CREDIT DERIVATIVES CAN CREATE A FINANCIAL INCENTIVE FOR CREDITORS TO DESTROY A CHAPTER 11 DEBTOR: SECTION 1126(e) AND SECTION 105(a) PROVIDE A SOLUTION

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INTRODUCTION

One of the basic presumptions supporting chapter 11 of the Bankruptcy Code is that creditors have a desire to maximize the distribution they receive on account of their claims. Given this presumption, it makes sense that creditors are provided substantial influence over the reorganization process, such as the ability to vote on a plan of reorganization. However, if some creditors, particularly large ones, have a financial incentive to *minimize* the distribution they receive on account of their claims, the chapter 11 process might be subverted.

Modern credit derivatives have created the potential for just such a situation in which creditors have a financial incentive to minimize the distribution they receive on account of their claims. By employing credit derivatives, individual creditors are able to voluntarily create a situation that enables them to gain financially *only* if the distribution they receive on account of their claim is minimized. By voting against any plan of reorganization, they could sabotage the debtor's reorganization effort at the expense of the debtor, other creditors and even third parties. This situation would hinder the achievement of several fundamental goals of chapter 11 such as equitable distribution and maximization and preservation of estate value.

Section 1126(e) of the Bankruptcy Code offers a solution to this problem. Section 1126(e) provides: "On request of a party in interest, and after notice and a hearing, the court may designate 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 this title." Although the Code does not define "good faith," and no court has decided a case in point, this article concludes that a court should find a lack of good faith when a creditor attempts to sabotage a debtor's reorganization efforts by blocking a plan in order to gain financially on a credit derivative position. Therefore, based on the authority provided in section 1126(e), a court could disenfranchise that creditor.

Obviously, before a bankruptcy court could consider a motion to designate a creditor's vote in this situation it must know of the credit derivative position. Therefore, a preliminary, and possibly more challenging issue, is whether the court can and should order disclosure of credit derivative positions held by creditors. Although the Code does not explicitly require disclosure by creditors of their third party agreements, section 105 certainly provides authority for courts to order disclosure of credit derivative agreements if those agreements create an incentive to subvert the chapter 11 process. Yet another difficult issue lies in crafting a disclosure scheme that reveals only necessary information while ensuring that creditors' are able to keep confidential their legitimate proprietary trading activities.

This Article will proceed in three parts and a conclusion. Part One will introduce credit derivatives and explain how they can be employed by creditors to create disastrous situations in chapter 11. This section will also make clear that at least one popular form of credit derivative exists that enables these disastrous situations to persist throughout the duration of a chapter 11 case. Part Two will examine the legal framework of designation under section 1126(e) and will establish the legal standard for good faith that should be employed when considering a creditor's use of credit derivatives. Part Three will analyze the authority of the court under section 105(a) to require disclosure of certain credit derivative positions.

I. INTRODUCTION TO CREDIT DERIVATIVES AND THE PROBLEM OF NET ADVERSE CREDITORS

According to iconic investor Warren Buffett, derivatives are "time bombs, both for the parties that deal in them and the economic system . . . . [They] are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."[1] Although Mr. Buffett was likely not considering the consequences of derivatives in chapter 11 proceedings, his statement aptly describes the dangers some derivatives present in chapter 11 cases. Mr. Buffett's statement also encapsulated the enormity of the global derivatives market. According to one report, the total notional amount[2] of all derivatives contracts at year end 2007 was $596 trillion of which $58 trillion alone was outstanding credit default swaps.[3] In

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[1] Warren E. Buffett, *Chairman's Letter to the Shareholders of Berkshire Hathaway Inc.*, in 2002 ANNUAL REPORT 13–15 (2003), *available at* http://www.berkshirehathaway.com/2002ar/2002ar.pdf.

[2] *See* ROBERT W. KOLB & JAMES A. OVERDAHL, FINANCIAL DERIVATIVES 12 (3d ed. 2003):

> Notional principal is simply the total principal amount used to calculate swap cash flows . . . . [The] notional amount underlying a swap reveals nothing about the capital actually at risk in that transaction. Despite these flaws, changes in notional principal over time provide a useful measure of growth in the market, if not absolute size.

See also DIMITRIS N. CHORAFAS, MANAGING DERIVATIVES RISK: ESTABLISHING INTERNAL SYSTEMS AND CONTROLS 25 (1995) (discussing concept of defining notional principal); Traders Log, Notional Principal, Definition—Trading Glossary, http://www.traderslog.com/Notional-Principal.htm (last visited Mar. 4, 2009):

> In an interest rate swap, forward rate agreement, or other derivative instrument, the amount or, in a currency swap, each of the amounts to which interest rates are applied in order to calculate periodic payment obligations. Also called the notional amount, the contract amount, the reference amount, and the currency amount.

[3] *See* NAOHIKO BABA & PAOLA GALLARDO, BANK FOR INT'L SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2007 1 (2008), http://www.bis.org/publ/otc_hy0805.pdf (detailing growth in financial derivatives market in later half of 2007); Niall Ferguson, *Wall Street Lays Another Egg*, VANITY FAIR, Dec. 2008 at 6, *available at*

comparison, the total market capitalization of all companies listed on the New York Stock Exchange at year end 2006 was $25 trillion.[4] Even more astounding than the sheer size of the derivatives market is its meteoric rise.[5] For example, credit derivatives, a type of derivatives, grew at a compounding annual rate of 100% between 2003 and 2007.[6] Partially as a result of the large notional amount of the global derivatives market and, in particular, the recent dramatic rise in credit derivatives, numerous problems related to derivatives have emerged (e.g. creation of excess systemic risk, etc.).[7] In addition to generic problems created by derivatives outside bankruptcy, credit derivatives have the potential to create serious problems within bankruptcy. The following sections will explain how credit derivatives work and how they can be employed to subvert an attempted reorganization in chapter 11.

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http://www.vanityfair.com/politics/features/2008/12/banks200812?currentPage=1(explaining derivatives and effect of financial crisis on derivatives market); Henry C.K. Liu, *US Government Throws Oil on Fire*, ASIA TIMES ONLINE, Oct. 23, 2008, http://www.atimes.com/atimes/Global_Economy/JJ23Dj05.html (discussing how outstanding derivatives rose by December 2007).

[4] *See* NYSE Euronext, N.Y. Stock Exchange Fact Book, Market Capitalization of NYSE Companies, http://www.nyxdata.com/factbook (follow "NYSE Historical Statistics;" then follow "Market Capitalization of NYSE Companies") (last visited Mar. 4, 2009) (charting market capitalization of NYSE companies from 1996 to 2006); *see also* Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 N.C. L. REV. 89, 98 (2007) ("As of December 31, 2006, the NYSE listed 2,764 issuers with an aggregate market capitalization of $25 trillion.") (footnote omitted); Embraer-Empresa Brasileira de Aeronáutica S.A., Annual Report (Form 20-F/A), at 87 (Nov. 26, 2007), *available at* http://www.sec.gov/idea/searchidea/-companysearch_idea.html (Enter file #: 333-132289; select "Documents" under filing 20-F/A, filing date 2007-11-26; follow document #1) ("The São Paulo Stock Exchange had an aggregate market capitalization of approximately R$1.5 trillion, equivalent to US$722.6 billion at December 31, 2006. In comparison, the NYSE had a market capitalization of approximately US$25 trillion at the same date.")

[5] *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES SECOND QUARTER 2008, at 5–6 (2008), http://www.occ.treas.gov/ftp/release/2008-115a.pdf [hereinafter *Comptroller of the Currency*] (indicating rapid growth of derivative markets from 2003 to 2007); Jonathon Keath Hance, Note, *Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm*, 65 WASH. & LEE L. REV. 711, 715 (2008) ("Despite a cloud of legal uncertainty that hangs over the derivatives market in the United States, derivatives show no sign of slowing. Widespread use of these instruments has led to an exponential growth in the worldwide derivatives market."); Paul B. Farrell, *Derivatives the new 'ticking bomb,'* MARKETWATCH, March 10, 2008, http://www.marketwatch.com (follow "Search" under "Tools & Research;" then type "Paul Farrell ticking bomb;" then follow "Paul B. Farrell: Derivatives are the new ticking time bomb") (stating in five years since Buffet's 2003 warning "[d]erivatives grew into a massive bubble").

[6] *See Comptroller of the Currency*, *supra* note 5, at 5 (discussing derivative growth rate); *see also* John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1382 (2008) (stating credit derivatives have greatly increased worldwide in recent times); International Swaps & Derivative Association Summaries of Marketing Survey Results, http://www.isda.org/-statistics/recent.html (last visited Mar. 4, 2009) (finding credit default swaps grew 103% in 2005 and 101% in 2006).

[7] *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1040 (2007) (indicating credit derivatives' prevalence could cause increase in systemic risk); *see also* Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3100 (2008) (presuming systemic risk would increase if party enters into large amount of credit derivative contracts "without disclosing any information"). *See generally* Tim Weithers, *Credit Derivatives, Macro Risks, and Systemic Risks*, 92 ECON. REV. 43 (Fourth Quarter 2007) (discussing marco and systemic risks of credit derivatives).

A. Overview of Credit Derivatives—Credit Default Swaps and Total Return Swaps

A derivative is essentially an agreement between two market participants, the value of which is determined by reference to some underlying asset, rate or index.[8] Take for example, a simple stock call option (a form of derivative) where the purchaser of the option has a right to purchase a specific stock at a predetermined price from the option seller.[9] The value of the option is therefore derived from the value of the underlying stock: as the value of the stock increases, the value of the call option increases; conversely, as the value of the stock decreases, the value of the call option decreases.[10] Like the stock call option, a credit derivative's value is also linked to a reference asset; however, a credit derivative is designed to isolate the credit risk of the underlying asset.[11] By isolating the credit risk of the underlying asset and creating a derivative whose value is tied to that isolated credit risk, market participants are, at least in theory, able to transfer credit risk.[12]

Credit derivatives are widely used in modern financial systems. For instance, in one application, a holder of a corporation's bonds could enter into a credit derivative agreement with a third party that transfers the risk that the corporation defaults on the bonds. In this application, the credit derivative is employed as a type of

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[8] *See* Blanchard and Co., Inc. v. Barrick Gold Corp., No. 02-3721, 2004 WL 737485, at *2 (E.D. La. Apr. 5, 2004) (explaining derivative is "a bilateral contract whose value is derived from the value of the underlying asset, reference rate or index"); KOLB & OVERDAHL, *supra* note 2, at 1 (construing derivative value is based on underlying instrument); *see also* CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 519 (S.D.N.Y. 2008) (discussing how "underlying instrument or index" establishes value of derivative).

[9] *See* KOLB & OVERDAHL, *supra* note 2, at 1.

[10] *See id.* at 2.

[11] *See id.* at 174 (suggesting credit swaps, which are linked in value to reference assets, help corporations to manage credit risk); Gunter Dufey & Florian Rehm, *An Introduction to Credit Derivatives: Teaching Note* 2 (2000), http://deepblue.lib.umich.edu/bitstream/2027.42/35581/2/b2034669.0001.001.pdf (explaining credit derivatives were created to separate credit risk by "transferring credit risk from one party to another"); *see also* Wynkoop, *supra* note 7, at 3097 (clarifying credit derivatives are contracts designed to hedge against risk and payments are based on risk); Dufey & Rehm, *supra* at 2 ("Credit risk is the risk of the debtor's default on financial claims, regardless whether s/he is unable or unwilling to pay."); Lynch, *supra* note 6, at 1382 (defining credit risk as risk counterparty will default on obligation); Wynkoop, *supra* note 7, at 3096 ("Credit risk is the risk that a borrower will not repay its obligation.").

[12] *See* Dufey & Rehm, *supra* note 11, at 2 (suggesting credit derivatives are designed to transfer risk and do so by "unbundling", then "'repackaging'", components of traditional financial instruments); *see also* Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., 375 F.3d 168, 171–72 (2d Cir. 2004) (defining credit derivatives as method for transferring "'risk from a protection buyer to a credit protection seller'") (citation omitted); Norman Menachem Feder, *Deconstructing Over-The-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 706–07 (2002) ("Essentially, credit derivatives . . . isolate specific risk . . . and transfer that risk to a willing party."); Dufey & Rehm, *supra* note 11, at 2:

> The main problem is to measure and define "credit risk" per se. . . . Nevertheless, the best indicator for credit risk is the credit spread between a default free interest rate – like that of Treasury bonds issued by major industrialized countries – and the interest rate of bonds the [sic] clearly are fraught with default risk, such as emerging market sovereign debt or corporate bonds.

insurance (i.e. the bond holder is attempting to insure against losses caused by a bond default).[13] In an alternative application, a market participant could enter a credit derivative agreement with a third party even though neither party owns any of the underlying reference assets. In this situation the parties are not employing the credit derivative as insurance or a hedge but as a means of investment or speculation.[14]

The following section introduces the two most popular forms of credit derivatives, credit default swaps and total return swaps. It is essential to understand how these derivatives work in order to fully grasp why some are potentially disastrous in a chapter 11 case, and specifically how a creditor who employs these devices would have a financial incentive to subvert a reorganization attempt in chapter 11. It is also important to understand the differences between credit default swaps and total return swaps, particularly, how a total return swap can endure throughout a chapter 11 case, whereas a credit default swap normally ends upon a bankruptcy filing.

B. Credit Default Swaps

The most popular form of credit derivative is the credit default swap ("CDS").[15] Under the basic CDS agreement, a party to the agreement, the protection buyer, makes a periodic premium payment to the other party, the protection seller, for a set term.[16] The amount of the periodic payment is a percentage of the notional amount agreed to by the parties in the CDS agreement and is based on the parties' assessment of the credit risk of the reference asset.[17] In return, the protection seller promises to "settle" with the protection buyer if a "credit event" occurs with respect

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[13] *See* Dufey & Rehm, *supra* note 11, at 2 (suggesting credit derivatives act as insurance against credit risk in effort to permit greater lending to valued clients).

[14] *See id.* at 7 (observing credit derivatives can also be used for investment purposes); *see also* Wynkoop, *supra* note 7, at 3098 (suggesting credit derivatives could return greater payoffs than "would otherwise be available from the same level of investment" partially because "the protection buyer does not need to own the reference asset in order to buy protection on it").

[15] Wynkoop, *supra* note 7, at 3097 (noting credit default swaps are most common form of credit derivatives). Reports estimate that CDS agreements account for between 29% and 98.77% of all credit derivatives. *Compare* Gary Barnett, *The Bond Market Association Comment Letter*, 1488 PRACTISING L. INST. 157, 169 (2005) ("Fitch Ratings has estimated that as of the end of 2003, 67% of the credit derivative market consisted of single-name credit default swaps."), *with* ROSS BARRETT & JOHN EWAN, BBA CREDIT DERIVATIVES REPORT 2006 EXECUTIVE SUMMARY 6 (2006), http://www.bba.org.uk/content/1/c4/76/71/Credit_derivative_report_2006_exec_summary.pdf (estimating single-name credit default swaps represented 29% of total credit derivative products at end of 2008), *and Comptroller of the Currency*, *supra* note 5, at 5 (finding credit default swaps make up about "99% of all credit derivatives notionals").

[16] *See* KOLB & OVERDAHL, *supra* note 2, at 174 (noting credit swaps take several forms, but typical credit default swap involves "two parties enter[ing] into a contract where company A makes a fixed periodic payment to company B for the life of the agreement").

[17] *See* Dufey & Rehm, *supra* note 11, at 3.

to the reference asset.[18] "Settle" and "credit event" are terms of art, defined in the CDS agreement. At a minimum, most CDS agreements define credit event to include: failure to pay on the reference debt, bankruptcy of the reference borrower, restructuring of the reference debt, or downgrade of the reference borrower's credit rating.[19] Once a credit event occurs, the CDS is settled by one of three methods according to the terms of the CDS agreement: binary settlement, physical settlement, or cash settlement.[20] With cash settlement, the most popular, the protection seller pays the protection buyer the difference of the notional amount and the market value of the reference asset after the credit event has occurred.[21] Neither of the three settlement methods requires that the protection buyer sustain any actual loss or own the reference asset before the credit event.[22] Thus, when a bankruptcy occurs a CDS agreement will trigger a settlement procedure and the CDS will not have a lasting effect in the bankruptcy case. However, despite the popularity of CDS, other credit derivatives exist, such as total returns swaps, that do not require a settlement when a chapter 11 case is filed and, therefore, endure throughout the chapter 11 case.

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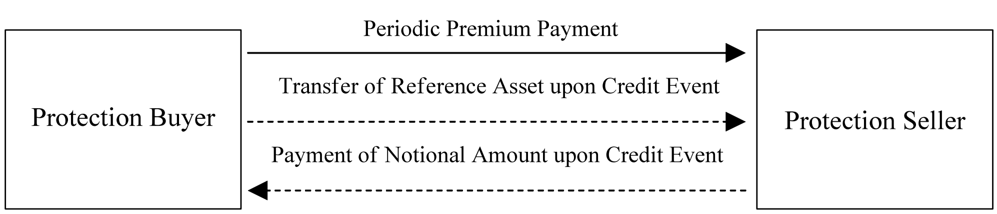
[18] *See* KOLB & OVERDAHL, *supra* note 2, at 174 (counterparty "makes no payments unless a specified credit event occurs"); Lily Tijoe, Note, *Credit Derivatives: Regulatory Challenges In An Exploding Industry*, 26 ANN. REV. BANKING & FIN. L. 387, 391 (2007) (protection seller is required to pay counterparty upon "triggering event," or credit event); *see also* Feder, *supra* note 12, at 708 ("credit event" obligates protection seller to make payments to protection buyer).

[19] *See* KOLB & OVERDAHL, *supra* note 2, at 174; *see also* André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the United States and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 157 (2000).

[20] Dufey & Rehm, *supra* note 11, at 3–4. *Cf.* Lynch, *supra* note 6, at 1389.

[21] *See* Dufey & Rehm, *supra* note 11, at 4 (discussing cash settlement); Lynch, *supra* note 6, at 1389; *cf.* Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 195 (2007). The following flowchart illustrates the potential payments between a protection seller and a protection buyer in a vanilla CDS:



[22] *See* David S. Miller, *Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace*, 55 TAX LAW. 481, 546 (2002) ("[C]redit derivatives do not require that the protected party actually own the referenced securities."). Although physical settlement requires the protection buyer to transfer the reference asset to the protection seller after the credit event, it does not require that the protection buyer own the reference asset before the credit event. In theory, the protection seller could arrange a transfer of the reference asset without acquiring actual ownership.

C. Total Return Swaps

Total return swaps ("TRS") might be considered the little sibling of CDS; often overlooked, but equally important. Although less eye-popping than the aggregate notional amount of CDS, estimates of the global outstanding notional amount of TRS approach $500 billion.[23] Despite less popularity, TRS have a potentially more potent effect in chapter 11 cases than CDS, because, as explained in greater detail below, the agreement survives a chapter 11 filing.

Under the typical TRS agreement, the two parties to the agreement periodically swap payments for a fixed term based on the return and value of a specific reference asset.[24] Although the reference asset could be debt or equity, this article assumes that the reference asset is always a debt obligation. In a TRS, the protection buyer's periodic payment consists of any positive capital changes of the reference asset and any coupon payments made by the reference asset (i.e. the total return of the reference asset).[25] In return, the protection seller's periodic payment consists of any negative capital changes of the reference asset and some fixed or floating premium, generally a reference rate like "LIBOR plus or minus a spread".[26] Like CDS, neither party to a TRS agreement must own the reference asset or incur any actual gain or loss as a result of the changes in the reference asset's value. In essence, a TRS is a form of leverage that allows the protection seller to create a synthetic position without using substantial capital to purchase the underlying assets.[27] In return, the protection buyer receives a stream of premium payments that compensate for the counterparty risk of the protection seller.[28] Unlike CDS, credit events have no

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[23] The Comptroller of the Currency estimates that TRS makes up at least one percent of credit derivatives and credit derivatives make up eight percent of total derivatives; therefore, assuming the notional amount of derivatives globally is $600 trillion, and TRS makes up .08% of total global outstanding derivatives the total notional amount of TRS is $500 billion. *See Comptroller of the Currency*, *supra* note 5, at 5–6.

[24] KOLB & OVERDAHL, *supra* note 2, at 174. *See* Dufey & Rehm, *supra* note 11, at 4.

[25] KOLB & OVERDAHL, *supra* note 2, at 174.

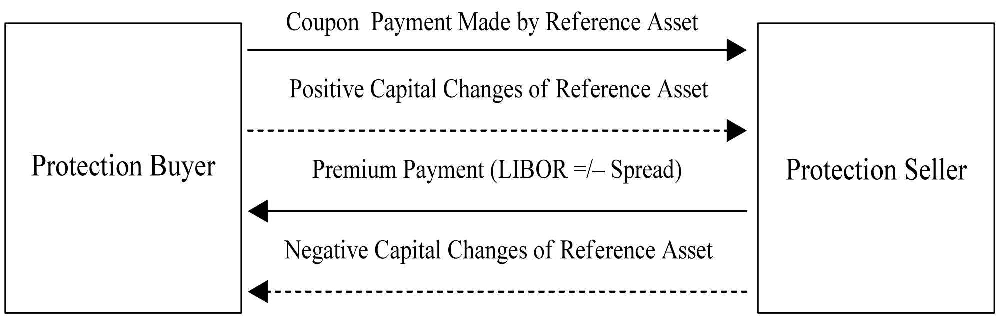
[26] *See* Dufey & Rehm, *supra* note 11, at 4; *see also* Jeffrey L. Rubinger, *IRS Rules Total Return Swap Tied to Real Estate Index Is Not Subject to FIRPTA*, 82 FLA. B. J. 57, 61 (Oct. 2008) (clarifying total return swap periodic payment means payments made in intervals throughout duration of contract and are based on index); David Z. Nirenberg, *Introduction to Securitization Taxation*, 899 PRACTISING L. INST. 671, 720 (2007) (stating protection seller in total return swap pays "periodic payments (often at a floating rate) based on a notional principal amount").

[27] *See* Dufey & Rehm, *supra* note 11, at 4 (reasoning total return swap is sale of credit and market risk, and "the 'total return payer' who normally physically owns a reference asset is paying all interest rate payments and possible positive market price changes of the underlying"); *see also* Jongho Kim, *Can Risks be Reduced in the Derivatives Market? Lessons from the Deal Structure Analysis of Modern Financial Engineering Debacles*, 6 DEPAUL BUS. & COMM. L.J. 29, 94 (2007) (noting in total return swap, protection seller makes more of loan rather than investment, and creates "hybrid derivatives instrument"); Deborah A. Monson, *Hedge Fund Derivatives Products*, 1672 PRACTISING L. INST. 569, 574–75 (2008) ("Total return swaps enable hedge funds to take long or short positions with respect to particular issuers or securities without buying the instrument or selling it short.").

[28] *See* Dufey & Rehm, *supra* note 11, at 4 (stating in order to compensate for counterparty's risk, protection buyer receives premium payments calculated by LIBOR payment and then "the LIBOR payment is applied to a lower notional amount than the coupon on the reference asset"); *see also* Andrew Behrman, *The Global Subprime Crisis: Issues You Need to Know*, 1688 PRACTISING L. INST. 413, 421 (2008)

contractual effect on a TRS agreement.[29] This difference is perhaps most profound in the context of bankruptcy because it means that, unlike a CDS agreement which would terminate upon a credit event, a TRS agreement could survive for the entire duration of a chapter 11 case.

The following flowchart illustrates the potential payments between a protection seller and a protection buyer in a TRS where the reference asset is a corporate bond that pays some periodic coupon.



In order to better understand the mechanics of a TRS, specifically during a chapter 11 case, consider the following example. Investor believed that Corp. Y was poorly managed and that its bonds would likely decline in value. Based on this belief, Investor entered a TRS agreement with Bank in which Corp. Y bonds that pay a 10% annual coupon were the reference asset. The TRS agreement provided for the following terms: a notional amount of $100 million, a term of five years, Bank shall pay to Investor an annual payment of LIBOR plus 100 basis points based on the original notional amount. Investor did not own any of the reference assets.

After the first year, Corp. Y made the coupon payment to bondholders and Investor paid Bank $10 million. Also, since the value of the bonds increased by one percent, Investor paid Bank another $1 million dollars. Since LIBOR was five percent, Bank then paid Investor $6 million. Thus, Investor paid a net total of $5 million and Bank received a net total of $5 million. Then during the second year, Corp. Y filed for chapter 11 and suspended coupon payments. As a result of the bankruptcy the value of the reference bonds plummeted from $101 million to $10 million. Thus, Bank made a payment to Investor of $91 million plus, since LIBOR was again five percent, an additional payment to Investor of $6 million. Thus, Investor received a net total of $97 million, and Bank paid a net total of $97 million.

(explaining how protection seller assumes risk of transaction "in exchange for a stream of premium payments" from protection buyer); Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L. J. 77, 89 (2008) (discussing how seller provides protection to buyer from swap by paying buyer premium to offset risk of possibility of negative credit event).

[29] *See* KOLB & OVERDAHL, *supra* note 2, at 175.

At this point, the practical difference between CDS and TRS is best illuminated. If Investor had employed CDS as an investment vehicle, the agreement would terminate as a result of the bankruptcy; but since Investor employed TRS, the agreement survives. Now, if Corp. Y's reorganization efforts were promising, the value of the bonds may increase by the end of year three in which case Investor would be required to make a corresponding payment to Bank for positive capital changes of the reference bonds. Conversely, if reorganization seemed unlikely, the value of the bonds may decrease further by the end of year three, in which case Bank would be required to make another payment to Investor for negative capital changes of the reference bonds.

This example makes clear that when Investor enters into a TRS agreement as a protection buyer and does not own the reference asset he can profit only if the value of the reference asset decreases. The example also demonstrates how Investor would have a financial incentive for Corp. Y to liquidate, but, at this point Investor is not a party in interest and likely has no significant influence on the chapter 11 process.

D. Net Adverse Creditors in Chapter 11

As discussed above, a protection buyer in a credit derivative who does not own the reference asset can only profit if the value of the reference asset decreases. Outside of bankruptcy this situation is relatively without problem, because the protection buyer has little influence over the performance of the reference asset. However, once the reference debtor enters bankruptcy, the protection buyer can acquire influence over the direction of the reference debtor by purchasing claims against the debtor and thus becoming a creditor.

To continue the TRS example from the previous section, assume that after Corp. Y filed for bankruptcy Investor purchased $50 million par value of Corp. Y bonds, paying only $5 million for the bonds. Despite paying only ten cents on the dollar, Investor is likely able to vote his claim against Corp. Y at par value of $50 million giving Investor substantial influence in Corp. Y's reorganization efforts.[30] Now, Investor has a $5 million dollar position in Corp. Y bonds and a $10 million position in the TRS agreement with Bank.[31] In other words, for every dollar Investor gains or loses on his bond position he will gain or lose twice that amount on his TRS position respectively. As a result, Investor has a net economic interest adverse to his interest as a creditor; that is, he is a "net adverse creditor."[32] If the value of Investor's bond position decreases by $1 million dollars, he will receive $2 million from the TRS for a net gain of $1 million. If Investor finds himself in this

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[30] *See generally* 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, 1394 (1991).

[31] The original notional amount was $100 million, but since Bank has already paid $90 million for negative capital changes of the reference asset, Investor's current position in the TRS agreement is essentially $10 million (i.e. $100 million – $90 million = $10 million).

[32] The remainder of the Article will refer to a creditor in this position as a "net adverse creditor."

position (i.e. the position of a net adverse creditor) and behaves rationally, he will use all of his available influence as a creditor to destroy value in Corp. X and the bonds.

The preceding is just one example, of potentially many, of a creditor whose credit derivative positions outweigh his claim positions and therefore creates a net economic interest adverse to his interest as creditor. Consider another brief example. Investment Bank purchases Corp. Z bonds. Investment Bank also enters a TRS agreement in the same amount in order to hedge against a default by Corp. Z. Corp. Z files bankruptcy and the value of its bonds plummet. Investment Bank then sells half of its position in the Corp. Z bonds leaving it in the exact situation as Investor from the previous example, whereby it can only gain financially if the value of Corp. Z bonds decreases further. Once again, he will use all of his available influence as a creditor to destroy value in Corp. Z and the bonds.

Despite the relative infancy of credit derivatives, several commentators have begun to recognize the potential for credit derivatives creating net adverse creditors in a chapter 11 case.[33] Authors who have previously considered the issue have made one of three conclusions about the situation: 1) the situation either does not actually exist or sufficient evidence does not exist to establish existence of the situation,[34] 2) the situation does exist but does not have a sufficiently large effect on chapter 11 reorganization to warrant a response from a party in interest or the courts,[35] and 3) the problem exists, and warrants a response, but the Bankruptcy Code does not currently provide a sufficient response.[36] Each of these conclusions will be discussed briefly in turn.

Whether credit derivatives result in net adverse creditor situations in actual chapter 11 cases is a legitimate inquiry.[37] Since creditors are not generally required to disclose their third party agreements in a chapter 11 case, evidence of net adverse creditor situations is circumstantial.[38] However, the circumstantial evidence points

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[33] *See* Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 621 (2008); Henry T.C. Hu & Bernard S. Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 728–35 (2008); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 407 (2007) (stating issues in chapter 11 cases arise when creditors no longer have motivation to act as such); Douglas G. Baird & Robert K. Rasmussen, Inst. for Law and Econ., Univ. Penn., *Anti-Bankruptcy: Hedge Fund Activity in Corporate Reorganizations* 1 (2007), http://www.law.upenn.edu/academics/institutes/ile/CRTPapers/1207/Anti-Bankruptcy.pdf (determining corporate reorganization faces issues as investors may not "act in concert with others" or may not have concern for reorganization's success).

[34] *See* Hu & Black, *supra* note 33, at 728–35. Professors Hu and Black do not conclude that net adverse creditor situations do not exist, but instead acknowledge that they cannot conclusively establish the frequency of the situation. *Id.* at 732.

[35] *See* Lubben, *supra* note 33, at 407; Baird & Rasmussen, *supra* note 33, at 3–4.

[36] *See* Coco, *supra* note 33, at 656.

[37] *See* Hu & Black, *supra* note 33, at 728–35.

[38] *See* Hu & Black, *supra* note 33, at 732–33 (addressing issue of lack of common rule for disclosures and ease with which creditors can avoid disclosure).

quite conclusively towards the existence of net adverse creditors.[39] Professors Hu and Black have considered the issue and offer several pieces of evidence that the situation exists.[40] First, they offer anecdotal evidence of creditors behaving oddly.[41] They claim for example, "one bankruptcy judge described a recent case wherein a junior creditor complained of too *high* a valuation being assigned to the bankruptcy estate, for reasons the creditor did not offer to the judge."[42] Second, and most convincingly, they reference the dramatic rise in the outstanding total notional amount of credit derivatives relative to the total amount of corporate debt.[43] For example, the professors assert that in the Delphi chapter 11 case, the total par value of outstanding bonds was $2 billion and the total outstanding notional amount of credit derivatives was $20 billion.[44] Of course, some of the credit derivatives would have likely been canceled by netting (i.e., a protection buyer in one transaction is also a protection seller in another and therefore some of the notional amount would cancel itself and should not be considered). However, even considering the effect of netting, it seems highly likely that some creditors would have a larger credit derivative position than claim position.

Some authors have argued, assuming net adverse creditors exist, the situation does not affect a chapter 11 case enough to warrant a response.[45] The thrust of their argument is, since CDS agreements, as distinguished from TRS agreements, require a settlement upon a credit event, such as bankruptcy, the effect of a net adverse creditor would only last briefly.[46] Although the conclusion may be correct as to

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[39] *See* Hu & Black, *supra* note 33, at 733–34 (stating opportunity for problem of undisclosed creditor hedging does exist); Lubben, *supra* note 33, at 428 (arguing credit derivatives may cause conflicts of interest among creditors who have downside protection); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1035 (2007) (positing lenders may have economic incentive to destroy value of company).

[40] Hu & Black, *supra* note 33, at 733–34.

[41] *See* Hu & Black, *supra* note 33, at 733.

[42] Hu & Black, *supra* note 33, at 733.

[43] *See* Hu & Black, *supra* note 33, at 733 n.265 (observing source which states "that the market for credit default swaps is now ten times larger than the dollar amount of underlying bonds") (citing Gillian Tett & Paul J. Davies, *Unbound: How a Market Storm Has Seen Derivatives Eclipse Corporate Bonds*, FIN. TIMES, Aug. 8, 2007, at 11)).

[44] *See* Hu & Black, *supra* note 33, at 733 n.265 (noting Delphi bankruptcy when observing how actual debt amount is many times exceeded by "the notional amount of swaps outstanding" (citing Richard Beales, *Uncertain Road Ahead for Delphi*, FIN. TIMES (London), Nov. 8, 2005, at 45)); *see also* Lubben, *supra* note 33, at 416 (observing in chapter 11 filing of Delphi, "$2 billion of bonds were said to be in circulation when it filed for bankruptcy. However, the notional amount of outstanding derivatives was more than $20 billion . . . .") (footnote omitted); Tijoe, *supra* note 18, at 400 (observing estimation "that the total credit derivatives market on Delphi bonds" was approximately $28 billion, even though Delphi only had $2.2 billion notional bonds).

[45] *See e.g.*, Baird & Rasmussen, *supra* note 33, at 22 (noting credit default swaps rarely matter in chapter 11 cases); Lubben, *supra* note 33, at 408 ("But that risk does not yet warrant the disruption of this promising new market simply to preserve the traditional role of chapter 11.").

[46] *See* Baird & Rasmussen, *supra* note 33, at 22 (noting chapter 11 is "'credit event'" and therefore "moral hazard problem" exists only up to point of chapter 11 filing and shortly after); Coco, *supra* note 33, at 654–55 (stating credit default swaps are unlikely to cause manipulation because agreement terminates upon filing of bankruptcy).

CDS, it does not completely address the problem of net adverse creditors. First, the conclusion ignores the availability of alternative credit derivatives, such as TRS, by which a net adverse creditor could maintain his position throughout the chapter 11 case. Second, the conclusion ignores the creativity of market participants. For instance, the modern credit derivative market was only *invented* in 1997.[47] These commentators base this conclusion on a false presumption that market participants will unanimously continue using the same conventions, in this case CDS, which ignores participants' ingenuity and ability to quickly create massive markets.

Last, at least one author who has delved deeply into the problem of net adverse creditors concludes that despite concern about the affect such creditors could have on a chapter 11 case, the Bankruptcy Code does not provide a solution.[48] Contrariwise, this Article suggests that although no case in point exists, Bankruptcy Code section 1126(e)[49] and section 105(a)[50] should provide a significant solution. Part Two and Part Three of this Article will discuss applications of those Code provisions in detail.

II. DESIGNATION OF NET ADVERSE CREDITORS UNDER BANKRUPTCY CODE SECTION 1126(e)

Although creditors in a chapter 11 case have numerous powers and opportunities that influence the outcome of the debtor's reorganization efforts,[51] few are as powerful or influential as the creditor's right to vote on a proposed plan of reorganization.[52] Voting on a proposed plan is also the place in a chapter 11 matter where a net adverse creditor could inflict the most damage on the debtor's reorganization attempt. A net adverse creditor would likely vote against any proposed plan other than one for liquidation, because a successful reorganization would presumably create more value for claimholders than liquidation.[53] If the

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[47] *See* Jesse Eisinger, *The $58 Trillion Elephant in the Room*, CONDE NAST PORTFOLIO, Oct. 15, 2008, http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash (noting J.P. Morgan started its derivates project in 1997 following Asian financial crisis).

[48] *See* Coco, *supra* note 33, at 613 ("[A]n adequate solution providing for ownership disclosure in bankruptcy has not been developed or proposed."); *cf.* FED. R. BANKR. P. 2019 (giving requirements for creditors to set up ad hoc committee to oversee chapter 11 or chapter 9 cases); *In re* Nw. Airlines Corp., 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007) (discussing how ad hoc committees may not often have the appearance of acting in their own self-interest).

[49] *See* 11 U.S.C. § 1126(e) (2006).

[50] *See* 11 U.S.C. § 105(a) (2006).

[51] *See* Lubben, *supra* note 33, at 418 (providing table of chapter 11 creditors' powers); *see also* Chad P. Pugatch, Craig A. Pugatch & Travis Vaughan, *The Lost Art of Chapter 11 Reorganization*, 19 U. FLA. J.L. & PUB. POL'Y 39, 52 (2008) (listing various powers held by creditors in chapter 11 reorganization).

[52] *See* 11 U.S.C. § 1126 (2006) (listing requirements for accepting plan of reorganization, including class accepting plan "hold[s] at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors"); *see also* Randolph J. Haines, *The Unwarranted Attack New Value*, 72 AM. BANKR. L.J. 400, 445 (1998) (describing how one creditor's refusal to confirm plan of reorganization could delay entire bankruptcy).

[53] *See In re* York Aviation, Inc., 115 B.R. 8, 10 (Bankr. D. Me. 1989) ("A viable reorganization plan typically provides greater payment to creditors . . . .").

creditor's claim is large enough it could block any proposed plan, force liquidation and ensure that the value of the estate is diminished. Fortunately, Bankruptcy Code section 1126(e), the successor to Bankruptcy Act section 203, gives a court authority to disenfranchise a creditor if his vote is not in good faith.

A. Designation under the Chandler Act

Section 203 of the 1938 Chandler Act ("Chandler Act")[54] has its origin in a 1936 bankruptcy case filed in the Western District of Texas.[55] In *Texas Hotel Securities Corp. v. Waco Development*, the debtor was a single asset real estate operation that owned the Roosevelt Hotel in Waco, Texas.[56] Immediately before the debtor filed for bankruptcy, Conrad Hilton purchased one-third of the debtor's outstanding debt in order to block any plan of reorganization that did not give Hilton a lease to the Roosevelt Hotel.[57] The Circuit Court held that Hilton's vote should *not* be designated even though "he bought the votes for the purpose of preventing confirmation unless certain demands of his should be met."[58] In reaction to *Texas Hotel*,[59] Congress included section 203 in the Chandler Act, which provides:

> If the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, in the light of or irrespective of the time of acquisition thereof, the judge may, after hearing upon notice, direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance of a plan.[60]

Although Congress employed the vague term "good faith," its intent was clear: to give the courts authority to prevent the type of conduct permitted in *Texas Hotel.* One contemporary commentator explained the intent as giving courts the authority "to prevent racketeering groups from obtaining control of the proceedings by

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[54] *Compare* 11 U.S.C. § 1126(e) (2006), *with* Chandler Act, ch. 575, § 203, 52 Stat. 894 (1938) (repealed 1978).

[55] *See* Young v. Higbee, Co., 324 U.S. 204, 211 n.10 (1945) (explaining how *Texas Hotel* case influenced drafting of section 203); *In re* Allegheny Int'l Inc., 118 B.R. 282, 288 (Bankr. W.D. Pa. 1990) ("[I]t is clear that section 203 of the Bankruptcy Act was enacted, inter alia, in response to [*Texas Hotel*] . . . ."). *See generally* Texas Hotel Sec. Corp. v. Waco Dev. Co., 87 F.2d 395 (5th Cir. 1936).

[56] *Texas Hotel*, 87 F.2d at 397.

[57] *Id.* at 398.

[58] *Young*, 324 U.S. at 211 n.10 (citing *Texas Hotel*, 87 F.2d 395).

[59] *See Texas Hotel*, 87 F.2d at 401 (holding confirmation of plan is reversed); *see also Hearings on Revision of the Bankruptcy Act Before the H. Comm. on the Judiciary*, 75th Cong. 180–82 (1937) [hereinafter *Hearings*] (hearings on Chandler Act where then Securities and Exchange Commissioner William Douglas used *Texas Hotel* as example for need of section 203).

[60] Chandler Act, ch. 575, § 203, 52 Stat. 894 (1938) (repealed 1978).

purchasing securities at depressed prices."[61] And if the legislative history and contemporary commentary concerning the Chandler Act was not clear, in 1945 the Supreme Court, in *Young v. Higbee*, weighed in to express its opinion that *Texas Hotel* was no longer good law.[62] In a footnote referring to *Texas Hotel*, which may prove more important than the remainder of the opinion, the Court explained:

> The hearings [on the Chandler Act] make clear the purpose of the Committee [was] to pass legislation which would bar creditors from a vote who were prompted by such a purpose [referring to the creditor's purpose in *Texas Hotel*]. To this end they adopted the "good faith" provisions of § 203. Its purpose was to prevent creditors from participating who "by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages from the other stockholders who are cooperating." Bad faith was to be attributed to claimants who opposed a plan for a time until they were "bought off"; those who "refused to vote in favor of a plan unless . . . given some particular preferential advantage."[63]

Also in 1945, the Second Circuit, in *In re P-R Holding Corp.*, articulated a practicable rule for evaluating a creditor's intent.[64] In *P-R Holding*, the debtor, forced into bankruptcy by its creditors, was the owner of a hotel in New York City.[65] Among several competing plans of reorganization was one for the sale of the hotel to a third party group in exchange for cash and a mortgage on the property.[66] With the avowed intent of ensuring the plan's success, the third party group purchased a significant portion of the debtor's debt at a substantial discount and planned on voting the claims for the plan.[67] In other words, the motivation supporting the third party group's vote was not to maximize the distribution they received on account of their claims, but instead was to ensure that they could purchase the hotel in bankruptcy. The Court determined that the purchases were not in good faith and designated the group's vote.[68] In so holding, the Court expressed a simple rule that provides the underpinning of all subsequent designation

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[61] E. Merrick Dodd, Jr., *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223, 241 (1938). *See* Chandler Act, § 203, 52 Stat. 840, 894 (1938) (repealed 1978); Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 95 (1991) (discussing reasoning behind section 203 of Chandler Act).

[62] Young v. Higbee Co., 324 U.S. 204, 211 (1945).

[63] *Id.* at 211 n.10 (quoting *Hearings*, *supra* note 59, at 180–82).

[64] *In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945) (when purchase of creditors' interests is "in aid of an interest other than an interest of a creditor" that purchase may be made in "'bad faith'").

[65] *Id.* at 896–97.

[66] *Id.* at 897–98.

[67] *Id.*

[68] *See id.* at 898–99 ("[T]he basic purpose of Chapter X is to procure a plan which will best serve the parties legitimately interested; and a reversal here, on the facts before us, would defeat that purpose.").

jurisprudence.[69] Specifically, the Court held: "When that purchase is in aid of an interest other than an interest as a creditor, such purchase may amount to 'bad faith' under section 203 of the Bankruptcy Act."[70]

B. Designation under Section 1126(e)

With the adoption of the Bankruptcy Code, Congress continued the basic provision of Bankruptcy Act section 203 in the form of section 1126(e), which provides: "On request of a party in interest, and after notice and a hearing, the court may designate 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 this title."[71] Although no court has faced a motion to designate a net adverse creditor, several cases in other contexts provide insight into the standard for good faith that should be applied in such a case. In the two cases, *In re the MacLeod Co.* and *In re Allegheny Int'l, Inc.*, the Court designated a creditor's vote under section 1126(e) by applying the framework articulated in *P-R Holding*.[72]

In *MacLeod*, several unsecured creditors were owners and employees of a business that directly competed with the debtor.[73] When these creditors voted against a plan of reorganization, the debtor made a motion to designate their votes pursuant to section 1126(e).[74] The Court, relying on *P-R Holding,* designated their votes, because the vote "was not in good faith, but rather was for the ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business with which the named individuals were associated, could be furthered."[75]

Whereas *MacLeod* was a straightforward and expectable application of the *P-R Holdings* rule, *Allegheny* was equally straightforward but perhaps less expected.[76] In *Alleghany*, Japonica Partners wished to gain control of the reorganized debtor despite not owning any of the debtor's debt or equity.[77] To accomplish its takeover,

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[69] *Id.* at 898.

[70] *In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945).

[71] 11 U.S.C. § 1126(e) (2006).

[72] *See In re* MacLeod Co., 63 B.R. 654, 655–56 (Bankr. S.D. Ohio 1986) (finding "rejection of debtor's plan . . . was for the ulterior purpose of destroying or injuring debtor in its business"); *In re* Allegheny Int'l, Inc., 118 B.R. 282, 290 (Bankr. W.D. Pa. 1990) (concluding creditor acted with "an ulterior motive" in blocking plan).

[73] *In re MacLeod*, 63 B.R. at 655.

[74] *Id.* at 654.

[75] *Id.* at 656.

[76] *Compare id.* at 655 (observing bad faith displayed in situations including blackmail and malice to further "'competing business'" (quoting *In re* Pine Hill Collieries Co., 46 F. Supp. 669, 671 (E.D. Pa. 1942))), *with In re Allegheny Int'l*, 118 B.R. at 289–90 (reasoning creditor's purchase of "almost exactly the amount required to block the plan" constituted bad faith present pursuant to section 1126(e), despite creditor's "allegedly longstanding interest in the debtor"). *See generally* Richard Lieb, *Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor*, 48 BUS. LAW. 915, 918 (1993) (observing *Allegheny's* holding of bad faith compared to holding in *P-R Holding*).

[77] *In re Allegheny, Int'l*, 118 B.R. at 286.

Japonica purchased claims of the debtor with a face value of $10,000 for $2,712 and filed a plan of reorganization that would give it control of the debtor.[78] In addition to Japonica's plan, the debtor also filed a plan.[79]

In order to defeat the debtor's plan and ensure that its plan would be confirmed, Japonica then began strategically purchasing claims against the debtor until it owned enough claims to block any other proposed plan.[80] In response, the debtor made a motion to designate Japonica's votes pursuant to section 1126(e), which the Court granted, relying heavily on *Texas Hotel*, *P-R Holding*, and *MacLeod*.[81] The Court had a particular issue with the timing of Japonica's purchases, noting: "Japonica knew what it was getting into when it purchased its claims. Japonica is a voluntary claimant. If Japonica was unsatisfied by the proposed distribution, it had the option of not becoming a creditor. Japonica could have proposed its plan without buying these claims."[82] The Court went on to explain:

> Although the debtor and Japonica are not engaged in competing businesses, the court finds *In re MacLeod* analogous to the case sub judice. Japonica and the debtor were proponents of competing plans of reorganization. Japonica's stated purpose was to take over the debtor. To do so, it was necessary for Japonica to block confirmation of the debtor's plan of reorganization. Thus, the court concludes that Japonica's actions were for an ulterior motive.[83]

Essentially, the Court was strictly applying the *P-R Holding* rule. Since control of a debtor is "'an interest other than an interest as a creditor,'" Japonica's scheme was not in good faith and designation was therefore appropriate.[84]

Allegheny likely represents the outer limit for designation under section 1126(e). Subsequent decisions have recognized that designation issues are seldom as simplistic as the issues in *MacLeod* and *Allegheny*; however, these other important cases do not establish a new test for good faith but turn on their unique facts.[85]

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[78] *In re* Allegheny Int'l, Inc., 118 B.R. 282, 286 (Bankr. W.D. Pa. 1990).
[79] *Id.*
[80] *Id.* at 286–87
[81] *Id.* at 287–90.
[82] *Id.* at 289.
[83] *Id.* at 290.
[84] *In re* Allegheny Int'l, Inc., 118 B.R. 282, 289 (Bankr. W.D. Pa. 1990) (quoting *In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945)).
[85] *See, e.g.*, *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 62 (Bankr. S.D.N.Y. 2006) (finding special considerations such as "releases, exculpation and reimbursement of fees expressly conditioned upon their acceptance of the settlement in the Plan, and used such as an enticement to others to support the Plan" where "[m]embers of the same class who rejected the Plan did not secure those benefits," did not constitute bad faith); *see In re* Landing Assocs., Ltd., 157 B.R. 791, 806–07 (Bankr. W. Tex. 1993) ("This court believes [*Allegheny*] to be far too strict a test to make section 1126(e) serve as the useful tool it was intended to be. . . . Most of the time, it is the *bona fides* of the debtor with whom we are concerned."); *In re* Micron Prods., Inc., No. 91-16324S, 1992 WL 252124, at *3 (Bankr. E.D. Pa. Sept. 25, 1992) ("We believe that the

In re Adelphia Communications Corp. was a multi-debtor chapter 11 case in which some of the creditors held claims, in the form of notes, against several of the debtors.[86] As a result of inter-creditor disputes, "an increase in any recovery on the Arahova [subsidiary] Notes results in a decrease in recovery on the ACC [parent] senior notes, and vice versa."[87] When a plan was proposed for ACC, a group of holders of ACC's notes made a motion to designate the votes on the proposed plan of those creditors who held claims in both Arahova and ACC (the "Targeted Creditors").[88] Their argument was that the Targeted Creditors' vote was not made in good faith because it was driven by the ulterior motive of increasing their returns as creditors of Arahova.[89]

In denying the motion to designate, the Court began its discussion by laying out the burden on the moving party:

> A right to vote on a plan is a fundamental right of creditors under chapter 11. Designation of a creditor's vote is a drastic remedy, and, as a result, designation of votes is the exception, not the rule. The party seeking to have a ballot disallowed has a heavy burden of proof.[90]

The Court then went on to explain, that a creditor has not acted in bad faith when he attempts to maximize his return or hedge his return by investing in multiple debt levels of a corporate enterprise whether by investing in multiple classes within a single debtor or within multiple debtors in a multi-debtor case.[91] The distinction the Court drew in *Adelphia* between such an investing strategy and "competitor" cases such as *MacLeod* is that in *Adelphia* the creditors were not attempting to destroy value of "the estate as a whole" or causing the entire reorganization to fail.[92]

Although the Court in *Adelphia* did not directly rely on *P-R Holding*,[93] its decision can be squared with the *P-R Holding* rule. Essentially, the Court applied

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holdings of *Allegheny Int'l* are fact-driven and the result in that case should not be broadly applied to all participants in a bankruptcy case who seek to protect their self-interests through claim-acquisition and/or the presentation of competing plans.").

[86] *In re Adelphia*, 359 B.R. at 55–56.

[87] *Id.* at 58.

[88] *Id.* at 55–56.

[89] *See id.* at 63.

[90] *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (citations omitted).

[91] *Id.* at 63 (enumerating examples of bad faith acts as those that "assume control of the debtor," "put the debtor out of business or otherwise gain a competitive advantage," "destroy the debtor out of pure malice," or "obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize").

[92] *Id.* at 64 n.41.

[93] Although *Adelphia* did not rely on *P-R Holding* directly, it relied on cases that tracked *P-R Holding*. *See, e.g.*, *In re Adelphia*, 359 B.R. at 61 (citing *In re* Dune Deck Owners Corp., 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995) ("[W]here the 'purchase is in aid of an interest other than an interest of a creditor, such purchases may amount to "bad faith"'" (quoting *In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945)))); *In re* Landing Assocs., Ltd., 157 B.R. 791, 807 (Bankr. W.D. Tex. 1993) (requiring disqualification "when the voting process is being used as a device with which to accomplish some ulterior

the rule but took a very expansive view of "interest of a creditor." In this sense, the Court considered the Target Creditors' interest as creditors to mean their interest as creditors in the entire chapter 11 case, as opposed to their interest as a creditor with respect to ACC only. Not only was the Court's decision appropriate from a strictly analytical perspective, it was also quite appropriate from a practical perspective as well. As the Court noted, intercreditor liabilities are ubiquitous in multi-debtor chapter 11 cases.[94] Therefore if a creditor's vote is designated any time the creditor holds claims in multiple debtor cases, investors would be discouraged from pursuing legitimate trading strategies and attempting to hedge their risk.

In re The Landing Associates, Ltd. is particularly interesting in the context of designation of net adverse creditors because it involves a creditor with an economic interest in a third party contract that gives the creditor a financial incentive to liquidate the debtor.[95] In *Landing Associates,* The Landing Associates was a single asset real estate concern that owned and operated an apartment complex near San Antonio, Texas.[96] Several years into the enterprise, The Landing Associates "began experiencing difficulty in servicing the mortgage debt, and so began negotiating for a work-out with" its sole secured lender.[97] Unfortunately for The Landing Associates, before a workout could be negotiated, the secured lender was closed by the Federal Savings and Loan Insurance Corporation (the "FSLIC") and later acquired by a third party bank, Bank United.[98] Bank United and the FSLIC "also entered into an Assistance Agreement, under which [Bank United] receives various incentives relative to the management and liquidation of certain assets, including the loan to [The Landing Associates]."[99] Since Bank United would not negotiate a workout, The Landing Associates filed for chapter 11 "on the eve of foreclosure."[100]

Over two years after it filed for relief, the debtor sought confirmation of a plan of reorganization and moved the Court to designate Bank United's vote pursuant to section 1126(e).[101] Debtor's argument for designation was as follows:

> In the instant case, Debtor suggests that Bank United was primarily motivated to vote against the proposed plan of reorganization by the desire to benefit from certain incentives in the Assistance Agreement between Bank United and FSLIC, and not so much by its interests as a creditor in this bankruptcy case. Debtor contends

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purpose, out of keeping with the purpose of the reorganization process itself, and only incidentally related to the creditor's status *qua* creditor"); *In re* Allegheny Int'l, Inc., 118 B.R. 282, 297 (Bankr. W.D. Pa. 1990) (finding bad faith reasoning conduct of creditors was "even more offensive than in *P-R Holding*").

[94] *See In re Adelphia*, 359 B.R. at 64.

[95] 157 B.R. 791, 798–99 (Bankr. W.D. Tex. 1993).

[96] *Id*. at 798.

[97] *Id.*

[98] *Id.* at 798–99. Bank United was originally United Savings Bank of Texas, FSB, but changed its name to Bank United of Texas, FSB ("Bank United"). *Id.* at 799 n.2.

[99] *Id.* at 799.

[100] *Id.*

[101] *In re* Landing Assocs., Ltd., 157 B.R. 791, 802 (Bankr. W.D. Tex. 1993).

> that, if Bank United is successful in blocking the Plan of Reorganization, it stands to make certain profits under the Assistance Agreement that would otherwise be unavailable; as a result, Debtor argues, Bank United is not acting out of its interests as "Bank United-creditor", but as "Bank United-party to the Assistance Agreement."[102]

Debtor's argument seemed to fit squarely within the *P-R Holding* rule and was substantially supported by the facts in the case. Specifically, the Assistance Agreement included a "shared gain" provision whereby Bank United would profit substantially if it foreclosed on the apartment complex and liquidated its claim before December 31, 1995.[103] While representatives of Bank United were able to articulate some objections to the plan apart from the Assistance Agreement, the Court recognized that the real issue was: "whether the bank's being motivated primarily by the incentives available to it under the Assistance Agreement renders its negative vote one cast in bad faith, for purposes of section 1126(e)."[104] Although the Court agreed that the Assistance Agreement creates an ulterior motive for Bank United and recognized that "the bank seems to be determined to destroy the debtor *at all cost* (literally),"[105] it continued further to look into the purpose of the Assistance Agreement to determine whether Bank United voted in good faith.[106] The Court asserted that:

> [T]he Assistance Agreement was, at least theoretically, designed to motivate [Bank United] to administer assets in a way deemed consistent with federal policy, much as though the RTC or the FDIC were itself administering this asset. . . . If all this renders the bank's resulting conduct "ulterior" for purposes of the statute, then the same charge could be leveled at the RTC and the FDIC in *their* administration of the assets of failed institutions—a result this court, with some misgivings, nonetheless shrinks from.[107]

Consequently, the Court denied the debtor's motion to designate Bank United's vote.[108] The decision in *Landing Associates* is difficult to reconcile in light of previous case law and bankruptcy policy generally. The case ostensibly attempts to broaden the *P-R Holding* test to mean that when a vote is in furtherance of an interest other than an interest of a creditor *qua* creditor, such vote will amount to

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[102] *Id.* at 803.
[103] *Id.* at 799, 805.
[104] *Id.* at 799, 809.
[105] *Id.* at 799, 808.
[106] *See id.* at 799, 809 (determining "the Assistance Agreement incentives offer the *only* sensible explanation for Bank United's conduct").
[107] *In re* Landing Assocs., Ltd., 157 B.R. 791, 809 (Bankr. W.D. Tex. 1993).
[108] *Id.*

bad faith, unless that non-creditor interest is somehow justifiable on other grounds. In *Landing Associates*, the justifiable grounds were the implementation of some federal policy pursued by the FSLIC.[109] This result is inconsistent with prior case law, specifically *P-R Holding*, because, no matter what created the ulterior motive, Bank United was admittedly voting to pursue an interest other than its interest as a creditor. The result is also inconsistent with Supreme Court precedent holding that a unit of the federal government is bound by the provisions of the Bankruptcy Code when it attempts to carry out its otherwise valid regulatory purpose.[110]

The result in *Landing Associates* is also contrary to fundamental bankruptcy policy, particularly the desire for an equitable distribution of the estate.[111] As the Supreme Court explained in *Nathanson v. NLRB*, "[t]he theme of the Bankruptcy Act is 'equality of distribution'; and if one claimant is to be preferred over others, the purpose should be clear from the statute[,]" [112] even when the claimant seeking favored treatment is a unit of the federal government and is pursuing a valid and worthy federal policy. In *Landing Associates*, the Court allowed Bank United to pursue an ulterior motive at the expense of other stakeholders in the case because the motive was supported by a policy of the federal government. In effect, the Court granted Bank United a priority over other creditors by allowing Bank United to force a liquidation in which the bank receives substantially more than under a plan of reorganization. In such a liquidation, the value of the estate would be diminished and other creditors would receive less on account of their claims. The policy supporting the RTC and FSLIC did not provide the Court with authority to overlook Bank United's ulterior motive and give the bank favorable treatment over other creditors. Therefore, because *Landing Associates* is inconsistent with precedent and bankruptcy policy, its precedential value should be limited to its very unique facts.

C. Section 1126(e) and Net Adverse Creditors

Although no court has addressed the issue of credit derivatives creating net adverse creditors, section 1126(e) of the Bankruptcy Code and the case law interpreting it likely provide a solution. When considering a motion to designate a creditor's vote on account of his positions in credit derivatives, a court would apply the test established in *P-R Holding* or some derivative thereof; specifically, if the interest advanced by the creditor's vote is an interest other than an interest as a creditor *qua* creditor then the vote is not in good faith. A court would likely not

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[109] *Id.* (rationalizing that agreement in question was "designed to motivate the lender to administer assets in a way deemed consistent with federal policy, much as though the RTC or the FDIC were itself administering this asset").

[110] *See, e.g.*, FCC v. NextWave Pers. Commc'n. Inc., 537 U.S. 293, 300, 302 (2003).

[111] *See* Begier v. IRS, 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code."); Nathanson v. NLRB, 344 U.S. 25, 29 (1952) (declaring Bankruptcy Act's theme to be "'equality of distribution'") (citation omitted).

[112] *Nathanson*, 344 U.S. at 29 (citation omitted).

hesitate to find that a creditor is not advancing an interest as a creditor *qua* creditor when his vote is motivated by an interest in a third party contract, such as a CDS or TRS, that results in a desire to destroy value in his claim. Therefore, a net adverse creditor would likely fail the generic *P-R Holding* test for good faith. Competitor cases, such as *MacLeod*, also supply clear authority for designating a net adverse creditor's vote. Like the designated creditors in *MacLeod*, a net adverse creditor would presumably vote to destroy the debtor since such destruction would increase its total return, and thus designation is appropriate.

Although the Court's denial of a motion to designate in *Adelphia* could be viewed as a limit on courts' willingness to designate a creditor, a net adverse creditor would likely not find *Adelphia* helpful. The Court in *Adelphia* implicitly approved a strategy of creditor hedging; thus, the decision would likely be important in the context of *some* uses of credit derivatives. However, *Adelphia* would only be helpful to a creditor who has credit derivative positions that are smaller than or exactly equal to his or her claims. In that situation, the creditor is using the credit derivatives as a hedge, and its total economic interest is still aligned with its interest as a creditor. However, once the credit derivative position becomes larger than the claim position, the creditor's economic interest diverges from its interest as a creditor, and the creditor cannot assert that he is attempting to hedge. In that situation (i.e. the case of a net adverse creditor) *Adelphia* is not persuasive authority.

III. DISCLOSURE OF CREDITORS' CREDIT DERIVATIVE POSITIONS

Although designation is a substantial substantive solution to problems created by creditors who are motivated by credit derivatives to destroy value, neither the court nor other interested parties typically know of a creditor's credit derivative positions. Thus, a creditor may have a net adverse interest, but it is not readily apparent to a plan proponent. Without some disclosure scheme that would reveal creditors' true economic positions, section 1126(e) is a completely ineffective tool to counteract the net adverse creditor problem. Although the Rules of Bankruptcy Procedure require creditors to disclose some information in specific situations, these explicit disclosure requirements do not require disclosure of sufficient information. Section 105(a), however, may provide authority for disclosure of certain credit derivative positions to be obtained.

A. Required Disclosures Are Inadequate

The Federal Rules of Bankruptcy Procedure explicitly require creditors to disclose information in specific situations pursuant to Rules 2019 and 3001.[113] Rule

[113] *See* FED. R. BANKR. P. 2019, FED. R. BANKR. P. 3001; *see also In re* Hughes, 313 B.R. 205, 212 (Bankr. E.D. Mich. 2004) (referencing specific situations' requirements under Rule 3001); Michael J. Guyerson & Darrell M. Daley, *Propriety of Class Proofs of Claim in Bankruptcy*, 63 AM. BANKR. L.J. 249,

3001 requires that when a creditor files his proof of claim that it "shall conform substantially to the appropriate Official Form."[114] The Official Form requires that creditors disclose basic information about their claim such as the amount of the claim, the basis for the claim and whether it is a secured claim or entitled to some priority under section 507 of the Bankruptcy Code.[115] The Official Form, however, does not require the creditor to disclose any interests adverse to maximizing its claim or to the debtor.[116] Rule 3001 also requires some disclosure when a party purchases a claim after a proof of claim has been filed; however, like the party filing the proof of claim, a claim purchaser is not required to disclose any interests adverse to its claim or the debtor.[117]

Rule 2019 requires disclosure that is potentially far broader than the disclosures required by Rule 3001.[118] However, Rule 2019 only applies in specific situations that a creditor could avoid, and is, therefore, unlikely to reveal a creditor's true economic interest.[119] The rule requires disclosure from "every entity or committee representing more than one creditor."[120] Accordingly, any creditor wishing to

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251 (1989) ("Bankruptcy Rule 2019 requires every person purporting to represent more than one creditor to file a verified statement setting forth the names and addresses of the creditors represented, the nature and amount of their claim and the relevant facts and circumstances surrounding retention and authority of the agent.").

[114] FED. R. BANKR. P. 3001(a).

[115] *See, e.g.*, Official Bankruptcy Forms, Form B 10 Proof Of Claim (Dec. 2007).

[116] *Id.*

[117] FED. R. BANKR. P. 3001(e).

[118] *See* FED. R. BANKR. P. 2019. Rule 2019 describes disclosure to include:

> (a)(1) . . . [T]he name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.

Id. Anthony Michael Sabino, *In a Class by Itself: The Class Proof of Claim in Bankruptcy Proceedings*, 40 DEPAUL L. REV. 115, 150 (1990) (comparing Rule 2019, which "requires a representative of more than one creditor to file a disclosure statement," with Rule 3001, "which requires the creditor or his authorized agent to file the proof of claim"). *See generally* Coco, *supra* note 33, at 644 ("Congress adopted Rule 2019 to protect small creditors' rights when larger creditors act in a representative capacity during bankruptcy.").

[119] *See* FED. R. BANKR. P. 2019; Hu & Black, *supra* note 33, at 733 (arguing creditors can avoid Rule 2019 in various ways); James M. Shea, Jr., Note, *Who Is at the Table? Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors Under Federal Rule of Bankruptcy Procedure 2019*, 76 FORDHAM L. REV. 2561, 2567 n.37 (2008) ("Professors [H]u and Black conclude that the debate is not that controversial since, '[i]n any case, creditors can avoid this rule in a number of ways, including not serving on ad hoc committees and, oddly, gaining membership on an official creditor committee,' which are exempt from Rule 2019 . . . .").

[120] FED. R. BANKR. P. 2019.

conceal his true economic interest could avoid Rule 2019 disclosures by refraining from joining a representative committee or entity.

B. Section 105(a) as Authority for Mandatory Disclosure of Credit Derivatives

Section 105(a) could be interpreted to provide broad authority for disclosure of certain credit derivative positions to be obtained. Section 105(a) provides: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[121] Although the language of section 105(a) is extremely broad, courts have recognized that "the powers granted by [section 105(a)] may be exercised only in a manner consistent with the provisions of the Bankruptcy Code. That statute does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity."[122] However, courts, including the Supreme Court, have given great deference to decisions made by bankruptcy courts concerning the application of section 105(a) and have paved the way for a broad application of the provision.[123]

The Supreme Court's recent decision in *Marrama v. Citizens Bank of Massachusetts* broadly interprets the authority granted in section 105(a).[124] In *Marrama*, the debtor, an individual, filed for protection under chapter 7 of the Bankruptcy Code.[125] In the schedules submitted with his petition, the debtor failed to include a substantial asset and made several other significant misstatements and omissions.[126] The debtor later admitted that he failed to disclose the asset "to protect the property from his creditors."[127] When the trustee advised the debtor's counsel that he intended to recover the asset as property of the estate, the debtor made a motion to convert his case to chapter 13. The debtor relied on section 706(a), which

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[121] 11 U.S.C. § 105(a) (2006).

[122] United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) (citations omitted). *See* S. Ry. Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985) (noting "section 105(a) does not authorize the bankruptcy court to create rights not otherwise available under law"); *see also* Timothy E. Graulich, *Substantive Consolidation—A Post-Modern Trend*, 14 AM. BANK. INST. L. REV. 527, 553–54 (2006) (emphasizing "section 105 is not an authorization to convert the court into a 'roving commission to do equity' and may be used only to implement powers already expressed in the provisions of the Bankruptcy Code"); Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 EMORY BANKR. DEV. J. 13, 38 (2006) ("According to this 'narrow view,' § 105(a) 'does not authorize bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity'.") (citation omitted).

[123] *See, e.g.*, Marrama v. Citizens Bank of Mass., 549 U.S. 365, 375 (2007) (noting bankruptcy judges are given "broad authority" by section 105(a)); *In re* Rodriguez, 396 B.R. 436, 458 (Bankr. S.D. Tex. 2008) ("Courts . . . have used § 105 to grant plaintiffs a broad range of remedies . . . ."); *In re* Kellett, 379 B.R. 332, 339 (Bankr. D. Or. 2007) (explaining Supreme Court "broadly interpreted" bankruptcy court's authority under section 105(a) in *Marrama*).

[124] *Marrama*, 549 U.S. at 375.

[125] *Id.* at 368.

[126] *Id.*

[127] *Id.*

provides: "The debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title."[128] The Bankruptcy Court rejected the motion and the United States Supreme Court affirmed.[129]

The Supreme Court held that, despite the language of section 706(a), the bankruptcy court had authority under section 105(a) "to take any action that is necessary or appropriate 'to prevent an abuse of process . . . .'"[130] Even though, as the dissent noted, "[t]he Bankruptcy Code unambiguously provides that a debtor who has filed a bankruptcy petition under Chapter 7 has a broad right to convert the case to another chapter," the majority held that section 105(a) provided authority to limit this right when the debtor has acted in bad faith.[131] In other words, section 105, according to the Court in *Marrama*, is a basis for precluding the exercise of a right when to do so is not in good faith. At a minimum, *Marrama* is authority that section 105 grants broad authority to the bankruptcy courts.

Additionally, at least one circuit court has upheld orders based on section 105(a) that require disclosure by third parties where such disclosure was necessary to enforce other provisions of the Bankruptcy Code. *In re Summit Corp*. provides an excellent example of such an order.[132] In *Summit*, the Court of Appeals for the First Circuit succinctly summarized the complicated facts as follows:

> During the Chapter 7 proceedings to liquidate the estate of John Grant, the district court noticed the sale of Grant's 70% interest in Atlantic Packaging Corporation ("APC"). The only bidders for the APC stock were Rand-Whitney Robertson Corporation ("Rand"), one of APC's major competitors, and Andrew D'Elia ("D'Elia"), a 30% owner of APC. The major dispute between the parties arose when Rand requested an order from the court to investigate APC's affairs. APC opposed such discovery on the ground that Rand was a principal competitor.[133]

The bankruptcy court granted a motion requiring APC to disclose information to Rand and the First Circuit affirmed.[134] In upholding the bankruptcy court's decision,

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[128] 11 U.S.C. § 706(a) (2006). *See Marrama*, 549 U.S. at 370 (stating debtor's main argument "was that he had an absolute right to convert his case from Chapter 7 to Chapter 13 under the plain language of § 706(a) of the Code").

[129] Marrama v. Citizens Bank of Mass., 549 U.S. 365, 370–71 (2007); Marrama v. Citizens Bank of Mass. (*In re* Marrama), 313 B.R. 525, 526 (B.A.P. 1st Cir. 2004), *aff'd*, 430 F.3d 474 (1st Cir. 2005), *aff'd*, Marrama v. Citizens Bank of Mass., 549 U.S. 365 (2007).

[130] *Marrama*, 549 U.S. at 375 (quoting 11 U.S.C. § 105(a) (2006)).

[131] *Id.* at 376 (Alito, J., dissenting) (arguing majority's application of good faith "is inconsistent with the Bankruptcy Code").

[132] *In re* Summit Corp., 891 F.2d 1, 5 (1st Cir. 1989) (determining issuing of order requiring disclosure was well within bankruptcy court's discretion).

[133] *Id.* at 2–3.

[134] *Id.* at 3, 7.

the First Circuit made the following assertions: 1) section 363 gives the trustee the authority to sell assets, including the interest in APC; 2) competitive bidding is necessary to maximize the value of the estate; 3) without the requested information, "Rand would have been unable to submit a competitive bid, particularly considering that the other bidder, D'Elia, had direct access to" the requested information.[135] Therefore, the Court held that section 105(a), in furtherance of section 363, provides authority for the Court to order the disclosures of confidential information held by a third party.[136]

In addition to *Summit's* significance as an example of a court using section 105(a) authority to order disclosure by a third party in order to carry out another provision of the Bankruptcy Code, it is also an excellent example of how the court can craft a disclosure order that protects the interest of the third party.[137] This is an important consideration in the context of a scheme requiring disclosure of credit derivatives because creditors are likely to insist that their proprietary trading strategies are protected against public dissemination. In *Summit*, "the [district] court specifically withheld from Rand sensitive information concerning customer lists, as well as cost and price information. Furthermore, the information released to Rand was protected under a Confidentiality Stipulation entered into between Rand and APC."[138]

C. Creating a Mandatory Disclosure Scheme that Exposes Net Adverse Creditors

Marrama and *Summit* provide bankruptcy courts with a basis to order disclosure of creditors' credit derivative positions. At least insofar as the order is limited to disclosure that reveals creditors whose net economic interest is adverse to their interest as creditors, such an order would not create or modify any substantive rights. Such a disclosure order is analogous to the order approved in *Summit* because a net adverse creditor's vote would be designated under section 1126(e) except that his position in credit derivatives is unknown. Therefore, a court would be unable to enforce section 1126(e) absent a disclosure scheme that revealed net

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[135] *Id.* at 5 & n.4. *See* Bernard Shapiro & Hydee R. Feldstein, *Bankruptcy Court Litigation Including Relief From Stay*, 591 PLI/COMM. 305, 433 (1991) (noting *Summit* court asserted need for discovery to ensure competitive bidding).

[136] *In re Summit Corp.*, 891 F.2d at 5 & n.4 (finding section 105(a) authorizes discovery to "maximiz[e] the value of the estate"). *See* Amy R. Doherty & Peter D. Bilowz, *Alternate Methods of Sale: Assets Sales In and Out of Bankruptcy*, 10th Annual Northeast Bankruptcy Conference, American Bankruptcy Institute (July 17–20, 2003), *available at* Westlaw 071703 ABI-CLE 317 (observing *Summit* court "held that in order to maximize value of the estate, the bankruptcy court has plenary power pursuant to section 105 to issue a discovery order to provide for competitive bidding"); *cf. In re* Wintex, 158 B.R. 540, 544 (D. Mass. 1992) (citing *Summit*, in conjunction with section 105(a), noting *Summit* court had power to ensure competitive bidding by issuing order).

[137] *See In re Summit Corp.*, 891 F.2d at 5–6 (stating stipulation restricted use of information, requiring party to "treat the information as strictly confidential").

[138] *In re* Summit Corp., 891 F.2d. 1, 5 (1st Cir. 1989).

adverse creditors' positions in credit derivatives. As it did in *Summit*, section 105(a) provides authority for such a mandatory disclosure scheme.

The disclosure scheme must also be implemented at an appropriate time and in an appropriate manner. Perhaps the most suitable method would be to include a disclosure on a ballot for a proposed plan of reorganization. Obviously, including a disclosure on a ballot would provide information at the relevant time for designation purposes, but it would not expose net adverse creditor misconduct before a plan of reorganization is proposed. As an alternative, a bankruptcy court could adopt a disclosure requirement as a part of its local rules. The creation of local bankruptcy rules is authorized by Federal Rule of Bankruptcy Procedure 9029, which provides: "A district court may authorize the bankruptcy judges of the district, subject to any limitation or condition it may prescribe and the requirements of 83 F.R.Civ.P., to make and amend rules of practice and procedure which are consistent with—but not duplicative of—Acts of Congress and these rules . . . ."[139] Federal Rule of Civil Procedure 83 requires that before a local rule is adopted the adopting court must make public notice of the rule and give an opportunity for comment.[140] Bankruptcy courts have, on numerous occasions, adopted local rules that require disclosure. For example, in the Southern District of New York the Court has adopted Local Rule 3020-1, which provides:

> In the event of the withdrawal of an objection to confirmation of a plan or the failure to prosecute an objection, the plan shall not be confirmed unless the proponent has disclosed to the Court the terms of any agreement reached between the proponent and the objecting party resulting in the withdrawal or failure to prosecute.[141]

By employing a local rule, the disclosure scheme could be implemented at an earlier point in a chapter 11 case and consequently prevent some misconduct that would go unnoticed if a ballot disclosure scheme was employed.

Regrettably, the courts may be reluctant to adopt a local rule because of the foreseeable opposition from the claims trading and hedge fund industries during the comment period under Federal Rule of Civil Procedure 83. Their arguments against a mandatory disclosure scheme that would expose net adverse creditors are likely

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[139] FED. R. BANKR. P. 9029. *See* Sheridan v. Michels (*In re* Sheridan), 362 F.3d 96, 99 (1st Cir. 2004) (citing authority of bankruptcy judges "'to make such rules of practice and procedure as they may deem appropriate'") (citation omitted); *see also* Brown v. Smith (*In re* Poole), 222 F.3d 618, 621 (9th Cir. 2000) (observing district courts and bankruptcy courts "are empowered to make local rules governing bankruptcy procedure").

[140] FED. R. CIV. P. 83. *See* Antoine v. Atlas Turner, Inc., 66 F.3d 105, 108 (6th Cir. 1995) (citing authority in Federal Rules of Civil Procedure for district courts "to adopt local rules," provided there is "'appropriate public notice and an opportunity to comment'") (citation omitted); *In re* Wilson, 153 F. Supp. 2d 1013, 1018 (E.D. Ark. 2001) (observing public notice and comment requirements for adoption of rules by district court which govern the practice of those courts).

[141] S.D.N.Y. R. 3020-1(b).

the same as those proffered in *In re Northwest Airlines Corp.*[142] In that case the debtor made a motion based on Bankruptcy Rule 2019 to compel a group of hedge fund equity holders, who had formed an ad hoc committee, to disclose information about their trading in the debtor's debt and equity.[143] The essence of the committee's argument against disclosure was that disclosure would reveal their proprietary trading strategies which could then be appropriated by competitors.[144] The Court in *Northwest* did not find this argument persuasive and it is less persuasive in the context of a disclosure scheme that would expose net adverse creditors. It is less persuasive in the later context because such a trading strategy is not a legitimate strategy. In other words, the argument, "we don't want to disclose our illegitimate trading strategy because then others could steal it" is entirely unconvincing.

CONCLUSION

Credit derivatives pose numerous risks to the chapter 11 process. In particular, they potentially create financial incentives for creditors to subvert a plan of reorganization in chapter 11. Although net adverse creditors have the potential to distort the chapter 11 process, the Bankruptcy Code provides ample authority to combat the problem. Specifically, section 1126(e) provides authority for courts to disenfranchise a net adverse creditor and section 105(a) provides authority for courts to implement a disclosure scheme that exposes net adverse creditors.

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[142] 363 B.R. 704, 707 (Bankr. S.D.N.Y. 2007) (rejecting Committee's contention that disclosure of information "would allow competitors of the funds that make up the Committee to discern the members' 'investment strategies'").

[143] *Id.* at 705 (explaining debtors motion to require Committee to comply with Rule 2019). *See generally* FED. R. BANKR. P. 2019 (setting forth information that is required to be disclosed).

[144] *In re Nw. Airlines Corp.*, 363 B.R. at 707.