Holdings, Inc., 129 S. Ct. 2890 (2009). \textsuperscript{56} Cartoon Network L.P. v. CSC Holdings, Inc., 536 F.3d 121, 124 (2d Cir. 2008), cert. denied sub nom. CNN, Inc. v. CSC Holdings, Inc., 129 S. Ct. 2890 (2009). \textsuperscript{57} Id. \textsuperscript{58} Id. \textsuperscript{59} Id.}
the programming feeds into one large stream of data in preparation of transmission to viewers’ individual homes.60 Cablevision’s RS-DVR system splits the linear network data stream into two separate data streams.61 One stream is broadcasted immediately to customers,62 while the other stream is channeled into a device called the Broadband Media Router (BMR) which buffers the data stream, then reformats it before sending it to a remote data server (the Arroyo Server).63

After the entirety of this second stream of data moves into the first buffer (the “primary ingest buffer”), the server automatically checks if a customer has scheduled a recording of any particular program.64 If such a request has been made by a subscriber, the data flows into a secondary buffer, and then onto an individual hard disk allocated for that specific customer where a copy is stored for customer playback.65 Irrespective of whether a copy has been requested by a subscriber, the BMR holds at most 1.2 seconds of programming time,66 and the primary ingest buffer overwrites the data occupying this buffer every 0.1 seconds.67 The steps in this process subsequent to the splitting of the signal into a second data stream are not present in set-top DVRs, since the stand-alone machines conduct this recording function once the media has already been transmitted to individual cable subscribers.68

II. KEY HOLDINGS IN THE CARTOON NETWORK CASE

In Cartoon Network L.P. v. CSC Holdings, Inc.,69 a multitude of content providers and copyright owners70 brought action against cable television operator Cablevision71 in an attempt to enjoin the commercial release of Cablevision’s new RS-DVR system to consumers.72 The plaintiffs claimed

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60. See supra text accompanying note 43.
61. Cartoon Network, 536 F.3d at 124.
62. See Turner’s Memorandum of Law, supra note 4, at 3; see also supra text accompanying note 45.
63. Cartoon Network, 536 F.3d at 124.
64. Id.
65. Id.
66. Id. at 125.
67. Id. at 124.
69. 536 F.3d at 124.
70. Id. at 121. Plaintiffs in this lawsuit included a large number of content providers that included movie picture production companies such as Twentieth Century Fox Film Corporation, Paramount Pictures Corporation, and Disney Enterprises, as well as television network entities such as CBS Broadcasting, NBC Studios, and Cartoon Network. Id.
71. Id. Cablevision’s operating company, CSC Holdings, Inc., was also named as a defendant in this suit. Id.
72. Id. at 124.
that the operation of this system would cause direct infringement of their copyrights by producing unlicensed copies of works stored in the RS-DVR buffers.\footnote{Id. at 125.} Since all data automatically flowed through the primary ingest buffer, plaintiffs alleged that the data stream that passed through this buffer created infringing copies, regardless of whether customers scheduled a recording (that is, regardless of whether consumers initiated any copying of the works).\footnote{Id. at 127.}

The Second Circuit announced three key holdings addressing the three ways in which Cablevision allegedly directly infringed on the plaintiffs’ copyrighted programming.\footnote{Id. at 126.} First, the court held that per the provisions of the Copyright Act of 1976, in order for a reproduction to be deemed an infringing “copy,”\footnote{17 U.S.C. § 101 (2006) (defining “copies”).} it must not only embody a “tangible medium of expression,”\footnote{§ 101 (defining “fixed”).} but also satisfy a “duration requirement”\footnote{Cartoon Network, 536 F.3d at 127 (quoting Melville B. Nimmer & David Nimmer, Nimmer on Copyright, § 8.02[b][3], at 8-32 (2007)).} of being permanent or stable for “a period of more than transitory duration.”\footnote{Id. (quoting § 101 (defining “fixed”)).} Cablevision’s use of buffers rapidly and automatically overwrites all processed programming data within 1.2 seconds.\footnote{Id. at 124.} This immediate overwriting of portions of the copyrighted works contained in the data stream prevents these reproductions from becoming “copies”\footnote{§ 101 (defining “copies”).} and thus their unauthorized creation does not constitute direct infringement.\footnote{Cartoon Network, 536 F.3d at 130.}

Secondly, the court ruled that although Cablevision’s hard drives would contain unauthorized fixed copies of the copyrighted programming, Cablevision would not incur liability for direct copyright infringement for storing these copies on its server.\footnote{Id. at 133.} The Second Circuit adopted the “volitional conduct” standard\footnote{Id. at 131.} set forth by the Northern District of California in Religious Technology Center v. Netcom On-Line Communication Services\footnote{Religious Tech. Ctr. v. Netcom On-Line Commc’n Servs., 907 F. Supp. 1361 (N.D. Cal. 1995).} which requires a volitional act on the part of a passive owner of an electronic facility in order for direct copyright infringement liability to attach.\footnote{Id. at 1370.} Here, the court viewed the volitional conduct associated with making the copies as from the individual acts of Cablevision’s customers.\footnote{Cartoon Network, 536 F.3d at 133.} Cablevision itself was regarded as a passive
owner\textsuperscript{88} since its RS-DVR system responding automatically to users’ scheduling of recordings.\textsuperscript{89}

Lastly, the Second Circuit addressed the legality of Cablevision’s retransmitting of the stored programming from the cable company’s remote location into the homes of individual viewers.\textsuperscript{90} The court decided that despite the “time-shifting”\textsuperscript{91} of the copyrighted programming and transmission to many individual subscribers, Cablevision’s system does not infringe on the plaintiffs’ public performance rights.\textsuperscript{92} The RS-DVR system allows customers to produce a single unique copy on Cablevision’s hard drives for playback, transmissions of which do not constitute performances “to the public”\textsuperscript{93} and thus do not infringe on the plaintiffs’ copyrights.\textsuperscript{94}

In bringing this action, the plaintiffs had alleged only theories of direct copyright infringement based on their exclusive rights to reproduce and publicly perform their works, but did not raise claims of contributory infringement.\textsuperscript{95} In analyzing the arguments, the court was careful in its attempt to make a determination by addressing the sole legal claim of whether direct infringement by Cablevision had occurred.\textsuperscript{96} The defendants, on the other hand, waived any fair use\textsuperscript{97} defense\textsuperscript{98} most likely

\begin{quote}
\textsuperscript{88} Id. at 133. The court did state that Cablevision may have been liable for \textit{contributory} copyright infringement but did not address the claim since plaintiffs did not allege such a theory. Id. at 124, 133.
\textsuperscript{89} Id. at 131.
\textsuperscript{90} Id. at 139.
\textsuperscript{91} Time-shifting is “record[ing] a video or audio program when it is broadcast and watch[ing] it at a later time.” Buffer Definition, supra note 21.
\textsuperscript{92} Cartoon Network, 536 F.3d at 139.

\begin{quote}
To perform or display a work ‘publicly’ means (1) to perform or display it at a place open to the public or at any place where a substantial number of persons outside of a normal circle of a family and its social acquaintances is gathered; or (2) to transmit or otherwise communicate a performance or display of the work to a place specified by clause (1) or to the public, by means of any device or process, whether the members of the public capable of receiving the performance or display receive it in the same place or in separate places and at the same time or at different times.
\end{quote}

\textsuperscript{94} Cartoon Network, 536 F.3d at 139.
\textsuperscript{95} Id at 124.
\textsuperscript{96} Id.
\textsuperscript{97} Fair Use is defined as:

\begin{quote}
A reasonable and limited use of a copyrighted work without the author’s permission . . . . Fair use is a defense to an infringement claim, depending on the following statutory factors: (1) the purpose and character of the use, (2) the nature of the copyrighted work, (3) the amount of the work used, and (4) the economic impact of the use.
\end{quote}

\textsuperscript{98} Cartoon Network, 536 F.3d at 124.
due to the high probability that the economic nature and market impact of their actions would preclude this defense for Cablevision.99

III. THE COURT’S MISPLACED REASONING REGARDING BUFFER COPYING100

A. DECONSTRUCTING THE BUFFER LOGIC

In reaching its decision and absolving Cablevision of any liability for direct copyright infringement incurred through the ownership and maintenance of its RS-DVR service, the Second Circuit first turned its focus to whether buffering data that contains copyright works constitutes the reproduction of a “fixed copy” as defined in the United States Code.101 Since copyright holders have the sole right to reproduce their works “in copies,”102 the court sought to answer the threshold question of whether the reproductions, assuming arguendo that these copyrighted works were reproduced through Cablevision’s volitional conduct,103 constituted “copies” as defined in the Copyright Act and thus should have been subjected to the infringement scrutiny in the first place.104 According to the language of the Copyright Act, direct infringement occurs when a “copy” of the material is made “in which a work is fixed by any method . . . from which the work can be . . . reproduced.”105 The court correctly recognized that if the buffer data containing the copyrighted work is not “fixed,” then an infringing “copy” has not been produced.106 This means that even if a copy is made (according to its colloquial meaning), the reproduction might not be a statutorily prohibited “copy” in violation of the Copyright Act if the plaintiff does not meet the burden of demonstrating that this reproduction also was “fixed.”107

In conducting its analysis of this issue, however, the Second Circuit utilized an abbreviated version of § 101 of the Copyright Act,108 whereby it

100. For a helpful discussion of the possible policies behind the Second Circuit’s decision and supplemental analysis of the “fixation” and “volition” requirements, see Megan Cavender, RS-DVR Slides Past Its First Obstacle and Gets the Pass for Full Implementation, 10 N.C. J. L. & TECH. 145 (2008).
101. Cartoon Network, 536 F.3d at 127 (stating that proof of infringement on a copyright holder’s reproduction rights requires a showing that the works were “reproduce[d]” in “copies” as defined by § 106(1)).
103. See brief discussion supra Part II and discussion infra Part III.C–D.
104. Cartoon Network, 536 F.3d at 127.
106. Cartoon Network, 536 F.3d at 127.
107. See MAI Systems Corp. v. Peak Computer, Inc., 991 F.2d 511 (9th Cir. 1993) (stating that plaintiff’s must prove that “copies” are indeed “fixed” per the definitions provided in § 101 in order to hold defendants liable for direct copyright infringement).
108. § 101.
misinterpreted the statute’s provision.\textsuperscript{109} The Court condensed the
provision\textsuperscript{110} to read: “a work is ‘fixed’ in a tangible medium of expression
when its embodiment . . . is sufficiently permanent or stable to permit it to
be . . . reproduced . . . for a period of more than transitory duration.”\textsuperscript{111}
When read in this shortened form, the court erroneously construed the
language as requiring the embodiment of the copy to remain for longer than
a transitory duration.\textsuperscript{112} This essentially means that despite Cablevision’s
concession that the data contained in the buffers exists for a long enough
period of time to make a reproduction,\textsuperscript{113} merely because the embodiment is
ephemeral enough to be considered “transitory” the court deemed the
reproduction as falling short of what the Copyright Act defines as a “fixed
copy.”\textsuperscript{114} In contrast, the provision should have been interpreted to indicate
that a work is “fixed” if the copies (here, the data being buffered in the
BMR)\textsuperscript{115} are embodied in a sufficiently permanent state that allows the
copyrighted work to be communicated or reproduced (i.e., the data
containing the programming being reproduced in the primary ingest
buffers)\textsuperscript{116} for a period of more than transitory duration. In other words,
according to the latter interpretation rejected by the court, the requisite
period of more than transitory duration is met if the embodiment persists
long enough for Cablevision to generate a reproduction or communication
from them.\textsuperscript{117} Thus, Cablevision would likely have been found liable for
producing impermissible fixed copies if these proper infringement criteria
were applied.

So, why should we care if these buffer copies are excused from liability
for directly infringing on copyrighted material? Should heed be paid to the
assertion that we must pardon this use of buffers, since a vast amount of the
technologies we use in our everyday life need to create fleeting and
temporary buffer copies to function?\textsuperscript{118}

\begin{itemize}
\item \textsuperscript{109} Second Circuit Gets it Wrong, supra note 24.
\item \textsuperscript{110} § 101; see also supra text accompanying note 22 (complete definition of “fixed” pursuant
to § 101).
\item \textsuperscript{111} Cartoon Network, 536 F.3d at 127 (emphasis in original) (citing § 101).
\item \textsuperscript{112} Id.
\item \textsuperscript{113} Id. at 129.
\item \textsuperscript{114} Id.
\item \textsuperscript{115} Id.
\item \textsuperscript{116} Id.
\item \textsuperscript{117} The Copyright Act is properly interpreted in the case to denote that as long as a copy may
be perceived, reproduced, or communicated, either directly or indirectly (directly by human eyes
or indirectly with the aid of a machine or device), the unauthorized creation of such a copy may
constitute an infringement of the copyright holder’s ownership rights. Haochen Sun,
Reconstructing Reproduction Right Protection in China (pt. 2), 53 J. COPYRIGHT SOC’Y U.S.A.
\item \textsuperscript{118} Brief for Law Professors as Amici Curiae Supporting Defendants-Counterclaimants-
Appellants and Reversal, at 18–19, Cartoon Network L.P. v. CSC Holdings, Inc., 536 F.3d 121
(2d Cir. 2008) (No. 07-1480-cv(L), 07-1511-cv(CON)) (stating that the Copyright Act should not
be interpreted to allow for potential infringement liability for the use of all devices that make

B. EFFECTS ON EVERYDAY USERS OF MODERN TECHNOLOGY

To address the latter question, if copies made through the use of buffered data were indeed deemed “fixed” and subject to direct infringement charges, it is unlikely that end-user consumers would be found liable for playing a song on their iPod or operating a digital phone despite their necessary use of buffers.\textsuperscript{119} The transitory Random-Access Memory (RAM) copies created in this manner would in all likelihood be defensible based on the fair-use doctrine.\textsuperscript{120}

Courts evaluate the affirmative defense of fair use\textsuperscript{121} according to four factors stated in the Copyright Act.\textsuperscript{122} Although none of these four factors are dispositive in determining whether fair use may be successfully applied\textsuperscript{123} meeting the criterion regarding “the effect of the use upon the potential market for or value of the copyrighted work”\textsuperscript{124} is the most persuasive of the four statutorily enumerated fair-use factors.\textsuperscript{125} Because of this weighted view, courts would not attach liability to average users engaged in noncommercial activities who are utilizing buffer-necessary technology for personal use, where the owner of the copyright is not likely affected financially by (nor likely even aware of) most of these daily occurrences.\textsuperscript{126} The likeliness that this consumer-friendly outcome would come to fruition under the above circumstances is further buttressed by the Supreme Court’s employment of an “equitable rule of reason” analysis, which allows more flexibility in deciding which other factors may be deemed acceptable purposes regarding a fair use determination.\textsuperscript{127} For example, the Supreme Court has criticized the Ninth Circuit Court of Appeals for not allowing “entertainment” or “increased access” to new technology to be considered acceptable purposes within the

119. Id.  
121. See BLACK’S, supra note 97 (listing the four statutory factors to be included for consideration in evidencing a showing of fair use).  
123. Id. at 448–49.  
125. See Stewart v. Abend, 495 U.S. 207, 238 (1990) (characterizing the commercial fair-use factor as “central fair use factor”); see also Sony, 464 U.S. at 448–49 (stating that although not conclusive, the first factor to be considered in a fair use analysis is the commercial character of an allegedly infringing activity).  
126. Snow, supra note 120, at 63–65, 67 (2005) (stating that this highly influential fair-use factor will likely be met where the purposes for using the copyrighted work are noncommercial and incentives for creative efforts are not hindered).  
127. Sony, 464 U.S. at 455 n.40.
scope of the fair use allowance, explaining that not every fair use must be productive in nature.

C. EXTENSION OF THE VOLITION TEST IN DIRECT INFRINGEMENT CASES

Consumer end-users and providers of systems that utilize buffers should not have to rely on a determination of the applicability of the fair use doctrine to avoid liability for direct infringement. Perhaps the courts could arrive at a more appropriate solution by realizing the important distinction between digital systems that use buffers to *incidentally* make reproductions in providing non-infringing services, and those systems that use buffers *primarily* in making reproductions to disseminate copyrighted material. This solution would not require the courts to impose blanket liability on the use of all buffers making digital reproductions, placing the burden on defendants to invoke a proper defense. Instead, it would compel the courts to make a determination of infringement liability for the use of buffers by placing greater weight on the system providers’ intentions to aid in spreading copyrighted material. In this way, direct infringement claims involving the use of buffers could be decided with an eye to discerning whether the core purpose of the system provided was to create unauthorized reproductions, as opposed to those acting as passive agents (which may merely allow for the possible facilitation of end-users’ infringing activity). Adoption of this method necessitates initially looking at the level of how passive a given system is in each case, in order to discover who is actually making these unauthorized copies: the end-user consumer or the host who maintains and creates this digital technology. Otherwise stated, before the courts can address why the providers of these systems are creating copies, it needs to deal with who is producing these copies.

One of the difficulties the court faces in making a determination of direct copyright infringement liability, as opposed to contributory liability, is deciding who was responsible for reproducing the works in question.

134. *Id.*
when end-users are provided access to copyrighted works from a service provider.\textsuperscript{135} In copyright infringement cases, determining who made unauthorized reproductions of copyrighted work is usually the least of the court’s problems.\textsuperscript{136} The outcome of the case normally rests on a finding of whether the activity engaged in by the accused party substantively constitutes an allegedly infringing act, rather than identifying the appropriate party to whom liability should attach.\textsuperscript{137} The additional problem of determining who actually created an infringing copy frequently arises and has greater relevance in cases such as \textit{Cartoon Network}, where end-users or customers engage in potentially infringing conduct by utilizing defendants’ systems to create a copy.\textsuperscript{138} Since the plaintiffs were alleging only charges of direct copyright infringement and not contributory infringement, the Second Circuit’s analysis of which party was supplying the requisite volitional conduct was a key issue in deciding where the blame should be placed.\textsuperscript{139} In order to be found accountable for direct infringement, a party must have provided the volitional conduct in making the reproductions.\textsuperscript{140}

Slowly, courts have adopted this “volition test,” applying it through a line of cases\textsuperscript{141} beginning with \textit{Religious Technology}.


\textsuperscript{136} \textit{Cartoon Network}, 536 F.3d at 130.

\textsuperscript{137} Id.

\textsuperscript{138} See, e.g., \textit{Religious Tech. Ctr.}, 907 F. Supp. at 1367–68 (determining whether defendant ISP or third-party customer who posted copyrighted work created a “copy” when work was posted automatically); \textit{see also} Princeton Univ. Press v. Mich. Document Servs., 99 F.3d 1381, 1383–84 (6th Cir. 1996) (en banc) (weighing the issue of whether copy shops were liable for direct infringement when unauthorized copies are made at the behest of requesting customers); RCA/Ariola Int’l, Inc. v. Thomas & Grayston Co., 845 F.2d 773, 776–77 (8th Cir. 1988) (discerning whether to attach direct liability to customers or to businesses who allowed these customers to use in-house equipment to copy sound recordings).

\textsuperscript{139} \textit{Cartoon Network}, 536 F.3d at 124, 130.

\textsuperscript{140} \textit{Religious Tech. Ctr.}, 907 F. Supp. at 1370 (stating that although contributory infringement may still attach, direct copyright infringement requires a showing of a causal or volitional element in producing unauthorized copies beyond mere ownership of a machine facilitating third-party reproductions).


\textsuperscript{142} \textit{Religious Tech. Ctr.}, 907 F. Supp. 1361.
Usenet143 BBS.144 The plaintiffs, copyright holders of Mr. Hubbard’s works,145 sued in response to Netcom’s refusal to comply with their request that Erlich not be allowed to gain access to the Internet through the access provider’s system.146 Netcom asserted that it would be impracticable to prescreen a user’s BBS postings and that they were not responsible for creating the unauthorized reproductions. In addition, Netcom argued that they were merely providing its subscribers with access to a system that third parties might possibly utilize to make copies.147 The District Court for the Northern District of California proceeded to expound the newfound principle that “[a]lthough copyright is a strict liability statute, there should still be some element of volition or causation which is lacking where a defendant’s system is merely used to create a copy by a third party.”148 Thus, the court excused from direct infringement liability those entities that provide access to and maintain systems which possess a certain degree of “passivity,” where the systems are conduits for the volitional conduct of potentially infringing end-users.149

Prior to the decision in Cartoon Network,150 courts primarily used the “passivity test” in determining direct infringement liability only in cases where the defendant was an ISP, BBS operator, or provider of some other type of web-based service.151 However, the Second Circuit has extended this principle to apply outside of this framework by allowing Cablevision, a digital cable operator, to escape culpability as a direct infringer.152 The court viewed Cablevision simply as a provider of the RS-DVR service and data stream buffers, which are conduits for the end-user subscribers’

143. A Usenet (or User Network) is “[a] public access network on the Internet that provides group discussions and group e-mail. It is a giant, dispersed bulletin board that is maintained by volunteers who provide news and mail feeds to other nodes.” PCMag.com, Encyclopedia Definition of: Usenet, http://www.pcmag.com/encyclopedia_term/0,2542,t=Usenet&i=53545,00.asp (last visited Oct. 19, 2009).
145. Id. Plaintiffs in this case were Religious Technology Center (RTC) and Bridge Publications, Inc. (BPI) who held copyrights in the unpublished and published works of L. Ron Hubbard, the late founder of the Church of Scientology. Id.
146. Id. at 1366.
147. Id. at 1368–70.
148. Id. at 1370.
150. See generally id.
152. Cartoon Network, 536 F.3d 121.
requests to record programs and create infringing copies.153 In doing so, the
court labeled the cable provider as merely maintaining a passive system that
lacks the requisite volitional conduct necessary to be deemed a direct
infringer.154 This broadened view of passive system operators will have
negative consequences for owners of copyrighted materials attempting to
safeguard their exclusive proprietary rights. Such ramifications may persist
if the courts rely upon this more widely interpreted passive system analysis,
which names end-users as sole suppliers of the volitional conduct. Applying
the volition test in this way may prevent copyright holders from pursuing
litigation against entities who are both more efficiently enjoined from
facilitating infringement and more easily identifiable as the true creators of
the unauthorized copies.155

D. PUTTING ASIDE THE VOLITION TEST WHEN A BUFFER’S SOLE
FUNCTION IS TO INFRINGE

An alternative (and arguably better) approach would require that courts
look past this relatively new volition element in direct infringement cases
involving buffers such as Cartoon Network, where the sole purpose of the
technology is to provide a means to create unauthorized reproductions of
copyrighted works.156 This proposed jurisprudential view should be adopted
because prior case law has specifically limited application of the Netcom
passivity defense to cases where the digital services at issue did not create
unauthorized reproductions as their primary raison d’etre, but rather as
incidental to providing a non-infringing service.157

The Second Circuit in Cartoon Network dismissed the plaintiffs’
argument that to allow Cablevision to provide the RS-DVR service is to
allow it to directly profit from the reproduction of unauthorized works by
providing subscribers with a commercial service geared towards facilitating

153. Id. at 133.
154. Id. at 131 (stating that the Netcom passivity test applies in the current case and transcends the Internet).
155. Access providers of information and digital works have historically made for more
156. It is important to note here that the Second Circuit stated in Cartoon Network that through
the use of the RS-DVR service, indeed, someone is directly infringing on the plaintiff’s copyright. 536 F.3d at 130. The court said that “after an RS-DVR subscriber selects a program to record, and
that program airs, a copy of the program—a copyrighted work—resides on the hard disks of
Cablevision’s Arroyo Server, its creation unauthorized by the copyright holder. The question is
who made this copy.” Id. Without the court’s view of Cablevision’s RS-DVR service and buffer
components as passive systems, it would follow that end-users were not the ones making copies of
these works and thus direct liability would almost certainly attach to Cablevision’s actions.
copyright infringement. In ignoring this assertion, the court failed to recognize principles established in pioneering cases distinguishing Netcom on the basis of the nature of the defendant as a provider of systems whose functions are dedicated solely to aiding in the creation of unauthorized copies. Cablevision’s data stream buffers are dedicated exclusively to aiding consumers in creating copies of programs, yet the cable company has escaped direct liability.

While the Supreme Court has recognized that an entity commits contributory infringement “by intentionally inducing or encouraging direct infringement,” the case law is relatively sparse regarding when the line has been crossed in facilitating third-party infringing behavior in such a significant way as to impute direct infringement liability. District courts that have addressed this issue have held that providers whose systems are instrumental in allowing end-users to make infringing copies—and who profit from encouraging these third-party users to engage in this conduct—are liable for direct copyright infringement. In such instances, the focus shifted away from the passivity of the systems. Instead, the determination of culpability was made by primarily examining whether the defendants had control over the content of information provided to its subscribers and whether the defendants developed these systems to commercially profit off of this infringing third-party behavior. For example, in Playboy Enterprises, Inc. v. Webbworld, Inc., the District Court for the Northern District of Texas held that where the defendant, a website operator, “exercised total dominion over the content of its site and the product it offered its clientele,” and “developed and launched the . . . software for commercial use,” it could not evade liability for direct infringement by claiming that it was merely a passive conduit that automatically responded to the requests of users. By establishing a business model based around providing systems that enable third-party infringement while controlling the

158. Cartoon Network, 536 F.3d at 133 (stating that although case law exists supporting the argument, there are no binding cases requiring the Second Circuit to find that facilitating copying in such a major way as the RS-DVR service should impute direct copyright infringement).
161. See discussion on RS-DVR operation supra Part I.B.
165. See Webbworld, 991 F. Supp. at 552; Russ Hardenburgh, 982 F. Supp. at 513.
168. Id. at 552.
169. Id. at 553.
170. Id.
digital content provided, an entity effectively becomes an infringing volitional actor.

In the same way, Cablevision’s development of an RS-DVR system that utilizes buffers to create unauthorized copies of copyrighted content licensed solely for instantaneous linear network programming\(^{171}\) should preclude its ability to evade direct infringement liability. However, in hearing the case on appeal, the Second Circuit gave short shrift\(^{172}\) to the finding of the District Court for the Southern District of New York that the RS-DVR system in fact provides sufficiently significant involvement in the end-users’ requests to record copies to hold Cablevision liable for the plaintiffs’ claims.\(^{173}\) The appellate court condoned the use of technologies such as the buffer system used in the Arroyo Server which serve no other practical purpose than as a necessary step in the process of infringement.\(^{174}\)

Properly interpreted, development of these systems interferes with copyright holders’ exclusive rights\(^{175}\) to reproduce and authorize reproduction of their copyrighted works.\(^{176}\) The consequences of this ill-reasoned decision could bleed into the judicial interpretation of future copyright cases\(^{177}\) where analogous technology blurs the line as to where volitional conduct takes place, and whether direct liability should attach to end users or with those entities that offer these copying services.

IV. SCREEN-SCRAPING

The outcome of this case may have a considerable impact on future judicial determinations regarding a number of potentially infringing technologies. This shift in viewpoint will likely affect those digital technologies that utilize buffers,\(^{178}\) as well as those designed as tools to aid infringing behavior.\(^{179}\) The nexus between the Second Circuit’s view of

\(^{171}\) See explanation supra Part I.A–B.


\(^{173}\) Twentieth Century Fox Film Corp. v. Cablevision Sys. Corp., 478 F. Supp. 2d 607, 621 (S.D.N.Y. 2007), rev’d in part, vacated in part sub nom. Cartoon Network L.P. v. CSC Holdings, Inc., 536 F.3d 121 (2d Cir. 2008), cert. denied sub nom. CNN, Inc. v. CSC Holdings, Inc., 129 S. Ct. 2890 (2009). It is important to reiterate here that Cablevision developed, maintained, and operated a system that splits data through the use of buffers. Id. at 619. This process required reconfiguration of the linear channel programming signals through the use of equipment Cablevision physically controlled at the head-end. Id. Combined with the fact that the cable company maintained control over source programming and individual subscriber hard drive capacity, it is easy to see how Cablevision may be viewed as the proper defendant here for producing unauthorized copies. Id.

\(^{174}\) Cartoon Network, 536 F.3d at 139–40.

\(^{175}\) Twentieth Century, 478 F. Supp. 2d at 622.


\(^{177}\) See generally Cavender, supra note 100, at 153–60.

\(^{178}\) See supra Part III.A–B.

\(^{179}\) See supra Part III.C–D.
buffers as transitory and non-infringing in nature, and the court’s dismissal of prior persuasive jurisprudence (that would otherwise impose liability for direct infringement on systems dedicated to facilitating the unauthorized copying of works) may also have significant consequences in the area of screen-scraping. Programmers who write screen-scraping applications may incorporate buffering and quick cache flushing into their programs in order to avoid copyright infringement claims. This may consequently encourage those who initiate such programs to engage in unethical practices by reducing the risk of liability. In order to understand how the Second Circuit’s view of the nature of buffer technology may result in an evasion of important copyright principles and potentially promote unethical behavior, it is important to first get a working knowledge of what this practice entails.

“Screen-scraping” occurs when software developers and data aggregators employ the use of programs that rove the Internet and programmatically evaluate digitally displayed information in order to extract from it the specific information the user requests. These screen-scraping or “spidering programs” are programmed to automatically collect information contained on websites, so that large amounts of data can be sifted through, thus “saving [users] the trouble of having to browse it all manually.” Although there is a distinction between “spiders” (which rove and collect entire web pages or files) and “scrapers” (which collect specific pieces of information from within these files), for purposes of this note,  

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180. See discussion supra Part III.A.  
181. See discussion supra Parts III.C, IV.  
182. See discussion infra Part V.  
183. Cache (“pronounced ‘cash’”) is used to speed up data transfer and may be either temporary or permanent. Memory and disk caches are in every computer to speed up instruction execution and data retrieval and updating. These temporary caches serve as staging areas, and their contents are constantly changing. Browser caches and Internet caches store copies of Web pages retrieved by the user for some period of time in order to speed up retrieval the next time the same page is requested.  
186. These screen-scraping spiders “range in complexity from the simplest script to grab the latest weather information from a web page, to the armies of complex spiders working in concert with one another, searching, cataloging, and indexing the Web’s more than three billion resources for a search engine like Google.” KEVIN HEMENWAY & TARA CALISHAIN, SPIDERING HACKS: 100 INDUSTRIAL STRENGTH TIPS & TOOLS xv (Rael Dornfest & Dale Dougherty eds., 2004).
these terms will be used interchangeably. These types of processes are usually employed in concert. Programmers often unleash “a program that uses a spider to follow links but then uses a scraper to gather particular information.”

A. THE NEXUS BETWEEN THE TYPE OF DATA EXTRACTED BY SCREEN-SCRAPERS AND THE COPYRIGHT PROTECTION AFFORDED

Screen-scraping practices, by their very nature, are often viewed as intrusive. Since scraping often involves one business actor’s process of data aggregation from information acquired on another entity’s website, disputes involving this practice “tend to involve commercial access of a website for profit and to the commercial detriment of the website owner.” The required data may be copyrighted material embedded in a page, but often the digital data desired for commercial purposes is comprised of facts and information gleaned from a company’s pricing structure or stored database. Although those employing the scraped data may simply want to gain an edge in collecting stock information, researching real estate listings, or tracking insurance prices, owners of the websites being scraped often do not want their information being aggregated by an outside user even when the website and information are made public. However, if “[c]ompanies usually go to great lengths to disseminate information about their products or services. . . . [W]hy would a website owner not wish to have his or her website’s information scraped?”

A simple, but perhaps overlooked, response to this question is that some view aggregation of their data as unethical since they invested the time and cost to put together this information in the first place. As the

187. Id. at 2.
188. Id.
189. While spider programs generally follow a series of Internet links, gathering up content, scrapers will instead pull data directly from web pages. Id.
190. See discussion infra Part IV.A–B.
194. Id.
195. Id.
196. Feist Publ’ns, Inc. v. Rural Tel. Serv. Co., 499 U.S. 340, 349 (1991) (acknowledging that while the result of data aggregation is not ultimately unfair, it may seem to the plaintiff that this practice is somewhat unethical).
Supreme Court recognized in *Feist Publications, Inc. v. Rural Telephone Service Co., Inc.*, “[i]t may seem unfair that much of the fruit of the compiler’s labor may be used by others without compensation.” These sentiments may not be unwarranted. For example, when airline flight prices are scraped via spidering software by a price comparison website, the target airline may accurately observe that a user of screen-scrapping programs interferes with the relationship between the airline and their customers by inflating their flight prices and charging the customer an additional unjustified service fee. However, in *Feist*, the Supreme Court decided that facts themselves are not copyrightable, and the primary objective of copyright is not to reward the labor of authors, but “[t]o promote the Progress of Science and useful Arts” per the Copyright Clause of the U.S. Constitution. In doing so, the *Feist* Court ruled that the plaintiff’s substantial efforts and investments in compiling an alphabetized white pages telephone directory database would be afforded no remedy under the Copyright Act for the defendant competitor company’s appropriation of this data. Since public websites often only display factual data, it follows that facts and information located on public websites which are collected

197. Id.
198. Shoosmiths, *How to Stop Your Website Being ‘Screen Scraped,’* Sept. 22, 2008, http://www.shoosmiths.co.uk/news/1525.asp. The target airline may also claim that websites using screen scrapers fail to pass on important flight information, such as cancellations and delays, to customers after the booking has been made and slow down the airline’s own transactional website. This has led to a spate of disputes between the airlines and websites using screen scraping.

Id. These practices, caused by the scraping site’s detachment from the target airline’s actual services, may subtract from the value of the airline’s service by negatively affecting the customer’s experience. *Id.* By gleaning the flight information, daily pricing, and other fare data from an airline’s online booking site, those parties utilizing screen-scrappers and offering tickets through their sites are unjustly building a business model around “shopping . . . fares for their [own] businesses.” E. Alan Arnold, Senior Attorney, Delta Airlines, Speaker at the Mercer Law Review Symposium: The Internet: Place, Property, or Thing—All or None of the Above (Oct. 30, 2003), in 55 MERCER L. REV. 919, 944 (2004).
199. *Feist*, 499 U.S. at 349 (alteration in original).

*Id.* at 159–60.
through the use of a screen-scraping program would also not result in the spider programmer incurring liability for direct copyright infringement.

B. SCREEN-SCRAPING “UNETHICS”

The United States judicature has asserted the meager copyrightability of factual works and information by “app[lying] Feist with a reasonable degree of consistency since 1991.”202 As a result, those seeking to protect the product of their invested time and effort, embodied in factual data, will find little help in the provisions of the Copyright Act.203 Commercial website owners attempting to block the activity of screen-scrappers and content aggregation programs have similarly been unsuccessful in litigating these issues under a copyright infringement theory.204 However, just because employing data aggregation spider programs have not typically been deemed illegal under copyright law does not mean that this practice is ethical.205 These target companies, whose data and information are being scraped, are joined in their opposition by many judicial decisions and legislative actions that recognize the harms that this usurpation can cause.206

The court’s general animus toward screen-scraping practices can be seen in its willingness to extend jurisprudential limits to accommodate claims against defendant developers and employers of data aggregation programs. While commercial data systems can no longer be protected from unauthorized data aggregation practices by relying solely on the copyrightability of facts, courts have not been very sympathetic to those who screen-scrape competing companies’ websites.207 As a result, courts often allow plaintiffs to proceed with charges on theories other than copyright infringement,208 namely trespass-to-chattels claims209 and alleged

203. See Cardinale, supra note 201.
205. See discussion infra Part IV.B.
206. Id.
208. See Goldstein, supra note 204, at 332–33.
violations of a website’s terms of use. Defendants who utilize spidering programs against competitors very frequently incur liability, “especially where the site has posted terms of use prohibiting commercial use of the site’s content.” Courts’ eagerness to punish screen-scraping through a number of imperfect causes of action serves as evidence of the judiciary’s normative view that this practice inherently violates ethical standards.

Many proposed and enacted pieces of legislation also seem to coincide with or embody a disdain for these unethical scraping practices. Website owners often rely on the anti-circumvention measures contained in the Digital Millennium Copyright Act (the DMCA) to thwart would-be appropriators of data by utilizing “self-help” technological protection measures, such as encryption, digital watermarks, password protection, and the embedding of data within a copyrighted page. The provisions of the DMCA protect those that employ these self-help measures by finding violations where persons utilize or profit from programs “primarily designed or produced for the purpose of circumventing a technological measure that effectively controls access to a [copyrighted] work” or those programs that have “only limited commercially significant purpose . . . other than to circumvent a technological measure that effectively controls access to a [copyrighted] work.” In other words, where owners of damages caused by lost server capacity on a trespass-to-chattels theory for employment of a data-aggregation bot unleashed on plaintiff’s website; CompuServe, Inc. v. Cyber Promotions, Inc., 962 F. Supp. 1015, 1022–23 (S.D. Ohio 1997) (allowing an actionable trespass-to-chattels claim for lost storage capacity and processing efficiency due to the sending of automated unsolicited commercial e-mails); Thrifty-Tel, Inc. v. Bezenek, 54 Cal. Rptr. 2d 468, 472 (Cal. Ct. App. 1996) (finding liability for unauthorized use of a telephone company’s computer system based on a trespass-to-chattels cause of action).

210. See, e.g., Register.com, Inc. v. Verio, Inc., 356 F.3d 393 (2d Cir. 2004) (defendant was enjoined from scraping in part for failure to comply with a non-commercial terms of use agreement); Cairo, Inc. v. Crossmedia Servs., Inc., No. C 04-04825 JW, 2005 WL 756610, at *1 (N.D. Cal. Apr. 1, 2005) (courts allowed claim to proceed based partly on failure to comply with terms of use when defendant’s robot culled uncopppyrighted data from plaintif’s website); Ticketmaster Corp. v. Tickets.com, Inc., No. CV997654HLHBKX, 2003 WL 21406289, at *1 (C.D. Cal. Mar. 7, 2003) (although no liability ultimately attached, plaintiff was granted a preliminary injunction and allowed to proceed with claim based in part on defendant’s failure to comply with terms of use on plaintiff’s website); Pollstar v. Gigmania, Ltd., 170 F. Supp. 2d 974 (E.D. Cal. 2000) (cause of action allowed for failure to comply with website’s terms of use when defendant’s scraper accessed plaintiff competitor’s website to glean information). All of these cases also involved allegations of a competitor linking to or scraping data from the website, and included allegations of additional torts. Mark A. Lemley, Terms of Use, 91 MINN. L. REV. 459, 470 (2006).

211. See Carver, supra note 207, at 3. This tendency toward liability extends beyond misappropriators of copyrighted works: “[D]ata aggregators that ultimately direct traffic and sales to the originating sites have found themselves losing in court.” Id.


214. See Yamamoto, supra note 192, at 121 n.256.

215. Id.

216. § 1201(a)(2)(A).

217. § 1201(a)(2)(B).
copyrighted materials have set up technological barriers to digitally accessing their work product, one may not provide or use a screen-scrapping service whose main purpose is to get around these barriers either to gain access to the copyrighted material or profit from it.\textsuperscript{218} While the main thrust of the DMCA’s enactment was to afford added protection to the creativity of artistic works,\textsuperscript{219} the recognition of the need to promote innovation in the digital medium\textsuperscript{220} supports the peripheral effect of chilling efforts to aggregate data contained in copyrighted pages.

In addition, many legislators have addressed the lack of fairness and reduced commercial development incentive that the practice of unauthorized information aggregation may cause.\textsuperscript{221} From 1996 to 2007, there were six database protection bills introduced.\textsuperscript{222} Two were passed by a House of Representatives vote (although eventually shelved by the Senate) and an additional two were approved by the standing House Judicial Committees.\textsuperscript{223} The introduction of these bills signifies the legislature’s awareness of the importance of the electronic database industry and its increasing vulnerability to unscrupulous practices.\textsuperscript{224} However, since the intellectual property clause of the U.S. Constitution\textsuperscript{225} was interpreted by the Supreme Court in \textit{Feist} as requiring “originality,”\textsuperscript{226} bills that would

\begin{itemize}
\item \textsuperscript{218} § 1201(a)(3) (clarifying the definitions of the illegal activities described in § 1201(a)(2)).
\item \textsuperscript{219} See Yamamoto, supra note 192, at 119–21.
\item \textsuperscript{221} See Cardinale, supra note 201, at 161–68.
\item \textsuperscript{222} Id. (providing a summary of legislative efforts regarding database protection).
\item \textsuperscript{223} See generally id. at 162–68 (describing the history of database protection bills). House Bill 3531 (the Database Investment and Intellectual Antipiracy Act of 1996) was referred by the Subcommittee to the House Judiciary Committee in 1996, although discussions were halted and the bill was sidelined at the end of the 104\textsuperscript{th} Congress’ term. H.R. 3531, 104th Cong. (1996). In 1998, during the 105\textsuperscript{th} Congress, the House passed House Bill 2652 (the Collections of Information Antipiracy Act) only to have it tabled by the Senate on one occasion and subsequently excised from the language of the Digital Millennium Copyright Act during negotiations later that year. H.R. 2652, 105th Cong. (1998). The 106\textsuperscript{th} Congress re-introduced this bill as House Bill 354 in 1999, along with an opposing bill, House Bill 1858, only to find House Bill 354 rejected by the Energy and Commerce Committee following the Judiciary Committee’s approval. H.R. 354, 106th Cong. (1999). Lastly, in early 2004, the House Judicial Committee passed House Bill 3261 (the Database and Collections of Information Misappropriation Act) only to fall prey to the opposition’s staunch resistance in the 108\textsuperscript{th} Congress. H.R. 3261, 108th Cong. (2004). In the same year, competing House Bill 3872 (Consumer Access to Information Act) also floundered. H.R. 3872, 108th Cong. (2004).
\item \textsuperscript{224} See, e.g., H.R. REP. NO. 108-421, pt. 1, at 7–9 (2004). The report stated:
\begin{quote}
In cyberspace, technological developments represent a threat as well as an opportunity for collections of information, just as for other works. Copying factual material from a third party’s collection and rearranging it to form a competing information product—behavior that copyright protection alone may not effectively prevent—is cheaper and easier than ever through digital technology that is now in widespread use.
\end{quote}
\item \textsuperscript{225} U.S. CONST. art. I, § 8, cl. 8.
\item \textsuperscript{226} See supra Part IV.A.
\end{itemize}
effectively prohibit the use of spidering programs to aggregate data without the target company’s permission must be able to “withstand judicial scrutiny under the Commerce Clause . . . [by] fram[ing] database protection proposals as a matter of protecting commercial interests, via unfair competition and misappropriation doctrines, rather than [intellectual] property.”

Thus, the continued goal of protective legislation has been framed as an effort to protect the economic interests of principal companies from unfair competition, rather than ensuring the exclusive control of creative work product afforded to artists and inventors. This acknowledgement of the need to safeguard against potential economic harm reinforces the categorization of screen-scraping and data misappropriation as unethical practices.

V. THE SECOND CIRCUIT’S PROMOTION OF SCREEN-SCRAPING PRACTICES AND THE NEED TO REEL IN THE NON-INFRINGEMENT STATUS OF BUFFERS

The unethical behavior of screen-scraping will likely increase after programmers latch on to the possible defenses to copyright infringement arising from the Cartoon Network decision. One of the most important principles to emerge from Cartoon Network is the notion that loading a program into a form of RAM does not necessarily constitute an

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227. See Cardinale, supra note 201, at 161.
228. These proposed legislative bills echo the sentiment of the European Union Directive on Legal Protection of Databases 96/9/EC, adopted by the European Union in 1996. H.R. Rep. No. 108-421, at 8. Both the EU Directive and its influenced U.S. counterparts recognize the competitive disadvantage created when firms who have invested time and money in maintaining data systems are hurt economically by third-party misappropriation of factual data through the use of digital technologies. Id. The shift in U.S. policymakers view of screen-scraping is underscored by this proliferation of proposed legislation. See id. at 9.
229. This is evidenced by the language of the proposed bills, which state, in part, that it is a violation to extract data maintained by another person only when there has been a substantial investment of resources or time. See, e.g., S. 2291, 105th Cong. § 1202 (1998); H.R. 3261, 108th Cong. § 3 (2003).
230. The need to protect against economic harm caused by digital data aggregation technologies is an important issue. As one author elegantly stated:

The strongest argument for database protection is the prevention of copying by a competitor seeking to compete head-to-head with the original compiler. Compiling a database is an expensive, time-consuming proposition; copying a database is cheap, particularly when digital technology can automate the copying. The copyist therefore does not share the original compiler’s development costs and can undercut the original compiler’s price. The original compiler must match this lower price to remain competitive, and may not be able to recoup its development costs as a result. Knowing that this outcome is possible, companies may not bother to compile databases in the first place, thus denying the public the benefit of useful products.

unauthorized copy, as a matter of law.231 Prior to the Second Circuit’s
decision, the controlling legal principle used to determine whether RAM
constitutes a statutorily defined “copy” was found in MAI Systems Corp. v.
Peak Computer, Inc.232 The Second Circuit distinguished this case by
declaring that the MAI decision failed to address the “transitory duration”
requirement in determining whether a copy is “fixed.”233 Thus, a ruling was
made on how the statute should be interpreted—free from stare decisis.234
The conclusion reached by the appellate court was that even if an entire
work is put through a buffer, as long as these small increments of data are
overwritten quickly, no direct copyright infringement has occurred.235

The Second Circuit’s ruling in this case will encourage the proliferation
of unethical screen-scraping practices by allowing potential defendants to
use buffers to procure information contained in copyrighted websites and
databases. Those seeking to engage in this web activity can sidestep
liability for direct copyright infringement by downloading a copyrighted
page, processing the data, and then overwriting or eliminating the copies.236
In redefining the process of reproducing copyrighted material and quickly
overwriting the data obtained as “non-infringing conduct,”237 the court has
provided users of scraping robots with a possible mechanism for letting the
uncopyrightable “ends” excuse the “means.”238 More simply, as long as a
scraper can sift the uncopyrightable facts from the copyrighted material
quickly enough that a court would deem it “transitory” (for example, a
buffer), the user gets to keep all the uncopyrighted data to utilize for her
own financial gain.239

232. MAI Systems Corp. v. Peak Computer, Inc., 991 F.2d 511 (9th Cir. 1993) (holding that
defendant computer maintenance company’s booting of plaintiff’s computer, and consequent
loading of plaintiff’s operating system into RAM, is “sufficiently permanent or stable to permit it
to be perceived, reproduced, or otherwise communicated for a period of more than transitory
duration,” thus, demonstrating infringing behavior by satisfying the Copyright Act’s statutory
definition of “fixed” copies).
234. Cartoon Network, 536 F.3d at 128 (finding that interpretation of the “transitory duration”
language was left open since the MAI Systems court did not discuss or analyze this term).
235. Id. at 129–30 (finding that the buffered data fell outside of the “transitory duration
requirement” prong of the “fixed-copy” test).
237. See discussion supra Part III.A.
238. In the current example, the “ends” would be obtaining uncopyrightable data, while the
“means” would be utilizing buffers or quickly rewriting the portions of data containing the
copyrighted works.
239. This practice would not likely violate the anti-circumvention provisions of the Digital
Millennium Copyright Act, since they primarily protect against “any technology . . . that . . . is
primarily designed or produced for the purpose of circumventing a technological measure that
effectively controls access to a work protected under this title. . . .” 17 U.S.C. § 1201–1(H)(A)
(2006) (emphasis added). Since facts are not protected by the Copyright Act, buffers employed to
circumvent direct infringement for scraping of embedded data would not likely be seen as a
Without this crucial layer of protection, financial actors may find it more difficult to secure profitability, resulting in a diminished incentive to invest in innovation and provide a public good.\textsuperscript{240} In the same way that the driving force behind copyright innovation is the desire for economic gain, which in turn produces a public good,\textsuperscript{241} firms are likewise motivated to gather and utilize data based upon a desire for profit.\textsuperscript{242} As digital communication systems expand and “the economic value of online databases increases, so too does the potential market harm wrought by database security breaches.”\textsuperscript{243} Thus, there is a great need to mitigate the financial harm that might result from excusing buffered screen-scraping, since the digital age has extended this market far into the global arena.\textsuperscript{244}

Screen-scraping practices may also be encouraged by the Second Circuit’s unwillingness to attach liability to digital services that construct their business models around employing buffers that serve the sole purpose of facilitating copyright infringement.\textsuperscript{245} For example, assume that a spidering program is integrated into a scraper’s service, allowing third-party end-users to provide the requisite “volitional conduct” for copyright infringement to attach where copyrighted pages are downloaded to extract information (for example, by initiating an unauthorized search for corporations that use a specific phone company). If this bot\textsuperscript{246} uses buffers to quickly overwrite all copyrighted portions of the data stream, even where the data stream transmits the “embodiment”\textsuperscript{247} of the entire copyrighted webpage bit by bit, the \textit{Cartoon Network} court would likely forgive the technology primarily designed to gain access to copyrighted works. \textit{See supra} text accompanying note 196.

\textsuperscript{240} See Huse, \textit{supra} note 228, at 33.


\textsuperscript{242} See Huse, \textit{supra} note 230, at 33.

\textsuperscript{243} See Cardinale, \textit{supra} note 201, at 176. The author notes that the expansion of the Internet carries with it the growing importance of database and information protection. \textit{Id}. The spread of digital information access becomes a greater focus “[a]s online databases continue to quickly grow in value, and as the factual reliability of a database becomes arguably a more considerable ‘value added’ feature in the internet context.” \textit{Id}.

\textsuperscript{244} See Directive 96/9/EC, The Legal Protection of Databases, 1996 O.J. (L 77) 20, 20–28 (EC). The Reciprocity Provision in Recital 56 grants protection from unauthorized data extraction for databases created by non-EU Member States, only where the third-party country adopts protective measures that “offer comparable protection” to those provided by the EU Directive. \textit{Id}.

\textsuperscript{245} See discussion \textit{supra} Part III.D.

\textsuperscript{246} A \textit{Bot} is “[a] program used on the Internet that performs a repetitive function . . . . Bots are used to provide comparison shopping . . . . The term is used for all variety of macros and intelligent agents that are Internet or Web related.” PCMag.com, Encyclopedia Definition of: Bot, http://www.pcmag.com/encyclopedia_term/0,2542,t=bot;i=38865,00.asp (last visited Oct. 19, 2009).

intrusive process as creating a non-infringing copy. However, even if the court did find that a fixed copy had been made, under the same erroneous buffer logic that exculpated Cablevision from liability, employers of the buffered screen-scraping program would not have committed the volitional conduct necessary to be labeled as direct copyright infringers. By applying the court’s reasoning and viewing the providers of buffered screen-scraping services as passive non-volitional actors, there will be little stopping the emboldened programmers of spidering bots from engaging in this harmful behavior.

VI. CONCLUSION

The Second Circuit erred in giving a broad and sweeping pardon for direct copyright infringement both to creators of unauthorized “transitory” copies and to those who maintain and produce systems that are dedicated to infringement-facilitating practices. While there certainly will be harm to the U.S. business sector, it remains to be seen how much damage the fallout from this decision will cause to society at large. It would be prudent for other courts to avoid this short-sighted jurisprudence.

The appellate court’s adjudication opened the door for Cablevision’s new consumer-friendly technology, but its lasting declarations continue to leave the door unlocked for more sinister bots and spiders to be unleashed on future commercial innovators. In allowing buffers to get around the “transitory duration” requirement for direct infringement, devisors of screen-scraping programs are given the key to practicing unauthorized and unethical data aggregation with few consequences. With an increasing need for protective legislation perhaps far on the horizon, courts need to recognize the dangers of screen-scraping and reign in this ill-concluded decision.

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248. See id. at 129–30 (excusing creators of “transitory” buffer copies from direct infringement liability).
249. See supra Part III.D.
250. See discussion supra Part IV.B.
251. See Cardinale, supra note 201, at 168 (stating that in recent years “no database protection legislation has been openly debated, nor will it be”).

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