The Law and Economics of Investing in Bankruptcy in the United States

Claims trading has become a significant and controversial feature of American bankruptcy practice over the past thirty years. This Report chronicles the rise of claims trading in the second decade of the Bankruptcy Reform Act of 1978 and analyzes the various policy concerns it raises. Most importantly, claims trade has led to, and been accelerated by, the development of an industry of specialized distressed investor who raise billions of dollars of capital to buy and sell the claims of Chapter 11 debtors. Despite attracting periodic concerns from policy-makers, the legal institutions of Chapter 11 appear to have mostly proven capable of handling the concerns raised by claims trading. In sum, the best interpretation of the available empirical evidence is that claims trading and activist investing has, at the very least, not harmed Chapter 11 or distressed corporations and may have actually improved the capacity of the American bankruptcy system to reorganize distressed assets.

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1. Introduction.

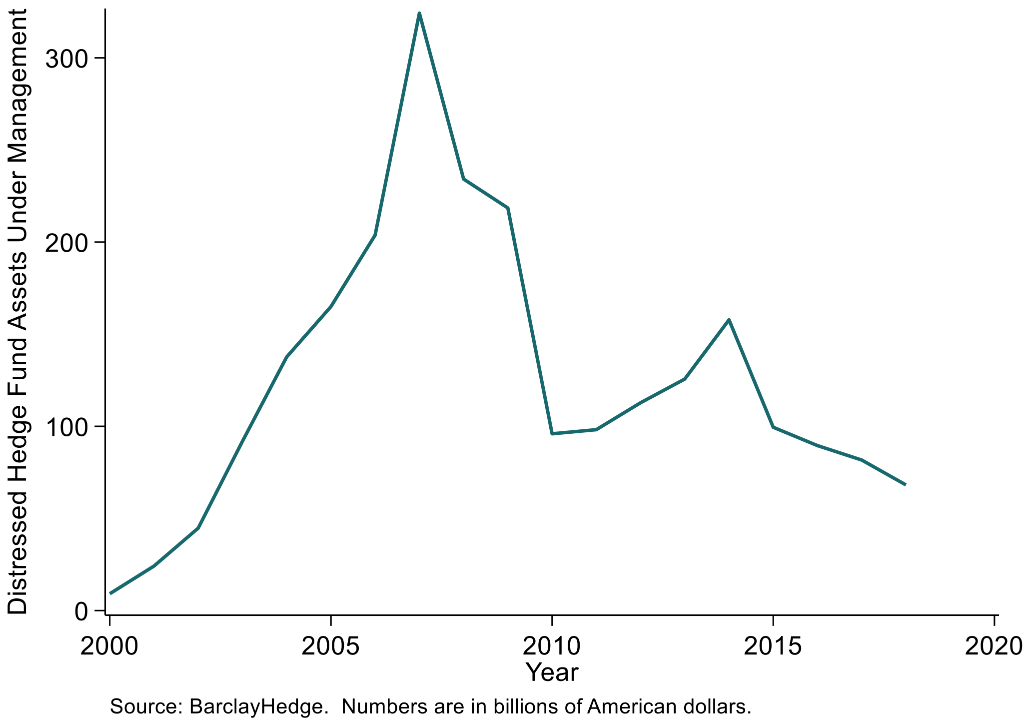
When commentators describe American bankruptcy law as "the model to which European restructuring laws should aspire,"[2] they are really speaking about an "American bankruptcy ecosystem" of which law is only a significant part. The American bankruptcy ecosystem is best understood as a complex system inhabited by bankruptcy judges, law firms, investment bankers and specialized investors. This ecosystem, which grew in its modern form from the bankruptcy code implemented by the Bankruptcy Reform Act of 1978, has proven capable and resilient. It has been tested across the full range of the business cycle and has, for the most part, smoothly resolved the financial distress of firms and entire industries. In 2008, the bankruptcy system faced perhaps its most significant challenge with the global financial crisis, and proved flexible enough to reorganize enormous financial institutions, automakers and municipalities. It is a core strength of the dynamic American economy.

In this Report, I focus on one of the major components of the ecosystem: specialized investors that participate in the "bankruptcy claims trade." Beginning in the late 20th century and continuing into the early 21st century, the role of bankruptcy courts evolved within the American system of finance. In the old view, the bankruptcy courts were a place of shame and failure. As I will explain in this Report, American bankruptcy courts today are best understood as an integrated part of the capital markets, similar to the private equity firms of New York and the venture capital investors of Palo Alto. As this new view of bankruptcy law took hold, investors, typically hedge funds, began to accumulate expertise in this part of the capital market and have

[2] *See* Samir D. Parikh, Bankruptcy Tourism and the European Union's Corporate Restructuring Quandary: The Cathedral in Another Light, *forthcoming* University of Pennsylvania Journal of International Law.

raised a large stock of capital to deploy in it.[3] As Figure 1 below shows, hedge funds went from managing a mere $10 billion in distressed assets in 2000 to more than $300 billion at the height of the financial crisis in the 2008. Importantly, as further explained below, while these investors were born of the bankruptcy bar's development of institutions that situated bankruptcy courts within the capital markets, they have deployed their capital to accelerate it.

Figure 1. Distressed Hedge Fund Assets under Management, from 2000 to 2018.



[3] For a good introductory discussion, *see* Wei Jiang et al., Hedge Funds and Chapter 11, 67 JOURNAL OF FINANCE 513 (2012).

This Report proceeds in four parts. In Section 2, I chronicle the transition of American bankruptcy law into a regular part of the capital markets with a class of service providers and investors that deploy a discrete and specialized body of knowledge. In Section 3, I discuss policy concerns raised by that transition, with a special attention to how activist investors use claims trading and the ways in which those strategies can distort the bankruptcy process and bankruptcy outcomes. In Section 4, I examine the regulation of claims trading and activist investors, with a focus on the ad hoc rulemaking function performed by bankruptcy judges. Section 5 briefly discusses additional policy concerns raised by claims trading. Section 6 concludes. The portrait of claims trading that emerges from this Report is a largely positive one and more evidence is needed before concluding that more regulation is necessary.

2. The Bankruptcy Marketplace: 1978-Present

In this Section, I situate the rise of claims trading within the maturation of the modern practice of corporate bankruptcy law. I first discuss the development of Chapter 11 legal practice after the Bankruptcy Act of 1978, which empowered a new industry of courts, lawyers and investment bankers. I then summarize the growth of the "claims trading business," the biggest investors in which are specialized hedge funds expert in the bankruptcy process. The purpose of this Section is to introduce both "claims trading" and "claims traders," which raise different concerns that are discussed in greater detail in Section 3.

2.1. The Development of the Modern Restructuring Industry.

In the early years of the United States, bankruptcy law was underdeveloped and had very little to do with corporations. While the framers of the United States Constitution expressly reserved to the Federal Government the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States," federal bankruptcy law only developed in fits and starts over the first hundred years of American independence.[4] At first, the federal government enacted a series of temporary bankruptcy laws in response to financial crises and repealed them shortly thereafter.[5] Finally, a permanent bankruptcy law was passed in 1898, although it expressly excluded corporations from the category of eligible voluntary debtors.[6] That changed in the 1930s, but that version of the law was not heavily utilized by corporations.[7] Fifty years later, after extensive study, Congress enacted the modern bankruptcy code with the Bankruptcy Act of 1978, which was explicitly designed to make bankruptcy more attractive for struggling businesses.[8]

Importantly, Congress made two policy changes in the new bankruptcy law that made bankruptcy a more attractive practice area for the most talented cohort of attorneys.[9] First, the law increased the level of compensation of bankruptcy lawyers to draw in attorneys who had been deterred by the practice's reputation as a low-paying and stigmatized area of the law.[10]

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[4] Article 1, Section 8 of the United States Constitution. James Madison worried that, without federal regulation, state governments would enact their own bankruptcy laws that favored their own residents over creditors in other states. *See* The Federalist No. 42.

[5] See Charles Jordon Tabb, The History of the Bankruptcy Laws in the United States, 3 Am. Bankr. Inst. L. Rev. 5, 14 (1995).

[6] See *id.* at *26*.

[7] See *id.*

[8] While corporations obtained the right to file for corporate bankruptcy in the 1930s, many of the legal doctrines that are key to Chapter 11 practice have their roots in railroad receiverships. *See id.* at 28.

[9] See Geraldine Mund, Appointed or Anointed: Judges, Congress and the Passage of the Bankruptcy Act of 1978: Part One: Outside Looking In, 81 Am. Bankr. J. 1, 3. Congress stopped short of making bankruptcy judges Article III judges after a campaign of sustained resistance to the idea led by Article III judges. Instead of Presidential Appointment with lifetime appointment, bankruptcy judges would be selected from the practicing bar of bankruptcy lawyers by the local Circuit Court and appointed to fourteen year terms.

[10] See Geraldine Mund, Appointed or Anointed: Judges, Congress and the Passage of the Bankruptcy Act of 1978: Part One: Outside Looking In, 81 Am. Bankr. J. 1, 3. Congress stopped short of making bankruptcy judges Article III judges after a campaign of sustained resistance to the idea led by Article III judges. Instead of Presidential Appointment with lifetime appointment, bankruptcy judges would be selected from the practicing bar of bankruptcy lawyers by the local Circuit Court and appointed to fourteen year terms.

Under the new law, bankruptcy lawyers were no longer expected work at low rates to avoid further injury to creditors.[11] Now, they could charge market rates for high-end corporate work.[12] As a result, the bankruptcy bar became a subset of the elite corporate bar, a dramatic shift that changed the profile of bankruptcy lawyers and bankruptcy judges.[13] Second, the law upgraded the status of bankruptcy judges by empowering them to hear a wider range of legal issues, improving their relative position within the federal judiciary and improving the prestige of bankruptcy judgeships.[14] As a result of these changes, lawyers embraced the new statute and produced legal work, customs and judicial opinions that streamlined the "onerous and complex procedures" created by the comprehensive reorganization section of the statute, Chapter 11 of the new bankruptcy code.[15]

Congress made further changes to make the bankruptcy system more attractive to American businesses. Most importantly, existing management would normally remain in control of the reorganization process and could hope to run the firm after the firm exited bankruptcy.[16] Under the prior bankruptcy law, appointment of a trustee was mandatory and managers and boards of directors of large businesses would effectively lose control – and their jobs -- after a bankruptcy filing.[17] American businesses were thus heavily disinclined to seek bankruptcy relief, likely

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[11] *See In re Drexel Burnham Lambert Grp., Inc.*, 133 B.R. 13, 18 (Bankr. S.D.N.Y. 1991) (discussing Congress' rationale in raising the level of compensation of bankruptcy lawyers to market levels).

[12] *See id.*

[13] New York's leading firms would enter bankruptcy practice over time – for example, it took another thirty years before Cravath, Swain & Moore created a bankruptcy practice. *See* Karen Donovan, Big Law Firm Embracing Bankruptcy Practice, N.Y. Times. (Aug. 3. 2007), *available at* https://www.nytimes.com/2007/08/03/business/03bankrupt.html.

[14] *See* Arthur L. Moller & David B. Foltz Jr., Chapter 11 of the 1978 Bankruptcy Code, 58 N.C. L. Rev. 881 (1980).

[15] *See id. See also* Harvey R. Miller & Shai Y. Waisman, Is Chapter 11 Bankrupt?, 47 B.C. L. Rev. 129, 146 (2005) ("From the outset, the Bankruptcy Code112 was understood to be a flexible document, with its provisions to be shaped and interpreted to meet the needs of the Congressional policy of furthering rehabilitation. Early caselaw illustrates the manner in which policy considerations behind the 1978 Act encouraged a pragmatic view and application of the Bankruptcy Code.")

[16] *See id.* at 139.

[17] *See id.*

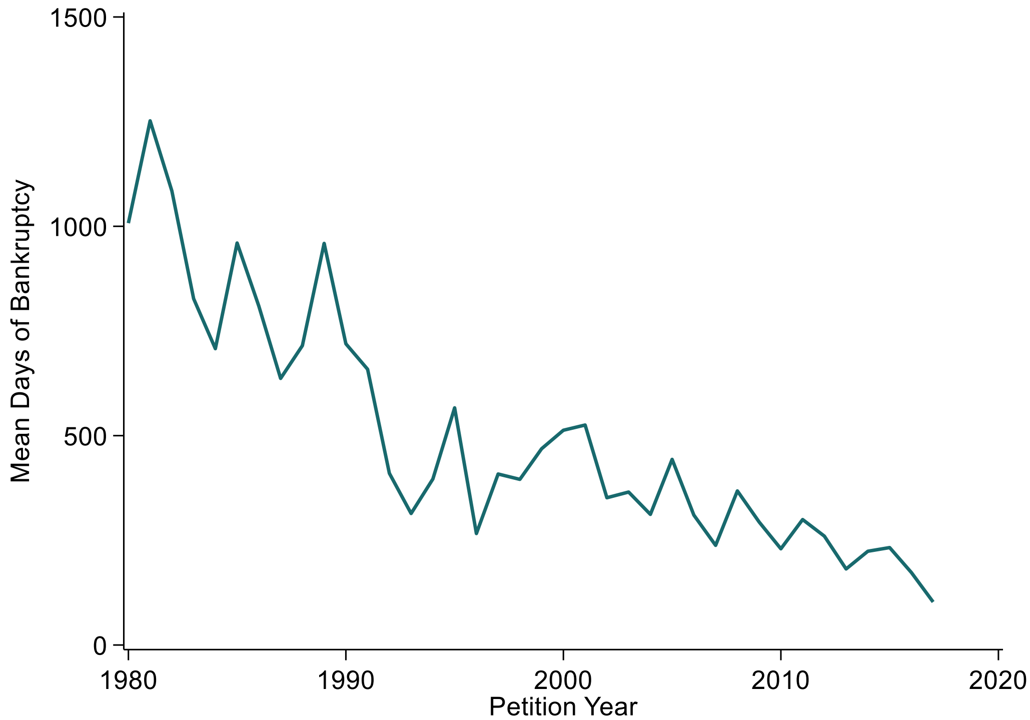
leaving the economy replete with "zombie firms" that needed to reorganize, but lacked a procedure that allowed them to do so.[18] In contrast, the new bankruptcy code left existing managers in control of the business, "reflecting Congress' view that … reorganization would be best effectuated by allowing the debtor to continue to operate its business as debtor-in-possession."[19]

2.2.Rise of Distressed Hedge Funds and the Bankruptcy Marketplace.

These three crucial ingredients – attractiveness to talented lawyers, empowered judges, and a bankruptcy system newly attractive to businesses – set the stage for the normalization of Chapter 11 as a tool available to firms for liability management. In Chapter 11, firms are able to solve liquidity shortages by borrowing debtor-in-possession financing,[20] tearing up bad contracts, rationalizing a firm's capital structure by forcing creditors to accept partial payments, selling and disposing of unnecessary assets and imposing losses on unionized workers. A manager of a Chapter 11 debtor has other rights that she would not have outside of bankruptcy, such as asking the judge to force creditors to accept a restructuring transaction over the objections of hold-out creditors. Importantly, the tools provided by the bankruptcy code supply managers with bargaining power with creditors outside of bankruptcy and lubricate out-of-court debt restructurings as well.

[18] *See id*.
[19] *See id*. at 143.
[20] *See* Kenneth Ayotte & David A. Skeel Jr, Bankruptcy Law As A Liquidity Provider, 80 U. Chi. L. Rev. 1557 (2013).

Figure 2. Average Length of Bankruptcy Case, by Year Filing for Chapter 11.[21]



The increased utilization of Chapter 11 fed a virtuous cycle as an increasingly capable group of lawyers, investment bankers and judges entered the practice and developed it. As Figure 2 above shows, the average bankruptcy case fell in length from more than three years in 1980 to fewer than three months for the firms that filed for Chapter 11 in 2017. Bankruptcy law proved adept at resolving a wide range of problems ranging from the business of the automotive industry, investment banks, airlines, industries with asbestos liabilities and the energy industry. By one measure, Chapter 11 has reorganized more than $2.6 trillion in inflation-adjusted current liabilities between 1980 and today.[22] One of the key steps forward in Chapter 11's maturity was the centralization of large corporate cases in the bankruptcy courts in the Southern District of

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[21] Source: UCLA-LoPucki Bankruptcy Research Database (accessed December 1, 2019).
[22] *See id*.

New York and Delaware, which created a cohort of super-experienced judges and lawyers and a store of caselaw and judicial procedures that other bankruptcy courts could adapt and copy.[23]

As Chapter 11 became more and more utilized by distressed businesses, a new industry grew of specialized investors that aimed to use their knowledge of the new bankruptcy law as part of a profitable investment strategy. While there is anecdotal evidence of investors buying the claims of bankrupt firms to acquire control of a firm as far back as 1930,[24] the practice was uncommon enough in the early years of the bankruptcy code that an Article written in 1990 by leading bankruptcy lawyers was able to recite the three prominent companies taken over in the bankruptcy code's first decade by name.[25] This soon changed. Writing only a decade later, a practitioner described how "the face of bankruptcy" had been altered "by the newfound liquidity in claims" over the 1990s.[26] This liquidity was driven by the emergence of investors who wanted to buy these claims.

To quantify the level of trading in the marketplace, I conducted the first empirical study into the complete record of trading in the public bonds and equity of firms that filed for bankruptcy between 2002 and 2012.[27] Importantly, this is only a part of the claims trading marketplace – there is also heavy trading in corporate loans and trade claims, which are not captured in my

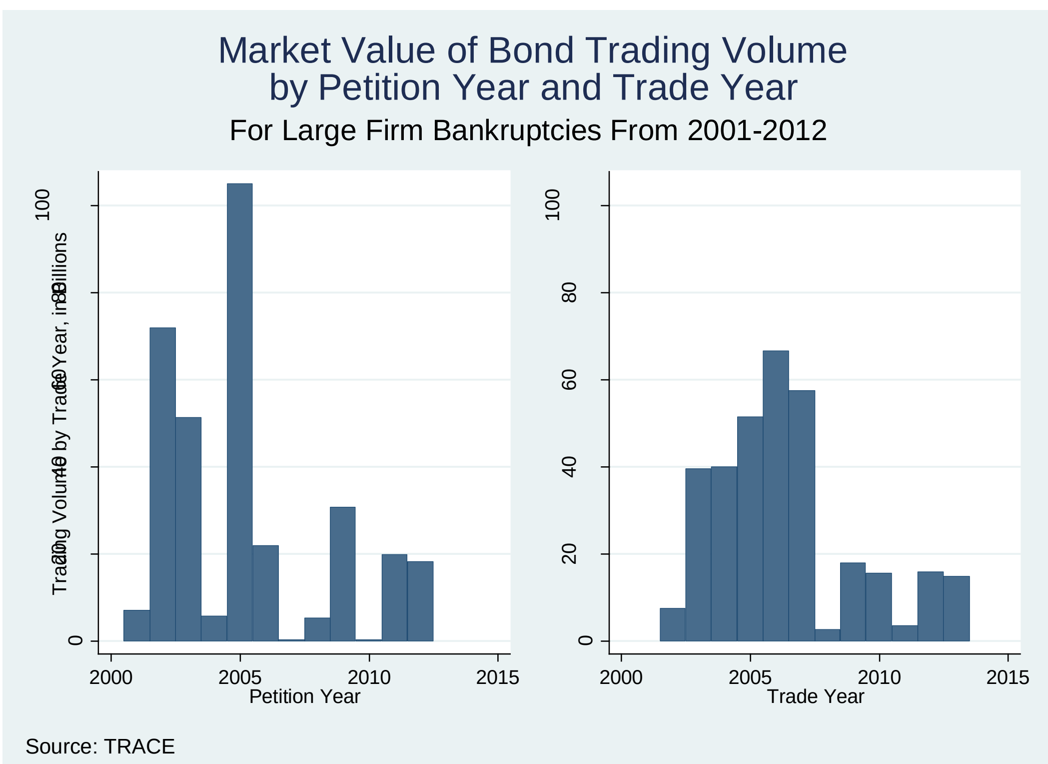
[23] *See* Jared A. Ellias, What Drives Bankruptcy Forum Shopping? Evidence from Market Data, 47 Journal of Legal Studies 119-149 (2018).
[24] *See* Chaim J. Fortgang & Thomas Moers Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 Cardozo L. Rev. 1 at 75 (1990)
[25] *See* id at 75-76 ("Since 1979, at least three debtors have been taken over through or in connection with claims purchases: King Resources, Inc., Baldwin United, Inc., Apex Oil Co., and Allegheny International, Inc.").
[26] *See* Glenn E. Siegel, Introduction: Abi Guide to Trading Claims in Bankruptcy Part 2 Abi Committee on Public Companies and Trading Claims, 11 Am. Bankr. Inst. L. Rev. 177, 177 (2003). The development of the market by also facilitated by amendments to Bankruptcy Rule 3001(e) in 1991. *See* Harvey R. Miller, Shai Y. Waisman, Does Chapter 11 Reorganization Remain A Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 182 (2004)

[27] The data in this section are generally drawn from my prior work on claims trading and include some unpublished summaries of the underlying dataset. *See* Jared A. Ellias, Bankruptcy Claims Trading, 15 J. Empirical Leg. Studies 772 (2018).

dataset. My dataset included 494 bonds issued by 204 firms with an aggregate face value of $512 billion. I rely principally on the TRACE dataset, which has the advantage of containing a complete record of bond trades during the sample period. However, TRACE has an important limitation: it consists of records indicating that a trade occurred on a certain date at a certain price without identifying information on the buyer or seller of the claim. This limits my ability to explore some questions directly, leaving important questions for future research to study, some of which I will highlight below.

Figure 3 below summarizes Chapter 11 bond trading volume by calendar year. As the Figure shows, this slice of the claims trading market alone is worth tens of billions of dollars a year in trading value, but there is a cyclicality to the marketplace.

Figure 3. Market Value of Bond Trading Volume by Petition Year and Trade Year.



This Figure summarizes aggregate observed market value of trading volume of bonds issued by firms operating under Chapter 11 bankruptcy court administration, by both the year of the bankruptcy filing (petition year) and the year of the observed trade.

Studying this marketplace, I learned that the view that claims trading is pervasive is well-supported by data. For the median bond in the sample, trading is intense enough during the bankruptcy case that the aggregate turnover is equivalent to more than 113% of the face value of the bond. A limitation of the dataset is that I cannot say for sure whether the entire bond issue turned over or whether a small fraction of the bond changed hands several times. However, in either case, it is fair to say that Chapter 11 bonds are heavily traded. In fact, trading is intense enough in these bonds that the median Chapter 11 bond trades at the 84th percentile of the debt market as a whole.[28] Thus, it is accurate to describe the market for Chapter 11 bonds as one of the most active corners of the American bond market.

It is commonly assumed that this marketplace is characterized in the first instance by traditional investors -- such as mutual funds and asset managers – selling Chapter 11 claims to specialists in distressed investing. I find indirect evidence supporting this view. Tracking a sample of 1,346 Chapter 11 bonds held by 48 mutual funds or asset managers between 2008 and 2012, I find that the average fund holding the bond of a future Chapter 11 debtor exits the position somewhere between ten and four months prior to a bankruptcy filing.[29] Examining the bankruptcy dockets corresponding to the 130 firms that filed for Chapter 11 bankruptcy in 2009 and 2010, I find evidence of specialized distressed investor involvement in more than 80% of

[28] *See id.* at 781.
[29] *See id*. at 790.

cases and 38% of the 496 unique debt claims that the firm had issued prior to bankruptcy, suggesting that a significant percentage of Chapter 11 creditors are specialist investors.[30]

Similarly, Ivashina et. al (2015) study another segment of the claims trading market: the market for "trade claims."[31] If the debtor has an unpaid bill owed to a supplier when it files for bankruptcy, we call that supplier a "trade creditor." Claims owed to investors are financial claims, while claims owed to suppliers or tort creditors are trade claims. The existence of a liquid claims trading market means that the supplier will receive offers from investors who want to buy their claim from them, which many prefer to do as many trade creditors are not interested in holding claims through the Chapter 11 process. Ivashina et. al. (2015) compare the list of creditors filed with the court at the beginning of the bankruptcy case to the list of voting creditors for 136 Chapter 11 debtors that filed between July 1998 and March 2009. Among other things, they find evidence that activist investors are the largest category of the buyer of Chapter 11 trade claims.[32] It stands to reason that many of the same activists who buy financial claims such as bonds and equity may also buy trade claims to grow their position and bargaining power.

In short, claims trading is the rule in Chapter 11. When a firm files for Chapter 11 bankruptcy, it can expect to see heavy trading in its financial debt and trade debt and it should also expect to negotiate its bankruptcy plan with distressed hedge funds, not with the investors who had originally provided the firm with capital. An interesting pattern revealed in the data, and illustrated in Figure 4 below, is that in the early part of the 2000s, trading was heavier for

[30] This an unpublished result from the data collected for *See* Jared A. Ellias, Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11? Evidence from Junior Activist Investing, 8 Journal of Legal Analysis 493 (2016).
[31] See Victoria Ivashina et. al, The Ownership and Trading of Debt Claims in Chapter 11 Restructurings, 119 J. Fin. Econ. 316 (2015).

[32] *See* id. at 317.

Chapter 11 bonds in bankruptcy than in the year prior to bankruptcy. That changed in 2006, when firms, on average, often began to experience heavier trading in their bonds in the year prior to bankruptcy than they did in bankruptcy. While this is certainly partially related to the shrinking duration of bankruptcy cases, I hypothesize that this is, in part, driven by the increased flow of funds into distressed investing strategies – investors do a better job of identifying firms that may file for Chapter 11 and acquire those claims earlier in the distress cycle than had been the case previously.

Figure 4. Percentage of Issue Observed to Trade in Year Prior to Bankruptcy as Compared to Trading in Bankruptcy, by Petition Year.

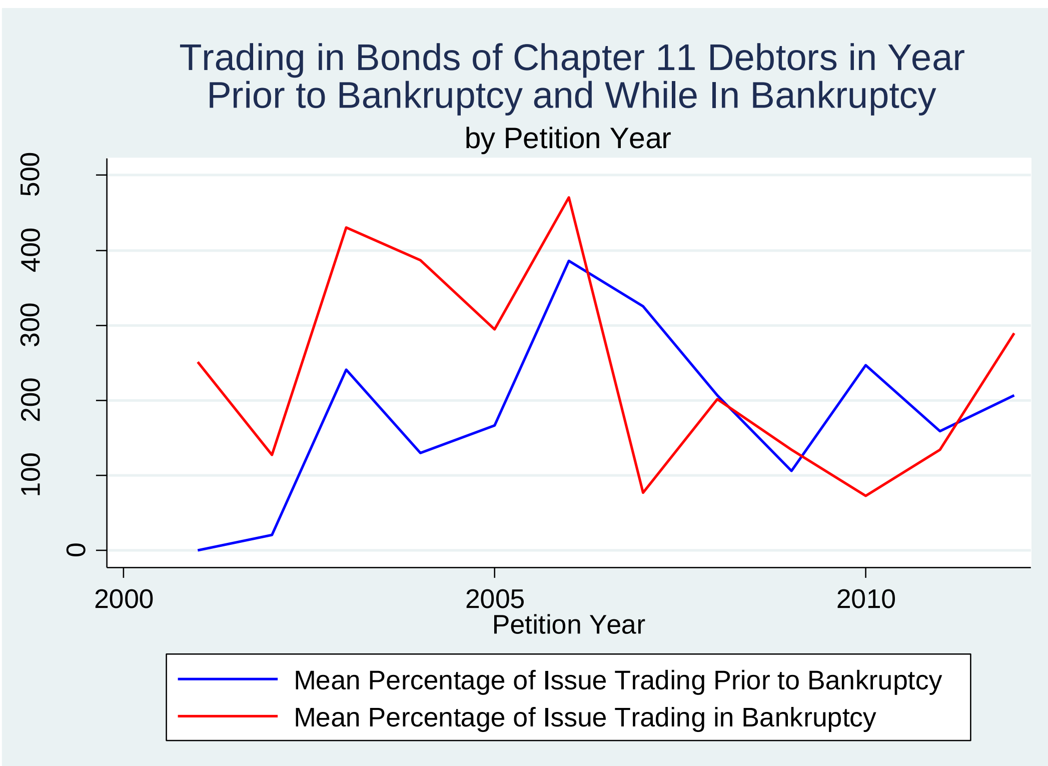


Figure 4 compares the mean percentage of bond issue that traded in the year prior to bankruptcy, as opposed to the period in which the firm's assets are administered by the bankruptcy court, by the year the debtor filed for Chapter 11 bankruptcy.

3. Criticism of Claims Trading.

There are two major lines of criticism of claims trading: (1) claims trading hurts Chapter 11 by undermining its statutory design, which depends on negotiations; and (2) claims trading hurts Chapter 11 by allowing for the entrance of activist investors into the capital structure, who then abuse the rights of creditors in Chapter 11 to distort bankruptcy outcomes in selfish and inefficient ways. I discuss each in turn.

3.1. Criticism #1: Claims Trading Undermines Chapter 11's Statutory Design.

Chapter 11's bargaining ideal is a fully consensual plan of reorganization and the bankruptcy code is built to prod all of the debtor's creditors to come to agreement on how to reorganize the debtor's assets. While bankruptcy judges have the power to confirm a plan of reorganization over a major creditor's objection, they strongly prefer to approve a plan of reorganization that is supported by all creditors. When creditors are unable to agree, the result is litigation that can be enormously expensive, running from the tens of millions of dollars in medium sized cases to hundreds of millions of dollars in the largest cases. For example, when the creditors of the Tribune Company were unable to agree on a restructuring plan, the result was a protracted, four year bankruptcy where the professional fees exceeded $500 million.[33]

Thus, an important line of criticism of claims trading is that it undermines the bargaining process and makes a fully consensual deal less likely because the debtor has to negotiate with a revolving cast of characters.[34] For example, the debtor could try reaching a bargain with a

[33] *See* Robert Channick, Tribune Co. Emerges from Bankruptcy, Chicago Tribune (December 31, 2012), available at https://www.chicagotribune.com/nation-world/ct-xpm-2012-12-31-chi-a-new-era-dawning-for-tribune-co-20121230-story.html.

[34] For a prominent example of this argument, *see* Douglas G. Baird, Robert K. Rasmussen, Antibankruptcy, 119 Yale L.J. 648 (2010). *See also* Frederick Tung, Confirmation and Claims Trading, 90 Northwestern University LL. Rev. 1684 (1996); Harvey R. Miller, Shai Y. Waisman, Does Chapter 11 Reorganization Remain A Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 181 (2004) ("Distressed debt

group of secured lenders, only to see the largest lender sell its claim to a new investor who comes in with their own agenda, forcing the debtor to start bargaining over from scratch. In practice, good debtor's lawyers have developed strategies and customs to deal with this concern. For example, the debtor's lawyer may require an *ad hoc* group of secured lenders to sign a confidentiality agreement to negotiate that requires them to restrict their trading activities as a price for participating in intense negotiations. Once deals are reached, as further discussed below, debtor's counsel can require the creditors it has negotiated with to sign an agreement promising to support the plan on the table, a promise that will be inherited by any subsequent purchasers of the claim.

While some anecdotal cases might suggest that claims trading is a major problem for Chapter 11 bargaining, the question is how problematic it is *on average*: does claims trading cause a churn of negotiating counterparties in the average case? To try to learn more about the answer to this question, I examined court documents for the 158 Chapter 11 debtors that filed for bankruptcy between 2004 and 2012 with publicly available court documents for which I have bond data to look at the pattern of activist entry, exit and churn in those cases.[35] While I cannot observe trading systematically, I can observe the appearance of lawyers representing activists into the Chapter 11 process. I find that the vast majority of them enter the bankruptcy process early on and that groups of creditors appear to be very stable in the average case.[36] This suggests that the average bankruptcy case is not destabilized by claims trading.

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trading and changing relationships as a result of globalization and technology have upset the symbiotic relationship of a debtor and its creditors. Traders purchase debt claims at a substantial discount, as they are concerned solely with the return on their investment.")

[35] *See* Ellias, *supra* note 27, at 786.

[36] *See id.* at 786-793. Interestingly, Ivashina et. al, *supra* note 31 , show that consolidation does seem to occur in the trade claims market even though it does not seem to occur in the bond market. I hypothesize that this may be a result of the different dynamics of the trade market, where that market may only become liquid once the list of trade creditors is filed with the bankruptcy court.[36]

Instead, my research suggests that it is probably most accurate to characterize the market for Chapter 11 claims as a market of passive traders who may participate in the bankruptcy process by consolidating classes of creditors and voting. On average, claims trading during Chapter 11 does not appear to lead to the entrance of new activist investors. It is important to qualify this conclusion by noting that there have been high-profile examples of cases destabilized by claims trading and the shadow of claims trading clearly hangs over every case. However, it is fair to conclude that the available evidence suggests that the average Chapter 11 case is not destabilized by trading that happens during the period of the firm's bankruptcy.

3.2. Criticism #2: Activist Investors Buy Claims and Abuse the Rights of Chapter 11 Creditors.

Critics worry that claims trading creates more than negotiating churn – it also leads to the entrance of specialist investors, who are self-interested and disruptive. On closer inspection, distressed activists deploy different strategies that raise different policy concerns. In this Part, I identify the major activist investing strategies deployed by these specialists and assess the empirical evidence as to whether the worries raised by these strategies are substantiated in practice.

3.2.1. Active Investing Strategies.

A bankruptcy activist investor has several potential moves to make, which are a function of the debtors' prepetition capital structure and level of solvency. At a high level, a distressed activist can profit in three ways from investing in the marketplace. First, an activist can put capital to work and earn attractive fees, either through providing debtor-in-possession financing ("DIP financing") or through providing a Chapter 11 debtor with a loan that allows it to leave bankruptcy ("exit financing.") Second, the activist can manipulate the bankruptcy process to obtain value it would not be entitled to if the process were run by an impartial social planner, often by buying control of the restructuring with covenants attached to a DIP financing or by winning victories in litigation. Third, the activist can use expertise in turnaround management to improve the firm's restructuring transaction beyond what management would have done on their own, for example by steering the firm into a value-maximizing sale when the firm is worth more in someone else's hands than when it reorganizes as a going-concern, or by improving the firm's operating performance. Appendix Table 1 summarizes these strategies, which are described in greater detail below, as well as the economic and bankruptcy policy concerns each raises.

3.2.1.1 Deploying Additional Capital.

The first and most straightforward way an activist can profit by buying the claims of a Chapter 11 debtor is by using their position as a creditor to invest additional capital in the company's restructuring. Indeed, the ability of Chapter 11 firms to borrow new money is a key strength of Chapter 11, and many firms file for bankruptcy to obtain financing through the bankruptcy process to fund a turnaround. There are two common financings that Chapter 11 debtors often seek to obtain: "DIP Financing" and "Exit Financing." I discuss each in turn.

"DIP Financing" is the bankruptcy-speak shorthand for loans made to firms that have filed for bankruptcy and need money to fund their reorganization.[37] "DIP" stands for debtor-in-possession. In most Chapter 11 cases, the early part of the bankruptcy process is dominated by disputes among creditors about the terms of the Chapter 11 financing. Examining a dataset of the 409 large firms with traded debt or equity that filed for bankruptcy between 2001 and 2012, I find that the average motion seeking to borrow a DIP Loan was filed on the same day that the

[37] For a good overview, *see* George G. Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 VAND. L. Rev. 901, 901 (1993).

firm filed for bankruptcy and that the borrowing was approved by the bankruptcy judge about a month after the petition date.

In general, bankruptcy law gives the debtor's existing senior creditors enormous advantages in competing to provide the DIP loan.[38] This is because investors are usually cautious about lending money to failed firms reorganizing in Chapter 11, leading most lenders to refuse to lend unless they receive a priming lien – a lien that is senior to all of the debtor's pre-bankruptcy creditors -- on substantially all of the debtor's assets.[39] Priming liens are hard for new lenders to get, because bankruptcy law protects existing lienholders and the vast majority of Chapter 11 debtors enter bankruptcy with a pre-existing lien on substantially all of their assets. Of the large firms filing for bankruptcy between 2001 and 2012, approximately 70% had already pledged such a lien. Bankruptcy law requires any Chapter 11 debtor that wants to pledge a new lien on collateral that is already encumbered by a lien to offer "adequate protection" to its existing secured creditor. Adequate protection normally takes the form of some combination of cash payments, replacement liens and claim priority for the pre-bankruptcy lienholder. However, the pre-bankruptcy lienholder can make a legal argument that any proposed adequate protection package is insufficient, forcing outside lenders to litigate if they want to prime the existing lienholder over their objection. Fortunately, an investor who wants to provide DIP financing can side-step this dynamic by buying the claims of the debtors' existing creditors so they can benefit from the bargaining power of pre-existing lien instead of being hurt by it.

[38] For a fuller description of this dynamic, *See* Ken Ayotte and Jared Ellias, Bankruptcy Process For Sale (unpublished working paper).
[39] *See* George Triantis, Debtor-in-Possession Financing, in Research Handbook on Corporate Bankruptcy Law (B. Adler ed.) (2019)..

The pseudo-monopoly power that the debtors' existing lenders enjoy in providing DIP financing raises the troubling possibility that these loans may not be made at arm's length. Sure enough, Eckbo, Li and Wang (2019) study all DIP Loans with publicly available documents borrowed by all large firms that filed for bankruptcy between 2002 and 2014 (n=267) and find evidence that the loans usually come from existing lenders in more than 70% of cases.[40] In their analysis, they compare the all-in cost of DIP loans to similar loans made to healthy firms and find that DIP loans appear to be priced 2% higher. In a separate analysis of 94 DIP loans borrowed by the 180 large firms that filed for bankruptcy in 2009 and 2010, I find evidence that every new dollar lent to a Chapter 11 debtor was repaid in full, with interest and fees. While this could imply that the lenders are overcompensated for the risk they take on, DIP loans likely more monitoring than loans to healthy firms, perhaps off-setting somewhat the 2% premium that Eckbo, Li and Wang found.

Claims trading can also create an opportunity to profit at the end of the bankruptcy case by providing "exit financing," which is the bankruptcy term for the funding that allows a debtor to leave bankruptcy. As this funding is also often provided by existing creditors, bankruptcy judges often worry that these investments are not being made at arm's-length either. Bankruptcy judges often combat this problem by requiring "market checks" of a proposed exit financing and that the opportunity to invest be open to anyone willing to commit money on the same (or better) terms as existing creditors. However, investors who bought some of the firm's claims earlier in the bankruptcy process often have an informational advantage relative to new investors, which may allow them to profit by earning above-market returns on their investment. To my

[40] B. Espen Eckbo et al., Rent Extraction by Super-Priority Lenders, *working paper* available at ssrn: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3384389. (May 16, 2019).

knowledge, no one has systematically studied this issue to determine whether this problem exists.

3.2.1.2 Improving the Value of a Purchased Claim With Contracting and Litigation.

Activists often seek to intervene in a Chapter 11 case to improve the value of their investment. Activists typically use a combination of two methods to do so: (1) buying control of the bankruptcy case; or (2) investing money in litigation to acquire favorable judicial rulings and settlements. They use these methods in support of two main goals: (1) improving the value of the firm (maximizing the size of the pie); or (2) extracting value from other investors (rent extraction). I first discuss the methods and then I discuss the goals.

At a high level, DIP lenders routinely ask management to agree to do things and to do them quickly. In an early study of this phenomenon, Ayotte & Morrison examined 153 firms that filed for Chapter 11 bankruptcy in the second half of 2001.[41] They found that 18% of the DIP loans in their sample (n=60) contained deadlines that required management to move through the bankruptcy plan process faster[42] and 17% of the DIP loans required management to seek a sale (presumably, promptly as well, although these two categories may overlap in their data). Studying a more recent sample (2002-2014, n=269), Eckbo, Li and Wang found that those numbers have crept up – 66% of DIP loans created deadlines for moving through the plan process and 13% (perhaps overlapping) of cases required deadlines for seeking a sale outside a plan of reorganization process.

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[41] *See* Kenneth M. Ayotte and Edward R. Morrison, Creditor Control and Conflict in Chapter 11, 1 Journal of Legal Analysis 511 (2009).

[42] These deadlines are generally created by forcing management to file disclosure statements for the plan of reorganization – which creditors use to vote on the plan – and to receive judicial approval ("confirmation") of a plan of reorganization by certain dates.

Ayotte and Ellias (2020) use a sample of DIP loan contracts from bankruptcies between 1995 and 2015 to show that the average DIP loan agreement has progressed from giving management money to reorganize to dictating the outcome of the Chapter 11 process itself.[43] Ayotte and Ellias (2020) propose a model of a manager who has incentives to sell control of the bankruptcy case in exchange for a side-payment (discussed in greater detail below) and identify conditions under which hose incentives are exacerbated. They find evidence broadly consistent with their model, suggesting that the DIP lending process often involves a control auction where different creditor groups may bid for control of the debtor. As the firm's most senior creditors are best situated to buy control, these control sales may yield inefficient outcomes.

Baird (2017) shows that DIP loans are not the only way activists can acquire control over a restructuring process with a contract. They can also use agreements which are often entered into prior to a Chapter 11 filing, which are often styled as "lock-up agreements," "plan support agreements" or "restructuring support agreements" ("RSAs").[44] In these agreements, management and creditors agree to jointly support a certain restructuring transaction and to do it on an aggressive time-table. RSAs are useful in a world with claims trading as they bind not only the creditor but also the creditor's subsequent assignees in the event the creditor sells the claim.

In addition to contracting for control, activists can also buy it with side payments to managers. Side payments can take the form of lucrative employment contracts, post-bankruptcy stock grants or bonuses during the bankruptcy period. In many cases, management will sell

[43] *See* Kenneth M. Ayotte and Jared A. Ellias, Bankruptcy Process for Sale (2020) (unpublished manuscript, on file with author).

[44] *See* Douglas Baird, Bankruptcy's Quiet Revolution, 91 American Bankruptcy Law Journal 593 (2017).

control to an activist and that control sale will be effectuated through a DIP loan agreement or RSA, as outlined above.

Alternatively, activists can invest money in litigation and try to obtain judicial rulings and bargain in the shadow of that litigation. In some cases, management will sell control of the firm to an activist investor in a senior claim and then another activist will buy the junior claim and try to fight the control sale. Ellias (2016) studies a sample of 107 firms that filed for bankruptcy in 2009 and 2010 and finds of pervasive creditor litigation.[45] For example, activist junior creditors objected to 37% of the disclosure statements filed in the sample period and 33% of the proposed DIP financings or cash collateral orders. Importantly, the study shows little evidence that litigation is systematically used by junior creditors to extract value from senior creditors in inefficient transfers. To the extent that a junior creditor uses litigation to obtain an unearned settlement from a senior creditor, such transfer could violate bankruptcy law's absolute priority rule. While those transfers are observed in about 27% of sample cases, the amount of such transfers is relatively small and unlikely to incentivize junior activists to embark on expensive activist campaigns.

3.3 Activist Goals

When hedge funds invest in Chapter 11 activism, they generally seek to improve the value of their claim in one of three ways: (1) by increasing the value of the firm – and derivatively, the value of their claim; (2) by extracting value that would go to other creditors if the bankruptcy process was run fairly; or (3) by defending their claim from the attempts of other to extract rents.

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[45] *See* Jared A. Ellias, Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11? Evidence from Junior Activist Investing, 8 Journal of Legal Analysis 493 (2016).

3.3.1.1 Improving the Restructuring Transaction.

The first activist strategy is to improve the restructuring transaction by contributing their capital and expertise. For example, an activist could offer to fund the reorganization of a firm that would otherwise be forced to liquidate inefficiently. Activists can also confront entrenched managers who, for example, refuse to sell a company and obtain a judicial ruling forcing a sale to go forward. For example, in the bankruptcy of Tropicana Casino, activists forced the management team who had led the company into bankruptcy to resign, laying the foundation for a change of control. Activists can do these things both by buying control and by using litigation to try to block management from selling control inefficiently to another creditor.

3.3.1.2 Improve Value of Claim through Rent Extraction.

Activists can also improve the value of their claim by trying to capture value that would otherwise go to other creditors. This sort of value extraction can take several different forms, but the most important ones involve buying control of the bankruptcy process and using that control to obtain a disproportionate share of the firm's value. The best ways to do that are: (1) to manipulate the firm's transaction choice; (2) to manipulate the appraised value of the restructuring transaction, which determines distributions to creditors; (3) or to use or threaten litigation to extract rents.

The first way to extract value from another creditor is to obtain ownership of a firm's assets in an inefficient restructuring transaction. Consider a hypothetical firm that has a senior creditor owed \$50 and a junior creditor owed \$30 and a true value of \$70. If the senior creditor buys control of the process and manages to emerge as the owner of all of the firm's assets, it will have parlayed a claim of \$50 into assets worth \$70 – and it can promptly turn around and sell the assets to realize that value if it so wishes. A common structure for this sort of extractive transaction is a credit bid auction, in which a senior creditor forces a quick auction of the firm's assets before any other bidder can get involved and then bids the amount of their claim as currency to buy the firm. This transaction would be a straightforward expropriation of value from junior creditors by senior creditors.

Another way to extract value from another creditor is to manipulate the appraisal of a reorganization transaction.[46] Consider the same firm, again with a senior creditor owed $50 and a junior creditor owed $30 and a true value of $70. For the firm to reorganize in a restructuring transaction that is not a sale, the judge will need to appraise the firm without the help of a value produced by an auction. The most common way that Chapter 11 firms do this is with the support of an investment banker who offers testimony as to the value of the firm with an analysis – typically a comparable companies analysis, a comparable transactions analysis and discounted cash flow analysis, each of which are prone to manipulation that is hard for judges to detect.[47] If the senior buys control of the bankruptcy process and persuaded management to appraise a transaction at $50 when the firm's true value is $70, the senior creditor will receive all of the firm's value including $20 that could go to senior creditors.

Alternatively, the junior creditor or shareholders can seek to transfer value to them by overappraising the firm. Consider the same firm, again with a senior creditor owed $50 and a junior creditor owed $30 and a true value of $70. If the shareholder acquires control of the bankruptcy process (either by buying it or through litigation), they can seek to appraise the firm

[46] *See* Douglas G. Baird and Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L. J. 1930 (2006).
[47] *See* Kenneth M. Ayotte & Edward R. Morrison, Valuation Disputes in Corporate Bankruptcy, 166 U. Pa. L. Rev. 1819 (2018); Anthony J. Casey & Julia Simon-Kerr, A Simple Theory of Complex Valuation, 113 Mich. L. Rev. 1175 (2015).

at a value that is in excess of the firm's true value. Simplifying things, consider a hypothetical transaction that values the firm at $100 and transfers to each creditor their proportionate share of the firm value. The senior creditor would be entitled to 50% of the distribution (50/100), the junior 30% (30/100) and the shareholder would receive 20% (20/100). As the firm is only worth $70, the senior would receive 50%*70 = 35, the junior would receive 30%*70 = 21 and the shareholder would receive the remaining 20%*70 = 14. As a result, the transaction would underpay both senior creditors and junior creditors.

A third way to extract value from other creditors is by threatening litigation to compel a settlement. For example, a junior creditor could threaten to challenge an appraisal in the hopes of getting the judge to overappraise the firm. Many commentators worry that this is a systematic problem in Chapter 11.[48] On the other hand, Ellias (2016) finds that, on average, junior activist litigation is associated with a relatively higher appraisal relative to the market value of the firm at the beginning of the bankruptcy process, which suggests that junior activists might focus their efforts on contributing capital and expertise to reach the optimal restructuring transaction, not rent seeking.[49] Ellias (2016) finds no evidence that these higher appraisals are caused by value being redistributed from senior classes to junior creditors or shareholders. However, the study does not foreclose the possibility that litigious rent seeking is a feature of at least some cases.

3.3.1.3 Defend Value of Claim from Rent Extraction.

[48] *See e.g.,* Douglas G. Baird and Donald Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L.J. 1930 (2006); Harvey R. Miller, Chapter 11 in Transition - From Boom to Bust and into the Future, 81 Am. Bankr. L.J. 375, 389 (2007) ("The threat of litigation by junior creditors has become standard operating practice in chapter 11 cases as a means to coerce secured or senior creditors to reach accommodations with unsecured or junior creditors.")

[49] *See* Jared A. Ellias, Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11? Evidence from Junior Activist Investing, 8 Journal of Legal Analysis 493 (2016).

Finally, activists can also intervene in the bankruptcy to defend their claim from rent extraction by other activists or managers. Given all of the various offensive activist strategies, investing in defensive activism can make a lot of sense. One of the downsides of claims trading and activist investing is that it has probably increased the need to invest in defensive activism, which presumably raises the costs associated with a bankruptcy filing.

3.3.1.4 Activist Strategies to Extract Exogeneous Profit from Claims Trade.

Additionally, activists can also seek to profit from activism outside of their capacity as claimholders in the Chapter 11 case. For example, activists might try to trigger a default under the firm's debt contracts to profit from an investment in credit default swaps.[50] Some activists might also be competitors of the debtor, hoping to delay the debtor's exit from bankruptcy to profit in the product market.

4. How Bankruptcy Law Addresses Legal Issues Created by Claims Trading.

Bankruptcy judges have enormous discretion under the structure of the bankruptcy code to use *ad hoc* rule-making to establish guardrails for claims trading. The situations in which bankruptcy judges police claims trading tend to fall into four discrete fact patterns: (1) "claims washing;" (2) vote manipulation; (3) insider trading; and (4) inadequate disclosure. I discuss each in turn.

4.1."Claims washing."

[50] *See* Vincent Buccola et. al., The Myth of Creditor Sabotage, *forthcoming* 87 University of Chicago Law Review (2020); Robert K. Rasmussen and Michael Simkovic, Bounties For Errors: Market Testing Contracts 10 Harvard Business Law Rev. 501 (2019).

A "claims washing" fact pattern typically involves debtor that has off-setting counterclaims against a creditor's claim and the creditor sells the claim against the debtor to a claims purchaser. To illustrate this, consider an industrial firm that files for Chapter 11 and owes $100 to a supplier who also received an avoidable transfer prior to the bankruptcy filing of $50. Congress has specified that the debtor does not need to provide the supplier with any distribution from the estate until the creditor disgorges the avoidable transfer of $50.[51] This policy promotes settlement and ensures the debtor is not giving property to a creditor that also owes the debtor money. Now imagine the supplier sells her claim against the debtor to a hedge fund, who then argues that it should not be subject to any infirmities that might have existed if the claim was still owned by the supplier. What result? Do the disabilities of a creditor travel with the claim when it is sold to a claims buyer in an arm's length transaction?

Courts have disagreed about this fact pattern but the trend in the law is towards holding that the disability travels with the claim.[52] This is now clearly the law in the Third Circuit, which is the most important Court of Appeals for bankruptcy decisions.

4.2. Vote Manipulation.

A second common problem arises when a claims purchaser is a pre-existing creditor and buys the claim to promote the interests of the other class of claims. Oftentimes, the purchaser of the claim aims to exploit bankruptcy voting rules to acquire more bargaining power. One way to do that is to acquire a "blocking position," which allows the purchaser to control the vote of the creditor class. There are two ways a blocking position can be acquired. Bankruptcy voting rules

[51] See 11 USC 502(d).
[52] Compare In re Enron Corp., 379 B.R. 425 (S.D.N.Y. 2007) ("Enron II") with In re KB Toys Inc., et al., Case No. 13-1197 (3d Cir. Nov. 15, 2013).

are such that a creditor class votes is deemed to have "yes" on a plan of reorganization when at least one half of the creditors (the "number" requirement) in the class holding at least two thirds of the amount of claims in the class (the "amount" requirement) vote in favor of the plan. Accordingly, a claims trader can acquire a blocking position in the class by, alternatively, acquiring at least one third of the amount of the claim *or* buying sufficient claims to hold more than one half of the pre-existing number of claims.

To illustrate this, consider the facts of *In re Fagerdala USA-Lompoc*.[53] Simplifying things, the owner of property in California filed for bankruptcy with two significant creditor groups: a bank with a lien on the property and unsecured trade creditors. As bankruptcy rules allow a debtor to confirm a plan over the objection of the secured creditor if the unsecured creditors support the plan and certain conditions are satisfied, the bank decided to buy a blocking position in the unsecured class of claims. After the bank successfully purchased a blocking position, the debtor moved under 11 USC 1126(e) of the bankruptcy code to designate the vote as having been cast in "bad faith," which would allow the bankruptcy judge to confirm a plan over the bank's objection, notwithstanding the "no" vote of all the unsecured claims that the bank had purchased. This law gives the bankruptcy judge broad discretion to eliminate the vote of a creditor that voted in some way that undermines the structure of the bankruptcy code.

However, the statute provides little to guide a judge in distinguishing "impermissible" strategic voting from "permissible" strategic voting. How do we draw the line? The trend in the law is to distinguish voting for "enlightened self-interest" (which is permissible) from voting with an "ulterior motive" (which is impermissible). In practice, the distinction is whether the

[53] 2018 WL 2472874 (9th Cir. June 4, 2018)

creditor's strategic concerns are driven more by protecting its existing claim (which is permissible) and profiting in some way from disrupting the debtor's reorganization (which is impermissible). As the court said in Fagerdala, quoting another Ninth Circuit decision, "the mere fact that a creditor has purchased additional claims for the purpose of protecting his own existing claim does not demonstrate bad faith or an ulterior motive." While the law in this area is still developing, it is clearest to summarize it to say that a strategic competitor of the debtor who buys a claim to improve its own market position is probably acting in bad faith and will have its vote designated,[54] while a senior creditor buying a junior claim to block a plan of reorganization is probably permissibly voting its purchased claim against the plan.

4.3. Insider Trading.

A third major area that is less well-developed than the first two is the area of insider trading.[55] Consider this situation: a hedge fund that owns a debtor's unsecured bonds is simultaneously negotiating a plan of reorganization with the company while trading the company's equity. Through its trading in the equity, the hedge fund earned profits, perhaps using confidential information from the settlement talks. Should the hedge fund's bonds be "equitably disallowed" because it acted in bad faith by engaging in insider trading? While one court initially found the answer to be potentially yes,[56] the judge later reversed herself and allowed the plan to be confirmed without changing the status of the bondholders.

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[54] See e.g Dish Network/DBSD.

[55] For a good overview, *see* Andrew Verstein, Insider Trading: Are Insolvent Firms Different?, 13 Brook. J. Corp. Fin. & Com. L. 53, 53 (2018)

[56] In re Washington Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011), vacated in part, No. 08-12229 MFW, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012)

4.4. Inadequate Disclosure.

One of the most important policy debates in the claims trading area is over the level of disclosure that claims traders must provide to bankruptcy judges, the debtor and the public. Critics of claims trading often advocate for additional disclosure to reduce the disruption trading allegedly causes to the creditor class.[57] Supporters of trading rebut this claim and allege that additional disclosure regulation could drain liquidity from the market.[58] While the market for the claims of bankrupt firms is typically referred to as "an unregulated securities market,"[59] one provision of the Federal Bankruptcy Rules of Procedure directly impacts claims traders who deploy activist investing strategies: Rule 2019.[60] Rule 2019 requires these activist investors to provide verified disclosure to the bankruptcy court and it has been the subject of a "roaring controversy" among scholars, practitioners and judges.[61] This Part first summarizes that debate and then examines how a 2011 change to Rule 2019 might have changed the market for the claims of bankrupt firms, which may serve as a test case for understanding how additional regulation impacts this market. The story as a whole demonstrates the various interests that are often at stake in claims trading debates.

4.4.1. The History and Debate Over Rule 2019.

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[57] *See e.g.* Harvey Miller, Congressional testimony to the House Judiciary Committee, "Circuit City Unplugged: Why did Chapter 11 fail to save 34,000 jobs?" (March 11, 2009).

[58] *See e.g.* Sharon Levine, "Bankruptcy Beat, The Examiners: Increasing Disclosures Would Chill Claims Trading.," *Wall Street Journal* (Feb. 18, 2016), *available at* http://blogs.wsj.com/bankruptcy/2016/02/18/the-examiners-increasing-disclosures-would-chill-claims-trading/.

[59] *See* Jonathan C. Lipson, The Shadow Bankruptcy System, 89 B.U. L. Rev. 1609, 1645 (2009).

[60] *See* Edward Janger, The Costs of Liquidity Enhancement, 3 Brook. J. Corp. Fin. & Comm. L. 39, 53-5 (2009). While another Federal Bankruptcy Rule of Procedure regulates claim trading, it explicitly exempts the public debt studied here. Rule 3001(e) creates procedural rules for trading in claims "other than a publicly traded note, bond, or debenture." *See* Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733 (1990)

[61] *See* Henry T.C. Hu. and Jay L. Westbrook, Abolition of the Corporate Duty to Creditors, 107 Colum. L. Rev. 1321, 1375 n. 193.

Bankruptcy law has long regulated the behavior of "groups" of creditors that act in concert in response to perceived abuses in the 1930s.[62] At that point in history, management teams corrupted bankruptcy negotiations by creating fake "protective committees" that purported to represent bondholders and other dispersed creditors but promoted the interests of management and large investors, often to the detriment of small investors.[63] The Securities and Exchange Committee studied the issue and proposed a set of disclosure requirements to stop the practice. Importantly, their new disclosure requirements, now implemented by the Supreme Court as Federal Rule of Bankruptcy Procedure 2019, required all "committees" to file a statement with the court including, among other things, the name of the holders of the claims, the amounts paid for the claim and the time of acquisition of the claim.[64]

After hedge funds emerged in the 2000s as important players in the bankruptcy process, their activist investing tactics quickly put them on a collision course with Rule 2019. As a general matter, activist hedge funds often pooled resources with other hedge funds that hold claims of the same priority, such as hiring a single law firm to represent them in court.[65] However, by joining forces, groups of hedge funds ran the risk of being forced to make Rule 2019 disclosures. Hedge funds found Rule 2019 extremely problematic for two reasons. First, hedge funds did not wish to disclose details of their investing activities, which they saw as proprietary information that was the outcome of expensive research. Second, hedge funds

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[62] More recently, a group of creditors acting together was discussed in *In re* Premier Int'l Holdings, Inc., 423 B.R. 58, 67 (Bankr. D. Del. 2010).

[63] *See* Lipson, *supra* note 59 at 1635.

[64] *See* Mark G. Douglas "Rule 2019 Update: Jones Day Business Restructuring Review," Jones Day, http://www.jonesday.com/Rule-2019-Update-12-01-2010 (accessed 24 January 2018).

[65] An example of this "pooling" can be found in *In re* Nw. Airlines Corp., 363 B.R. 701, 702 (Bankr. S.D.N.Y. 2007), where an "Ad-hoc Committee of Equity Holders" was formed and represented by a single firm. Judge Gropper found that the ad hoc committee was a "committee" for the purposes of Rule 2019, thus compelling disclosure of individual holding and member trading history.

worried that disclosing the price they paid for the claim would undermine their position in bankruptcy negotiations.[66] For example, if a hedge fund purchased bond debt with a face value of $100 for a 75% discount, the debtor might be able to efficiently calibrate a settlement offer to pay the hedge fund a small profit, even though the hedge fund held a claim of $100.

Hedge funds responded to Rule 2019 mostly by ignoring it, leading one lawyer to call it "a forgotten rule."[67] As Judge Gerber of the Southern District of New York wrote in a letter to the Advisory Committee on Bankruptcy Rules, "in the absence of a court order requiring otherwise, failures to provide the information actually required by Rule 2019, as it is now written are widespread, and failures to make all of the required disclosures are the rule, not the exception."[68] Judge Gerber complained that the large law firms that specialize in representing distressed activist investors developed a practice of making filings that purported to comply with the Rule, while reporting only a list of hedge funds and their holdings in the aggregate, without breaking out individual information. Additionally, even when there was partial compliance, Judge Gerber complained that he had "never seen" disclosure of dates or the acquisition price.

In the late 2000s, hedge funds began to complain that Rule 2019 had become an "offensive weapon against activist investors."[69] When debtors or other creditors wanted to

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[66] This worry was especially apparent in the response to Judge Gropper's ruling in *In re* Nw. Airlines Corp. (2007), as creditors quickly moved to keep ordered disclosures under seal. See Mark Berman & Jo Ann J. Brighton, *Will the Sunlight of Disclosure Chill Hedge Funds? The Tale of* Northwest Airlines, 26 AM. BANKR. INST. J., 24-65 (2007) ("The affidavits all contained statements alleging a dire need to keep the information ordered by the bankruptcy court under seal. One of them likened themselves to car dealers who cannot disclose the original cost of vehicle purchases in order to preserve the competitive marketplace for cars.").
[67] *See* Michael D. Fielding, Remember the Forgotten: Fed. R. Bankr. P. 2019., Presented at the 35th Annual Southern Bankruptcy Law Conference, Atlanta, Georgia (25 Apr. 2009).
[68] *See* Robert Gerber, Letter 8-BK-M to the Advisory Committee on Bankruptcy Rules, (Jan. 9, 2009) *available at* http://www.uscourts.gov/sites/default/files/fr_import/08-BK-M-Suggestion-Gerber.pdf.
[69] *See* Securities Industry and Financial Markets Association & The Loan Syndication and Trading Commission, Letter 8-BK-G to the Advisory Committee on Bankruptcy Rules, (Nov. 30 2007), *available at* http://www.uscourts.gov/sites/default/files/fr_import/07-BK-G-.pdf. ["SIFMA"]

acquire bargaining leverage over hedge funds, they filed a motion demanding that the lawyer appearing on behalf of a group of hedge funds file a full Rule 2019 disclosure. This most famously occurred in the bankruptcy of *Northwest Airlines*, where the bankruptcy judge in the Southern District of New York rejected an argument by a group of hedge funds that they did not constitute a "committee" and ordered them to make Rule 2019 disclosures. This decision "sent shockwaves through the 'distressed' investment community," which were partially reduced after a Texas bankruptcy court reached a contrary conclusion on a similar motion.[70]

The *Northwest Airlines* decision led to a ferocious lobbying effort by hedge funds and their trade associations to ask the Committee on the Rules of Practice and Procedure of the Judicial Conference of the United States to repeal Rule 2019.[71] To do otherwise, warned the main trade associations representing hedge funds, could "lead to an exodus of distressed investors from the market of distressed securities … decreas[ing] liquidity for the debt and equity of bankrupt companies."[72] The controversy faded from view and largely lay dormant as hedge funds mostly continued to ignore Rule 2019, until a series of bankruptcy court decisions in 2009 and 2010 reached contrary determinations as to whether Rule 2019 compelled hedge funds to file disclosures.[73]

In the wake of controversy over the 2009 and 2010 decisions, the Advisory Committee on Bankruptcy Rules began to consider amending Rule 2019. To the hedge funds' surprise, the Advisory Committee began to discuss strengthening the requirements instead of repealing

[70] *See* Douglas, *supra* note 64.
[71] *See* SIFMA, *supra* note 69.
[72] *See* id. at 24.
[73] The decisions were *In re* Wash. Mut., 419 B.R. 271 (Bank. Dist. Del. 2009) (holding groups of hedge funds needed to file Rule 2019 statements), *In re* Premier Int'l Holdings, 423 B.R. 58 (Bank. Dist. Del. 2010), *In re* Accuride, 439 B.R. 364 (Bankr. Dist. Del. 2010) (holding in an oral ruling that groups of hedge funds do need to file Rule 2019 statements).

them.[74] To avoid a worse outcome, the main trade associations representing hedge funds reversed course from 2007's repeal effort and agreed to accept increased disclosure obligations of their identity and holdings so long as the price and time of purchase requirements were removed from the Rule.

In the end, the Advisory Committee agreed with the hedge fund trade associations and proposed a new Rule 2019 that was approved by the Supreme Court on April 26, 2011 and became effective on December 1, 2011.[75] The new Rule 2019 eliminated the two requirements that the hedge fund community found most troubling: the disclosure of price and time of acquisition.[76] This eliminated the "offensive use" of Rule 2019 that hedge funds had complained about in 2007. However, the price of the elimination of those requirements was the elimination of any ambiguity as to whether Rule 2019 applied to hedge fund groups acting in concert to influence bankruptcy cases, increasing the disclosure obligations of activist investors – but to a level they had already decided to voluntarily comply with in most cases, as Judge Gerber noted above.

This leads to a testable hypothesis: if the new Rule 2019 eliminated the risk that activist investors would be forced to disclose sensitive information, we might expect to see higher levels of trading, but lower levels of information in the market. While the old Rule 2019 was clearly not an overwhelming concern for traders, the fact that they waged such a ferocious lobbying

[74] For a detailed explanation of the heightened disclosure requirements, see Mayer et al., New Bankruptcy Rule 2019: Brighter Lights, Darker Shadows. Kramer Levin Naftalis & Frankel, LLP. June 27, 2011, https://www.kramerlevin.com/images/content/2/0/v4/2073/Bankruptcy-Client-Alert-June-27-2011-Rule-2019-Brighter-Lights-Darker-Shadows.pdf.

[75] The court order approving the amendments, as well as the official text of the amendments, can be found at https://www.supremecourt.gov/orders/courtorders/frbk11.pdf

[76] The new Rule also required disclosure of "economic interests" whose value was affected by the bankruptcy case, a requirement aimed at Credit Default Swaps and other short positions but outside the scope of this Article.

campaign that resulted in an amended rule suggest that it was, in fact, something they cared enough about to devote resources to amending.

4.4.2. Did the New Rule 2019 Affect Trading in Distressed Bonds?

My identification strategy to evaluate the effect of the new Rule 2019 is to compare changes in bond market trading for bonds that appear to be more likely to default, where traders might anticipate having to make Rule 2019 disclosures in bankruptcy or sell to those who might make Rule 2019 disclosures, to healthy bonds that are less likely to default and where bankruptcy activism is likely further from the mind of investors. Accordingly, I assemble a dataset for all bond trades that took place in the three months before and after the new Rule 2019 implementation period in December of 2011 from TRACE and join it to CompuStat's dataset of firm financial characteristics and MergentFISD's information on bond issues.[77] I use the trading week as the unit of analysis because it allows me to identify trading subsequent to the implementation of the new Rule 2019 on December 1, 2011 and it also allows time fixed effects in all specifications. Time fixed effects are important, because liquidity is generally thought to have declined over the bond market generally after the financial crisis. I focus on short time periods around the change to try to avoid confounding effects.

I use the price of the bond as a measure of distress and default risk, which is consistent with prior literature that uses bond price to identify distressed debt.[78] I first compute a mean average traded price for each bond, then I divide the entire bond market into ten deciles

[77] I join the three datasets using CUSIP codes, which results in considerable attrition.

[78] *See* Edward I. Altman & Brenda J. Kuehne (2012) "The Investment Performance and Market Dynamics of Defaulted Bonds and Bank Loans: 2011 Review and 2012 Outlook." NYU Salomon Center, Working Paper, New York. HENRY F. OWSLEY & PETER S. KAUFMAN, DISTRESSED INVESTMENT BANKING: TO THE ABYSS AND BACK 6-7 (2005) call bond prices "sensitive to concerns about credit quality and solvency" and "a more reliable indicator of a company's financial health than stock price." In unreported results, I find that the results displayed below are similar if I instead use the yield-to-maturity implied by the bond's trading price.

corresponding to their price, with the lowest priced bonds in the tenth decile and the bonds with the highest mean price in the first decile.[79] I re-compute the deciles for each week in the sample. My independent variable of interest is a categorical variable that takes on a value corresponding to the decile of each week's average bond price. To account for unobserved heterogeneity across bond issues, I use a bond fixed effects specification with dummy variables for each bond issue. I omit the sixth decile, which means I am comparing trading in all of the other deciles to trading in the bonds whose market implied default risk is average.[80]

Figure 5. Average Days Before the Filing of First Rule 2019 Statement, by Comparable Firm Return over Chapter 11 Process.

[79] The results below are qualitatively similar if I use weekly price quarters as the independent variable of interest instead of deciles. This strategy is similar to the identification strategy in Schoenherr (2017), who divides his sample into five quintiles based on measures of default risk to explore the impact of a bankruptcy reform, where the firms less exposed to bankruptcy law might be, in theory, less affected.

[80] The results below are the same if I instead omit the first decile of bonds, to compare trading in the most distressed decile to trading in the least distressed decile.

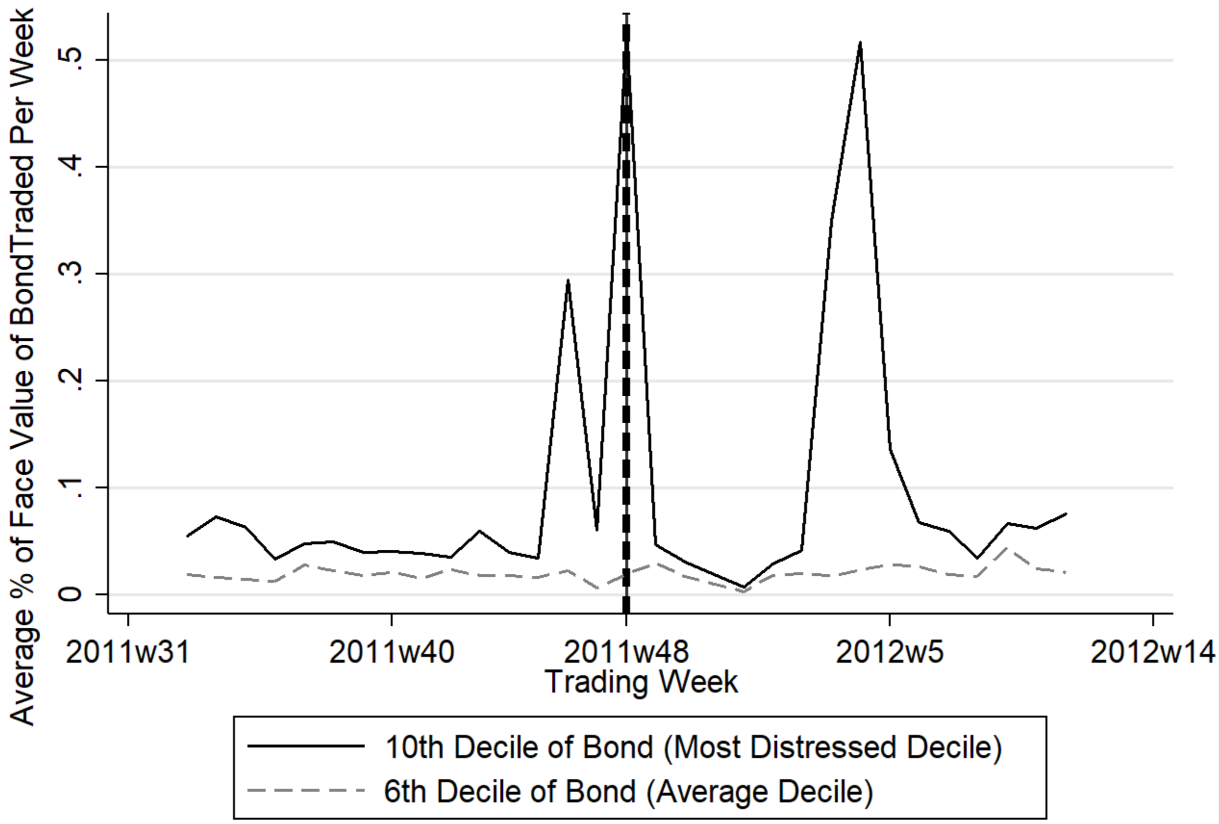

Figure 5 shows the average trading in the most distressed decile of bonds, as compared to the average bond, around the time that Rule 2019 was amended. The dotted line marks the week the new Rule 2019 came into effect. The identifying assumption in a difference-in-differences analysis is that the control group and the treatment group followed parallel trends prior to the rule change. Figure 5 shows the mean percentage of the bond issue trading in each week for the control decile, which is the 6th decile representing bonds with average risk, and the treatment decile, which is the 10th decile, corresponding to the most distressed bonds in the market. As the Figure shows, the two lines follow reasonably parallel trends until the new Rule 2019 came into effect, at which point a large number of very large trades in the most distressed decile meant that the two paths diverged. The sheer magnitude of the observed outlying trades suggests that caution is due in interpreting the results in this section, as a relatively small number of trades drive the result.

Table 1 shows the result of these specifications. I study two dependent variables: the percentage of the issue trading in each week, as a proxy for liquidity, and the estimated bid-ask spread as a proxy for the level of information in the market. I use three event windows, looking 15 weeks, 10 weeks and 3 weeks before and after the enactment of new Rule 2019. Longer event windows raise the probability of confounding variables, while shorter event windows reduce the sample size.[81]

Table 1. The Impact of the Amended Rule 2019 on Trading in Distressed Debt.

	(1) Log Total Percentage Traded in Week	(2) Log Total Percentage Traded in Week	(3) Log Total Percentage Traded in Week	(4) Log Weekly Mean Bidask Spread	(5) Log Weekly Mean Bidask Spread	(6) Log Weekly Mean Bidask Spread
1st Decile (Least Distressed Bond Decile)	0.233**	0.349**	0.458*	-0.253***	-0.247*	-0.383
	(0.113)	(0.142)	(0.268)	(0.088)	(0.133)	(0.301)
2nd Decile	-0.002	0.025	0.217	-0.352***	-0.407***	-0.360
	(0.089)	(0.110)	(0.221)	(0.074)	(0.108)	(0.285)
3rd Decile	-0.079	-0.088	0.104	-0.227***	-0.154*	0.051
	(0.072)	(0.092)	(0.176)	(0.058)	(0.079)	(0.183)
4th Decile	-0.069	-0.083	-0.038	-0.100**	-0.093	0.053
	(0.058)	(0.076)	(0.144)	(0.047)	(0.064)	(0.145)
5th Decile	-0.025	-0.014	-0.104	-0.045	-0.051	0.038
	(0.048)	(0.060)	(0.113)	(0.034)	(0.040)	(0.099)
7th Decile	0.163***	0.216***	0.280**	0.033	0.037	-0.141
	(0.052)	(0.061)	(0.113)	(0.037)	(0.048)	(0.106)
8th Decile	0.269***	0.277***	0.352**	0.109***	0.102**	-0.034
	(0.062)	(0.076)	(0.143)	(0.039)	(0.046)	(0.105)
9th Decile (Most Distressed Bond Decile)	0.385***	0.338***	0.719***	0.194***	0.244***	0.277**
	(0.074)	(0.090)	(0.182)	(0.045)	(0.053)	(0.120)
10th Decile (Most Distressed Bond Decile)	0.034	0.158	0.875***	0.194**	0.311***	0.301
	(0.107)	(0.138)	(0.271)	(0.080)	(0.079)	(0.186)
New Rule 2019 in Effect	0.093	0.089	-0.010	0.069	0.102	0.007

[81] 3 weeks is the narrowest window in which I observe the result displayed in Table 1.

	(0.087)	(0.091)	(0.109)	(0.070)	(0.072)	(0.080)
1st Decile x New 2019 (Least Distressed Bond Decile x New 2019)	-0.018	-0.039	-0.074	-0.040	-0.184***	-0.130
	(0.061)	(0.071)	(0.110)	(0.052)	(0.069)	(0.150)
2nd Decile x New 2019 (Second Least Distressed Bond Decile x New 2019)	0.018	-0.007	0.026	0.008	-0.048	0.018
	(0.063)	(0.075)	(0.117)	(0.045)	(0.057)	(0.097)
3rd Decile x New 2019	0.150**	0.132*	0.137	0.075	-0.036	-0.041
	(0.064)	(0.073)	(0.111)	(0.046)	(0.046)	(0.078)
4th Decile x New 2019	-0.006	0.004	0.136	-0.030	-0.117**	-0.020
	(0.058)	(0.069)	(0.113)	(0.045)	(0.054)	(0.085)
5th Decile x New 2019	0.050	0.059	0.159	-0.062	-0.118**	0.005
	(0.062)	(0.071)	(0.117)	(0.041)	(0.049)	(0.090)
7th Decile x New 2019	-0.049	-0.086	0.076	-0.033	-0.071	0.083
	(0.064)	(0.073)	(0.115)	(0.043)	(0.049)	(0.084)
8th Decile x New 2019	-0.166***	-0.108	0.100	-0.079*	-0.069	0.119
	(0.064)	(0.076)	(0.122)	(0.043)	(0.046)	(0.075)
9th Decile x New 2019	-0.273***	-0.156*	-0.143	-0.163***	-0.196***	-0.100
	(0.074)	(0.086)	(0.127)	(0.049)	(0.051)	(0.089)
10th Decile x New	0.207**	0.240**	0.281**	0.206***	0.058	0.134

2019						
	(0.099)	(0.105)	(0.138)	(0.071)	(0.062)	(0.124)
R^2	0.06	0.08	0.10	0.01	0.01	0.01
N	68,547	45,723	14,913	59,726	39,935	12,975
Firms	1133	1108	1046	1127	1103	1025
Sample Range from Rule Change	+/- 15 weeks	+/- 10 weeks	+/- 3 weeks	+/- 15 weeks	+/- 10 weeks	+/- 3 weeks
Bond FE	Yes	Yes	Yes	Yes	Yes	Yes
Week FE	Yes	Yes	Yes	Yes	Yes	Yes
Financial Controls	Yes	Yes	Yes	Yes	Yes	Yes

* p<0.1; ** p<0.05; *** p<0.01

Table 1 analyzes the impact of the new Rule 2019 on trading in distressed debt, where the decile of the most distressed debt in the market is identified using the average bond price over the course of a week. The dependent variable for Models 1 to 3 is the aggregate percentage of debt that traded, where the aggregate amount of observed trading is scaled by the original amount of the bond outstanding, as identified in MergentFISD. The variable of interest is the 10th Decile v. New Rule 2019, which isolates the change in trading volume for the most distressed decile of bonds that correlates with the implementation of the New Rule 2019. The omitted decile is the 6th decile, making each decile dummy a comparison against trading in the average bond in the dataset. For example, the results suggest that trading in the 10th decile in the three weeks before and after the rule change is 22% higher than trading in the average bond in the dataset. Standard errors clustered at the firm level are in parenthesis.

The results suggest that, while there appears to be no change in most deciles of the bond market after Rule 2019 was amended, trading volume appears to have increased, relative to the safest bonds, for the riskiest bonds. For example, in Model 3, trading increased about 32% for the riskiest decile of bonds. There are no consistent effects for any other decile in the sample. Additionally, the results from Models 4 suggest that the bid-ask spread also increased for the riskiest deciles, but I do not find the same result using the estimations in Models 5 and 6 and a shorter window.

Overall, the results support the view that changing the level of disclosure might affect the liquidity that the market provides to creditors. The most conservative interpretation of the finding is that traders may have cared enough about the rule change to delay buying and selling claims until after the disclosure risk had been eliminated. Given that the effect is driven by outliers, this interpretation seems reasonable.

5. Other Policy Concerns Raised by Claims Trading.

There are at least three other concerns raised by claims trading which have not been the subject of major scholarly debate or judicial decisions. I raise each briefly.

First, bankruptcy courts have become experts in mediating disputes between warring hedge funds holding claims at different levels of the capital structure, which may limit the capacity of bankruptcy courts to handle situations with different problems. This expertise has become, in many ways, the primary thing that bankruptcy courts do, leaving bankruptcy judges at the mercy of market participants when it comes to evaluating a distressed situation. The ongoing bankruptcy of the Pacific Gas and Electronic Gas Corporation reveals some of the weaknesses in the institutional capacity of bankruptcy judges. PG&E is Northern California's main electrical utility, and it is filed for bankruptcy in January of 2019 after its equipment caused wildfires that decimated entire cities in California to the tune of more than $20 billion in damages. Despite the tools bankruptcy law might offer to PG&E to rehabilitate its business, most of its Chapter 11 case thus far has centered on the bankruptcy judge mediating the dispute between the hedge funds that own its debt and the hedge funds that own its equity. It is not obvious that bankruptcy judges could do better in a different universe, but the orientation of the bankruptcy industry as a whole to serving activist investors and resolving their disputes may have reduced its overall capacity to use other tools.

Second, and relatedly, as lenders often build their underwriting models around selling the claim when the firm falls into financial distress, there may now be a knowledge gap between the "origination" side of lending and the "distressed" side. For example, a major bankruptcy court decision may not be known by the investment banks preparing corporate loan documents. One example of this is the so-called "J Crew maneuver," which exploited ambiguities in a collateral document that has not yet been fixed in the corporate lending market even years after the transaction shocked the market for corporate debt.[82] While there is no empirical evidence on this point yet, future research should investigate whether the speed of adjustment in the market for corporate finance has decreased as a result of the bankruptcy claims trade.

Third, the perception that bankruptcy courts are arenas for combat between warrior hedge funds may have reduced public confidence in the bankruptcy system. Again, the recent bankruptcy filing of PG&E provides an example. That case is currently characterized by fights between hedge funds over who will make the most money even though issues of intense public concern – how California can reduce the risk of wildfires – loom very large. In the Toys R Us bankruptcy, the largest Toy Retailer in America was forced to liquidate after a fight between distressed hedge funds.[83] The bankruptcy system depends on public confidence in the fairness and integrity of the process. To the extent the public comes to believe that the bankruptcy system is full of mercurial hedge funds who only care about their own interest, it may damage public confidence in a process that nearly always imposes difficult losses on employees and, in many cases, pensioners.

6. Conclusion.

[82] For a discussion of this problem, *see* Jared A. Ellias and Robert J. Stark, Bankruptcy Hardball, 108 Calif. L. Rev. 101 (2020). *See also* Rasmussen and Simkovic, *supra* note 50.
[83] *See* Gretchen Morgenson and Lillian Rizzo, Who Killed Toys 'R' Us? Hint: It Wasn't Only Amazon, Wall St. J. (Aug 23, 2018), available online at https://www.wsj.com/articles/who-killed-toys-r-us-hint-it-wasnt-only-amazon-1535034401.

This Report summarized the development of bankruptcy claims trading, the tactics and goals of activist investors and some of the policy questions claims trading and activists raise. While there can be no doubt that claims trading has dramatically changed bankruptcy practice, the evidence presented here suggests that, on average, bankruptcy judges and lawyers have been largely up to the challenges that claims trading has created, and American business writ large is likely better off for having a robust roster of experienced distressed investors wielding large pools of capital to rehabilitate distressed assets. I would encourage policymakers to continue down the road indicated by the new Rule 2019, by forcing additional disclosure into the marketplace of information about activist investors. It would be useful, for example, for more formal marketplaces to develop to provide public disclosure of pricing and trading volumes when a firm is in bankruptcy. In general, though, it is not obvious that radical changes are needed to the way claims trading is regulated and the past three decades provide every confidence that bankruptcy courts will continue to be up to the challenges created by new financial innovations and business cycles.

Appendix Table 1. Summary of Activist Investing Strategies

Assume: A Chapter 11 Debtor Can Reorganize in Transaction With a True Value of $650

Financial Contract and Amount Owed	Financial Position	Potential Activist Investor Strategy	Dangers for Activist
$100: Revolving Loan With Lien on Receivables	Deeply in the money; limited value to activists	1) **DIP Finance Investing**. Earn Profits by Providing DIP Financing 2) **Exit Finance Investing**. Earn Provides by Providing the Firm with Financing to Leave Bankruptcy.	1) The First Lien Lenders may want to provide DIP Financing themselves and fund the Debtors' bankruptcy; the Revolving Lender may be refinanced against its wishes or will have to reduce the price of DIP financing. The Second Lien Lenders may offer a defensive DIP Financing to block the First Lien Lenders from expropriating value. 2) Competition from First and Second Lien Lenders
$500: First Lien Debt with Blanket Lien	In the money; may control firm after bankruptcy case; attractive activist options that could be worth more than 100% of the First Lien Lenders' claim and downside is limited	1) **DIP Finance Investing**. Earn Profits by Providing DIP Financing 2) **Offensive Control Transaction**. Perhaps Use Covenants in DIP Financing to Buy Control of Bankruptcy Process; Steer Firm into Favored Transaction that Appraises Firm at $650, leaving First Lien Lenders with $550 in value on first day after Chapter 11 3) **Defensive Control Transaction**. Perhaps Use Covenants in DIP Financing to Buy Control of Bankruptcy Process; Keep Second Lien Lenders from expropriating Value; Steer Firm into Fair	1) May need to compete with Revolving Lenders, reducing the potential profits; Second Lien Lenders may seek to compete 2) As the firm can reorganized in a transaction valued at $650, the Second Lien Lenders may try to obtain a judicial ruling blocking a expropriative plan or provide their own rival financing package, perhaps re-financing the First Lien Lenders and limiting their upside. 3) As above, potential competing, expropriative DIP loan from Second Lien Lenders who can at very least put pricing pressure on First Lien Lenders

		Transaction that Under appraises Firm at Less than Market Value, leaving First Lien Lenders with more value than they deserve. 4) **<u>Exit Finance Investing</u>**. Earn Profit by Providing the Firm with Financing to Leave Bankruptcy.	4) Competition from Revolver and Second Lien Lenders.
$100: Second Lien Debt with Subordinated Blanket Lien	Barely at the money depending on how the firm is appraised; attractive activist options, could try to acquire control of firm and earn return through operational improvements; can also litigate for side payments	1) **<u>DIP Finance Investing</u>**. Earn Profits by Providing DIP Financing 2) **<u>Offensive Control Transaction</u>**. Perhaps Use Covenants in DIP Financing to Buy Control of Bankruptcy Process; Steer Firm into Favored Transaction that Appraises Firm at more than $650, expropriating value that would otherwise go to First Lien Lenders 3) **<u>Defensive Control Transaction</u>**. Perhaps Use Covenants in DIP Financing to Buy Control of Bankruptcy Process; Keep First Lien Lenders from Expropriating Value; Steer Firm into Fair Transaction that Appraises Firm at Market Value . 4) **<u>Exit Finance Investing</u>**. Earn Profit by Providing the Firm with Financing to Leave Bankruptcy. 5) **<u>Invest in Defensive Litigation</u>**. Even if First Lien Lenders buy control of the firm with DIP Financing, invest in litigation to defend value entitlements.	1) Second Lien Lenders are typically in a poor position to out-compete First Lien Lenders for DIP Financing, although it does happen from time-to-time; bankruptcy code requires any DIP financing that provides the lender with a priming lien to provide the First Lien Lenders with “Adequate Protection.” 2) As the Second Lien Lenders are likely to lose a competition over providing financing, they will struggle to buy control of the Chapter 11 with DIP financing. 3) The First Lien Lenders or Unsecured Creditors are likely to fight back. 4) Competition from other creditors to provide exit financing. 5) Could lose in court. 6) Could lose in court.

		6) **Invest in Offensive Litigation**. Use judicial process to try to obtain ruling or stall bankruptcy process to acquire bargaining power that compels First Lien Lenders to pay settlement that provides Second Lien Lenders with more than $50 in a recovery	
$1000: Unsecured bond debt	Out of the money; limited activist upside	1) **Litigate for Hold-Up Value.** Invest in litigation to create uncertainty for senior creditors to earn settlement as return on investment in litigation.	1) Evidence suggests that hold-up value settlements are not very valuable and legal services are expensive, which means this investment may not work out well. The bankruptcy judge may neutralize whatever litigation tactics the unsecured bondholders deploy.
Equity	Out of the money; negligible value for activists	1) **Litigate for Hold-Up Value.** Invest in litigation to create uncertainty for senior creditors to earn settlement as return on investment in litigation.	1) As the shareholders are way out of the money, hold-up litigation will be an uphill battle unlikely to yield a return.