THE DEBTOR IS DEAD, LONG LIVE THE DEBTOR*

I. Introduction

Bankruptcy reorganization in the United States has traditionally offered a bankrupt debtor the opportunity to seek a "fresh start" from its creditors and reorder its affairs to move forward without the pressure of outstanding debts.[1] Though this may be just one of many aims promoted by the current bankruptcy framework,[2] the architecture of the present-day Bankruptcy Code (the Code)—implemented by the Bankruptcy Reform Act of 1978[3]—is described by one commentator as a system whereby "an inadequate pie" is divided among creditors to share in the remains of a bankrupt enterprise.[4]

Under this framework, debtors may use the Code to address a number of economic issues facing a struggling corporation, all in an effort to preserve the corporate enterprise under the debtor's same management.[5] There are a number of recent examples demonstrating that debtors control their fate as they reach the precipice of bankruptcy,[6] even though we might intuitively expect debtors to seek legal protection only after creditors come in search of repayment. Indeed, the legislative history surrounding the Bankruptcy Reform Act emphatically rejected any proposition that creditors dominated the bankruptcy reorganization process:

> The notion of creditor control, while still theoretically sound, has failed in

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1. *See, e.g.*, Grogan v. Garner, 498 U.S. 279, 286–87 (1991) (discussing aims of bankruptcy law following reforms in 1978); Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (describing goal of bankruptcy law prior to 1978 reform measures); *see also In re* Scarpiello, 240 B.R. 203, 208 (Bankr. E.D. Pa 1999) (explaining that discharge from bankruptcy is "the embodiment of this 'fresh start' principle").

2. *See, e.g.*, S.R. REP. NO. 95-989, at 2 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5788 ("The major purpose of this bill is the modernization of the bankruptcy laws.").

3. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1532 (2006)).

4. Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785 (1987).

5. DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 221 (2001).

6. *See* David A. Skeel, Jr., *Bankruptcy Phobia*, 82 TEMP. L. REV. 333, 338 (2009) (noting the former CEO of GM's hesitancy to file for bankruptcy for fear that it would discourage consumers from buying GM cars). One corporate spokesperson recently addressed described a bankruptcy filing as an option that was neither a "goal [n]or preference" for its board of directors. Mary Schlangenstein, *AMR Bankruptcy Risk Rises as Lack of Pilot Deal Cuts Options*, BLOOMBERG (Nov. 16, 2011, 4:21 PM), http://www.bloomberg.com/news/2011-11-16/amr-bankruptcy-risk-rises-as-lack-of-pilot-deal-narrows-options.html. Even discussing a bankruptcy in such terms suggests that the debtor views bankruptcy as a procedure or tool that offers some measure of control and is a legitimate method for restructuring the enterprise and effectuating corporate policies. *See* SKEEL, *supra* note 5, at 9 ("No other bankruptcy system in the world gives the managers of a troubled firm so much influence.").

> practical terms. Creditor control in bankruptcy cases is a myth. Creditors take little interest in pursuing a bankrupt debtor. They are unwilling to throw good money after bad. As a result, creditor participation in bankruptcy cases is very low. . . .
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> . . . . In practice, creditor control has become attorney control, and the bankruptcy system operates more for the benefit of attorneys than for the benefit of creditors. The practices that have grown out of this shift of control often work to the detriment of both debtors and creditors. They benefit only those administering bankruptcy cases.[7]

In spite of congressional skepticism regarding the creditor's role in reorganization, congressional faith in the debtor seems misplaced; creditors retain significant protection of their interests under the Code.[8]

Recent analyses of corporate bankruptcies demonstrate that creditors have taken a more prominent role in the bankruptcy process, becoming a driving factor in corporate reorganizations filed under Chapter 11.[9] Though Congress may have manifested an initial intent that the debtor would be the driver of the bankruptcy process, examples in recent years have demonstrated the immense powers retained by secured creditors.[10] The dominance of the secured creditor in the bankruptcy process should come as no surprise—a security interest bestows tremendous advantage on a creditor to ensure the protection of its loan to a debtor.[11] Despite the fact that secured creditor control may appear to be an inequitable outcome for a process designed to be friendly to a debtor's fresh start, the institutional protections guaranteed to secured creditors in bankruptcy are institutional advantages bestowed by a system in which security interests are granted to creditors. In recent years, various commentators have proposed changes to the Code in an effort to prevent abuses that seem to further entrench the powers granted to secured creditors.[12] However, the Code fundamentally manifests advantages for secured creditors in its structure, and reforms to the Code would ultimately fail to make the debtor dominant so long as secured creditors can still retain these institutional advantages. Though proposed changes might attempt to improve a debtor's standing in the bankruptcy reorganization process to better effectuate Congress's 1978 belief that creditor control is merely a "myth," the structure of the Code empowers secured creditors to dominate the reorganization process.

This Comment addresses the advantages of creditor control by tracing bankruptcy

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7. H.R. REP. NO. 95-595, at 92 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6053 (footnotes omitted).

8. See *infra* Part III.B and III.C for a discussion of the bankruptcies of Radnor Holdings Corporation and Trans World Airlines, which serve as examples of how creditors may influence the bankruptcy reorganization process, as compared to those tools reserved to the debtor.

9. *See, e.g.*, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 538 (2009) ("[C]reditor control is pervasive.").

10. *Id.* at 538–39. See *infra* Parts II.B and II.C for a discussion of the role of debtors and creditors in the bankruptcy negotiation process, and their respective statutory rights.

11. LYNN LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH xxxi (7th ed. 2011).

12. *See, e.g.*, Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1668 (2009) (suggesting increased disclosure requirements to diminish the influence of disruptive creditors); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1748–49 (1996) (describing a proposed system of "equitable relief from claims trading").

legislation dating to Congress's first statutes under its constitutional authority to make laws governing bankruptcy.[13] After examination of the influence of nineteenth century bankruptcy legislation and New Deal reforms,[14] the 1978 Bankruptcy Reform Act, as codified and adopted today, is examined in detail to highlight the various tools available to both debtors and creditors seeking to reorganize a bankrupt corporate entity.[15] With a firm understanding of the Code and its underpinnings, this Comment addresses the advantages bestowed on secured creditors in bankruptcies by examining two recent bankruptcies, reviewing the important role of secured creditors in each case.[16] In light of these case studies, Section III reviews these case studies and proposals to reform the Code with an eye towards elements of creditor control. Part III.E concludes that efforts to address creditor advantages through reforms of the Code are ultimately inadequate, as the Code institutionalizes structural advantages under the system of secured credit.

II. OVERVIEW

A. *The Historical Context: The 1978 Bankruptcy Code and the Road to Chapter 11*

The now-familiar legal process of bankruptcy is still a relatively new creature of American law, with our current system reaching its thirty-fifth anniversary as part of the United States Code.[17] Though businesses and consumers have long faced issues of insolvency,[18] the American legal framework for accommodating a business debtor's insolvency has undergone multiple iterations since first being formalized in the early nineteenth century.[19] Though the historical path of bankruptcy legislation may appear inconsistent given the sheer number of bankruptcy statutes since 1800,[20] a review of prior legislative action demonstrates certain themes that influence the laws currently governing the bankruptcy process.

13. See *infra* Part II.A for an analysis of Congress's authority and specific bankruptcy acts leading up to the Code.

14. See *infra* Parts II.A.2 to II.A.4 for an examination of the influence of railroads and the factors leading up to New Deal changes to the Code.

15. See *infra* Part II.B for an overview of the Code as amended and currently in effect.

16. See *infra* Parts II.D, III.B, and III.C for the factual background on these case studies examining *In re Trans World Airlines* and *In re Radnor Holdings*.

17. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101–1532).

18. Congress's first bankruptcy statute dates to 1800, when Congress constructed a system whereby debtors could petition the local district court for protection from creditors seeking repayment of delinquent debts, preempting state law. Act of April 4, 1800, ch. 19, §§ 1–64, 2 Stat. 19 (repealed 1803).

19. *See* SKEEL, *supra* note 5, at 5.

20. *E.g.*, Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978); Act of June 7, 1878, ch. 160, 20 Stat. 99 (1878) (repealed 1898); Act of March 2, 1867, ch. 176, 14 Stat. 517 (repealed 1878); Act of Mar. 3, 1843, ch. 82, 5 Stat. 614 (1843) (repealed 1867); Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 (repealed 1843); Act of Dec. 19, 1803, ch. 6, 2 Stat. 248 (1803) (repealed 1841); Act of April 4, 1800, ch. 19; *see also*, SKEEL, *supra* note 5, at 3–5 (discussing the number of separate bankruptcy acts throughout the nineteenth and twentieth centuries).

1. The Constitutional Underpinnings of Federal Bankruptcy Laws

Laws regarding the regulation of bankruptcy by the federal government date to the ratification of the Constitution in 1787.[21] As a prerequisite to bankruptcy legislation, the Constitution establishes that Congress retains the power, "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[22] Despite the straightforward language adopted by the drafters of the Constitution, federal bankruptcy laws were anything but settled prior to 1898.

From the ratification of the Constitution through the turn of the twentieth century, federal bankruptcy laws were frequently short-lived and subject to intense debates among politicians.[23] "All told, then, Congress passed three federal bankruptcy laws prior to 1898: the Bankruptcy Acts of 1800, 1841, and 1867. Together, the acts lasted a total of sixteen years."[24] The politics of the haphazard legislative history were not entirely black-and-white; rather, debates of the day took a slightly more nuanced tone representing three distinct positions.[25] Senator Daniel Webster, representing northern commercial interests in the nineteenth century, served as a spokesman for an "expansive and permanent federal bankruptcy framework."[26] In contrast, Senator John Calhoun of South Carolina, representing the Southern agrarian interests, "embodied the opposing view that federal bankruptcy legislation would be a serious mistake."[27] Senator Henry Clay of Kentucky, who advocated for a federal bankruptcy framework applying only to "voluntary bankruptcy," represented a third perspective that was "similarly influential" to the ones espoused by his colleagues.[28] The debate among these three positions was highly polarizing and tied to strongly held constituent interests, contributing to the instability of bankruptcy legislation and disagreement within Congress during the nineteenth century.[29]

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21. U.S. CONST. art. I, § 8, cl. 4.

22. *Id.*

23. SKEEL, *supra* note 5, at 23.

24. *Id.* at 25. Those acts were codified as the following: Act of June 7, 1878, ch. 160, 20 Stat. 99 (1878) (repealed 1898); Act of March 2, 1867, ch. 176, 14 Stat. 517 (repealed 1878); Act of Mar. 3, 1843, ch. 82, 5 Stat. 614 (1843) (repealed 1867); Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 (repealed 1843); Act of Dec. 19, 1803, ch. 6, 2 Stat. 248 (1803) (repealed 1841); Act of April 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).

25. SKEEL, *supra* note 5, at 28.

26. *Id.* Senator Webster's concerns were influenced by the commercial pursuits of many of his constituents; a uniform federal bankruptcy power that protected debtors by offering both voluntary and involuntary structures for bankruptcy protection logically appealed to the northern merchant class. *Cf.* CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 60 (1935) (explaining dynamics of regional interests in bankruptcy legislation).

27. SKEEL, *supra* note 5, at 28. Senator Calhoun's objections rested substantially on his opposition to the exercise of federal power, which led to the position that the states ought to retain the right to force or protect debtors from their obligations; a superior outcome to letting the federal government secure ever greater powers over the states. *Cf.* WARREN, *supra* note 26, at 61–62 (noting that many Democrats, including Senator Calhoun, opposed any type of national bankruptcy law).

28. SKEEL, *supra* note 5, at 28 (citing WARREN, *supra* note 29, at 62–63). Senator Clay saw no need for involuntary bankruptcy protections and moved to strike those provisions from the 1841 bill. WARREN, *supra* note 26, at 62–63.

29. *See* SKEEL, *supra* note 5, at 28–34. Skeel describes the "voting irregularity" created by each of the respective Senators' second and third choices for the bankruptcy regime, resulting in a situation where

Though Congress was practically paralyzed over the substance of federal bankruptcy legislation in the nineteenth century, there was little true debate over whether Congress retained the power to create such legislation.[30] The constitutional framework governing federal bankruptcy laws required "uniformity" and consistency in the United States, and while politicians argued over the merits of a particular piece of legislation, opponents who sought to invalidate bankruptcy laws for lack of uniformity were fairly unsuccessful.[31] By the late twentieth century, uniformity meant that Congress retained the ability to treat different types of debtors (that is, corporate versus personal) in different fashions, but Congress could not enact a bankruptcy law that privileged one specific debtor over another.[32]

As Congress struggled with a variety of different bankruptcy schemes during the nineteenth century, the states retained some flexibility in the creation of bankruptcy and insolvency law. Prior to 1898, states adopted laws governing insolvent debtors to "fill[] the gap[s]," before federal bankruptcy law offered a comprehensive regime for debtors and creditors to resolve their disputes.[33] Even before Congress passed a more stable bankruptcy regime in 1898, state laws could serve as gap fillers, but would be

consensus on the broad legal framework of bankruptcy would be impossible. *Id.* at 30. Because of the preferences held by each spokesperson, logical allies had no ground for compromise; that is, Senator Webster's ideal solution would have built a bankruptcy system with mechanisms for both voluntary and involuntary bankruptcy protection, with Webster's second choice being a system with only voluntary bankruptcy protection. *Id.* His logical ally, Senator Clay, held firmly to the proposition that bankruptcy protection should be reserved to voluntary filings, but if that could not come to fruition, his second choice was that there be no bankruptcy legislation at all to avoid a system where debtors could be placed into bankruptcy protection against their will. *Id.* Introducing a third position with similarly conflicting views resulted in a nasty cycle creating only gridlock in the legislative process. *Id.*

30. *Cf.* Ry. Labor Exec. Assoc. v. Gibbons, 455 U.S. 457, 469 (1982) ("Prior to today, this Court has never invalidated a bankruptcy law for lack of uniformity."); *see also* SKEEL, *supra* note 5, at 27 ("As the nineteenth century wore on, the Supreme Court rejected several of the arguments for a narrow reading of the Bankruptcy Clause." (citing Sturges v. Crowninshield, 17 U.S. 122 (1819)). On the other hand, Democrats and Whigs in the nineteenth century could credibly argue that bankruptcy legislation only offering legal protections for a system of voluntary bankruptcy was nothing more than a "pure insolvent law," different from the bankruptcy powers discussed and granted at the constitutional convention. WARREN, *supra* note 26, at 61–62.

31. *Gibbons*, 455 U.S. at 469. "The uniformity requirement is not a straitjacket," and was never used to strike down bankruptcy legislation prior to 1982. *Id.* The *Gibbons* Court determined that the Rock Island Railroad Transition and Employee Assistance Act ran counter to Congress's enumerated powers, resulting in the first invalidation of a bankruptcy law for lack of uniformity (or any other constitutional ground). *Id.* at 470–71.

32. *See id.* at 473 ("To survive scrutiny under the Bankruptcy Clause, a law must at least apply uniformly to a defined class of debtors. A bankruptcy law . . . confined as it is to the affairs of one named debtor can hardly be considered uniform."); Blanchette v. Conn. Gen. Ins. Corp., 419 U.S. 102, 159–61 (1974) (upholding a federal statute applying specifically to railroad debtors in the midst of reorganization, on the grounds that the act treated a certain class of debtors in a consistent manner even if that treatment did not apply equally in a geographic sense).

33. SKEEL, *supra* note 5, at 23. The stopgap bankruptcy laws applied by some states were undoubtedly tenuous; while state insolvency laws were not called into question, state laws on bankruptcy could be overturned as a clearly unconstitutional exercise of a power reserved by Congress. *See, e.g.*, Golden v. Prince, 10 F. Cas. 542, 545–46 (C.C.D. Pa. 1814) (No. 5,509) (explaining power vested in Congress to create bankruptcy laws and relevant principles of federalism).

superseded by federal legislation relevant to the dispute.[34] Thus, the years leading up to New Deal reforms lacked some level of consistency—federal laws came into effect and were quickly repealed—while state laws created a patchwork system unique to each state. Despite the legislative upheaval, the constitutionality of a federal bankruptcy statutory scheme was never seriously in doubt.

2. The Role of the Railroads and Equity Receivership

In the midst of America's unsettled bankruptcy regime, complex corporate organizations facing insolvency made use of the common-law doctrine of equity receivership to facilitate an orderly process for collecting outstanding debts.[35] In particular, struggling railroads in twentieth-century America were a "capital intensive" endeavor with little liquidation value, creating a significant challenge for creditors to collect outstanding debts.[36] Despite its flexibility, the equity receivership process failed to facilitate a framework for reorganization; instead, it constructed a framework designed to preserve the value of the railroad's assets, while creditors took apart the corporation to satisfy debts.[37] Equity receivership and its application to railroads was originally applied to an era of less complicated (and smaller-scale) issues of railroad insolvency, but as railroads grew in size and scope beyond a single geographic state, "creditors and their lawyers developed their own rules."[38] These new rules were necessary because the legislative framework (if it even passed Congress) failed to address insolvency issues for corporations until 1867.[39]

Equity receivership proceeded in just a few discrete steps that appear as almost

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34. Stellwagen v. Clum, 245 U.S. 605, 613 (1918) ("In such cases the [federal] bankruptcy proceedings, taken within four months, displace those in the state court and terminate the jurisdiction of the latter." (citing Randolph v. Scruggs, 190 U. S. 533, 537 (1903); *In re* Watts, 190 U.S. 1, 31 (1903))); *Ex parte* Eames, 8 F. Cas. 236, 237 (C.C.D. Mass. 1842) (No. 4,237) (holding that state insolvent law is preempted by federal bankruptcy law when insolvent law and federal law apply to citizen of that state).

35. Benjamin A. Berringer, Note, *"It's All Just a Little Bit of History Repeating:" An Examination of the Chrysler and GM Bankruptcies and Their Implications for Future Chapter 11 Reorganizations*, 7 N.Y.U. J.L. & BUS. 361, 365 (2011).

36. SKEEL, *supra* note 5, at 49–51.

37. *Id.*; Berringer, *supra* note 35, at 365.

38. SKEEL, *supra* note 5, at 57. This process of receivership has been characterized as inefficient, as the process was not tailored to the unique needs of large railroad enterprises that spanned across state lines. *Id.* An early use of equity receivers to distribute the assets of insolvent railroads can be traced to the equitable action of Georgia state courts in 1845. Oscar Lasdon, *The Evolution of Railroad Reorganization*, 88 BANKING L.J. 3, 6–7 (1971). In that early case, the Georgia Supreme Court endorsed the distribution of the assets of the insolvent Monroe Railroad and Banking Company among multiple creditors, rather than permitting a payout to just one class of creditors. Collins v. Cent. Bank of Ga., 1 Ga. 435, 435–36 (1846). The state power used to facilitate this distribution was challenged by a class of creditors claiming that all the assets of the corporation should have rightfully gone to satisfy their debt, but Georgia's courts of equity stepped in at the behest of other creditors in an effort to more evenly distribute the corporation's assets. *Id.*

39. SKEEL, *supra* note 5, at 57. In an exercise of congressional brevity, the 1867 Act only included two sections discussing unique provisions for corporations and partnerships seeking bankruptcy protection. Act of Mar. 2, 1867, ch. 176, §§ 36–37, 14 Stat. 517 (repealed 1878). In comparison, the Code today covers the entirety of Title 11, with Chapter 9 dedicated to municipalities and Chapter 13 dedicated to individual consumer reorganization, while almost the rest of Title 11 at least applies to the bankruptcy of corporations in some form. *See* 11 U.S.C. § 103 (2006) (giving general guidelines for application of individual chapters).

parallel with today's bankruptcy reorganization process. These steps required insolvent railroads seeking protection from creditors to appoint a receiver at the start of the receivership process, in order to prevent creditors from reaching the assets of the insolvent railroad until a sale process could begin.[40] While the next step required the initiation of a foreclosure sale,[41] a reorganization negotiation would begin wherein committees representing both equity and debt holders would jockey among one another to protect their own interests in the "new capital structure of the corporation."[42] The final step in the process, after negotiations were complete, combined each of the committees to form one large "reorganization committee," which purchased the insolvent railroad at a foreclosure sale, using the value of the creditors' claims to outbid any potential competition and structured the new equity and retooled debts according to the already-concluded negotiations among stakeholders in the bankruptcy.[43] By the end of the reorganization process, large and influential creditors generally were successful in rearranging the structure of the railroad in receivership in a fashion that tended to disadvantage public equity holders.[44] While the common law provided flexibility in reorganizing large and complex debtors, the informal receivership process seemed to be controlled by a small number of influential parties, steering the resolution in their favor.

3. Rise of the Securities and Exchange Commission and Structural Shifts in the Bankruptcy Regime

Entering the twentieth century and the unique economic events surrounding the Great Depression and New Deal reforms, the Bankruptcy Act of 1898 remained in effect and maintained the "ongoing compromise between creditors and pro-debtor interests."[45] Nearly forty years after passage of the 1898 Act, William O. Douglas—prior to his service on the Supreme Court—began working to upset the balance between those interests.[46] In 1934, Douglas's appointment to the newly formed Securities and Exchange Commission (SEC) began a significant process of reform for the bankruptcy process in the United States.[47] In the passage of the Securities Exchange Act of 1934, Congress mandated that the SEC conduct a study to "investigate[] . . . the

40. *See* SKEEL, *supra* note 5, at 58 ("The principal reason for appointing a receiver was that putting the receiver in place technically shifted control of the railroad's assets . . . out of the reach of prying creditors."). While the power to appoint a receiver still exists today under relevant state and federal statutes, the bankruptcy process laid out in the Code preempts this form of receivership and requires debtors to use tools like trustees or the debtor in possession to effectuate Congress's aims in passing the 1978 Bankruptcy Code. *E.g.*, *In re* Bayou Group, LLC, 363 B.R. 674, 688–90 (S.D.N.Y. 2007).

41. SKEEL, *supra* note 5, at 58.

42. Berringer, *supra* note 39, at 365–66 (citing SKEEL, *supra* note 5, at 58–59).

43. SKEEL, *supra* note 5, at 59.

44. For example, one plan of reorganization effectively disenfranchised an unsecured creditor in the insolvency reorganization of the Coeur D'Alene Railway & Navigation Company, instead promoting the interests of equity holders of the Northern Pacific Railway who should have been subordinate to the unsecured creditor. *See* N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 502–08 (1913).

45. SKEEL, *supra* note 5, at 100.

46. *Id.* at 110–11.

47. *Id.* at 108–09.

work, activities, personnel, and functions of protective and reorganization committees in connection with the reorganization, readjustment, rehabilitation, liquidation, or consolidation of persons and properties and to report the result of its studies and investigations and its recommendations to the Congress on or before January 3, 1936."[48]

The results of the landmark study, titled *Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees: Strategy and Techniques of Protective and Reorganization Committees*, shocked its authors and spurred the beginnings of major reforms surrounding insolvent companies seeking protection from creditors.[49] The results of the study focused on the "dominance" of the reorganization practice by the lawyers and investment bankers of Wall Street.[50] The study concluded that:

> The bankers paid themselves generous fees for running the reorganization, including a substantial underwriting fee when the firm issued new securities to its old investors. The lawyers, too, received their fees before anyone else was paid, and, because the cases sometimes lasted several years, the lawyers' fees might run to millions of dollars.[51]

Douglas's findings "led the New Deal charge into bankruptcy," where the harmony between interests was finally upset.[52] In particular, the report called for the appointment of trustees and the ouster of management in an effort to curb "Wall Street's stranglehold" on the practice of complex corporate reorganizations.[53]

With pressure building from Douglas and the SEC, equity receivership moved into disfavor, and pro-debtor attitudes ascended in popularity among lawmakers.[54] These pro-debtor attitudes were born out in the Chandler Act,[55] which updated both the "substantive law and procedural workings" of relevant bankruptcy law and improved the administration of cases.[56] The "defining provision" of the reforms included a

48. Securities Exchange Act of 1934, Pub. L. No. 291-73, § 211, 48 Stat. 881, 909 (1934). The final report was released three years later. *See* SECURITIES & EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES: STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937) [hereinafter SEC REPORT].

49. SKEEL, *supra* note 5, at 110–11.

50. *Id.* at 110.

51. *Id.*; *see also* SEC REPORT, *supra* note 48, § 1, at 4 (highlighting the "vast amount of business patronage present in any reorganization").

52. SKEEL, *supra* note 5, at 112. In a release accompanying Douglas's report, the SEC trumpeted the findings that the "banker-management" groups that won the battle for control at the outset of a corporate bankruptcy frequently reaped tremendous rewards in fees, commissions, underwriting discounts, and the profits of the reorganized entity. Securities Exchange Commission Release Notice, Securities Exchange Act Release No. 34-1189, 1937 WL 31518, at *1 (May 10, 1937). Douglas's report helped inform future legislative efforts, as mandated by the Securities Exchange Act of 1934, which authorized his report. *Id.*

53. SKEEL, *supra* note 5, at 110–13; *see also* SEC REPORT, *supra* note 48, § 5, at 897–98 (reporting the study committee's recommendations).

54. Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 28 (1995).

55. Chandler Act of 1938, Pub. L. No. 75-575, § 1, 52 Stat. 840 (1938).

56. Tabb, *supra* note 54, at 29. The changes were far reaching and "immediate." SKEEL, *supra* note 5, at 125. With the Chandler Act in hand, significant updates were made to bankruptcy law and the administration

mandatory trustee appointment for any debtor with liabilities exceeding $250,000.[57] Chapter X, the relevant section of the Chandler Act for large corporate reorganizations,[58] imposed a condition of reorganization that the trustee be "disinterested," barring any parties involved with outstanding securities of the debtor from taking a role in the reorganization until after an outsider trustee was appointed and a plan was built for acceptance by the court.[59] Accompanying the reforms of the Chandler Act, the SEC pressed Congress for passage of the Trust Indenture Act, which gave each bondholder the right to vote individually on restructuring terms of an outstanding bond.[60] By doing so, Congress effectively limited the ability of creditors to band together in the cozy arrangement that marked the days of equity receivership.

4. The Dawn of the Code

While the Chandler Act was amended periodically after its initial passage,[61] its requirements for the appointment of disinterested trustees in corporate reorganizations remained in place for forty years, until calls for reform began the process of building a refreshed method for facilitating reorganization.[62] The process of amending the bankruptcy regime took nearly ten years from the initiation of congressional hearings to the final passage of the 1978 Bankruptcy Reform Act.[63] The debate, negotiations, and competing plans over those ten years considered multiple shortcomings stemming from the Chandler Act, but ultimately, the success of the Chandler Act led to its demise.[64]

The Chandler Act's Chapter X, the provision applying to large, publicly traded corporate entities,[65] was not the only provision that could apply to a corporate bankruptcy. Chapter XI offered a path to reorganization in which "the debtor's

of corporate bankruptcy cases, as compared to mid-nineteenth-century legislation. See *supra* note 45 and accompanying text for information on the minimal congressional framework in existence before the Chandler Act updated the Bankruptcy Act of 1898. The continued presence of the equity receiver did not entirely disappear after Douglas's findings were incorporated into the 1938 legislative action; instead, Congress chose to insert language that "a trustee, upon his appointment and qualification . . . shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor." Chandler Act § 187.

57. SKEEL, *supra* note 5, at 119.

58. Chandler Act § 101.

59. SKEEL, *supra* note 5, at 120.

60. Trust Indenture Act of 1939, Pub. L. No. 76-411, § 301, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa–77zzz); SKEEL, *supra* note 5, at 121.

61. *See, e.g.*, Act of July 7, 1952, Pub. L. No. 82-456, § 1, 66 Stat. 420 (amending procedural aspects of Chandler Act). After holding that a bankruptcy case inappropriately filed under Chapter XI of the Chandler Act (as amended) had to be dismissed in *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 456–57 (1940), the 1952 amendment gave the debtor the power to amend their bankruptcy petition and seek relief from more appropriate sections of the Chandler Act framework, as necessary, Act of July 7, 1952 § 30. In an explanation of Congress's intentions for the 1952 Amendment, the House of Representatives included a report noting that the "bill represents the unanimous views of the conference [an advisory body of bankruptcy professionals] on what might be called clarifying and perfecting changes deemed necessary [to update the Chandler Act]." H.R. REP. NO. 82-2320, at 2 (1952), *reprinted in* 1952 U.S.C.C.A.N. 1960, 1961.

62. SKEEL, *supra* note 5, at 136; Tabb, *supra* note 54, at 32.

63. Tabb, *supra* note 54, at 32.

64. SKEEL, *supra* note 5, at 161; Berringer, *supra* note 35, at 369.

65. Chandler Act of 1938, Pub. L. No. 75-575, § 126, 52 Stat. 840, 885 (1938).

managers retained control, [the onerous burden of] absolute priority was not required, and the SEC was nowhere to be seen."[66] While Chapter XI only permitted debtors to restructure unsecured debt obligations, "nothing in the Chandler Act explicitly *required* a publicly held firm to use that chapter."[67] Given an option, a publicly traded debtor that belonged in Chapter X (under the spirit of the Chandler Act, if not under its written requirements) would almost always prefer to seek Chapter XI protections, given that the current management would remain in place while debt restructuring could be worked out.[68] Creditors also wished to avoid the burdens of Chapter X, where any voice they might have had in a Chapter XI reorganization would be diminished due to the appointment of the disinterested trustee (and subsequent loss of control of the process to that trustee).[69]

Though the SEC fought to keep large, publicly traded debtors in Chapter X regardless of the debtor's preference, the Supreme Court rejected any bright-line test in favor of an individualized review of each debtor.[70] In *General Stores Corp. v. Shlensky*,[71] the Supreme Court considered a debtor seeking bankruptcy protection under Chapter XI despite having a (relatively small) number of equity shares outstanding and debt traded on public markets.[72] Under its analysis, the Court concluded that "[t]he character of the debtor is not the controlling consideration in a choice between c. X and c. XI. . . . The essential difference is not between the small company and the large company but between the needs to be served."[73] By concluding that publicly traded companies need not file under Chapter X, the Court permitted attorneys to once again mold bankruptcy cases into instances where debtors and creditors could negotiate the resolution they sought to achieve.[74]

As debtors and creditors once again circumvented efforts at their cozy arrangements for reorganizations, the Bankruptcy Reform Act of 1978 stepped into the breach, pinning back the role of the Chandler Act's bankruptcy trustee in the new reorganization process.[75] Support for a more flexible corporate reorganization process returned, and the rehabilitation of debtors through negotiation became more palatable to lawmakers and the interest groups lobbying them.[76] Rather than permitting two different reorganization chapters, the Code brought provisions of Chapters X and XI of the Chandler Act together, "streamlin[ing] [the] reorganization practice."[77] In particular, Chapter 11 of the Code

left the debtor in possession, with a trustee to be appointed only for cause;

66. SKEEL, *supra* note 5, at 162.

67. *Id.* (emphasis in original).

68. *Id.* at 162–63.

69. Berringer, *supra* note 35, at 370 (citing Eric Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 109–11 (1997)).

70. Gen. Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956); SKEEL, *supra* note 5, at 164.

71. 350 U.S. 462 (1956).

72. *Shlensky*, 350 U.S. at 463.

73. *Id.* at 466.

74. SKEEL, *supra* note 5, at 164.

75. *Id.*

76. *Id.* at 180–81.

77. Tabb, *supra* note 54, at 35.

> gave the debtor in possession a limited exclusive period to file a reorganization plan; adopted a modified form of the absolute priority rule, to be applied only when a class dissents; [and] limited the involvement of the SEC in reorganization cases.[78]

Under this broad construct, the new face of bankruptcy reorganization seemed to promote a speedy resolution, with flexibility for both debtors and creditors to work out sticking points before the appointment of a disinterested trustee.

B. *The Code and Chapter 11 Reorganization*

The current bankruptcy regime builds on both the Chandler Act and the history that came before it. To understand how its flexibility treats both corporate debtors and creditors, we begin by examining the Code in greater depth.

Under the Code, the filing of a bankruptcy reorganization case may be initiated through either voluntary or involuntary means.[79] The Code takes a permissive tack in the filing process, and while it applies some restrictions on who may file for bankruptcy protection, it broadly permits "a person that resides or has a domicile, a place of business, or property in the United States, or a municipality" to be a debtor.[80] Throughout the Chapter 11 reorganization process, the existing management of the corporate debtor retains control of the process,[81] with a trustee brought into the case only for cause.[82]

The mechanics of the reorganization process are important for understanding how an insolvent, bankrupt debtor can emerge from Chapter 11 protection operating as a solvent entity at the completion of a case. Immediately after filing for bankruptcy, creditors seeking any type of payment, lien, or other action from a bankrupt debtor, based upon prepetition arrangements, are not permitted to even attempt collection of these debts.[83] The so-called "automatic stay" is a powerful tool for a debtor, serving two important goals for any reorganizing debtor: first, it allows the debtor to take a

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78. *Id.* (footnotes omitted) (citing 11 U.S.C. §§ 1104(a), 1121(b), 1129(b) (1988)).

79. *Compare* 11 U.S.C. § 301 (2006) (voluntary), *with id.* § 303 (involuntary). An additional provision of the Code permits the filing of a "joint case," applying to individual debtors and their spouse, which will not be considered for the purposes of corporate reorganization under Chapter 11. *Id.* § 302. From a functional perspective, there is little difference in the actual bankruptcy process whether a filing is voluntary or involuntary; that is, there is not a separate substantive body of statutes for involuntary bankruptcy filings other than some specific requirements for creditors wishing to force a debtor into involuntary bankruptcy. *Id.* § 303(b); *see* 9 WILLIAM NORTON, JR. & WILLIAM NORTON III, NORTON BANKRUPTCY LAW & PRACTICE § 171:4 (3d ed. 2008) (describing general considerations for involuntary bankruptcy petitions).

80. 11 U.S.C. § 109(a).

81. Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANK. L. J. 153, 176 (2004).

82. 11 U.S.C. § 1104(a)(1)–(2). This section permits the appointment of an examiner "to conduct such an investigation of the debtor as is appropriate" in limited circumstances as well. *Id.* § 1104(b). Additionally, appointment of a trustee for cause under § 1104(a) is rare. *See In re* Marvel Entm't Grp., 140 F.3d 463, 472–73 (3d Cir. 1998) (citing Cajun Elec. Power Coop., Inc. v. Cent. La. Elec. Coop., Inc. (*In re* Cajun Elec. Power Coop.), 74 F.3d 599, 600 (5th Cir. 1996), *cert. denied*, 519 U.S. 808) (adopting case-by-case analysis to determine cause worthy of trustee appointment); *In re* Sharon Steel Corp., 871 F.2d 1217, 1225 (3d Cir. 1989) ("It is settled that appointment of a trustee should be the exception, rather than the rule.").

83. 11 U.S.C. § 363(a)(1)–(8).

"breathing spell" from its obligations that have driven it to bankruptcy in an effort to preserve some value and initiate a reorganization process;[84] and second, the stay prevents creditors from picking through the estate in a haphazard search for value, instead protecting the value of the entire estate to pay out creditors in an orderly fashion.[85]

While the automatic stay protects a debtor from prepetition mistakes, the postpetition debtor in possession (DIP) framework provides for continuing business operations in an effort to make a reorganization process fruitful. The role of the DIP is to act with all the same powers as a disinterested trustee would, while continuing operations of the bankrupt debtor's estate.[86] Though the DIP is legally different from the debtor, it is the same essential entity and is frequently managed by the debtor's same management.[87] To facilitate continuing operations, the DIP must obtain financing; after all, if the bankrupt estate had significant cash on hand, bankruptcy protection would likely not be necessary.[88] In doing so, the DIP must comply with requirements for filing a motion with the bankruptcy court, provide notice to creditors, and appear at a hearing in front of the bankruptcy court.[89] The ability to obtain postpetition financing is not unfettered, as the DIP must satisfy the court that the postpetition financing still grants existing creditors "adequate protection" in their claims against the debtor's estate.[90] This postpetition financing receives higher priority relative to other creditors of the bankrupt estate, and by encouraging lenders to provide financing, the court incentivizes postpetition lending and promotes orderly reorganization through continued operations.[91] In striking this balance between

84. *See, e.g.*, *In re* Siciliano, 13 F.3d 748, 750 (3d Cir. 1994) ("The purpose of the automatic stay provision is to afford the debtor a 'breathing spell' by halting the collection process."); Stringer v. Huet (*In re* Stringer), 847 F.2d 549, 551 (9th Cir. 1988) ("In addition to protecting the relative position of creditors, . . . [the automatic stay] was designed to shield the debtor from financial pressure during the pendency of the bankruptcy proceeding.").

85. *See, e.g.*, Underwood v. Hilliard (*In re* Rimsat, Ltd.), 98 F.3d 956, 961 (7th Cir. 1996) ("[The use of the automatic stay] is consistent with . . . the statutory purpose of preventing a 'chaotic and uncontrolled scramble for the debtor's assets in a variety of uncoordinated proceedings in different courts.'" (quoting Holtkamp v. Littlefield (*In re* Holtkamp), 669 F.2d 505, 509 (7th Cir. 1982))); Dean v. Trans World Airlines, Inc., 72 F.3d 754, 755–56 (9th Cir. 1995) ("[T]he stay assures creditors that the debtor's other creditors are not racing to various courthouses to pursue independent remedies to drain the debtor's assets.").

86. 11 U.S.C. § 1107(a).

87. Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1467–68 (1993).

88. There are rare occasions where a debtor might declare for bankruptcy protection without requiring DIP financing; in the recent bankruptcy of AMR Corporation, the parent company of American Airlines, the debtor sought bankruptcy protection with $4 billion cash on hand, eliminating the need for immediate DIP financing. Doug Cameron et al., *American Lands in Bankruptcy—Parent of No. 3 Airline Seeks Court Protection Amid High Fuel and Labor Costs*, WALL ST. J., Nov. 30, 2011, at A1; *see also* Affidavit of Isabella D. Goren at 13, *In re* AMR Corp., 477 B.R. 384 (Bankr. S.D.N.Y. Nov. 29, 2011) (No. 11-15463-SHL), ECF No. 4 (explaining AMR's capital structure).

89. 11 U.S.C. § 364(b). For the procedure debtors must follow to obtain credit, see FED. R. BANKR. P. 4001(c)(1)–(3).

90. 11 U.S.C. § 364(d)(1).

91. *Id.* § 364(c)(1)–(3); *e.g.*, *In re* Zech, 185 B.R. 334, 337 (D. Neb. 1995) (citing *In re* Sobiech, 125 B.R. 110, 114 (Bankr. S.D.N.Y. 1991)) (explaining statutory incentive structure for creditors providing

creditors' needs for priority in postpetition financing and a debtor's need for financing, the reorganization process contains an effective method for continuing operations of a business.

In addition to key provisions for debtors, the Code offers provisions ensuring the organization of creditors involved in Chapter 11 reorganization. In particular, the Code seeks to ensure that unsecured creditors are represented in the reorganization process and also creates a vehicle for formation of a committee representing "equity security holders, as the United States trustee deems appropriate."[92] These committees have a voice throughout the reorganization process, which they can exercise through their rights to consult with the debtor in the administration of the bankruptcy, to propose a plan of reorganization, and to "perform such other services as are in the interest of those represented."[93] As interpreted by the courts, "[t]he three basic functions of a creditors' committee are (1) to monitor the Debtor's operations, (2) to investigate for potential insider causes of action where the facts warrant it, and (3) to negotiate on the plan."[94] To ensure that the committee members serve creditors' interests, courts have imposed fiduciary duties on representatives of the committees.[95] Under the regime set up by the Code, unsecured creditors and equity holders cannot be ignored during the reorganization process thanks to the statutory scheme providing for their involvement.

Chapter 11 reorganization contemplates a successful reorganization concluding with the creation and approval of a plan explaining how the debtor will reorganize operations and satisfy outstanding creditors.[96] While the debtor has 120 days to file a plan of reorganization, after that exclusivity period, "[a]ny party in interest" may file a competing plan for approval by the court.[97] Plan confirmation can be a difficult process for a debtor due to the numerous requirements imposed on the court for approval.[98] Not every creditor must agree with the plan for confirmation, but the requirements of § 1129(b) (the so-called "cramdown" provision) present a formidable challenge for

postpetition financing).

92. 11 U.S.C. § 1102(a)(1). Additional parties are protected under other provisions scattered throughout Chapter 11 in a manner that some scholars characterize as rooted in the success of lobbying for those special interests. *See, e.g.*, Miller & Waisman, *supra* note 81, at 178 ("Congress has responded to the needs and, at times, wants of certain groups and has passed provisions protecting their interests."). Creditors who have lobbied with some success vary, covering a range of industries and interests, but all appear to receive some preferential treatment relative to other creditors as a result of these congressional enactments. *Id.* at 178–79.

93. 11 U.S.C. § 1103(c)(1)–(5).

94. *In re* Cumberland Farms, Inc., 154 B.R. 9, 12 (Bankr. D. Mass. 1993); *see also* 11 U.S.C. § 1102(b)(1) (discussing the typical structure of the committee); Westmoreland Human Opportunities, Inc. v. Walsh, 246 F.3d 233, 256 (3d Cir. 2001) ("We have construed § 1103(c) as implying a fiduciary duty on the part of members of a creditor's committee . . . toward their constituent members." (citing *In re* PWS Holding Corp., 228 F.3d 224, 246 (3d Cir. 2000))).

95. *E.g.*, Murphey v. Lattimore, Black, Morgan & Cain P.C., No. 3-10-0490, 2011 WL 2420265, at *3 & n.5 (M.D. Tenn. June 13, 2011) (citing *In re* Spiegel, 292 B.R. 748, 750 (Bankr. S.D.N.Y. 2003)).

96. *See* 11 U.S.C. § 1141 (regarding discharge from bankruptcy after confirmation of a reorganization plan).

97. *Id.* § 1121(a)–(c).

98. *See id.* § 1129(a) (containing an extensive list of requirements that the plan must meet before a court confirms it).

debtors that elect to fight for plan approval.[99]

Though plan confirmation appears to create a neat and tidy end to the reorganization process, the Code does not require that all the assets of the bankrupt estate flow through the confirmation process.[100] Providing flexibility to the reorganization process, § 363 creates a sale process for assets of the bankrupt estate, which may be used during the reorganization process regardless of the creation of a plan for the reorganized debtor, subject only to an approval by the bankruptcy court.[101] Creditors cannot ignore this powerful tool, as a debtor need only provide notice and hearing, rather than the onerous burdens of plan approval, to dispose of assets via § 363.[102] Generally, asset sales through § 363 cannot come solely at the pressure of creditors or to somehow avoid the procedural requirements elsewhere in the reorganization process; instead, there must be an "articulated business justification" beyond creditor convenience.[103] The recent bankruptcies of General Motors and Chrysler—both ostensibly reorganizations completed through asset sales of substantially all of the debtor's assets under § 363—have prompted study because of the nontraditional use of the Code, but seem to be accepted as unique circumstances rather than a paradigm shift in the use of § 363.[104]

Ultimately, the various provisions of the Code aim to effectuate congressional visions of a bankruptcy process that facilitates payments to creditors and the

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99. *See, e.g.*, *In re* Premier Int'l Holdings, Inc., No. 09-12019, 2010 WL 2745964, at *1, *14 (Bankr. D. Del. Apr. 29, 2010) (explaining classifications of creditors who objected to plan confirmation despite debtor's successful plan proposal); *see also* Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 450–54 (1984) (discussing challenges to plan confirmation). Tensions between debtors and creditors, including debtors favoring one proposed plan over another, are part of the longstanding tension first identified by Douglas. See *supra* Part II.A.3 for more information on the history of conflicts inherent in controlling the reorganization process. More broadly, complex corporate reorganizations with multiple creditor groupings tend to create situations where debtors may favor certain plans (typically preferring the one initially proposed by the debtor), compromising to join with certain classes of creditors while opposing proposals by other creditors, depending on a number of context-specific factors to the bankruptcy. *See, e.g.*, *In re* Tribune Co., 464 B.R. 126, 135–36 (Bankr. D. Del. 2011) (describing the numerous machinations of the reorganization plan negotiations between debtor and creditors).

100. *See* Berringer, *supra* note 35, at 372 (noting that § 363(b) allows for sales to occur with only notice and hearing procedures).

101. 11 U.S.C. § 363(b).

102. *Compare id.* (requiring just notice and a hearing), *with id.* § 1126 (developing the reorganization plan), *and id.* § 1129 (confirming the plan and accounting for votes on confirmation by creditor groups).

103. Comm. of Equity Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983); *see also In re* Boston Generating, LLC, 440 B.R. 302, 321–29 (Bankr. S.D.N.Y. 2010) (explaining factors considered by the *Lionel* court to substantiate the "articulated business justification"). *See generally* William T. Bodoh et al., *The Parameters of the Non-Plan Liquidating Chapter Eleven: Refining the* Lionel *Standard*, 9 BANKR. DEV. J. 1 (1992) (commenting on *Lionel*'s impact on asset sales through § 363).

104. *See In re* Gen. Motors Corp., 407 B.R. 463, 479–81 (Bankr. S.D.N.Y. 2009) (summarizing the terms of General Motors' bankruptcy sale); *In re* Chrysler LLC, 405 B.R. 84, 87–92 (Bankr. S.D.N.Y. 2009) (summarizing the terms of Chrysler's bankruptcy sale); *cf.* Berringer, *supra* note 35, at 375–76 (explaining that the Chrysler and GM bankruptcies fit the general pattern of the § 363 sale process but were nonetheless unique). *See generally* Barry E. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305 (2010); A. Joseph Warburton, *Understanding the Bankruptcies of Chrysler and General Motors: A Primer*, 60 SYRACUSE L. REV. 531 (2010).

maintenance of corporate enterprises continued as going concerns.[105] As articulated by the House of Representatives, a reorganization case is "unlike a liquidation," in that there is inherent value in the assets and operations of the business as structured, and without a flexible structure permitting reorganization, the Code would not be able to satisfy three groups it seeks to protect: employees, creditors, and shareholders.[106] In particular, the House sought to ensure that unsecured creditors, "normally the largest body of creditors and most in need of representation," would have their needs met to ensure fair repayment of debts.[107] As described above, provisions of the Code balance these obligations to competing groups.

C. The "New" Role for Creditors in Chapter 11 Reorganization

In reality, not much is truly new about the role that creditors play under the reorganization regime of Chapter 11. There is, however, a significant market for "claims against, and interests in, distressed firms," that goes unmentioned throughout the Code.[108] Though the Code may never have "contemplated" the sheer amount of distressed debt trading in the global marketplace over the past decade, creditors have always sought leverage in one form or another in negotiations with insolvent debtors.[109] To understand the importance of this marketplace and its role, we further review some key legal structures available to creditors in the Chapter 11 reorganization process.

In an important and oft-used provision, the Code offers creditors the ability to exercise leverage in the sale of an asset under § 363 by permitting secured creditors to bid for that asset, based upon the security interest that the creditor holds.[110] This process, known as credit bidding, offers some significant advantages to both debtors and creditors, but it almost certainly gives the secured creditor the most enviable position when the asset in which the creditor holds a security interest is at stake of being sold off:

> First, credit bidding increases the often small pool of bidders sufficiently familiar with the debtor's assets to buy them on a truncated timetable. Second, it constrains debtors from favoring "white knight" buyers who do not offer the highest purchase price. Third, credit bidding reduces the cost to submit a bid and minimizes transaction costs in general.[111]

Recent developments appear to weaken the secured creditor's position by diminishing

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105. *See* H.R. REP. NO. 95-595, at 220 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 ("The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.").

106. *Id.*

107. *Id.* at 235.

108. Lipson, *supra* note 12, at 1645.

109. Miller & Waisman, *supra* note 81, at 181.

110. 11 U.S.C. § 363(k) (2006). For an example of the mechanics of credit bidding, see Vincent S. J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99, 102–04 (2010).

111. Buccola & Keller, *supra* note 110, at 100 (footnotes omitted) (citing Gandal v. Telemundo Grp., Inc., 997 F.2d 1561, 1562 (D.C. Cir. 1993); Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 711 (7th Cir. 1986)).

the ability of secured creditors to submit credit bids during the bankruptcy process.[112] Nonetheless, a secured creditor's interest in an asset or claim ensures a privileged bargaining position, as the aim of reorganization (even in the face of a secured creditor's claims) is to permit the debtor to "emerge from bankruptcy with property cleansed of all hidden liens, ensuring that future businesses will transact with the reorganized entity without fear that an unanticipated creditor will emerge with a superior interest in purchased property."[113]

Despite the advantageous position that a security interest provides in the § 363 sale process, creditors of all types have some strengths in the bankruptcy proceedings. For example, unsecured creditors have long banded together to negotiate for favorable terms in bankruptcy proceedings, both prior to the passage of the Code,[114] and with the Code's blessing.[115] The traditional perspective on the distinction between secured and unsecured creditors suggests that unsecured creditors, in their haste for speedy repayment (and lacking the protection of a security interest), "act as a unified constituency, usually agitating for quick liquidation."[116] Recent analysis suggests, however, that unsecured (and, for that matter, undersecured) creditors are actually more willing participants in bankruptcy negotiations, consequentially supporting the lengthier reorganization process over a swift sale.[117] A patient reorganization process at least offers the potential to protect the value of the debtor's assets as opposed to sale or liquidation, and because unsecured creditors would share in the "upside" of a reorganization plan, the reorganization process encourages fruitful participation from this class of creditors.[118]

In addition to the new attitudes of unsecured creditors, scholars have also pointed to a broader change impacting bankruptcy reorganizations. In particular, the rise of robust secondary markets for the debt of insolvent or bankrupt companies is a recent phenomenon.[119] The practice of trading in these claims, and benefiting from them, is a lawful practice condoned by the current bankruptcy regime.[120] Recent estimates suggest that hundreds of billions of dollars in creditor claims are traded on an annual basis, facilitated by firms like SecondMarket.[121] Throughout the plan proposal and

112. *See, e.g.*, *In re* Phila. Newspapers, LLC, 599 F.3d 298, 315–16 (3d Cir. 2010) (holding that a debtor need not absolutely accept the secured creditor's credit bid in a § 363 sale of assets).

113. *Id.* at 317 (quoting *In re* Airadigm Comms., Inc., 519 F.3d 640, 649 (7th Cir. 2008)).

114. *See* SKEEL, *supra* note 5, at 112 (noting that holders of distressed bonds "fare[d] quite well" in the first half of the twentieth century).

115. Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 93–94 (2004).

116. Ayotte & Morrison, *supra* note 9, at 512.

117. *Id.* at 514.

118. *Id.*

119. Lipson, *supra* note 12, at 1645.

120. *See* FED. R. BANKR. P. 3001(e) (governing claim trading after filing for bankruptcy).

121. Lipson, *supra* note 12, at 1645–46. SecondMarket is a trading platform originally designed as an alternative platform for buying and selling restricted securities in privately held companies, and has since incorporated other asset classes like bankruptcy claims and other debt securities. *Company Overview*, SECONDMARKET, https://www.secondmarket.com/about-us?t=hlo (last visited June 18, 2013). There are some obvious profit motives inherent to trading on bankruptcy claims, in particular, the potential purchase of a creditor claim at a discount when a debtor enters bankruptcy (and repayment of bonds looks unlikely as the debtor is presumably close to insolvent), in the hopes that the debtor will pay out more on that claim than the

confirmation processes, creditors may work with debtors to propose a plan, both formally and informally, without violating restrictions on solicitation that are placed on creditors (as defined in § 1125).[122] However, with the rise of new market actors (investors who were not originally creditors of the debtor), different forces now come into play as part of the struggle between debtors and creditors.[123] Claim trading, and the entities that engage in the practice, present a challenge for the Code in the opacity these actors bring to the bankruptcy process.[124] When the creditor is no longer interested in working out the full value of a claim, but instead calculates its return on an investment likely made below face value, the principles of Chapter 11's "breathing space" are compromised because the varying motivations of new claim holders may not fully align with the upside sought by the initial unsecured creditors.[125]

In tandem with the new leverage exercised by private investors, creditor control in large Chapter 11 reorganizations is impacted by the structure of postpetition financing (DIP financing).[126] In analyzing the degree of creditor control in such circumstances, Professors Ayotte and Morrison examined both direct and indirect measures that creditors may manipulate; focusing on how postpetition financing may impact the plan of reorganization.[127] Using the postpetition interest rates offered to debtors as a direct measurement, and metrics charting management turnover as an indirect measurement (using only data gathered from loan agreements that stipulated mandatory management changes), the study demonstrated that postpetition lenders have leeway to impact a debtor's operations even prior to the start of formal reorganization negotiations.[128] These findings suggest that senior lenders may exercise a greater influence over the reorganization process, to the detriment of the debtor and its equity holders, who take a backseat to the privileged position that the creditor with a secured or senior position holds.[129] As a result, "[b]argaining between secured and unsecured creditors can distort the reorganization process."[130] Given this additional tension among creditors, debtors expecting to negotiate towards a fruitful reorganization process seem to become a secondary consideration.

In light of both new market actors and preexisting dynamics, the rise in control for creditor groups in an insolvent (or nearly bankrupt) large business is not an entirely

purchaser initially paid for that claim, after purchasing it on SecondMarket or another trading platform.

122. Baird, *supra* note 115, at 93–94.

123. *See* Lipson, *supra* note 12, at 1646 ("Generally speaking, three types of claims may trade: (1) bank loans or portions thereof, known as 'participations'; (2) public bonds; and (3) 'trade claims,' which can include unpaid debts for goods, services, etc.").

124. *Id.* at 1651–52.

125. *Id.* at 1651 n.198 (quoting *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985)). These new entities include "private investors," like hedge funds and private equity firms, sometimes trading based upon proprietary strategies that seek to protect these strategies by remaining anonymous. *Id.* at 1653. However, some scholars have proposed that there is a more nefarious purpose, namely to "buy low and sell high . . . . to the harm of debtors and their larger constituencies." *Id.* at 1653.

126. Ayotte & Morrison, *supra* note 9, at 521–22.

127. *Id.* at 520–21.

128. *Id.* at 520–22.

129. *Id.* at 539.

130. *Id.*

new challenge facing the Code.[131] Indeed, courts have declared that a debtor's obligation to a creditor rises to the level of a fiduciary once a firm reaches insolvency.[132] As the debtor reaches the "zone of insolvency," its obligations to shareholders (and the impact of those obligations on negotiations with creditors working towards payment or reorganization) are decidedly murkier.[133]

The dynamics of the debtor's financial position and potential fiduciary obligations to creditors present an additional layer to the negotiations forced on debtors in the Chapter 11 reorganization process. In sum, the legal structures in favor of creditors, coupled with the market structures that have grown up around the Code's legal framework, continue to strengthen the position of creditors in the reorganization process.

D. *Case Studies in Creditor Control: The Bankruptcies of TWA, Inc., and Radnor Holdings Corporation*

To better demonstrate the unique tensions inherent in the debtor-creditor relationship, two case studies may offer a helpful illustration of the influences creditors can exert on debtors under the current legislative regime. While these corporate reorganizations vary in size,[134] each shows the pressures on a debtor facing reorganization processes with secured creditors seeking to impose their will.[135]

1. The Bankruptcy and Acquisition of Trans World Airlines

The story of Trans World Airlines' (TWA) bankruptcy and acquisition by American Airlines (American) provides an example of the favorable terms offered to a secured creditor in the bankruptcy process (perhaps with good reason, given TWA's precarious circumstances leading up to the filing). TWA's third and final bankruptcy filing in January 2001 was the end of a highly leveraged period during which the airline failed to turn a profit in ten years.[136] Though the airline was the eighth largest in the

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131. Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 337 (2007); *see also* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 779 (2002) (explaining how creditors may begin to exercise control as a corporation reaches an insolvent position).

132. *E.g.*, Prod. Res. Grp., LLC v. NCT Grp., Inc., 863 A.2d 772, 790–91 (Del. Ch. 2004) (citing Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992)). In particular, the debtor's board of directors (assuming the debtor is organized in the corporate form) must act for the benefit of creditors, as the creditors have a contractual claim on the debtor's assets before the equity holders. *Id*.

133. *See* Bainbridge, *supra* note 131, at 337 (noting that courts that use the "zone of insolvency" approach define directors' duties as extending to the corporate entity itself, rather than the shareholders, which can lead to much confusion).

134. *E.g.*, Second Amended Disclosure Statement for the Second Amended Joint Liquidating Plan of Reorganization of the Debtors and the Official Committee of Unsecured Creditors Pursuant to Chapter 11 of the United States Bankruptcy Code at 1, *In re* Trans World Airlines, Inc., No. 01-00056 (PJW), 2002 WL 34555021, at *1 (Bankr. D. Del. Jan. 16, 2002) [hereinafter Second Amended Disclosure Statement]; Voluntary Petition at 1, *In re* Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006) (No. 06-10894).

135. See *infra* Parts III.B and III.C for further analysis of how exerting pressure on the debtor was ultimately a product of the legislative structures in place under the Code.

136. *In re* Trans World Airlines, Inc., No. 01–00056(PJW), 2001 WL 1820326, at *1–2 (Bankr. D. Del. Apr. 2, 2001).

United States as of the date of filing, more than twenty-seven million passenger revenue miles in the year 2000 could not sustain TWA as a profitable enterprise.[137] TWA undertook various restructuring efforts in late 2000 in an attempt to sustain itself through negotiations with the lessors of its airplanes and efforts to amend wage and work rules with its unions.[138] On June 16, 2000, the *Wall Street Journal* reported that TWA went so far as to explore what a merger might look like with another struggling airline, but nothing came of the discussion.[139] Sometime in December of 2000, American approached TWA regarding a transaction between the two airlines and began preparing a merger agreement that hinged on TWA entering bankruptcy protection.[140]

Bankruptcy protection served as a means to a predetermined end in TWA's third and final bankruptcy.[141] As TWA realized its "increasingly perilous" financial condition, management and its financial advisors drew the inevitable conclusion that TWA's "only feasible means of survival was to enter into a strategic transaction."[142] In summarizing the key facts of TWA's final days, the bankruptcy court explained that TWA and American quickly turned what had previously been on-again, off-again merger discussions into more substantive negotiations that contemplated the purchase of TWA's assets "as a going concern."[143] Though the bankruptcy court characterized TWA's bargaining position in these merger talks as weak because of TWA's financial condition, the court noted that TWA was able to obtain "meaningful concessions" in facilitating the sale.[144] The sale transaction, ultimately consummated by TWA and American in the bankruptcy court, was found to be free of "unlawful insider influence or improper conduct," yet maneuverings regarding the sale price of TWA's assets focused almost exclusively on ensuring that secured creditors recovered the value of their claims.[145]

2. The Bankruptcy and Acquisition of Radnor Holdings Corporation

Radnor Holdings Corporation was a plastic-goods manufacturer that filed for bankruptcy in August 2006. Upon filing, Radnor Holdings intended to sell substantially all of its assets to its secured lender, Tennenbaum Capital Partners (TCP), which

137. Second Amended Disclosure Statement, *supra* note 134, at 6.

138. *Id.* at 11.

139. Susan Carey & Martha Brannigan, *Air Tran, TWA Discuss Possible Merger: Talks are Response to Fiscal Conditions*, WALL ST. J., June 16, 2000, at A3.

140. Second Amended Disclosure Statement, *supra* note 134, at 11.

141. *Trans World Airlines*, 2001 WL 1820326, at *2.

142. *Id.*

143. *Id*.

144. *Id.* The court pointed to American's assumption of significant pension liabilities from both currently employed and already-retired TWA employees. *Id.*

145. *Id.* at *3; *see also* Susan Carey, *Icahn Revises TWA Offer as AMR Bid Faces Judge*, WALL ST. J., Mar. 9, 2001, at B8 ("American on Wednesday topped its earlier $500 million cash offer by $242 million—$125 million in cash that would be added to American's existing $200 million emergency financing of TWA, and $117 million in aircraft deposits and other payments TWA has made that American would return to the TWA estate. TWA said its investment bankers and bankruptcy counsel had pushed American to revise its bid. *One benefit is that the $117 million will go to TWA's secured creditors, of which [Carl] Icahn is one, and is expected to fully compensate them*." (emphasis added)).

provided a stalking horse bid for all those assets based on the value of its security interest in Radnor Holdings.[146] In the months leading up to the bankruptcy filing, TCP became increasingly involved with Radnor Holdings through a series of debt and equity transactions that resulted in TCP becoming Radnor Holdings' only secured creditor in the bankruptcy filing.[147] As the ensuing litigation surrounding the administration of the estate demonstrated, the unsecured creditors were dissatisfied with their role in the process and battled with TCP to take control of the debtor.[148] Given Radnor Holdings' capital structure at its time of filing, TCP's purchase of substantially all of Radnor Holdings' assets raised suspicion among unsecured creditors, who were worried that there would be no proceeds to compensate them for their outstanding claims.[149] TCP's position of leverage provides a relevant example for examination of creditor control under the Code.

III. DISCUSSION

Despite congressional efforts to the contrary, secured creditors retain control over the bankruptcy process under the current legislative framework of the Code. The rise in influence of the secured creditor has ushered in an era that looks substantially similar to a system of equity receivership, in which cozy relationships steered the reorganization process to one creditor to the detriment of smaller creditors.[150] There is little inherently wrong with granting a privileged position to the secured creditor, who has generally paid some premium to hold a security interest in the debtor.[151] Among the benefits granted to the secured creditor over equity holders, unsecured creditors, and the actual debtor, is some degree of actual control of the reorganization process.[152] Despite the putative importance of the DIP,[153] it logically follows that the secured creditors, with legal claims on the assets of a bankrupt debtor, have some measure of control once the debtor reaches insolvency and files for bankruptcy.[154]

146. Official Comm. of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (*In re* Radnor Holdings Corp.), 353 B.R. 820, 835 (Bankr. D. Del. 2006); *Radnor Holdings Files for Bankruptcy, Lines up Sale*, PHILA. BUS. J. (Aug. 22, 2006, 12:11 PM), http://www.bizjournals.com/philadelphia/stories/2006/08/21/daily15.html.

147. *Radnor Holdings Corp.*, 353 B.R. at 828–29.

148. *Id.* at 838.

149. *Id.* at 826–27.

150. *See, e.g.*, Susan Carey, *American Airlines' TWA Financing Plan is Approved, Although Rivals Cry Foul*, WALL ST. J., Jan. 29, 2001, at A3 ("[Alternate buyers have] contended that because American is providing the interim financing to TWA, it would be the favored buyer. . . . [This potential buyer] also has complained about a chill on the bidding process because of American's breakup fee, and its right to match competing offers."). See *supra* Part II.A.3 for a discussion about the impetus to break apart the relationships between preferred parties and the regulatory regime that provided them significant advantages at the point of insolvency.

151. A security interest is generally created either by operation of law, or "by agreement," as in a voluntary contractual relationship. BLACK'S LAW DICTIONARY 1478 (9th ed. 2009).

152. Ayotte & Morrison, *supra* note 9, at 525.

153. *See* 11 U.S.C. § 1107(a) (2006) (defining the rights of a debtor in possession as akin to those granted to a trustee). See also *supra* notes 86–91 and accompanying text for a discussion of the DIP and its relationship with creditors.

154. Ayotte & Morrison, *supra* note 9, at 512.

Examination of the different methods of obtaining creditor claims in Chapter 11 bankruptcy provides a relevant context for making a value judgment in whether creditor control is a productive feature of Chapter 11 reorganization under the Code, as it is currently constituted.[155] To better understand secured creditor control and its potential for abuse under the Code, we must examine methods by which a secured creditor could become involved with a bankrupt debtor. In general, there are three opportunities for secured creditors to voluntarily acquire a position whereby they may exercise a degree of control over the debtor in the bankruptcy reorganization process: (1) obtaining a security interest in the debtor prior to filing bankruptcy (prepetition),[156] (2) obtaining the security interest simultaneous to a debtor's bankruptcy filing (traditional postpetition),[157] and (3) acquiring secured claims in the bankruptcy through a secondary market for the debtor's outstanding debt obligations (postpetition claim trading).[158]

Secured creditors that participate in the reorganization process should maintain similar advantageous bargaining positions as holders of pre- and postpetition security interests.[159] Though such advantages might be different for a postpetition creditor (receiving an incentive to lend to a bankrupt debtor for purposes of facilitating reorganization), the nature of that security interest should not intuitively be wholly different.[160] To determine whether this is the case, and whether the Code properly treats creditor claims in relation to the claims of the debtor, we must compare how the Code deals with each of the three possibilities for taking a security interest in the bankrupt debtor.[161] Thus, we begin by examining how creditor control is balanced against

155. *See* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 712–17 (2008) (discussing types of distressed debt trading and general strategies traders employ).

156. *See, e.g.*, U.C.C. § 9-201 cmt. 2 (amended 2012) (explaining that a security agreement is generally binding as to the debtor, creditor, and third parties, and operates unless superseded by operation of law).

157. *See, e.g.*, 11 U.S.C. § 364(c) (permitting a trustee or DIP to incur debt "with priority over any or all [other] administrative expenses" or existing liens).

158. *See* Lipson, *supra* note 12, at 1645 (describing the "development of a robust secondary market for claims").

159. In other words, the practical power or leverage exercised by a pre- or postpetition secured creditor should not be altogether different under the Code, given the fact that the bankruptcy code provides a standard legal structure for the reorganization process. *See, e.g.*, 11 U.S.C. § 506(a)(1) (failing to further distinguish secured claims based on whether they were made pre- or postpetition). Of course, a secured creditor who receives a senior postpetition lien under § 364(d) that comes higher in priority than collateral that is already secured would become a senior lien-holder, and would therefore be granted any leverage over a junior lienholder associated with that senior lien position. *See id.* § 364(d) (granting higher priority lien). Because the postpetition lender that receives a higher priority claim on the debtor's assets may change the dynamics of the reorganization process, some local rules require debtors to highlight and justify the inclusion of such postpetition lien interests in court filings for additional financing. *E.g.*, DEL. BANKR. L.R. 4001–2(a)(i)(A).

160. *See, e.g.*, *In re* Zech, 185 B.R. 334, 337 (D. Neb. 1995) (citing *In re* Sobiech, 125 B.R. 110, 114 (Bankr. S.D.N.Y. 1991)). For further discussion of these incentives, see *supra* note 91 and accompanying text.

161. There are additional opportunities to acquire an interest in a debtor beyond the three security interests described in *supra* notes 156–58 and accompanying text. For example, § 507's explanation of priority indicates that a debtor must satisfy a number of higher priority obligations even before a secured or unsecured creditor may assert claims on the debtor's assets. 11 U.S.C. § 507(a). However, many of those creditors who receive these higher priority liens are less likely to exercise significant pressure by nature of their normal course of business. *See, e.g.*, *id.* § 507(a)(2) (giving higher priority to claims asserted under outstanding

sources of debtor leverage in bankruptcy reorganization under Chapter 11.[162] After that, we look to recent examples of secured creditors exercising their advantageous position as part of the reorganization process including the "loan-to-own" case of *In re Radnor Holdings Corp.*,[163] demonstrating the position of a prepetition secured creditor. In a similar fashion, the bankruptcy and subsequent sale of TWA[164] demonstrates an example of the power wielded by a postpetition secured creditor, initiating a sale process and pushing it to closing in a short time frame.[165]

This Section closes with a discussion of claim-trading strategies in the reorganization process, in order to determine the role of creditor claims operating on a short-term strategy in potential conflict with reorganizational goals.[166] This analysis leads to the conclusion that proposed changes to address creditor control may be hamstrung by legal obstacles inherent in the currently adopted Code.[167]

A. Sources of Debtor Leverage in the Reorganization Negotiation: An Examination of the Powers of the DIP and Creditor Countermeasures

One of the key tools in the Chapter 11 reorganization process is the negotiation and confirmation of a plan of reorganization. The Code's provisions on plan confirmation demonstrate the importance of creditor assent during, and for confirmation of, the reorganization process. The basic framework of the Chapter 11 reorganization process offers a number of terms that provide debtors some measure of leverage in the initial stages of reorganization, including giving the DIP an exclusive right to propose a plan of reorganization in the first 120 days after filing for bankruptcy.[168] In forming the reorganization plan, the Code requires that creditors' claims be divided into "classes."[169] These classes are to be based upon the shared interests of that class, so that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or

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Federal Reserve Bank loan facilities).

162. See *infra* Part III.A for further discussion on sources of debtor leverage in reorganization negotiations.

163. 353 B.R. 820 (Bankr. D. Del. 2006). See *infra* Section III.B for further analysis of the Radnor Holdings loan-to-own transaction.

164. *In re* Trans World Airlines, No. 01-0056(PJW), 2001 WL 1820326, at *2–3 (Bankr. D. Del. Apr. 2, 2001).

165. *See id.* at *1 (describing objections of creditors and hurdles to complete the sale process within 60 days).

166. *See* Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 183 (2011) (describing the "potential for gamesmanship and abuse in debt-based takeovers"); Richard D. Thomas, Comment, *Tipping the Scales in Chapter 11: How Distressed Debt Investors Decrease Debtor Leverage and the Efficacy of Business Reorganization*, 27 EMORY BANKR. DEV. J. 213, 229–30 (2010) (discussing trading strategies of hedge funds and private equity firms). For further discussion of claim trading, see *infra* Part III.D.

167. See *infra* Part III.E for an analysis of the inadequacies of certain proposed changes to the Bankruptcy Code.

168. 11 U.S.C. § 1121(b) (2006). See *supra* notes 86–91 and accompanying text for discussion of the DIP's privileges after filing for bankruptcy protection.

169. 11 U.S.C. § 1123(a)(1).

interests of such class."[170] Creditors (or claim holders) consent to a plan through each class voting for or against the plan, with a minimum threshold that half of the total claims equaling or exceeding two-thirds of the value of the class assent to the plan.[171] Approval of the plan is contingent upon each class accepting the terms of the plan, among additional requirements for the court to consider.[172]

The DIP's plan proposal exclusivity period is a point of significant leverage for the debtor, as it permits the DIP to "(1) propose the consideration creditors will receive if the plan is confirmed; (2) gerrymander classes of creditors to minimize the voting strength of adversaries while maximizing the influence of allies' votes; and (3) set the pace of negotiations, usually through delay."[173] This delay may work to the advantage of a debtor, as it prolongs the period during which creditors must wait to have their claims satisfied, thereby pressuring creditors to back off their demands in an effort to speed the reorganization process (and limit its expense).[174] The opportunity to craft the plan, taking into consideration simple privileges like actual contract drafting, or more substantive ones like class formation, gives the DIP the ability to craft a plan of reorganization in a favorable fashion.[175] Despite these additional protections, the DIP retains an additional protection for intransigent creditors who refuse to accept a plan of reorganization—the "cramdown" provision—permitting a plan of reorganization to be accepted over the objections of creditors.[176]

On balance, however, creditors retain significant rights throughout the reorganization plan process. One creditor tactic for obstruction is through savvy positioning in the class apportionment negotiations, which can result in the creation of a class that will either obstruct reorganization votes or easily assent to the plan under consideration.[177] Because of the tremendous power held by any creditor in each respective creditor class, the flexibility bestowed by § 1122 has been curtailed by judicial interpretations of the classification power.[178] "[S]eparate classification of

170. *Id.* § 1122(a).

171. *Id.* § 1126(c)–(d). Certain classes of creditors will have the right to vote on a plan of reorganization: (1) unimpaired creditors, who are receiving the full value of their claims and are presumed to accept a plan of reorganization that pays them the full value of their claim; and (2) fully impaired creditors, who are recovering nothing on their claim and are presumed to reject a plan of reorganization that pays them none of their claim. *Id.* § 1126(f)–(g).

172. *Id.* § 1129(a)(8). The Code provides sixteen statutory requirements for plan confirmation. *See id.* § 1129(a)(1)–(16). Each unique provision may provide creditors leverage to apply in negotiations with a debtor, but the voting right attached to claims is key to understanding the motivations and strategies of bankruptcy claim investors.

173. Thomas, *supra* note 166, at 225.

174. Tung, *supra* note 12, at 1696.

175. *Id.* at 1694–96.

176. 11 U.S.C. § 1129(b); *see also* 6 WILLIAM NORTON, JR. & WILLIAM NORTON III, NORTON BANKRUPTCY LAW & PRACTICE § 113:2 (3d ed. 2008) (explaining that a bankruptcy court may institute a plan of reorganization over the objections of creditors, subject to satisfying statutory conditions). See *supra* note 99 and accompanying text for a brief summary of how the DIP may use the cramdown provision.

177. *See* MARTIN J. WHITMAN & FERNANDO DIZ, DISTRESS INVESTING: PRINCIPLES AND TECHNIQUES, 214–15 (2009) ("Strategic investors like ESL and Third Avenue frequently seek to influence the reorganization process. In order to do this they will seek to hold large amounts of the fulcrum security . . . . [in] large enough amounts to either control or significantly influence the reorganization process.").

178. *E.g.*, Boston Post Rd. Ltd. P'ship. v. Fed. Deposit Ins. Corp. (*In re* Boston Post Rd. Ltd. P'ship), 21

unsecured claims solely to create an impaired assenting class will not be permitted; the debtor must adduce credible proof of a legitimate reason for separate classification of similar claims."[179] Though a debtor might attempt to construct a "legitimate reason" to construct creditor classes in a favorable way, the sensitivity to "gerrymander[ing]" and its destructive implications for the recovery of unsecured creditors that have the most to "gain or lose . . . from . . . reorganization" suggests that courts will be wary of this problem and look skeptically at debtors who propose plans with potentially manipulated classes.[180]

In addition to interpretation of the classification system, Congress also restricted the DIP's ability to control the pace of proposing reorganization plans. In a 2005 amendment to the Code, Congress struck down a great deal of the flexibility initially granted to bankruptcy courts to extend the exclusivity period for a debtor to file a plan without creditor interference, setting a firm limit of eighteen months, after which the court may no longer grant any further extensions.[181] In light of this amendment, the plan negotiation and confirmation process reserves some measure of leverage to debtors, but secured creditors still retain a number of opportunities to undercut the debtor's leverage in this area.

B. *Endorsing the Advantage of a Prepetition Secured Creditor:* In re Radnor Holdings Corp.

Radnor Holdings' bankruptcy case demonstrates principles regarding the influence of the secured creditor in the reorganization process.[182] On balance, the allegations of the secured creditor "behaving badly" were not enough to undermine Radnor Holdings' reorganization process.[183] Indeed, the bankruptcy court deemed prepetition secured creditor control of the reorganization plan to be acceptable for similar pragmatic reasons as those discussed in the context of the postpetition secured

F.3d 477, 482–83 (2d Cir. 1994); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 955 F.2d 1274, 1279 (5th Cir. 1991).

179. *Boston Post Rd.*, 21 F.3d at 483.

180. *Id.* While firm guidelines to determine whether a suspect class exists may be hard to come by, one guideline that appears clear is that "each class must represent a voting interest that is sufficiently distinct and weighty to merit a separate voice in the decision whether the proposed reorganization should proceed. Otherwise, the classification scheme would simply constitute a method for circumventing the requirement set out in 11 U.S.C. § 1129(a)(10) (1988)." John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assoc., 987 F.2d 154, 159 (3d Cir. 1993).

181. 11 U.S.C. § 1121(d)(1); NORTON & NORTON, *supra* note 176, at § 108:3. As a result, some debtors "who legitimately need additional time to file a plan" could easily be forced into liquidation, forcing the debtor's hand and permitting creditor's to creep into the plan proposal process earlier than they might once have. *Id.*; *see also* 11 U.S.C. § 1121(d)(2)(A) ("The 120-day period specified [for debtor's plan proposal] . . . may not be extended beyond a date that is 18 months after the date of the order for relief under this chapter.").

182. Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, L.L.C. (*In re* Radnor Holdings Corp.), 353 B.R. 820, 835 (Bankr. D. Del 2006) (No. 06-10894). See *supra* Part II.D.2 for additional background information on Radnor Holdings' decline into bankruptcy protection and subsequent sale to its secured lender.

183. Robert J. Rosenberg & Michael J. Riela, *Hedge Funds: The New Masters of the Bankruptcy Universe*, NORTON J. OF BANKR. L. & PRAC., October 2008, at 701.

creditor.[184] However, further examination of the bankruptcy of Radnor Holdings illustrates the fact that a potential for creditor improprieties exists as the debtor reaches insolvency. Hedge funds and other private investors, unlike traditional lenders, may often bring different (and nontraditional) motivations to the bargaining table.[185] Where a traditional lender once did "virtually everything" to avoid getting stuck with the assets of a debtor, a hedge fund or private equity firm might instead engage in a strategy to control the reorganization process to facilitate an acquisition.[186] Radnor Holdings' trip through bankruptcy protection and sale of assets to its secure lender demonstrates this type of strategy, and elucidates the changing considerations for secured lenders when a debtor enters bankruptcy.

The reorganization of Radnor Holdings began nearly a year prior to its Chapter 11 filing.[187] Facing a liquidity shortage that threatened the viability of the business, Radnor went into the public markets seeking an investment on top of $70 million in outstanding senior secured notes.[188] After actively seeking investors with the aid of investment bankers, Radnor entered into an arrangement with Tennenbaum Capital Partners (TCP), a hedge fund that was "willing to move the most quickly."[189] TCP's investment in Radnor came in the form of both debt and equity—a commitment to purchase $25 million in preferred shares, coupled with a senior secured loan in the amount of $95 million.[190] These preferred shares contained warrants offering TCP the opportunity to expand its equity ownership stake based upon earnings targets set through negotiations between TCP and Radnor.[191] After completion of the debt and equity offering, Radnor elected to use the cash infusion to redeem the $70 million worth of secured notes, leaving TCP as the senior secured creditor to Radnor's assets.[192]

Despite renegotiating its capital structure, Radnor faced significant market challenges shortly after commencing TCP's investment and fell victim to a second

184. *Radnor Holdings Corp.*, 353 B.R. at 841 ("TCP [the secured creditor] did *not* engage in misconduct; TCP did *not* seek to benefit itself at the expense of others; TCP did *not* seek to mislead trade creditors, public noteholders or other stakeholders. TCP at all times acted in good faith with a view to maximize Radnor's value to all constituents.").

185. Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and in the Future: An Overview and Insolvency Perspective*, 29 CAL. BANKR. J. 213, 229 (2007).

186. *Id.* at 229–30.

187. *Radnor Holdings Corp.*, 353 B.R. at 827–28.

188. Rosenberg & Riela, *supra* note 183, at 701.

189. *Radnor Holdings Corp.*, 353 B.R. at 828.

190. *Id.* at 829. See *supra* notes 119–25 and accompanying text for a description of other options a hedge fund or private equity firm might pursue to build a position with negotiating leverage in a bankrupt (or nearly bankrupt) debtor.

191. *Radnor Holdings Corp.*, 353 B.R. at 828. Beyond just the preferred shares and debt instruments, TCP also placed partner Jose Feliciano on Radnor's board of directors. *Id.* Mr. Feliciano's role on Radnor's board (and the implication that it presented a conflict for the sale to TCP) was an unsuccessful avenue for unsecured creditors seeking to gain more favorable terms in the sale of Radnor's assets in an effort to obtain some recovery. *See id.* at 844–45 ("The Committee has failed to prove that Mr. Feliciano was interested in any transaction and voted in favor of it due to his outside financial interests rather than voting in the best interests of Radnor." (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993))).

192. Rosenberg & Riela, *supra* note 183, at 701.

liquidity crisis requiring another substantial cash investment.[193] After receiving an additional loan from TCP, Radnor missed its earnings benchmarks, and soon thereafter, Radnor's revolving lenders cut off Radnor's credit lines, leaving Radnor on the brink of insolvency.[194] Faced with dire circumstances, Radnor finally filed for Chapter 11 protection and requested that TCP make an offer for sale of substantially all of Radnor's assets by bidding the amount of TCP's secured claim, rather than the only apparent alternative of immediate liquidation.[195] As a result of this offer, TCP gained substantial leverage in the sale process, including onerous covenants in the additional debtor-in-possession financing that TCP provided to Radnor, in order to maintain Radnor's business operations even for the short time required to file a bankruptcy petition and auction Radnor's assets pursuant to the Code.[196]

As Radnor entered bankruptcy, the Committee of Unsecured Creditors brought suit challenging the sale arrangement, contending that TCP's secured claims on Radnor's assets should have properly been recharacterized as equity investments, or TCP's claim should have been equitably subordinated behind the unsecured creditors.[197] Success on either of these claims would have undermined the sale by prohibiting recognition of TCP's credit bid for Radnor's assets; a bid that the unsecured creditors believed would leave few valuable assets for auction and distribution to their subordinate claims.[198] In other words, the Unsecured Creditors Committee alleged that TCP's strategy was premised on "loan-to-own"—essentially arguing that TCP's debt investments were an opportunistic ploy to take control of Radnor's assets by co-opting legal creditor protections in an eventual bankruptcy.[199]

In rejecting the allegation of misconduct, the bankruptcy court summarily dismissed the allegations of TCP's wrongdoing, providing a potential blueprint for future creditor control strategies.[200] In the case-by-case analysis required for a

193. *Radnor Holdings Corp.*, 353 B.R. at 832.

194. *Id.* at 835. The loss of this credit line was unexpected, and demonstrates the desperate nature of Radnor's precipitous fall into bankruptcy. *Id.*

195. *Id.* Perhaps more than any other action, Radnor's request that TCP make an offer to purchase substantially all of Radnor's assets demonstrates the leverage that TCP would ultimately hold in Radnor's fate, postpetition.

196. Interim Order (I) Authorizing Debtors (A) to Obtain Post-petition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(c)(1), 364(c)(2), 364(c)(3), 364(d)(1) and 364(e), and (B) To Utilize Cash Collateral Pursuant to 11 U.S.C. § 363; (II) Granting Liens, Security Interests and Superpriority Claims; (III) Granting Adequate Protection to Pre-petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 364; and (IV) Scheduling a Final Hearing Pursuant To Bankruptcy Rules 2002, 4001 and 9014 at 19, *In re* Radnor Holdings Corp., 353 B.R. 820 (2006) (No. 06-10894). In particular, the interim financing order gave TCP a "superpriority" claim over all administrative and other secured claims to Radnor's assets. *Id.* While TCP already held all of Radnor's outstanding secured claims, this superpriority position ensured that unsecured creditors with claims junior to TCP prior to Radnor's bankruptcy filing would fall behind a second level of priority, also reserved to TCP, and thereby further lessening any leverage that other creditors might seek to exercise.

197. *Radnor Holdings Corp.*, 353 B.R. at 838–41.

198. Rosenberg & Riela, *supra* note 183, at 701.

199. *Id.*

200. The bankruptcy court dismissed both recharacterization and equitable subordination efforts, in both counts noting that TCP had no nefarious purpose with regard to other creditors or equity-holders, and weighing that in TCP's favor on the Committee's claims. *Radnor Holdings Corp.*, 353 B.R. at 838–41.

successful recharacterization claim, the intentions of the noteholder and debtor are key to whether a debt instrument should instead be construed as an equity security.[201] This case-by-case analysis led to the conclusion that all the debt agreements between TCP and Radnor were intended solely as debt based on the way the transaction documents were drafted, the language used in those documents, the set maturity date, and the nature of the terms (e.g., the security interest and provisions surrounding default).[202] Furthermore, the claim of equitable subordination, a power conferred by statute,[203] required both a showing that "inequitable conduct . . . caused injury to . . . creditors or conferred an unfair advantage," and that application of the doctrine would not be inconsistent with the aims of the Code.[204] Given that TCP had not engaged in any misconduct or behavior that could be construed as fraudulent and had actually improved the position of the debtor, the grounds for equitable subordination were absent.[205] Moreover, TCP lacked an alternative motive that might obstruct the reorganization process;[206] rather, TCP seemed to have made efforts to avoid Radnor Holdings' insolvency, even if their position in the bankruptcy ultimately privileged their recovery at the expense of the Unsecured Creditors Committee.[207]

In all, TCP's actions in Radnor's bankruptcy did not require the court to invalidate TCP's actions—despite their activities with Radnor before the start of the bankruptcy case, they did not violate the legal institutions protecting debtor and creditor rights in Radnor's bankruptcy. There is little doubt, however, that the leverage TCP held over Radnor, as a prepetition creditor, at least appeared to be both substantial and arguably overwhelming to both the debtor and competing (unsecured) creditors. In any case, Radnor and TCP's close and predetermined arrangement looks similar to the cozy relationships that Douglas criticized less than a century before, pointing to similar possible criticisms under our current bankruptcy regime.

C. *The Strength of the Postpetition Secured Creditor:* In re Trans World Airlines, Inc.

As previously described,[208] TWA worked through a number of efforts at reorganization before finally finding a merger partner in a competitor, American Airlines.[209] According to the terms of this merger, TWA laid itself at the mercy of its secured creditor when American insisted that it would set the terms for the bankruptcy in their agreed-upon asset purchase agreement.[210] In the Second Amended Disclosure

201. *Id.* at 838–39 (citing Cohen v. KB Mezzanine Fund II (*In re* SubMicron Sys.), 432 F.3d 448, 455–56 (3d Cir. 2006)).

202. *Id*. at 839.

203. 11 U.S.C. § 510(c)(1) (2006).

204. *Radnor Holdings Corp*., 353 B.R. at 840.

205. *Id.* at 841.

206. Futter & Wells, *supra* note 185, at 229.

207. *Radnor Holdings Corp*., 353 B.R. at 841.

208. See *supra* Part II.D.1 for a discussion of TWA's distressed financial situation leading up to its 2001 bankruptcy filing.

209. Second Amended Disclosure Statement, *supra* note 134, at 11.

210. *Id.* at 12.

statement filed with the bankruptcy court for approval, the debtor candidly detailed the favorable terms offered to American Airlines in order to complete the sale:

> Specifically, American agreed that upon the Debtors' commencement of the Chapter 11 Cases, American (or its designee) would provide debtor in possession financing to fund TWA's liquidity needs, and that this financing would be secured by a Lien on *substantially all of the Debtors' assets*. Early in the Chapter 11 case process, the Debtors would seek court authority to sell substantially all of their assets to American or its designee (in the context of an open auction with court-approved bidding procedures), free and clear of all Liens, Claims, and encumbrances. Provided that American was the successful bidder and purchaser, American would, among other things, offer employment to the vast majority of the Debtors' employees and assume certain liabilities of the Debtors.[211]

As described in reports following the bankruptcy filing, TWA's situation was undeniably desperate by the time American stepped in, as TWA had only $20 million cash on hand, and a deadline to pay off or refinance $100 million in notes approaching.[212]

After TWA officially filed for Chapter 11 protection, the strength of American's position as the secured, postpetition creditor was borne out in the terms of the bidding procedures for the bankruptcy auction of TWA's assets. Not only would competing bidders have to use the text of the asset purchase agreement agreed to by American and TWA prior to the filing, but a qualifying bid also required an offer at least $75 million more than American Airlines offered TWA and a "good faith deposit of $50 million in [c]ash."[213] As if that were not enough, bids were due to TWA seven weeks from the January 10 filing date.[214] Furthermore, as an airline now in Chapter 11 bankruptcy, TWA faced an additional time pressure solely based on the unique nature of the airline industry—after filing for Chapter 11 protection, TWA's secured creditors could foreclose on their property after sixty days with nothing more than "a written demand" for the property.[215] With American's inherent advantages in the bidding process, there was little hope for any additional qualifying bids to challenge American Airlines' offer.[216]

To judge whether American Airlines exercised a degree of practical control that usurped the independence of the DIP, one need look no further than the bidding procedures and the public pronouncements of the DIP following the arrangement of the sale terms. On February 1, 2001, TWA's and American Airlines' chief executives appeared before Congress, presenting a united message that the only way TWA could

211. *Id.* at 11–12 (emphasis added).

212. Susan Carey, *American Airlines' TWA Financing Plan is Approved, Although Rivals Cry Foul*, WALL ST. J., Jan. 29, 2001, at A3.

213. Second Amended Disclosure Statement, *supra* note 142, at 23.

214. *Id.*

215. 11 U.S.C. § 1110(c)(1) (2006).

216. As the bankruptcy court ultimately noted in its findings of fact, "[t]he only bid TWA received on February 28, 2001 was the American bid." *In re* Trans World Airlines, Inc., No. 01-00056(PJW), 2001 WL 1820326, at *7 (Bankr. D. Del. Apr. 2, 2001). While an additional bidder, led by Carl Icahn, submitted a proposal on the same date, it was judged as unqualified and ultimately not accepted for consideration, over the objection of Icahn. *Id.* at *8.

preserve the 20,000 jobs at stake was to qualify for American's offer of $200 million for DIP financing in the event of a Chapter 11 filing.[217] American's $200 million loan, which included terms providing for a first priority security interest on substantially all of TWA's assets, set TWA on a course of sale to American that would have been difficult for any potential bidder to derail.[218] When the Unsecured Creditors Committee raised an objection to the proposed bid procedures, the concessions that they extracted resulted in relatively minor changes, with the exception of a provision that American Airlines would deposit $4 million of the DIP financing in the remaining estate after the sale for distribution to unsecured creditors.[219] On top of the short six-week period to submit a bid, the high $50 million deposit requirement made it hard to suggest TWA was still in substantive control over the course of its business and assets after it entered into negotiations with American.

In the abstract, the terms of TWA's bankruptcy and quick sale to American may sound unduly harsh and troubling to TWA as a debtor, particularly in light of the aims of reformers who sought to move away from the cozy relationships and advantages found under equity receivership reorganizations.[220] On the other hand, there is a highly pragmatic approach to American's sale strategy. Given TWA's posture prior to entering bankruptcy, the debtor and unsecured creditors faced troubling circumstances if American's terms were not accepted. Under this pragmatic view, the Unsecured Creditors Committee acknowledged TWA's troubles and went along with the sale process given the lack of a palatable alternative.[221] The Committee elected to "measure success in a very simple way: What is going to be in the pockets of the unsecured creditors? . . . [W]e've got to get that process started. And it can be done in a plan, it can be done in a sale. It can be done in a group sale."[222] Ultimately, the debtors, unsecured creditors, and the postpetition secured creditor felt that time was of the essence and reorganization in any form was the only option, as compared to further delay.[223] Again, like the negotiations in railroad bankruptcies a century before, TWA's bankruptcy process was swiftly navigated thanks to a cozy relationship among the key players.

217. Stephen Power, *Senate Panel Grills American and TWA on Planned Merger*, WALL ST. J., Feb. 2, 2001, at B8.

218. Carey, *supra* note 212, at A3.

219. *Trans World Airlines*, 2001 WL 1820326, at *6. Other changes included: permitting sale processes that would result in a standalone reorganization, the ability of multiple bidders to band together in one bid for TWA's assets, permission for bidders to enter separate bids for TWA's valuable computer reservation system, a reduction in American's breakup fee from $65 million to $55 million, and the payout to the estate on the closing of the sale. *Id.* Though each of these provisions may have been adopted with an intent to make the terms of the auction less favorable for American Airlines' bid, it bears repeating that only one compliant bid was ultimately submitted. *Id.* at *7.

220. See *supra* Part II.A.3 for a discussion of those aims, which include breaking apart the coercive, cozy relationships that drove corporate reorganizations prior to the Code.

221. *Trans World Airlines*, 2001 WL 1820326, at *6.

222. *Id.*

223. *Id.*

D. Claims Trading and the Control of Disruptive Creditors

In light of disputes between debtors and their pre- and postpetition creditors, critics of claim trading argue that claim-trading activity presents significantly more opportunities for creditor misbehavior.[224] Distressed debt trading in bankruptcy is defined as the market for trading in the indebtedness of a "financially troubled company that carries a high risk of default or nonpayment and, in turn, a potentially high rate of return."[225] The outstanding debts of bankrupt companies seeking Chapter 11 protection fall into this realm, given the low possibility of such companies paying off their preexisting debts. Given the largely unregulated nature of the distressed debt market,[226] there is little infrastructure in place to assure that creditors trading claims do not act contrary to the Code; indeed, the lack of legislative structure permits an investor to hold both short positions in the equity of a debtor and various debt instruments, resulting in payoffs in conflicting circumstances.[227]

At first glance, an investor's trading strategies with a short-term focus may appear innocuous, simply buying and reselling claims before maturity, ideally at a profit.[228] There are some benefits to building an active market in bankruptcy claims.[229] By accumulating a number of claims, an investor need not always be destructive in reorganization negotiations, but it instead might accumulate claims to effectuate a speedy reorganization and resolution (even if that investor is able to impose its own strategy on a DIP).[230] Furthermore, there is some efficiency in permitting a creditor

224. Thomas, *supra* note 166, at 229–30.

225. Harner, *supra* note 155, at 712.

226. *See* Lipson, *supra* note 12, at 1615 (noting that private markets for bankruptcy claims operate outside the purview of much of the regulated securities markets); Geoffrey Groshong, *Trading Claims in Bankruptcy: Debtor Issues*, 10 AM. BANKR. INST. L. REV. 625, 638–42 (2002) (explaining that Federal Rule of Bankruptcy Procedure 3001(e) requires disclosure of certain transfers of claims, but otherwise bankruptcy courts use equitable powers when regulating transfer of bankruptcy claims).

227. Thomas, *supra* note 166, at 230. In other words, through the use of various trading strategies, an investor may take positions that pay returns for a successful reorganization, or by betting on a failed reorganization. These strategies may be employed for legitimate hedging purposes, in other words to favorably allocate risks. Lipson, *supra* note 12, at 1653–54. On the other hand, unscrupulous investors can easily repurpose these same risk allocation tools for personal gain at the expense of meaningful participation granted by trading in creditor claims. *See id.* at 1653–56 (using survey data and interviews to explain hedging strategies and investor malfeasance).

228. Harner, *supra* note 155, at 716.

229. *See* Vladimir Jelisavcic, Note, *Trading Claims Against Chapter 11 Debtors: Disclosure as the Criterion for the Less Favorable Treatment Standard of Section 1123(a)(4)*, 17 J. CORP. L. 385, 398–99 (1992) (explaining that an investor that puts capital into a nearly bankrupt debtor has strong incentives to increase the value of that investment); Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 73 (2010) (explaining traditional justifications for claims trading and promoting an active marketplace of claims); Tung, *supra* note 12, at 1699–1703 (describing how to further productive use of capital through moving into and out of claim positions).

230. *See* Harner, *supra* note 155, at 718–20 (discussing the restructuring of Allied Holdings, Inc.). Though the negotiations to reorganize Allied Holdings were particularly contentious, including a civil RICO suit against a distressed investor, ultimately that suit was dismissed by the plaintiffs and a reorganization was effectuated after the investor struck a deal with the major union holding up the debtor's ability to present a workable reorganization plan. *Id.*; *see also* Tung, *supra* note 12, at 1702 ("Claims trading may also hold benefits for debtors and for creditors remaining in the case who do not hold marketable claims. In some

facing substantial risk of loss to accept a payout from a willing investor, or alternatively, permit creditors who lack patience to remove their capital and put it to work in other profitable pursuits.[231]

Despite the efficiencies inherent in the productive allocation of capital, the potential for misconduct in bankruptcy reorganization claim trading can arise in a number of ways. The most obviously destructive involves purchasing short positions in a bankrupt entity's equity, in addition to debt claims. By simply obstructing the reorganization process, the overall position will result in a significant payoff for an investor, conflicting with the historic aims of Chapter 11 and any reasonable interpretation of a productive reorganization process.[232] Additionally, the ability to quickly move into and out of claim positions presents an obstructionist tactic during the reorganization process. Even if done without malice, the debtor may lose out on "relationship-value" each time an investor buys into a creditor position, establishes some type of relationship with the debtor, then trades out of the position, taking a profit on any gains made in the interim.[233] The investor's quick move out of the position leaves the debtor in the lurch, having to start all over on developing a viable plan of reorganization with another investor holding that creditor position.[234] Ultimately, claim trading can facilitate a myriad of these obstructionist tactics, "us[ing] their unique positions to maximize their own returns at the expense of other creditors."[235] While this threat underlies perhaps any creditor claim on the bankrupt debtor, in an unregulated, liquid securities market, savvy claimants have the ability to enter into the reorganization process with their own aims (as opposed to appearing at the invitation, pre- or postpetition, of the debtor) and control a class of bankruptcy claims for their own ends.[236] With the 2010 market for distressed debt valued at nearly $1.06 trillion, distressed debt investing remains an active part of the securities marketplace, and shows no sign of slowing despite a nascent economic recovery after 2009's record valuation of the market at $1.61 trillion.[237] In light of the growing market for claims and potential for malfeasance, this marketplace seems to offer secured creditors another

situations, the debtor and nonselling creditors might welcome the investor's participation. A purchase of claims may be part of a larger deal that would benefit the reorganization.").

231. Tung, *supra* note 12, at 1701–02; *see also* Jelisavcic, *supra* note 229, at 399 ("Assuming adequate disclosure and awareness by a claim seller of its rights, it is in the best interest of the original trade creditor to have access to a liquid market in which claims can be sold quickly. In this way, losses can be realized, and recoveries reinvested in other profitable business ventures." (citations omitted)).

232. *See* Frank Partnoy & David A. Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1035 (2007) (noting that some lenders have a financial incentive to force the debtor to declare bankruptcy when it will enhance their short position).

233. Thomas, *supra* note 166, at 228.

234. *Id.* at 229.

235. *Id.* at 238.

236. *See id.* at 237 (discussing the actions of a sophisticated investor); *see also* Josef S. Athanas, *Using Bankruptcy Law to Implement or Combat Hostile Takeovers of Targets in Chapter 11*, 55 BUS. LAW. 593, 602–03 (2000) (explaining how a hostile bidder may purchase senior secured claims because there are frequently few holders of senior secured claims, thus there is little competition from other creditors that could prevent an investor from accomplishing their aims).

237. EDWARD I. ALTMAN & BRENDA J. KUEHNE, DEFAULTS AND RETURNS IN THE HIGH-YIELD BOND AND DISTRESSED DEBT MARKET: THE YEAR 2010 IN REVIEW AND OUTLOOK 3 (2011).

point of leverage over debtors in the reorganization process.

E. *Proposed Changes to the Code and the Inherent Inadequacies in Proposals that Fail to Address the Systemic Advantages Granted to Secured Creditors*

In the creditor-privileged environment of reorganization, greater disclosure and even broader systemic changes may fail to address the fundamental advantage conferred on creditors over the DIP.[238] While a DIP may always retain the right to dismantle the assets of the estate through Chapter 7 liquidation, this obviously provides little leverage to the debtor as it results in dissolution.[239] Commentators have suggested two paths for addressing creditor control in the claim-trading marketplace, including added measures of disclosure and additional impediments to decrease and discourage creditor malfeasance. This Part addresses these two proposed solutions, ultimately concluding that neither solution can fundamentally address the advantages granted to secured creditors, which are institutionalized in the Code.

1. The Shortcomings of Increased Disclosure

Greater disclosure of positional claims in a bankrupt debtor offers "the elimination of the . . . [distressed debt investor's] ability to bet on the failure of reorganization."[240] Under the current legal framework, disclosure requirements are imposed on "every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders."[241] In other words, any party or representative holding a claim on the debtor must disclose their identity. This requirement serves to protect the interests of those who are represented by these creditors or security holders that choose to be active in the reorganization process.[242] The underlying rationale for any disclosure requirement in this area is focused on protecting other parties holding similar claims, who may be impacted by the actions of other claimants in the reorganization negotiation.[243] Proponents of liberalizing the practice of trading bankruptcy claims liken the trade of these claims to the public equity and debt securities markets, which operate in a regulatory scheme premised on disclosure.[244] Despite the appeal of this familiar regulatory regime, "disclosure alone

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238. *See* Ayotte & Morrison, *supra* note 9, at 538–39 (explaining the pervasive nature of secured creditor control).

239. 11 U.S.C. § 721 (2006) (noting that a trustee may operate the debtor estate for a limited period if "such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate"). It should be noted that this threat is not empty, as liquidation may destroy the going-concern value of a business or its collective assets, but liquidation through Chapter 7 of the Bankruptcy Code is not a viable plan of reorganization by its very definition.

240. Thomas, *supra* note 166, at 247.

241. FED. R. BANKR. P. 2019(b)(1).

242. *In re* Nw. Airlines Corp., 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007).

243. *Id.*

244. Jelisavcic, *supra* note 229, at 398. The proposal to increase disclosure in the market for bankruptcy claims rests at least partially on the idea that the oversight provided by bankruptcy courts and their equitable powers lead to inefficiencies in the marketplace for bankruptcy claims, due to the opaque nature of disclosures and thus a limited ability for the marketplace to accurately price risk of any given bankruptcy claim. *Id.* Extending this theory further, increased disclosure would properly price the risk inherent in the marketplace.

may be necessary but not sufficient to correct systemic abuses."[245]

An enhanced disclosure regime encounters significant challenges both from the contents of positions that must be disclosed and the logistical challenges of such disclosures.[246] In particular, determination of what content should be disclosed is difficult, not least because distressed firms subject to creditor control might fall outside the purview of Chapter 11 protection because distress and substantive creditor control might begin before a bankruptcy filing.[247] In addition, mandating greater disclosure of investor positions in a debtor would impact creditors with both honorable and nefarious intentions—likely driving out those who wish to maintain the secrecy of trading strategies from competitors.[248] The logistics of such disclosure, proposed as a real-time updating system, presents an equally daunting challenge for policymakers, in that any open marketplace for bankruptcy claims would seem to require building upon the infrastructure created by proprietary markets, which would raise concerns about the spread of proprietary information.[249]

Ultimately, the objective of increasing disclosure is to increase the information available to other investors and participants in the reorganization process, to better sort the beneficial offers (i.e., the TWA postpetition creditor that sweeps in to the rescue, rather than see 170 airplanes sit on runways) from the obstructionist.[250] However, the previously described case studies explain the shortcomings in an increased disclosure scheme, at least with the pre- and postpetition creditors described. Taking the TWA postpetition creditor as an example, the competing bidders (who never materialized because of American's onerous terms) in the TWA bankruptcy were aware of the identity and motives of the few other bidders who they were competing against.[251]

Id. at 399.

245. Lipson, *supra* note 12, at 1677.

246. *Id.* at 1672.

247. *Id.* at 1669. See Part III.B for a discussion of Radnor Holdings and how a prepetition secured creditor can become involved with a distressed debtor and the other relevant creditor claims prior to the initiation of the Chapter 11 reorganization.

248. Tom Hals, *Hedge Funds, Bankruptcy Judges Spar Over Disclosure*, REUTERS (Feb. 4, 2010, 5:10 PM), http://www.reuters.com/article/2010/02/04/us-bankruptcy-disclosure-idUSTRE61362Y20100204. Though policymakers may argue that it would be good policy to force those with dishonorable intentions out of the claim-trading marketplace, there are significant issues with actually identifying bad actors from the positions that they take in a debtor, or forcing them to somehow affirm that their position was taken in good faith. *See* Harner, *supra* note 166, at 183 (noting the potential for abuse in debt-based takeovers). Furthermore, such a regulatory regime would likely require verification of good faith, or at least an enforcement mechanism to ensure that the information disclosed was not intentionally false. *Id.* Enforcement on par with regulatory bodies like the SEC would raise significant challenges. *Cf.* Kelli A. Alces, *Limiting the SEC's Role in Bankruptcy*, 18 AM. BANKR. INST. L. REV. 631, 639–45 (2010) (arguing that the SEC has more important work to focus its efforts on, and that SEC involvement in the regime established by the Code imposes significant additional costs on debtors and the current bankruptcy regulatory environment).

249. Lipson, *supra* note 12, at 1672–73. In other words, an open marketplace does not exist in bankruptcy claims, beyond those that have been built by private actors, and any proposal from scratch would require either substantial behavioral changes by investors (i.e., moving to another newly created marketplace, also likely built from scratch at some expense), or making changes to a private market and appropriating it for public benefit, also at some expense. *Id.*

250. Thomas, *supra* note 166, at 247.

251. Scott McCartney, *Icahn-Backed Offer Delays Sale of TWA—Bidder AMR Must Wait for Carrier to*

Rather, the issue faced by challengers to the postpetition arrangement was the privileged realm that American occupied through its DIP financing agreement.[252] Similarly, the prepetition secured creditor in the Radnor Holdings bankruptcy did not draw its strength from its anonymity—the funds obtained from TCP were used to pay off other creditors, leaving TCP as the sole secured creditor in the bankruptcy.[253] Though an increased disclosure scheme might help increase the knowledge of other creditors regarding claim-trading activities after the filing of a bankruptcy case, increased disclosure would fail to address the other substantial advantages granted to pre- and postpetition creditors.

2. The Potential Failure of Increasing Restrictions on the Exchange of Creditor Claims to Address the Systemic Advantages of Secured Creditors

Imposing some type of "equitable relief" on the claim-trading process offers an additional method to constrain claim trading and act as a barrier to investors seeking to enrich their own position at the expense of other creditors.[254] While a "blanket prohibition" on claims would be overly broad and overlook the benefits of a liquid market in creditor claims,[255] the imposition of a barrier to resale would narrow the list of potential investors, ensuring that only those interested in reorganization remain in the negotiations.[256] Bankruptcy courts have regulated the transfer of claims for a variety of reasons,[257] and some secured creditors have even inserted claim-trading restrictions in credit agreements.[258]

However, like disclosure issues, the systemic issues of creditor control would not be addressed through limiting a creditor's ability to trade claims. The conflicts between bargaining positions for the secured and unsecured creditors stem from disputes over value maximization in the reorganization, a problem that remains if claims cannot be transferred to other market participants.[259] Decreasing the ability for a pre- or postpetition creditor to transfer their claim to a third party might indeed decrease creditor leverage, but at the expense of driving debtors into a precarious position. Indeed, if TCP, the prepetition secured creditor, had been approached by Radnor Holdings but ultimately chose not to pursue Radnor's reorganization process after making the loan, a restriction on transferring their claims would have been devastating both to Radnor's planned reorganization, and to any alternative reorganization plans

Consider $650 Million Proposal, WALL ST. J., Mar. 6, 2001, at A3.

252. Second Amended Disclosure Statement, *supra* note 134, at 11.

253. Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, L.L.C. (*In re* Radnor Holdings Corp.), 353 B.R. 820, 829 (Bankr. D. Del 2006).

254. Tung, *supra* note 12, at 1748–54.

255. *Id.* at 1749. See *supra* notes 228–31 and accompanying text for a discussion of the productive and efficient use of claims trading in its efficient allocation of capital for investors.

256. Thomas, *supra* note 166, at 248.

257. *See, e.g.*, FED. R. BANKR. P. 3001(e) (granting bankruptcy courts an oversight role and permitting registration of the transfer of bankruptcy claims).

258. *See* Groshong, *supra* note 226, at 640–42 (discussing the bankruptcy of Comdisco, Inc. and its experiences with credit agreement restrictions).

259. Ayotte & Morrison, *supra* note 9, at 538–39.

that other creditors or outside bidders might have been interested in.[260] Without the possibility of accepting the offer to credit bid and purchase the debtor's assets to continue smooth operation of the business, liquidation would have been the most likely alternative.[261] Similarly, given the high burdens to involving other bidders in the postpetition example of TWA,[262] if American had ultimately chosen to change course and walk away from purchasing TWA, restrictions on transferring American's creditor claims could have been devastating. Given the urgency placed on TWA by the Code and its financial obligations, the pressure inherent in reorganization might have resulted in liquidation if American were not able to freely transfer its claim as an alternative. Indeed, inhibiting the transfer of claims might make the reorganization process more difficult for debtors, which would fail to address the underlying issues of creditor control.

IV. CONCLUSION

Corporate debtors have a lengthy history in the United States of seeking legal protections from overbearing creditors in times of financial distress.[263] In looking at corporate bankruptcy and reorganization under the current legislative framework, recent scholarship has pointed to the singular importance of creditors in the bankruptcy process at the expense of other constituent groups to a corporate bankruptcy.[264] Secured creditors hold significant advantages by virtue of their security interest (formed either pre- or postpetition)[265] in the bankruptcy case, although creditor control in reorganization is not exclusively reserved to the secured creditor.[266] Meanwhile, parties not originally involved with the debtor may invest in creditor claims for a variety of profit-driven motives.[267] This state of affairs seems contrary to congressional intent—the proposition that the debtor controlled its own fate in bankruptcy.[268] Indeed, examples of bankruptcy cases in recent years suggest that creditors have significant

260. In Radnor's case, TCP was so far involved with Radnor that its interest in the debtor's assets was obvious. Another example is the case of Allied Holdings, where had an investor not stepped in to present a plan of reorganization that brought the union into the fold, the reorganization process was in danger of failing and could have resulted in conversion to forced liquidation, or at the very least significant further delay. Harner, *supra* note 155, at 718–20.

261. Official Comm. of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (*In re* Radnor Holdings Corp.), 353 B.R. 820, 829 (Bankr. D. Del. 2006).

262. See *supra* notes 210–16 and accompanying text for a discussion of American's onerous sale terms and TWA's unlikely alternatives to American as a purchaser.

263. See *supra* Parts II.A through II.C for historical perspectives on the development of bankruptcy law in the United States.

264. Ayotte & Morrison, *supra* note 9, at 538.

265. 11 U.S.C. § 1129(a)(7)(B) (2006). In addressing the priority of secured claims, § 1129 makes no distinction as to whether the security interest was formed prior to or after the filing of the bankruptcy petition. *Id.*

266. *See* WHITMAN & DIZ, *supra* note 177, at 214–15 (describing hedge funds purchasing unsecured debt to influence reorganization plan claims to gain greater voting advantages and leverage in negotiations).

267. *See* Lipson, *supra* note 12, at 1645–50 (explaining motivations for claims trading and the scope of the unregulated claims market); Tung, *supra* note 12, at 1699–1701 (discussing motivations and incentives for claim-trading strategies).

268. *See* H.R. REP. NO. 95-595, at 92 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6053.

opportunity to dominate the reorganization process, a proposition that is born out both in empirical and anecdotal studies.[269]

Unfortunately, proposals to adjust the Code seem to fall short of addressing the potentially dangerous aspects of creditor control. The bankruptcies of TWA and Radnor Holdings both demonstrate how creditor control is a substantial part of the bankruptcy reorganization process. Additionally, claim trading offers third parties an avenue to participate in the tools of creditor control. Proposals to reduce creditor control comport with the original congressional views on the important role of the debtor in the bankruptcy reorganization process. However, in view of the history of bankruptcy legislation in the United States, the legal structure that underpins our current bankruptcy reorganization process harkens back to the era of railroad reorganization, with a cozy relationship between creditors, sorting out the fate of the bankrupt debtor. Proposals to amend or reduce creditor control must address the structural and historical legacy of creditor control, particularly if such proposals are to meet congressional intent to strengthen the debtor's role in reorganization and move away from the disturbingly close relationships and advantages granted to creditors in the current bankruptcy regime.

269. *See* Ayotte & Morrison, *supra* note 9, at 543–46 (describing an empirical methodology for evaluating degree of creditor control); Harner, *supra* note 155, at 718–20 (explaining how Allied Holdings, Inc. creditors exercised control in bankruptcy). See *supra* Part III.B for a discussion of the *Radnor Holdings* published opinion, and allegations of creditor control. See *supra* Part III.C for discussion of the TWA bankruptcy and sale to its secured creditor, American Airlines.