AUCTION DESIGN FOR CLAIMS TRADING

ANTHONY J. CASEY*

INTRODUCTION

Claims are traded regularly in today's large corporate bankruptcy cases. While the concept is nothing new,[1] the volume has increased dramatically in the last decade.[2] Much of this increase is associated with the rise of hedge fund involvement in corporate bankruptcy.[3] The reactions of scholars and practitioners to these changes to the bankruptcy landscape have been mixed. While some laud the liquidity that is facilitated by hedge fund claims trading, others worry that hedge fund involvement complicates and distorts an already flawed system of reorganization.[4]

An emerging literature has explored means to retain the benefits of claims trading while ameliorating its costs.[5] Conventional regulatory suggestions focusing on disclosure requirements have been proposed and criticized.[6] And empirical work is now beginning to test the assumptions underlying these theoretical arguments.[7] In this essay, I suggest that conventional disclosure regulation is both inconsistent with

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[1] *See* Chaim Fortgang & Thomas Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 8 (1990).

[2] *See* Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. 648, 669 (2010); Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. FIN. & COM. L. 23, 37 (2009); Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 77 (2009); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1614 (2009). The increase continues. *See, e.g.*, Lisa Abramowicz, Miles Weiss & Christine Harper, *Hedge Funds Rush Into Debt Trading With $108 Billion*, BLOOMBERG, May 7, 2013, http://www.bloomberg.com/news/2013-05-07/hedge-funds-rush-to-debt-trading-where-wall-street-tread.html; Scott K. Charles, Amy R. Wolf & Emil A. Kleinhaus, *Buying Claims Against a Chapter 11 Debtor*, AM. RESTRUCTURING & INSOLVENCY GUIDE (2008/2009), *available at* http://www.americasrestructuring.com/08_SF/p193-199%20Buying%20claims.pdf.

[3] I say "associated" to avoid any causal claim that cannot currently be supported by empirical evidence.

[4] *See* Sparkle L. Alexander, Note, *The Rule 2019 Battle: When Hedge Funds Collide with the Bankruptcy Code*, 73 BROOK. L. REV. 1411, 1415–16 (2008) (discussing conflicting views on hedge fund involvement in bankruptcy proceedings).

[5] *See id.* at 1461 (discussing costs and benefits of claims trading in Rule 2019 context, and proposing revised Rule 2019 to properly balance those costs and benefits).

[6] *See generally* Adam Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 67 (2010) (arguing that because effects of claims trading are impossible to determine, any type of regulatory action should be narrow in scope).

[7] *See generally* Victoria Ivashina, Benjamin Iverson & David C. Smith, *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings* (Apr. 21, 2011) (unpublished), *available at* http://www.stanford.edu/group/SITE/archive/SITE_2011/2011_segment_3/2011_segment_3_papers/ivashina.pdf (analyzing how claims trading during restructuring process affects concentration of debt ownership).

bankruptcy's fundamental goals and introduces unnecessary complications. In the place of such regulation, I explore a more streamlined reform based on an already fundamental mechanism of corporate bankruptcy: the auction.

As one scholar has suggested, all markets must be regulated in some form.[8] This is undoubtedly true. But the impact of that regulation should be consistent with the foundational goals of the market to which it is applied and—all else being equal—it should minimize disruption to existing rights and entitlements. For claims trading, a centralized auction market is most likely to accomplish those ends.

The word auction is sometimes used simply to refer to a private market for exchange. I use the word more formally here to refer to a process of organized competitive bidding without private negotiation.[9] That definition still encompasses a large range of mechanisms. There are many types of auctions varying across different dimensions: reverse, blind, ascending, single bid, and so on.[10] The particular design of the dynamics of the auction mechanism will be crucial to its suitability for any given purpose.[11]

Of course, many claims *are* auctioned in corporate bankruptcy today. Exchanges, like SecondMarket, have sprung up to facilitate the private auctions of claims.[12] My suggestion is different. Private auctions within contained pockets of the market that are conducted alongside negotiated sales do not accomplish the same outcome as an exclusive centralized mandatory auction. Thus, I explore in this essay the benefits of having a court-facilitated auction (or auctions) of claims in bankruptcy. This auction would be the exclusive market for claims. Just as the court can oversee an exclusive auction of the estate or its assets under section 363 (or a plan sale), the court could oversee the exclusive auction of claims on the estate.[13]

This court-facilitated auction will reduce many of the costs inherent in a claims-trading market; and it will do so with minimal regulation of the market participants

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[8] *See* Baird, *supra* note 3, at 23.

[9] *See* Jeremy Bulow & Paul Klemperer, *Auction Versus Negotiation*, 86 AM. ECON. REV. 180, 180 (1996).

[10] *See* Paul Klemperer, *Auction Theory: A Guide to the Literature*, 13 J. ECON. SURV. 227, 229 (1999) (describing various methods of auction).

[11] *See* Paul Klemperer, *What Really Matters in Auction Design*, 16 J. ECON. PERSP. 169, 184 (2002) (arguing a good auction must cater to ends it is meant to achieve); *see also* Anthony Casey, *Auctions in Chapter 11: Theory and Design* (unpublished work in progress).

[12] Emily Chasan, New Exchange Offers Trading of Bankruptcy Claims, REUTERS, June 9, 2008, http://www.reuters.com/article/2008/06/09/us-bankruptcy-exchange-idUSN0945340720080609; *Introducing Our New Trade Claim Series: An Interview with Andrew Gottesman from SecondMarket*, DISTRESSED DEBT INVESTING BLOG, March 25, 2012, http://www.distressed-debt-investing.com/2012/03/introducing-our-new-trade-claims-series.html; *see also* Marie Leone, *Taking a Bite out of Bankruptcy Claims*, CFO.COM, May 16, 2007, http://www.cfo.com/article.cfm/9184071 (discussing new online exchange called "T-Rex," which provides online auctions for bankruptcy trade claims, trade-credit insurance, and receivables-purchase contracts).

[13] *See* Casey, *supra* note 12 (developing a more general theory of auctions in bankruptcy).

and minimal disruption of pre-bankruptcy entitlements.[14] Moreover, the introduction of a central auction house provides for previously unrecognized solutions to some of the more stubborn problems of modern bankruptcy. Chief among those are the empty-voting and empty-core problems that appear to have been exacerbated by the increasing involvement of hedge funds in the process.[15]

I. THE PROBLEM: HEDGE FUNDS AND CLAIMS TRADING

Hedge funds are popularly viewed as a villain in the financial world today. This is especially true in the world of bankruptcy. Hedge funds increasingly act as distressed debt ("vulture") investors who buy their way into restructuring and bankruptcy processes.[16] And while these funds serve the recognized function of providing valuable liquidity, their other impacts on the process have been highlighted in the press and academic literature, as well as in courtroom battles.[17]

These funds—the story goes—are complicating and disrupting the bargaining dynamics of an already complicated negotiation. Hedge funds push their way into the bankruptcy process by buying up large swaths of debt or other claims.[18] Once in, the funds seek to exercise control over the process to maximize the return on their short-term investment.[19] The problem is that all of this is going on behind closed doors.

Critics suggest that hedge funds stealthily buy claims from unsophisticated creditors for less than they are worth. Or they buy a chunk of a class of debt to maximize external interests. While that may not be inefficient in all cases, it creates a potentially costly wealth transfer from claimholders to funds or from non-selling to selling claimholders in a given class. In turn, the funds take positions in the debtor that are not publicly disclosed. They may hold claims across various classes of debt or they may hedge their economic position through financial derivatives. When the fund finally comes to the bargaining table, it is difficult to know its position or goals. The funds may take secret actions that harm the estate or a certain class of creditors in which they hold claims. Or the bargaining may fall

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[14] *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857, 861–62 (1982) (discussing costs associated with current bankruptcy process).

[15] *See* Baird & Rasmussen, *supra* note 3, at 567 (stating participation of distressed debt professionals has changed traditional bankruptcy process).

[16] *See* Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 71 (2008) (describing how some commentators and practitioners cast distressed debt investors as "vultures" who "are always vying for control of the debtor, at the expense of the debtor and its other stakeholders.").

[17] *See* sources cited *supra* notes 1 & 2; *see also* Mike Specter & Tom McGinty, *Bankruptcy Court is Latest Battleground for Traders*, WALL ST. J., Sept. 7, 2010, http://online.wsj.com/article/SB10001424052748703309704575413643530508422.html.

[18] *See* Abramowicz et al., *supra* note 3.

[19] *See id.*

apart in light of the information deficit.[20] And, even while at the bargaining table, the funds continue to trade in claims, raising the specter of insider trading.[21] These are new spins on the classic problems of private information.

II. THE "CURE-ALL" SOLUTION: DISCLOSURE

Unsurprisingly, many have suggested increased market regulation to address these problems. No one reasonably suggests banning claims trading or hedge funds altogether.[22] The goal is, thus, often stated as reducing the private information problems. As with most problems of private information, the leading regulatory hero is mandatory disclosure.[23] Disclosure requirements have been discussed, proposed, and enacted in the bankruptcy context.[24] Disclosure is a common remedy in legal scholarship. But it is also heavily criticized. In this and other contexts, the potential costs of disclosure have been noted.[25]

Beyond these conventional critiques, the disclosure reforms that have been considered are costly because they are inconsistent with the fundamental goals of the bankruptcy regime and will likely have the opposite of the intended outcome. Rather than remedy private information problems, disclosure requirements on hedge funds are likely to exacerbate them. I explore that outcome in the remainder of this section.

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[20] *See* Baird & Rasmussen, *supra* note 3, at 686–87 (explaining hedge funds hold complicated positions and pursue their own agendas, which can undermine or complicate reorganization process).

[21] *See In re* Wash. Mut., Inc., 461 B.R. 200, 256 (Bankr. D. Del. 2011) ("[T]he Equity Committee contends that the Settlement Noteholders purchased (and sold) the Debtors' securities with 'the benefit of non-public information acquired as a fiduciary' for the 'dual purpose of making a profit and influenc[ing] the reorganization in [their] own self-interest.'"); *see also* Wolf v. Weinstein, 372 U.S. 633, 642 (1963) ("Access to inside information or strategic position in a corporate reorganization renders the temptation to profit by trading in the Debtor's stock particularly pernicious.").

[22] *See* Levitin, *supra* note 3, at 73 (listing benefits of claims trading); Baird, *supra* note 3, at 23 ("Long passed is the time when we could usefully debate whether claims trading in bankruptcy was a good or bad thing. We should accept that it has become a fundamental feature of bankruptcy.").

[23] Disclosure is almost universally the proposed regulation for claims trading. Professor Levitin has noted that few serious critiques can be found that propose other regulations. Levitin suggests that the literature seemingly breaks down to a binary divide between arguments that claims trading is good or bad. *See* Levitin, *supra* note 3, at 67 (suggesting an approach to regulate claims that would result in disclosure to market participants). Below I suggest auctions as an alternative regulation to disclosure, and one that is less disruptive of the claims market.

[24] *See generally* Fortgang & Mayer, *supra* note 2; Baird, *supra* note 3, at 24 ("All markets have disclosure rules, and the bankruptcy exchange should not be an exception.").

[25] *See, e.g.*, Baird, *supra* note 3, at 31–37 (discussing potential costs of disclosure); Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 PA. L. REV. 647, 735–42 (2011) (same).

A. Hedge Funds and Bankruptcy Fundamentals

Corporate reorganization is essentially an attempt to maximize asset value in the face of a collective action problem coupled with a private information problem. Creditors acting alone will enforce their rights according to their private interests without regard to the impact on the estate as a whole. Chapter 11 puts an automatic stay in place to prevent creditors from tearing the estate apart to their collective detriment.[26]

On the other hand, the company must ultimately be reorganized and the stay lifted. This entails restructuring the debtor's capital and allocating rights in the new entity.[27] The private information problem creates an obstacle. Various stakeholders possess private information that other creditors do not about the value of the estate and the best uses to which its assets can be put. For example, a senior creditor often has unique information about the true value of the estate. And its incentives are to use that information for its own private gain.

This makes it difficult for the court to assess the firm's value and the reorganization plan that should be pursued. Increasingly, courts and parties turn to auctions of the estate to maximize its value.[28] But even these auctions are imperfect in light of the information imbalance among creditors.[29]

In the face of this imbalance, it is not surprising that small creditors that are not in the business of investing in distressed debt are eager to sell their claims.[30] They lack the information and experience to value the various strategies involved in the bankruptcy process. They lack the resources and collective organization to make it worthwhile to develop further information. This is where hedge funds come in. They have expertise and their own private information. They know their own positions and they know the leverage and strategic maneuvers they can employ to extract value from the senior creditors.[31] They use this information to place a value on claims and attempt to purchase them for less than that private value.

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[26] *See* 11 U.S.C. § 362(a) (2012).

[27] *See* Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 2010 U. ILL. L. REV. 1375, 1375 (2010) (noting chapter 11 reorganization plan has "elaborate requirements for disclosure, creditor voting, and allocation of stakes in reorganized debtor entity's new capital structure among creditors and owners.").

[28] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 786 (2002) ("The market for selling firms as going concerns is well-developed.").

[29] *See* Kenneth M. Ayotte and Edward R. Morrison, *Creditor Control in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 514 (2009).

[30] *See* Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. PA. J. BUS. L. 35, 35–36 (2009) ("Selling a claim allows a creditor to convert into cash a claim that may not be paid for years and is unlikely ever to be paid in full. By selling its claims, a creditor can obtain some immediate value out of overdue debts and write at least a portion of its losses off its books.").

[31] In the paper I assume there is a central senior creditor and the hedge funds are buying claims of junior debt. In other cases the funds may buy debt from senior lenders as well or there may be no senior creditor. The dynamics are slightly different but the general principle is the same. The hedge funds are buying positions that impact their negotiations with other major creditors.

Because the original claimholders lack information about the hedge fund's valuation, the claimholders will inevitably sell the claims for less than they could get in a world of perfect information. This problem has been highlighted by others.[32] But it must be considered in the more general dynamic of the process.

The claimholder faces a choice: sell to a hedge fund with private information or deal with a senior creditor (and management) with private information. The uninformed seller will generally do better in a world where two asymmetrically informed parties are competing than in a world where one party has a monopoly on private information.[33] It is hard to imagine how a claimholder could do worse selling to a hedge fund than it would do being convinced to vote on a plan proposed by management at the behest of senior creditors, or having the assets sold out from under its feet in a senior-creditor controlled 363 fire sale.[34] The claimholder has less control over those processes than over the sale of a claim to a hedge fund.

B. Problems with Disclosure

Proposals for disclosure suggest that we can keep the hedge fund in the game but increase the knowledge of the claimholder by requiring the hedge fund to reveal its private information. These proposals are too narrowly focused on just one lever in the bankruptcy process. While the idea of a level playing field may be attractive, there are too many moving parts to create one by regulating the information advantage of only one party.

In the extreme, disclosure will push the hedge funds out of the process. The hedge funds are only profiting by function of their private information.[35] If they were required to reveal that information, they would gain no surplus from the trade and exit the market. For example, imagine a fund has private information about a surplus of 8 that can be created if it starts buying claims. Once it is forced to reveal that information, either 1) claimholders will demand the surplus, or 2) other buyers will compete with the fund to buy the claims (until the price is just below 8) only to turn around and sell them back to the fund. That result will diminish all profit opportunity, drive the fund out of the market, and eliminate the opportunity for the surplus in the first place.

This will increase the power of the asymmetrically informed senior creditors at further expense to the uninformed junior creditors. Indeed, it is likely that even

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[32] *See* Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, *Valuation of Bankrupt Firms*, 13 REV. FIN. STUDIES 43, 43–44 (2000) ("The absence of market forces makes valuation more complex and less precise.").

[33] *See* Craig W. Holden & Avanidhar Subrahmanyam, *Long-Lived Private Information and Imperfect Competition*, 47 J. FIN. 247, 248 (1992).

[34] *See* Ayotte & Morrison, *supra* note 30, at 525 (explaining level of control senior creditor has over bankruptcy process).

[35] *See* Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J. L. ECON. & ORG. 27, 33 (1991) ("A bidder's profit in a common-value auction equals the value of the private information that the bidder brings to the auction.").

under many circumstances short of this extreme, requiring one party to reveal its private information does not shift value to uninformed parties, but rather to other holders of private information because it reduces the competition between the holders of private information.[36]

For example, imagine an estate with a true value of 110. The estate owes Senior Creditor 100. Only Senior Creditor and Management know the true value. There are other claims against the company including another 15 in junior debt held by 50 disperse creditors. Senior Creditor and Management have proposed a quick 363 sale, arguing that the firm is a melting ice cube. Senior Creditor has made a credit bid for 100 and after a quick marketing campaign, no other bidders have been identified.[37] The 50 junior creditors are unsophisticated and disorganized. It is not worth it to any of them individually to fight senior creditor because the cost will exceed the likely benefit. And coordination is blocked by a massive free-rider problem.

Fund steps in and starts bidding for the junior claims. Through its expertise, fund has either 1) learned the true value of Debtor, or 2) knows that firms are generally sold too cheaply by senior creditors.[38] Fund is privately confident that it can extract value of 8 from senior creditor if it can amass a significant block of claims.

If Fund offers any surplus above zero, the junior creditors are better off. But Secured Lender is not likely to let Fund buy valuable claims for cents on the dollar without making its own effort. Senior Lender liked the idea of getting 110 for 100. That option, however, is now off the table. Senior Lender knows that Fund can muster up objections to stop the sale and it would rather out bid fund than deal with those objections.[39] The competition between Fund and Secured Lender will push up the price paid to the junior creditors.

Start requiring Fund to reveal information about its position and increase Fund's compliance costs (by subjecting it to discovery motions about disclosure) and you reduce Fund's potential profit and thus reduce its bid. Before Fund was willing to pay up to 8 for the claims if a bidding war ensued. Now it is only willing to pay 8 – x where x is equal to the cost of compliance and discovery. And, as noted above, if Fund has to reveal its private information it may leave the auction altogether. The only party benefiting from that move is Senior Lender who has fewer bidders with which to compete.

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[36] *See* Holden & Subrahmanyam, *supra* note 34, at 247 (arguing privately informed traders compete aggressively, causing most of their common private information to be revealed rapidly); Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315, 1316 (1985).

[37] *See* Ayotte & Morrison, *supra* note 30, at 539 ("[C]hapter 11 gives senior lenders, unsecured creditors, and equity holders leverage over resource allocation issues. The bargaining process can yield a misallocation of assets because these parties have distinct preferences.").

[38] It may be that Fund simply jumps in and buys claims in a diversified portfolio of bankruptcies knowing that on average there is a profit of around 8% to be made. This may change the outcome in a given case but may not change the dynamics across the portfolio.

[39] I am assuming that Secured Lender does not know the precise amount that Fund can extract.

This framework makes its puzzling that so many would suggest that bankruptcy reform include information disclosure requirements on hedge funds. It is true that the competition between Senior Lender and Fund may not be very effective in creating value for junior lenders if everything is going on in secret. Fund is stealthily buying up claims and so the market does not drive up the price paid. But disclosure is not the solution to that problem.[40] With no disclosure, Fund underpays. With disclosure, Senior Lender underpays. A better solution, discussed below, is to create a mechanism that forces the fund and the lender to compete with each other without mandating expensive disclosure.

If information disclosure was an effective remedy for asymmetric information in chapter 11, the process would barely be necessary. Courts would impose an automatic stay, and then restructure with perfect information. In reality, however, bankruptcy is a forum for using *markets* to arrive at an efficient outcome in a web of relationships riddled by intractable asymmetric information.[41] That is why scholars so often commend auctions as the ideal process for bankruptcy.[42] Auctions are particularly useful in allocating assets in the face of private information.[43] It would be odd to suggest that bidders in a classic auction would have to disclose information about their private value. That is what bids are for. It is equally odd to do it in bankruptcy.

It would be even stranger to require one class of bidders in an auction to reveal private information but not others. And yet, this is essentially what disclosure proposals for claims trading are doing. Without considering the information asymmetries throughout the entire bankruptcy system, pulling one information lever will have unintended consequences for the entire system. From the perspective of small claimholders, private information held by hedge funds that are claims trading could offset the widely recognized private information held by senior lenders. If there is an auction, it will create a competition for their claims. The problem then is not disclosure, but rather that such an auction does not currently exist.

The disclosure proposals are even more problematic when administrative considerations are taken into account. As a starting point, it is at least suggestive of the cost implications of such a requirement that private parties often opt out of any liability for lack of disclosure.[44] Disclosure and other regulatory reforms require the

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[40] As an aside, it is unlikely that Secured Lender is completely ignorant of all potentially interested hedge funds. And likely even without knowing about a specific hedge fund, a sophisticated senior lender will still buy up claims to insulate itself from secret maneuvers.

[41] *See* Yaad Rotem, *Better Positioned Agents: Introducing a New Redeployment Model For Corporate Bankruptcy Law*, 10 U. PA. J. BUS. & EMP. L. 509, 511–512 (2008) (stating market agents and mechanisms should be involved in bankruptcy process to achieve efficient allocation of assets).

[42] *See id.* at 540–541 (citing several scholars that have advocated auction solution).

[43] *See id.* at 541 (describing virtues of auction, such as providing incentive for parties to reveal information).

[44] *See* Daniel Sullivan, Comment, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533, 537 (2008) (describing two commonly used methods to opt out of liability known as "Chinese Walls" and "big boy letters").

extensive involvement of the court. Much effort has been spent by scholars and practitioners to propose mechanisms to reduce the involvement of courts and the procedural hurdles that parties face in the chapter 11 process.[45] Disclosure proposals go in the opposite direction. Courts will routinely be called upon to police the claims market and verify the adequacy of disclosure.

Any time the courts' involvement increases there are two potential groups of costs. The first contains the straightforward direct costs of judicial oversight, compliance, and verifying compliance.[46] The second contains the costs of hold up. Stakeholders in bankruptcy have not been shy in using procedural mechanisms to exert influence over the valuation and confirmation processes. Lawyers are not likely to waste the chance to allege improper disclosure whenever a fund has amassed enough claims to influence a reorganization even if just to extract a ransom payment.[47] The history of takeover litigation in Delaware is instructive on this point.

One might not worry too much about hold up if the accuracy of disclosure was cheaply verifiable. Objections could be easily rejected. But that is not the case. In the absence of some major and wide-reaching shift in bankruptcy procedure, the process of verification will no doubt require extensive discovery that introduces large costs and induces nuisance settlements. [48]

And even with extensive discovery, the disclosure may still be impossible to verify. The structure of hedge funds and other financial institutions are exceedingly complex. The right hand often doesn't know what the left hand is doing. And that is not by accident. Strict information controls are put in place to allow one division of a fund to continue trading claims while another division sits at the bargaining table.[49] This prevents insider trading allegations. And the funds do not stop at metaphorical walls of fire. In one case, the fund built an actual sound proof room.[50] But even that may not be enough.

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[45] *See id.* at 533 (providing suggestions to increase bankruptcy court efficiency including using ethics walls in connection with non-reliance letters).

[46] *See* Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 467 (2007) (noting high costs of litigation including "costs of legal representation, prolonged discovery, and time spent by the court that could be devoted to other cases.").

[47] One might think that procedural hold up is fair play against these hedge funds. They do have a reputation for taking their own strong positions in asserting objections in bankruptcy. But we should not be tempted to create an ever escalating and costly war of endless objections. Adding objection opportunities in the current environment may seem fair, but it is unlikely to reduce the costs of reorganization.

[48] *See* FED. R. BANKR. P. 2004(b) (allowing broad discovery that covers "any matter which may affect the administration of the debtor's estate[.]").

[49] *See generally* Andrew N. Vollmer, *How Hedge Funds Advisers Can Reduce Insider Trading Risk*, 3 J. SEC. L. REG. & COMPLIANCE 106, 106–13 (2010) (describing information control methods funds employ to prevent insider trading allegations).

[50] *See* Tom Hals, *Update 1-Hedge Fund Denies Insider Trading in WaMu Case*, REUTERS, July 18, 2011, http://www.reuters.com/article/2011/07/18/washingtonmutual-idUSN1E76H1QP20110718.

Recent suggestions that funds may be held liable for insider trading may dramatically change their activity in the bankruptcy process.[51] And that is a world without a disclosure requirement. It is difficult to imagine a comprehensive disclosure regime integrated into a system that requires impenetrable firewalls. The potential for nuisance claims would increase exponentially. And if those claims create enough noise, the result may even be to allow funds to *increase* serious misrepresentation by masking it as a boilerplate technical violation that can be bought off with attorneys' fees.[52]

These new opportunities to challenge the action of the fund are likely to add friction and inefficiency to a reorganization process that is already marked by constant objections and procedural hold up.[53]

The takeaway is that disclosure is ill-suited for the problems raised by claims trading in bankruptcy. If such disclosure were feasible, it would have to be coupled with disclosure requirements across the board. These will massively expand the role of the court. But the whole reason bankruptcy scholars have repeatedly embraced the idea of auctions is that bankruptcy is a world where disclosure of private information is not feasible. If we don't want to expand disclosure requirements across all of bankruptcy—and we do not—an alternative might be to do the opposite and expand auctions. There is no reason that the value of auctions should be limited to the sale of assets and not the purchase of claims. And, as I explore in more detail in the next section, it may actually be that auctions function even better for claims than they do for asset and estate sales.

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[51] *See* Tiffany Kary, *Hedge Funds Seek to Trade in Comfort as Bankruptcy Insiders*, BLOOMBERG, Oct. 18, 2013, http://www.bloomberg.com/news/2013-10-18/hedge-funds-seek-to-trade-in-comfort-as-bankruptcy-inside.html (suggesting if hedge funds are to be held liable for insider trading, mutually beneficial relationship between estates and hedge funds may be halted because of risk involved for hedge funds).

[52] *See* Anthony Casey & Anthony Niblett, *Noise Reduction: The Signaling Value of Qui Tam*, WASH. U. L. REV. (forthcoming 2014) (showing increases in weak information may cause reduction in deterrence and in increase in prohibited behavior).

[53] *See* Ayotte & Morrison, *supra* note 30, at 513–15 (noting frequent creditor conflict, including objections filed in 46-50% of chapter 11 cases, hedge funds participation in increasing creditor conflict, and possible role of creditor conflict in creating inefficiency in sales).

III. OF GEMS AND LEMONS: A CASE FOR AUCTIONS

The idea that we would auction off ultimate ownership of a debtor but not the intermediate transfers of ownership has little grounding. Auctions are fundamental and ancient information revelation mechanisms.[54] The auction creates an incentive for sellers to reveal information,[55] and for bidders to competitively bid. The bid reveals private information about their valuation. Auctions are, therefore, most useful when private information makes a negotiated private sale costly or impossible. The key function of an auction is to gather potential buyers of a good in which there is not a thick liquid market and extract information about their private value. The seller reveals its product qualities to the market and the potential buyers make bids based on their private valuation.

If the use of centralized auctions were expanded to claims, many of the concerns about hedge funds and claims trading would be ameliorated.

First, auctions would reduce the costs of uninformed and unsophisticated creditors selling their claims well below their true value. Auctions do particularly well in forcing value information from buyers to uninformed sellers.[56] Indeed, some have suggested that auctions are more effective at solving problems of private information held by buyers, the "gems" problem, than problems of private information held by sellers, the "lemons" problem.[57] But, as it is, bankruptcy uses auctions where there is a lemons problem (the sale of the estate or its assets to a third party) but not when there is a gems problem (the purchase of claims by distressed debt investors).

A lemons problem occurs when the seller has private information that is not verifiable to the market.[58] A seller of a high quality good cannot differentiate itself from the seller of a low quality good.[59] This drives the price of high quality goods

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[54] *See* Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA 1089, 1089, 1094–95 (1982).

[55] *See* Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J. L. ECON. & ORG. 356 (2001) ("A regime of mandatory auctions is strongly information forcing. It gives managers (and everyone else with an incentive to preserve the firm as a going concern) an incentive to make information available and verifiable to potential buyers. Such a rule destroys the option value associated with purchase the firm *in toto* at the outset), but it gives the managers an incentive to ensure that a market for the firm's assets always exists.").

[56] *See* Giuseppe Dari-Mattiacci, Sander Onderstal & Francesco Parisi, *Inverse Adverse Selection: The Market for Gems* 15 (Tinbergen Inst. Discussion Paper No. TI 2011-017/1, 2010) (stating that competing in an auction forces informed buyers to reveal their valuations and fills asymmetric information gap between buyers and sellers).

[57] *See id.* at 3 (describing how auctions elicit useful information from buyers, solving gems problem, while being ill-suited to solve lemon problems); *cf.* Yoram Barzel, Y., Michel A. Habib, & D. Bruce Johnsen, *Prevention is Better than Cure: The Role of IPO Syndicates in Precluding Information Acquisition*, 79 J. BUS. 2911, 2912–13 (2006) (explaining example of investor not acquiring information and "buying blind").

[58] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 489 (1970).

[59] *See id.* at 490, 495.

down, pushes those goods out of the market and causes the market to unravel.[60] Traditional ascending auctions are not good at solving this problem. The competition is among the buyers and the high quality seller has no more ability (and the same incentive) to reveal the private information about the good.[61]

It has long been recognized that the sale of an estate in bankruptcy is likely to pose a lemons problem.[62] The problem is even more complex because the party controlling the sale is often also a potential buyer. For example, revelation of private information held by senior creditors may be valuable to junior creditors who benefit from a higher sale price. Meanwhile, the senior creditors are themselves making a credit bid to buy the assets and have no incentive to solve the lemons problem.[63] Nonetheless, auctions (and ascending ones at that) are regularly used in bankruptcy estate sales.[64]

The gems problem is the inverse.[65] The buyer has the private information about the quality of the good and the seller is uninformed. This is akin to a buyer who knows there is oil under a property and the seller has no idea or when a buyer knows that an item for sale is a "gem" while the seller has no idea if it is a gem or junk (or a simple commodity). The buyer knows if the good is a gem. This drives the price of gems down and sellers may leave the market in fear that they are parting with a gem.[66] The concept is straightforward and shows up in classic contracts cases.[67]

The claims-trading market can essentially be viewed as a gems-market problem. The hedge funds know the value of the claims. They have expertise in valuing claims and exercising leverage. The holder of the claim has no information. Some holders will fear parting with gems; others will sell gems cheaply. Often, the result is a concentration of gems in the hands of a hedge fund. One additional dynamic is that the more gems the hedge fund holds, the more value it may be able to extract from the non-selling claimholders. That may feed back and make claims holders

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[60] *See id.* at 490.

[61] *See* Dari-Mattiacci et al., *supra* note 57, at 2 (observing dual problem that occurs when buyers, rather than sellers, possess imbalance of information about quality of goods sold).

[62] *See* Richard D. Thomas, *Tipping the Scales in Chapter 11: How Distressed Debt Investors Decrease Debtor Leverage and the Efficacy of Business Reorganization*, 27 EMORY BANKR. DEV. J. 213, 235–36 (2010) (analogizing interchangeability of claimants and lemons problem).

[63] *See* Douglas G. Baird & Anthony J. Casey, *Bankruptcy Step Zero*, 2012 SUP. CT. REV. 203, 217 & n.44, 45 (2013) (discussing how senior creditors' ability to credit bid without costs may aggravate "winner's curse" problem, especially when one bidder has asymmetric information).

[64] Recently a bankruptcy plan experimented with a reverse Dutch auction for secured notes. *See* Mark S. Chehi, *Central European Distribution Corporation's Chapter 11 Plan Incorporates Dutch Auction*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., Aug. 20, 2013, http://www.skadden.com/sites/default/files/publications/2013-08-20-central-european-distribution-corporations-chapter-11-plan-incorporates-dutch-auction.pdf.

[65] *See* Dari-Mattiacci et al., *supra* note 57, at 2 (explaining how "inverse adverse selection" occurs when buyers, rather than sellers, possess private information about quality of good).

[66] It is not obvious that the market will unravel as easily as the lemons market—particularly if the seller is not even aware of the existence of gems.

[67] *See* Dari-Mattiacci et al., *supra* note 57, at 2.

more eager to sell. In the end, there is a wealth transfer to the hedge funds (both from selling and non-selling holders; though the non-selling shareholders may lose more).

Unlike lemons markets, recent literature suggests that auctions are particularly *well suited* to solve problems in gems markets.[68] As long as there are multiple informed buyers, they will compete with each other and drive the price of the good up. The seller needs to know nothing about the value of the good because a competitive auction will provide a signal about the informed buyers' assessment of whether it is a gem. Auctions do better than private negotiated sales because they force the informed bidders to compete with each other and prevent a take-it-or-leave-it low-ball offer from one informed bidder who reaches the seller first.

Second, because the auctions can be run as a tender offer where the purchase is allocated pro rata to tendering sellers, this eliminates any involuntary wealth transfer from non-selling to selling claim holders. In the current system, if the fund's control allows it to extract private value from remaining claimholders, the early sellers may be offered some premium for their claims. This exacerbates the collective action problem. But with a tender process, any claimholder may tender his or her claims for sale. If more claims are tendered than the bid requires, the purchase can be allotted to the tendering holders pro rata. As with tender offers for public corporations, there is the potential for a coercive tender offer if the new holder is expected to take advantage of control to expropriate value from anyone who does not tender. But, if the point about auctions and gems is correct and collusion is prevented, there is likely to be competing funds and creditors. That should push the price of the claims up until the price includes nearly the full value that could be expropriated.[69]

Finally, like the current regime of claims trading, these auctions would allow for the beneficial concentration of claims. But they do so more effectively and in a way that avoids value destroying concentrations. That salutary effect results because auctions properly designed can address the problem of empty voting and the empty core.[70] In that way auctioning claims can concentrate control and reduce the risk that the bargaining table will be overturned by secret positions and shifting alliances.

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[68] *See id.* at 15 (noting how auctions are not generally effective solutions for traditional lemons problems but may effectively solve gems problem).

[69] *See* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 180 (Harvard Univ. Press 1991) ("It is hard to see how the two-tier bid could lead to success by anyone other than the firm placing the highest value on the target's assets"). This assumption has been criticized as theoretic in the takeover context. But, with a court overseeing the process and all the parties already in the auction room, competitive bidding should be even more likely in the bankruptcy context.

[70] *See* Casey, *supra* note 12.

The problem of the empty or dispersed core—while somewhat neglected by legal scholars[71]—has long been the focus of auction design scholars.[72] While there is not universal agreement, there are various innovative designs that have been suggested by leading economists for how to use an auction to reassemble a core. In this way, implementing an auction might be valuable solely for the purpose of assembling the core.[73] By that benefit alone the auction is superior to the current system of claims trading.

By virtue of the fact that the core is dispersed, these mechanisms cannot be adopted by private negotiation. That is where the court steps in. The court is the auctioneer and the auction designer.[74]

One may worry that a bidder will get a large share that enables it to hold up the process. But an auction properly designed should prevent this. The party with the highest value should bid enough on the assembled core to make it too costly for anyone else who stands to gain only from hold up. Of course, no system is perfect and there will be cases where the core ends up in the hands of a party who can only profit from hold up. That can also occur when parties have substantial holdings before bankruptcy. In both cases, the concern should not be as much that parties have concentrated claims but that the bankruptcy procedures provide so many opportunities for opportunistic uses of objections to secure nuisance payments.

The focus of reforms should be on reducing these nuisance opportunities. Indeed, any disclosure requirements will just provide more opportunities for procedural hold up.

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[71] Douglas Baird and Bob Rasmussen recently brought a new focus on this problem. *See* Baird & Rasmussen, *supra* note 3, at 689–90 (suggesting where creditors cannot reach agreement in reorganization process, problem may be that core is empty).

[72] *See generally* Lawrence M. Ausubel & Paul R. Milgrom, *Ascending Auctions with Package Bidding*, 1 B.E. J. THEORETICAL ECON. 1, 20 (2002).

[73] *See* Casey, *supra* note 12.

[74] Baird & Casey, *supra* note 64, at 217 & n.45 (discussing court involvement in auctions); *In re* Texas Rangers Baseball Partners, 431 BR 706, 710 (Bankr. N.D. Tex. 2010) (discussing "clear" authority of court to set bidding procedures for sale of debtor's assets).

IV. POTENTIAL OBJECTIONS AND OBSTACLES

A first objection may be that I am replacing disclosure requirements with a limitation on a holder's ability to individually sell a claim that is fully alienable outside of bankruptcy. That is true. But that is entirely consistent with the first principles of bankruptcy. The first problem that bankruptcy is designed to solve is one of collective action.[75] Many provisions in the Code prevent parties from exercising rights individually when doing so would be to their collective detriment.[76] We assume a hypothetical creditors' bargain that maximizes their ex ante expectations in bankruptcy.[77] Just as that bargain includes a stay on the creditors' ability to enforce collection rights individually, it could include a stay on the creditors' ability to sell claims individually if that stay would maximize the collective recovery of holders of claims within a certain class. The idea of providing the entire class with the same potential payouts (prorated, of course) and requiring some coordination across the class of claimholders is consistent with, and furthers, the fundamental principles of chapter 11. And if it maximizes value to the class of claimholders, it fits nicely into the creditors' bargain theory.

Claims trading has in some sense evolved into an exception to the collective action rules. The automatic stay does not touch the process even though claimholders may rush to sell while destroying collective value. Faced with the costs arising from this individual self-interested trading, scholars have suggested regulation without considering the possibility of simply removing that exception and bringing claims trading under the umbrella of bankruptcy's fundamental principles.

A second objection would focus on the effects that this process has on pre-bankruptcy behavior. As Professor Levitin has suggested, proposals to regulate claims trading should not be evaluated with an artificial view of "bankruptcy as a world in and of itself."[78] All proposals to reform bankruptcy should be measured by the cost and benefits they produce for firms both in and out of bankruptcy. Changes to the rights that parties have in bankruptcy can ripple out and change incentives for firms across their entire life cycle.

The mechanism explored here is no exception. Perhaps the strongest critique of a mandatory claims auction is the effect it would have on distressed debt investment and claims trading in the period immediately preceding bankruptcy. As danger looms on the horizon, hedge funds who want to take full advantage of their private information will prefer to buy claims in a private market where there are no competing bids. Knowing that this is not allowed in bankruptcy, the funds will seek

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[75] *See* Jackson, *supra* note 15, at 862–63.

[76] *See, e.g.*, 11 U.S.C. § 362(a) (2012) (providing debtors temporary relief, thereby preserving debtor's estate for creditors as a whole, by way of automatic stay).

[77] *See* Jackson, *supra* note 15, at 861–62 (describing hypothetical creditors maximizing their distributions through bargaining).

[78] Levitin, *supra* note 7, at 94 (2010).

to buy up debt claims prior to bankruptcy. Claimholders who are unfamiliar with the bankruptcy process, or who do not want to hold risky claims any longer than they have to, will be induced to sell well below value. This pushes the wealth-transfer problem one step earlier without actually solving it.

There may be solutions. But, before addressing those, one important thing should be noted. The empty core and voting problems are not created ***here***. The fact that the claims will be centrally auctioned in a well designed auction after bankruptcy filing, will lead to a reassembly of the core. If the core is more valuable when assembled, those auctions should result in that reassembly. The hedge fund purchases prior to bankruptcy will be either 1) an attempt to purchase the core at a discount or 2) an attempt to purchase parts of the core so that it can extract the lion's share of its value in the bankruptcy auction.

The claims will end up in the hands of those who value them the most. The only issue is who captures the surplus. The question then is how problematic is the wealth transfer when it is divorced from the other problems of claims trading. That is a normative question about wealth distribution that I do not try to answer here.

Assuming the problem is significant, it suggests the need to regulate claims trading outside of bankruptcy as well. It would be an unwieldy and unprecedented limitation on market contracting to suggest that claims against any firm must be centrally auctioned at all times during the life of the firm. No one should seriously suggest that bankruptcy principles dominate market dynamics in that way.

A more reasonable alternative might be to have a preference period for claims trading just as the Code has for payments to creditors. A creditor cannot receive a payment preference on the eve of bankruptcy because this reintroduces the collective action problem.[79] In the same way, an outsider might be prohibited from preferentially profiting from the trade of claims on the eve of bankruptcy. Rather than voiding the preferences, however, the Code could simply require that they be put up for auction with any surplus going to the preference period transferor.

For example, the Code could require the holder of any claim that was transferred within 90 days of bankruptcy to offer that claim for auction with a reservation price equal to its preference period purchase price. If no one bids on the claim, the transferee keeps it. If it sells above the preference period purchase price, the surplus goes to the transferor.

For example, Fund pays Holder $100 for a claim against Debtor on August 1. Debtor files for bankruptcy on September 1. The bankruptcy court organizes a claims auction process for all registered claims. Most claimholders have the option to put their claim up for auction.[80] But Fund is *compelled* to do so because it acquired the claim during the preference period. Fund is required to offer the claim up for auction with a reservation price of $100. If NewFund buys the claim for

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[79] *See supra* note 76 and accompanying text.

[80] If they do not participate then they continue to hold the claim and cannot sell it in a private transaction.

$110, then Holder gets $10 and Fund gets $100. Fund will have the option to bid on the claim itself (with a credit bid for the first $100).

The only disclosure required in this process is the date of transfer on a claim. The preference auction requirement eliminates any wealth transfer from Holder to Fund that occurred by virtue of Fund's private information on the eve of bankruptcy. Of course, 90 days is a crude measure of the "eve." In some cases it will be over inclusive and in others it will be under inclusive. But that is true of the existing preference rules and many other rules in bankruptcy.[81] If empirical evidence suggested a different time period was more likely to correct the problem, then the rule could be adjusted.

This preference mechanism will have the additional effect of changing the value of debt claims. A claim purchased within the 90 day preference period carries downside risk without the full upside. This could chill purchases of debt outside of bankruptcy or encourage early filing of bankruptcy to avoid the distortion. Chilling effects are always a problem in bankruptcy rules. But this problem is not likely to be significant here. The difference in the value of the claim will turn on the probability that the debtor is within 90 days of a bankruptcy filing, the probability that bankruptcy is actually filed, and the probability that there will be a high upside appreciation of the claim between the purchase date and the bankruptcy filing. This means that the distortion will only be significant if there is likely to be large appreciation of a claim in a 90 day period, and that appreciation is likely to occur even when the debtor ends up filing for bankruptcy, and the firm is likely to end up in bankruptcy. For that to be true the firm must be highly volatile and have a high likelihood of bankruptcy.

For example, an asset that has a value of 100 today but has a high probability of being worth 200 in the next 90 days must also have a high probability of being worth little or nothing in those 90 days.[82] Such a firm and its stakeholders are likely to benefit from a bankruptcy filing, especially where the likelihood of bankruptcy in the next 90 days is very high, as it must be for the value differential to be significant.[83]

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[81] *See* DOUGLAS BAIRD, THE ELEMENTS OF BANKRUPTCY (5th ed. 2010).

[82] The only other alternative would be that the claim would sell for 100 even though it is actually worth 200. This would only be the case if the claims trading market is allowing hedge funds to take advantage of claims holders. This is the exact problem we are trying to solve so the fact that the mechanism chills these types of transaction is a benefit rather than a cost.

[83] More formally, the difference in value of a claim in the current regime and a claim in the regime where the preference rule is in effect can be stated as:

$V_1 – V_2 = [p/(1-p)]*(H – V_1)$

Where

V_1 = the value of the claim in a distressed period in the existing system

V_2 = the value of the claim in a distressed period before bankruptcy with the preference mechanism

p = the probability that the debtor will end up in bankruptcy ***and*** the claim will appreciate

H = the value of the claim if it appreciates

Thus, $H – V_1$ = the amount of appreciation in the 90-day period.

It is unlikely that any pressure to file early in such case would impose extreme costs. Indeed, the bankruptcy filing might be necessary to stabilize the debtor and reduce the volatility.

Again, this mechanism is consistent with first principles of bankruptcy. The auction is a mechanism to extract private information about valuation, transfer the claims to those who value them most, and reduce collective action problems. The preference mechanism serves as a backstop to prevent parties from circumventing the auction and reintroducing the collective action and private information problems.

To say the process is practically feasible and consistent with the principles of bankruptcy is not, however, to say it is legal under the existing law. A new provision in the Code would obviously be required. And such a provision would raise significant questions about the reach of the Bankruptcy Code and bankruptcy courts because it regulates the relationship between a creditor and a third party that does not directly involve the debtor.[84]

CONCLUSION

Stories of hedge fund activity creating problems for bankruptcy courts can be found in the case law. But they are anecdotal. As usual, we must be careful in drawing conclusion from the outlier cases that result in reported decisions or coverage in the press. Possibly none of the problems discussed above arise very often.

The empirical data on the impact of claims trading and hedge fund activity is still being gathered. And many factors—not least of which is the private information problem I discuss in this essay—will make it difficult to draw inferences from that data when it is ultimately gathered.[85] Additionally, many do not think the wealth transfer, even if it occurs regularly, is a problem at all.

Still, it is a worthwhile endeavor to explore potential improvements on the existing regime. And if a solution introduces little new costs while creating other benefits, it may be optimal no matter how small the initial problem. On the flipside, a "solution" that provides a marginal benefit but disrupts the overall dynamic across the entire bankruptcy regime is unlikely to be valuable even if the original problem is quite large.

Imagine then that a debtor has a 50% chance of going into bankruptcy. And, if it goes into bankruptcy, a debt claim has a 10% chance of appreciating by 20%. Then the change in value of the claim pre-bankruptcy between the two regimes is only 1.05%. Given that a 20% appreciation of a distressed claim in 90 days is extremely unlikely, we should expect that the change in most cases will be significantly lower. Moreover, as the chance of bankruptcy increases from 50% to 100% we worry less about pushing a firm into bankruptcy a few weeks early.

[84] *See* Stern v. Marshall, — U.S. —, 131 S. Ct. 2594, 2620 (2011). Indirectly it does affect the value of the estate significantly.

[85] The other participants in this symposium have made major strides in overcoming these obstacles.

In this essay, I have suggested the possibility that conventional disclosure proposals for regulating claims trading fit the latter description, while a streamlined reform introducing a centralized auction mechanism fits the former. Faced with these two options, the choice should be straightforward in the face of most plausible empirical findings.