

## Big Boys and Chinese Walls

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### INTRODUCTION

In most modern bankruptcy cases under Chapter 11, creditors and sophisticated investors trade in the claims against the debtor. Treating these claims like securities, various parties—including creditors serving on creditors’ committees—buy and sell bank debts, trade debts, tort claims, and other obligations the debtor incurred in the course of business. Amid an unstable judicial and academic consensus that the securities laws do not apply to trading in these claims, courts have developed a set of bankruptcy-specific remedies for abusive claims trading, including for situations that resemble insider trading. Courts generally allow creditors on committees to trade claims as long as they have in place a “Chinese Wall”<sup>1</sup> separating their committee activity from their trading activity. But although Chinese Walls effectively prevent harms arising from violations of fiduciary duty, they are inappropriate guards against harms arising from insider trading itself. The crucial distinction between liability based on fiduciary duties and liability based on insider trading proper means that courts should accept the use of “big boy letters”—essentially nonreliance letters in which each party agrees to accept the possibility that the other has undisclosed inside information relevant to the trade—as an independent defense to insider trading liability.

This Comment thus argues that, together, big boy letters and Chinese Walls respond to the harms that animate the bankruptcy remedies. Chinese Walls address the harms involved in fiduciary duty liability, though they have certain practical deficiencies. Big boy letters, for their part, guard against the harms associated with insider trading liability. This core insight—that Chinese Walls address one source of liability and big boy letters the other—suggests that bankruptcy courts should incorporate Chinese Walls and big boy letters into their claims trading regulations, and thereby realign the remedies for insider claims trading along the division between fiduciary duty liability and insider trading liability proper.

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<sup>1</sup> Also called a “trading wall,” “screening wall,” “ethical wall,” or an “informational barrier.”

## I. A BIRD'S EYE VIEW OF CLAIMS TRADING, CHINESE WALLS, AND BIG BOY LETTERS

When an entity files for Chapter 11, typically its creditors hold various claims against it that exceed the debtor's assets.<sup>2</sup> These claims against the debtor can include secured and unsecured loans, trade debts, tort or contract claims, wage obligations to employees, and other sorts of obligations incurred in the course of business. The length, complication, and uncertainty of a bankruptcy case mean that a given claim could end up being worth more or less when the debtor finally reorganizes than it might appear at various points during the case. Some creditors, preferring not to take the risk that a claim's value will fall, may want to sell their claims to others who do. They can do so because the claims at issue are normally assignable to third parties.<sup>3</sup>

Thus it happens that in bankruptcy, sophisticated investors routinely bundle, buy, and sell these same claims several times over, often at steep discounts from their face values.<sup>4</sup> This "claims trading"<sup>5</sup> can give the original holder a quick and certain return while providing an investment vehicle to those with a high tolerance for risk. In addition, because claims against a debtor give the claimant a voice in the reorganization plan, some investors acquire claims in order to acquire the debtor itself.<sup>6</sup> Whether for speculation or for acquisition, trading in

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<sup>2</sup> The short version of the Bankruptcy Code's definition of "claim" is a "right to payment." 11 USC § 101(5) (2000 & Supp 2005). This is a broad definition that includes stocks and other securities. For simplicity, this Comment will use "claimant" and "creditor" interchangeably, and "claim" and "debt" interchangeably. In addition, for reasons that will become apparent below, this Comment uses "claim" to mean only forms of debt to which the securities laws do not now, but might in the future, apply. Most of this trading involves bank debt because the Bankruptcy Code definition of "security" explicitly excludes trade debt. See 11 USC § 101(49)(B)(vii) (2000 & Supp 2005) (stating that "security" does not include "debt or evidence of indebtedness for goods sold and delivered or services rendered").

<sup>3</sup> See, for example, *In re Pleasant Hill Partners, LP*, 163 BR 388, 391 n 5 (Bankr ND Ga 1994) (explaining that FRBP 3001(e) outlines the procedure for transfer, typically through sale and purchase, of bankruptcy claims).

<sup>4</sup> See Harold S. Novikoff and Barbara Kohl Gerschwer, *Selected Topics in Claims Trading*, in *Chapter 11 Business Reorganizations* 191, 195 (ALI-ABA 2003) ("The record number of bankruptcies during the past several years has brought with it an active market in claims trading."). See also Chaim J. Fortgang and Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 *Cardozo L Rev* 1, 2-3 (1990) (explaining that there is an active market for investors trading claims against corporations in Chapter 11).

<sup>5</sup> If a claim is a "right to payment," 11 USC § 101(5), "claims trading" occurs when investors buy or sell that right. In bankruptcy, however, the right usually sells for less than face value because at the end of bankruptcy the claimants against the debtor may not—indeed probably will not—receive all the debtor owes them. The debtor's inability to pay back its creditors, after all, is usually why it filed for bankruptcy (the claims exceed the assets). This Comment uses "claims trading" to refer only to trading in claims that are currently not subject to the securities laws.

<sup>6</sup> The basic idea of Chapter 11 is to provide a coherent framework for those with claims against the debtor to get a partial return on their claims, while reorganizing the debtor's capital

this kind of distressed debt has increased dramatically since the middle of the 1980s. Indeed, investors have formed distressed debt funds, some with assets of over a billion dollars.<sup>7</sup>

As claims trading has developed into a big business in American bankruptcies, it has posed a number of difficult legal questions. For starters, the more liquid and active the market in bankruptcy claims, the more claims begin to look like securities.<sup>8</sup> Indeed, whether or not such claims fall under the definition of securities under current securities case law remains an open question.<sup>9</sup> The similarities between claims trading and securities trading raise the question of why courts

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structure so that it can pay its debts as a going concern, insofar as that is possible given economic realities. A reorganization plan does this. The creditors or claimants holding a certain threshold percentage of the value of the total claims against the debtor can control whether the reorganization plan is accepted. See 11 USC § 1126(c) (2000). Frequently, part of a reorganization plan involves exchanging the debt a creditor holds for stock in the reorganized debtor. Thus acquiring claims against the debtor may give a creditor the chance to influence the plan so that its claims exchange for stock. See Alan N. Resnick and Henry J. Sommer, eds, 9 *Collier on Bankruptcy* ¶ 1.03[4] at 1-55 to -56 (Matthew Bender 15th rev ed 2007). See also Michael H. Whitaker, Note, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 Cornell J L & Pub Policy 303, 311 (1994) (observing that some traders acquire large blocks of claims to gain control by either blocking plans that do not give the trader a favorable equity stake or independently approving plans that do give the trader a favorable equity stake).

<sup>7</sup> See Robert D. Drain and Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 Am Bankr Inst L Rev 569, 569 n 1 (2002) (“Commentators offer anecdotal evidence of a [bankruptcy claims] market in the billions of dollars.”).

<sup>8</sup> For more discussion of this basic point, see notes 34–36 and accompanying text. See also Drain and Schwartz, 10 Am Bankr Inst L Rev at 620 (cited in note 7) (observing that claims traders, as voluntary investors in claims for profit, “have developed, if not a formal exchange, at least enough trading activity to create an informal market in distressed claims” and suggesting that this voluntary, active market in investment instruments resembles the securities markets). Again, securities are themselves claims against the debtor but this Comment uses “security” to denote those claims, like traditional bonds and stocks, to which the securities laws uncontroversially apply, and “claims” to denote those claims over which there is controversy regarding whether the securities laws apply to trading in them.

<sup>9</sup> See generally, for example, Richard G. Mason and Gregory E. Pessin, *Legal Issues in Claims Trading* (Papers of the 32nd Annual Workshop on Bankruptcy and Business Reorganization, NYU School of Law, Sept 27–29, 2006) (discussing the importance of contemporary developments to the question of whether debt trading should be regulated under securities law); Drain and Schwartz, 10 Am Bankr Inst L Rev 569 (cited in note 7) (arguing against treating bankruptcy claims as securities except in limited circumstances); Thomas Donegan, Note, *Covering the “Security Blanket”: Regulating Bankruptcy Claims and Claim-Participations Trading under the Federal Securities Laws*, 14 Bankr Dev J 381 (1998) (arguing for treating bankruptcy claims as securities); James D. Prendergast, *Applying Federal Securities Laws to the Trading of Claims in Bankruptcy*, 3 Faulkner & Gray’s Bankr L Rev 9 (1992) (same); Anthony Michael Sabino, *No Security in Bankruptcy: The Argument against Applying the Federal Securities Laws to the Trading of Claims of Chapter 11 Debtors*, 24 Pac L J 109 (1992) (reviewing legal developments in bankruptcy and concluding that bankruptcy claims are not securities); Fortgang and Mayer, 12 Cardozo L Rev 1 (cited in note 4) (same). Despite this academic debate, the general view among bankruptcy judges and practitioners is that claims are not securities. See Alan N. Resnick and Henry J. Sommer, 6 *Collier Bankruptcy Practice Guide* ¶ 94.08 at 94–127 (Matthew Bender 2007) (“The securities laws do not, . . . as interpreted by recent decisions, define trade claims in bankruptcy as ‘securities.’”).

do not apply the securities laws to trading in bankruptcy claims. The debate over this question is important background, but this Comment does not join it, except to note that for most commentators the non-application of the securities laws to claims trading hinges in part on the ability of bankruptcy courts to develop sensible rules regulating claims trading—rules that can address, in the particular context of bankruptcy, the problems the securities laws address elsewhere.

One situation where this challenge arises involves insider trading, which this Comment defines as trading with material nonpublic information.<sup>10</sup> In a bankruptcy, some of the parties trading the debtor's securities or other claims may have inside information about the likely prospects of the debtor, information relevant to the value of both the securities and other claims. The SEC's Rule 10b-5<sup>11</sup> and the case law interpreting it already govern insider trading in securities. Alongside the securities laws, bankruptcy courts have begun to develop remedies from the Bankruptcy Code<sup>12</sup> ("the Code") and precedent to govern insider trading in claims.<sup>13</sup> If one assumes that the securities laws do not apply to claims trading, one can analyze this alternative regulatory regime to determine how it might adapt to new investor behavior in productive and conceptually consistent ways. This background regime ("the bankruptcy remedies" or "claims trading remedies") is still evolving. If it is to be a sensible alternative to securities law in this context, that regime must successfully address the problems that insider trading poses inside of bankruptcy. This Comment focuses on insider trading by members of creditors' committees and examines how claims trading regulations in this particular context might evolve to account for some new investor behaviors.

The creditor who sits on a creditors' committee, then, is the central character of this story.<sup>14</sup> Because creditors on such committees

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<sup>10</sup> As with "claims," one must be careful here with terminology. The Bankruptcy Code has a specific definition of "insider," 11 USC § 101(31) (2000 & Supp 2005), but this Comment defines "insider trading" simply as trading on material nonpublic information and "insider" as one who trades on such information.

<sup>11</sup> 17 CFR § 240.10b-5 (2000).

<sup>12</sup> 11 USC § 101 et seq (2000 & Supp 2005).

<sup>13</sup> See, for example, *Citicorp Venture Capital, Ltd v Committee of Creditors Holding Unsecured Claims*, 160 F3d 982, 991–92 (3d Cir 1998) (granting equitable subordination where a fiduciary purchased notes at a discount based on inside information to make a profit and influence the reorganization plan for its own gain without disclosing this information to any third parties).

<sup>14</sup> Creditors' committees are groups of creditors who work together to negotiate with the debtor regarding its reorganization. See 11 USC § 1103(c). Although any group of creditors can do this informally, § 1102 typically requires the appointment of an official creditors' committee consisting of the seven largest creditors. See 11 USC § 1102(a)(1), (b)(1). In practice, this committee often includes a representative sampling of the general creditors, whether or not they are among the top seven. See Douglas G. Baird, *Elements of Bankruptcy* 21–22 (Foundation 4th ed

negotiate with the debtor frequently, they often have material, non-public information about the debtor. Creditors on official committees are always fiduciaries for the creditors they represent;<sup>15</sup> those on unofficial committees may be fiduciaries, depending on the circumstances.<sup>16</sup> Some of bankruptcy's claims trading regulations aim to compensate those harmed when creditors on committees trade claims on inside information.<sup>17</sup>

In response, some institutional investors who were creditors of the debtor and who wanted to trade in the debtor's securities or claims started asking courts to issue "trading orders," allowing them to trade provided they meet certain requirements.<sup>18</sup> These requirements are collectively known as a Chinese Wall, and they separate the trading activity of a creditor from its committee activity. This prevents the traders from capitalizing on inside information and ensures that the committee members represent their constituents without any conflict of interest.<sup>19</sup> Courts have allowed these Chinese Walls to act as an ex ante defense, immunizing claims trading creditors from some liability.<sup>20</sup>

Into this quickly developing scene has stepped a new figure: the big boy. As courts continue to struggle with how to address claims trading, sophisticated investors with potential inside information have developed their own strategy. This is the new trading behavior referred to above. Put briefly, an insider admits that he might have inside information and another party acknowledges this admission and agrees not to rely on the insider's representations, to accept the risk, and to do the trade anyway. The idea is that all the parties are adults and can make their own judgments. The parties memorialize their agreement in a document fittingly called a big boy letter.<sup>21</sup>

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2006). Its purpose is to represent the interests of a certain class of creditors, usually the general unsecured creditors. *Id.*

<sup>15</sup> Novikoff and Gerschwer, *Selected Topics in Claims Trading* at 195 (cited in note 4) (stating that committee members are not, however, necessarily fiduciaries to the debtor and citing *Woods v National Bank and Trust Co of Chicago*, 312 US 262, 268–69 (1941) in support).

<sup>16</sup> Ralph R. Mabey, *The Legal Consequences for a Claims Trader Who Is a Fiduciary* 45, 46–49 (Papers of the 32nd Annual Workshop on Bankruptcy and Business Reorganization, NYU School of Law, Sept 27–29, 2006) (explaining who qualifies as a "fiduciary" and distinguishing the duties of ad hoc committee members from those of official committee members).

<sup>17</sup> See Part IV.

<sup>18</sup> For a detailed discussion of these requirements, see Part V.

<sup>19</sup> Maintaining a Chinese Wall is not costless for a firm; it entails certain inefficiencies and is not always feasible. See text accompanying notes 128–30.

<sup>20</sup> See, for example, *In re Federated Department Stores, Inc*, 1991 WL 79143, \*2 (Bankr SD Ohio) ("Fidelity will not be violating its fiduciary duties as a committee member . . . provided that Fidelity employs an appropriate information blocking device or 'Chinese Wall.'").

<sup>21</sup> A typical big boy letter might include the following representations by the buyer: that it is financially sophisticated; that it knows the insider may possess material nonpublic information; that it is not relying on any representations that the big boy letter does not contain; and that it is waiving all claims against the insider arising from the trade. Stephen E. Older and Joshua M.

To figure out the differing roles of these two investor tools—Chinese Walls and big boy letters—is the challenge at hand. The next Part begins with a review of the legal debate about whether the securities laws should apply to claims trading and what justifies their current nonapplication. Part III summarizes the law regulating fiduciary trading on inside information, of which trading by committee members is a type. It highlights the critical distinction at the heart of this Comment between liability arising from the law of fiduciaries and liability arising from the law of insider trading. Part IV turns to specifics. It analyzes the parallel bankruptcy remedies for claims trading violations to explain how the principal harms that bankruptcy courts fear from the practice map onto these two sources of liability. These are the background rules that would apply in the absence of prophylactic measures like Chinese Walls. Part V then lays out the core argument of this Comment. Part V.A discusses Chinese Walls and outlines the class of harms they can stop and the sources of liability from which they can immunize a committee member. Part V.B does the same analysis for big boy letters. Part V.C compares big boy letters with Chinese Walls in this respect. Here the Comment presents its thesis: courts should treat Chinese Walls as a defense to one source of liability (fiduciary duty liability) and big boy letters as a defense to the other source (insider trading liability).<sup>22</sup> Even though courts and the SEC have not always clearly distinguished between these two sources of liability, the harms they worry about and the remedies they impose nonetheless illustrate the difference.

Part VI connects the core argument to the larger field of relevant law by asking what big boy letters and Chinese Walls tell us about Rule 10b-5 liability outside of bankruptcy. The answer, merely traced here, suggests a new line of inquiry. For if big boy letters and Chinese Walls apply to two separate legal harms—insider trading and the breach of fiduciary duties, respectively—requiring distinct remedies,

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Bloomstein, *Cutting "Big Boys" Down to Size*, 38 *Mergers & Acquisitions* 38, 39 (2003) (noting that courts have not reached a clear decision on whether the letters are enforceable). For a current sample of the big boy language used in distressed debt trading documents, see Loan Syndications and Trading Association, *User's Guide for LSTA Distressed Debt Trading Documentation* § IV.C.2.b.20 at 19–20 (2007), online at <http://www.lsta.org/WorkArea/downloadasset.aspx?id=1114> (visited Jan 12, 2008).

<sup>22</sup> See Part III for a detailed discussion of the difference between these two sources of liability. Although insider trading liability has some basis in the common law, see note 49 and accompanying text, the modern law is a creature of federal statute, whereas fiduciary duties derive from state common law. In its enforcement of the insider trading regulations, however, the SEC and courts have not kept this distinction clear. See, for example, *United States v O'Hagan*, 521 US 642, 652–53 (1997) (expanding insider trading liability to include a “misappropriation” theory under which, even if he has no duty to the party with whom he trades, an insider with a fiduciary duty to his information’s source can be liable to that source under Rule 10b-5).

then the law of securities and corporate governance outside of bankruptcy should also treat these harms separately.

## II. THE BACKGROUND DEBATE: DO THE SECURITIES LAWS APPLY TO CLAIMS TRADING?

The debate over whether securities laws apply to claims trading casts a long shadow over claims trading jurisprudence. For it turns out that among the compelling reasons not to apply the securities laws to claims trading, the foremost is the presence of an alternative regulatory regime: the bankruptcy remedies. If that regime does not work well, then it cannot, as it now does, justify the current consensus that the securities laws do not apply to claims trading.

In general, the Supreme Court determines when an instrument is a security by looking to “the economic substance of the transaction, rather than just to its form.”<sup>23</sup> Indeed, “[t]he fundamental purpose undergirding the Securities Acts,” Supreme Court opinions have repeatedly stated, “is to eliminate serious abuses in a largely unregulated securities market.”<sup>24</sup> According to the Court, Congress did not want a rigid definition that would be easy for traders to avoid by structuring their transactions around it because the purpose of the securities laws was “to regulate *investments*, in whatever form they are made and by whatever name they are called.”<sup>25</sup>

The Securities and Exchange Acts<sup>26</sup> define “security” by a lengthy list of some rather ambiguous terms, ambiguity that may reflect Congress’s preference for flexibility.<sup>27</sup> “[N]ote[s]”—likely to accurately

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<sup>23</sup> *Landreth Timber Co v Landreth*, 471 US 681, 688 (1985) (holding that a sale of stock amounting to the entire business is regulated by securities law).

<sup>24</sup> *Reves v Ernst & Young*, 494 US 56, 60 (1990) (discussing whether a promissory note is a security), quoting *United Housing Foundation, Inc v Forman*, 421 US 837, 849 (1975) (stating that securities laws are focused on preventing fraud and protecting the interests of investors).

<sup>25</sup> *Reves*, 494 US at 61. Justice Marshall followed precedent in making clear that “Congress did not, however, intend to provide a broad federal remedy for all fraud.” *Id.*, quoting *Marine Bank v Weaver*, 455 US 551, 559 (1982) (holding that a certificate of deposit is not a security regulated by federal securities law).

<sup>26</sup> Securities Act of 1933 (“Securities Act”), 48 Stat 74, codified as amended at 15 USC § 77a et seq (2000 & Supp 2002); Securities Exchange Act of 1934 (“Exchange Act”), 48 Stat 881, codified as amended at 15 USCA § 78a et seq (2007).

<sup>27</sup> The definitions from the Securities and Exchange Acts are very long and appear here only in relevant part. The Securities Act states: “The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . or, in general, any interest or instrument commonly known as a ‘security.’” 15 USC § 77b(a)(1). The Exchange Act provides: “The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement, . . . or in general, any instrument commonly known as a ‘security.’” 15 USC § 78c(a)(10) (2000).

encompass the claims traded in bankruptcy—is one of these ambiguous terms. *Reves v Ernst & Young*<sup>28</sup> supplied the governing test for whether a note is a security, under which a note is presumed to be a security unless it bears a “family resemblance” to certain types of notes commonly understood not to count as securities.<sup>29</sup> A court must determine the resemblance with reference to four factors: (1) whether the purpose of the transaction centers on profitable investment, the facilitation of capital, or some other commercial purpose; (2) whether the “plan of distribution” involves “common trading for speculation or investment”; (3) the “reasonable expectations of the investing public”; and (4) “the existence of another regulatory scheme.”<sup>30</sup>

Commentators have applied *Reves* to bankruptcy claims and come up with opposite, but equally supported, results.<sup>31</sup> Courts have

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Commentators once thought that the absence of “evidence of indebtedness” from the Exchange Act’s definition of security was significant (especially, for present purposes, if claims were to count as evidences of indebtedness). But the Supreme Court definitively precluded such thinking when it reaffirmed in 1990 that the definitions in the Acts are “virtually identical” and that “the coverage of the two Acts may be considered the same.” *Reves*, 494 US at 61 n 1. But see Resnick and Sommer, 6 *Collier Bankruptcy Practice Guide* ¶ 94.08[1] at 94–129 (cited in note 9) (arguing that the absence of “evidence of indebtedness” from the Exchange Act might mean that Rule 10b-5 does not regulate trade claims even if the Securities Act does). In any case, this Comment takes “note[s]” as the most likely term (appearing in both definitions) to apply to claims.

As mentioned in note 2, the Bankruptcy Code’s definition of “security” explicitly leaves out trade claims.

<sup>28</sup> 494 US 56 (1990).

<sup>29</sup> See *id.* at 65 (reasoning that not all notes are securities because Congress did not intend to create a general cause of action for fraud). The notes recognized as not being securities are: a note delivered in consumer financing; a note secured by a home mortgage; a short-term note secured by a lien on a small business; a note evidencing a “character loan” to a bank customer; a short-term note secured by an assignment of accounts receivable; a note finalizing an open-account debt incurred in the ordinary course of business; or a note evidencing loans from a commercial bank for current operations. *Id.*

<sup>30</sup> *Id.* at 66–67 (reasoning that a transaction based upon profitable investment supports treatment as a security, but that another regulatory scheme may significantly reduce the risk of the instrument and render securities regulation unnecessary).

<sup>31</sup> See, for example, the capable demonstration of possible opposing positions in Drain and Schwartz, 10 *Am Bankr Inst L Rev* at 619 (cited in note 7) (arguing for a context-dependent analysis because the *Reves* test can go both ways for bankruptcy claims). One could credibly take either side. Donegan, Prendergast, and Sabino engage in the most straightforward debate over the application of the *Reves* test. They assume that the moment a claim would become a security is the filing of the bankruptcy petition. See Donegan, Note, 14 *Bankr Dev J* at 403 (cited in note 9) (implying that both the original claimant and any subsequent purchaser of the claim meet the passive investment requirement for securities regulation); Prendergast, 3 *Faulkner & Gray’s Bankr L Rev* at 13–14 (cited in note 9) (noting that all the criteria in *Reves* seem to argue for application of the federal securities laws in the claims trading environment); Sabino, 24 *Pac L J* at 119–22 (cited in note 9) (arguing that a claim should not turn into a security once a bankruptcy petition is filed). For an important weakness of their focus on the time of the petition, see note 37. By contrast Fortgang and Mayer, the first and probably most thorough commentators on this question and on claims trading in general, point to the resale of the claim as the time of its possible transformation into a security. Fortgang and Mayer, 12 *Cardozo L Rev* at 52–53 (cited in note 4) (“The trade claim in bankruptcy would not be the first instrument which is not a security

almost never addressed the question directly, and the existing cases are out of date and unhelpful.<sup>32</sup> Though a mechanical application does not provide a clear answer, some recent lower court opinions (addressing instruments similar to claims) and the commentary suggest the following basic principles.<sup>33</sup>

The securities laws are designed to regulate investments and prevent abuses in their trading, including abuses of inside information.<sup>34</sup> Although traditionally most creditors in a reorganization were not investors, contemporary distressed-debt traders do in fact resemble securities investors. They frequently “buy in” to the bankruptcy process and trade claims voluntarily and actively.<sup>35</sup> Does it make functional sense to apply the securities laws to them? In answering this question, one might synthesize the disparate case law on claims trading as follows. First, as Robert Drain and Elizabeth Schwartz contend, there are two scenarios in which the argument for treating claims as securities is strongest: “(i) where active trading is taking place, particularly [insider trading] and (ii) where an investor is seeking to acquire claims or a class of claims to gain control of the reorganized debtor.”<sup>36</sup> Part IV illustrates that these are precisely the scenarios with which the claims

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when issued but is a security when resold. Consider the humble home mortgage.”). For a contemporary discussion of the question, see Mason and Pessin, *Legal Issues in Claims Trading* at 9 (cited in note 9) (arguing that increased liquidity and fewer covenantal protections in bank term loans, combined with the involvement of largely unregulated hedge funds in trading them, weakened the case against applying the securities laws to at least that kind of claim).

<sup>32</sup> The only two cases to ask whether bankruptcy claims are securities contradicted each other on similar, rather narrow, facts. Compare *SEC v Texas International Co*, 498 F Supp 1231, 1240 (ND Ill 1980) (holding that fraud claims against a debtor counted as securities where the settlement provided for transfer of claims into equity in the reorganized debtor), with *Lipper v Texas International Co*, 1979 WL 1200, \*4 (WD Okla) (holding that the bankruptcy claims sold by members of a tort class action settlement fund were not securities where the settlement provided for transfer of claims into equity in the reorganized debtor).

<sup>33</sup> See, for example, *Banco Espanol de Credito v Security Pacific National Bank*, 973 F2d 51, 56 (2d Cir 1992) (holding, over a strong and well reasoned dissent, that loan participations are analogous to commercial bank loans and thus do not count as securities under the *Reves* test). Loan participations, like claims, are instruments that normally are not securities, but “the manner in which [they] . . . are used, pooled, or marketed might establish that such participations are securities.” *Id.* *Banco Espanol* both illustrates the difficulty of applying the *Reves* test mechanically and provides some ideas relevant to claims trading regulation.

<sup>34</sup> See, for example, *United Housing Foundation*, 421 US at 849 (“The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on . . . the need for regulation to prevent fraud and to protect the interest of investors.”).

<sup>35</sup> See Drain and Schwartz, 10 Am Bankr Inst L Rev at 620 (cited in note 7) (noting that vulture investors actively seek to become creditors with the intent of turning a profit or gaining control). These observations, and those of this paragraph generally, owe a great deal to Drain and Schwartz’s article at 620–21.

<sup>36</sup> *Id.* at 620–21. Note that by including the integrity of the reorganization process among the concerns of securities law, Drain and Schwartz might follow the courts in mixing fiduciary liability with insider trading liability.

trading remedies are in fact concerned, meaning that the remedies do constitute an analogous regulatory regime.

Second, among several practical considerations that have persuaded many commentators to accept the assumption that claims are not securities,<sup>37</sup> the most important is precisely that these specialized bankruptcy remedies do provide an alternative regulatory regime.<sup>38</sup> Indeed, the existence of alternative bankruptcy remedies goes to the fourth factor of the *Reves* test for withholding application of the securities laws.<sup>39</sup>

One must therefore ask: how well do bankruptcy courts do what the securities laws would do if they applied to claims trading? Before this Comment focuses on the alternative bankruptcy remedies, however, Part III provides some additional background on the two types of liability involved and the kinds of harms they aim to prevent and deter. As will be seen, these are the same harms animating the scenarios that most merit regulation under the securities laws and the claims trading remedies.

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<sup>37</sup> See, for example, Resnick and Sommer, 9 *Collier on Bankruptcy* ¶ 94.08[1] at 94-132 (cited in note 6) (“It is therefore, difficult to see how, under existing case law, claims in bankruptcy can fall within the definition of ‘security,’ unless they qualified as securities prior to bankruptcy.”). This observation may have further implications. Nothing about the filing of a bankruptcy petition changes the nature of the claim, which predates bankruptcy. The only thing a petition does is allow a bankruptcy court to intervene according to the claims trading remedies. This means that where the debtor has not yet filed a petition and no court can apply the bankruptcy remedies, the case for nonapplication of the securities laws to claims trading may be correspondingly weaker.

<sup>38</sup> Drain and Schwartz, 10 *Am Bankr L Rev* at 575 (cited in note 7).

<sup>39</sup> Even before *Reves*, the Supreme Court at least twice based a holding that certain instrument are not securities on the presence of an alternative regulatory regime. See *Marine Bank*, 455 US at 559 (holding that a bank certificate of deposit is not a security due to the adequate protection provided by the alternative regime of the banking laws); *International Brotherhood of Teamsters v Daniel*, 439 US 551, 569–70 (1979) (holding that an interest in a noncontributory compulsory pension plan is not a security due to the alternative ERISA regime). Furthermore, the majority in *Banco Espanol* emphasized the narrow, commercial scope of the purchases at issue and the presence of an alternative regulatory regime under the Office of the Comptroller of Currency. 973 F2d at 55.

### III. THE LAW OF FIDUCIARIES AND THE LAW OF INSIDER TRADING<sup>40</sup>

An inside trade can cause harm to two distinct parties.<sup>41</sup> First, it can harm the party with whom the insider trades. This generates the core insider trading liability with which federal securities law, primarily Rule 10b-5, is concerned. Second, an inside trade can harm third parties to whom the insider owes some duty by statute, contract, or fiduciary relationship. (This Comment focuses on obligations arising from fiduciary duty.) This second, fiduciary theory of liability is not unique to insider trading. It merely arises here as an instance of the wider set of obligations, generally enforceable at state common law, that a fiduciary owes to his principal. The legal concept of a fiduciary simply indicates someone who manages someone else's property.<sup>42</sup> The fiduciary duties of care and loyalty track the concept—the fiduciary cannot neglect or incompetently mismanage the principal's property, and he cannot use it in his own interest rather than the interest of the principal for whom he manages it.<sup>43</sup> Just like any fiduciary, therefore, an insider (assuming he is also a fiduciary) who trades has duties of care and loyalty.<sup>44</sup> Thus, regardless of whether there was insider trad-

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<sup>40</sup> The distinction between fiduciary duties and insider trading proper is not new, although it seldom receives attention. One exception is Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 269 (Harvard 1991) (pointing out problems with conflating fiduciary duties and insider trading). The original emphasis here is on the distinction in the context of claims trading and the extent to which it separates the two legal regimes.

<sup>41</sup> For general information on fiduciary duties and insider trading, see Larry D. Soderquist and Theresa A. Gabaldon, *Securities Law* 143 (Foundation 2d ed 2004) (noting that insider trading regulations are most commonly applied to insiders with a fiduciary duty to their traders, which may be the shareholders, to whom they have a fiduciary duty as beneficial owners of the corporation); Easterbrook and Fischel at 265 (cited in note 40) (explaining the cause of action for insider trading).

<sup>42</sup> See Arthur R. Pinto and Douglas M. Branson, *Understanding Corporate Law* 199 (Matthew Bender 2004) (“[A fiduciary relationship] is generally created when one is given power that carries a duty to use that power to benefit another.”). The word fiduciary comes from the Latin *fides*, meaning “faith,” or *fiducia*, meaning “trust,” “confidence,” or “assurance.” See *The American Heritage Dictionary of the English Language* 656 (Houghton Mifflin 4th ed 2000).

<sup>43</sup> See Pinto and Branson, *Understanding Corporate Law* at 200 (cited in note 42) (claiming that the duty of care requires the diligence of a reasonable person in similar circumstances and that the duty of loyalty requires the fiduciary to act in the best interests of the corporation and in good faith). Although one typically speaks of a duty of loyalty, it is worth noting that this really denotes a duty of disinterestedness—a less vague and indeterminate term than loyalty, and tied closer to the meaning of fiduciary. This Comment follows standard usage of the duty of “loyalty,” but on the assumption that the core of the duty is to be disinterested with respect to the principal's property. Thanks to Richard Levin for this insight.

<sup>44</sup> See, for example, *In re TASER International Shareholder Derivative Litigation*, 2006 WL 687033, \*14 (D Ariz) (describing allegations of breach of duty of care and loyalty where fiduciaries released misleading information so they could sell stock at inflated prices).

ing, whenever the fiduciary violates his obligations, the injured principal can usually sue in state court.<sup>45</sup>

Insider trading law proper, by contrast, imposes liability particular to the inside trade. Most of the attention focuses on the federal statutes, but state common law actions for insider trading remain available.<sup>46</sup> Indeed, the Exchange Act § 10(b)<sup>47</sup> and Rule 10b-5<sup>48</sup> codified and clarified the developing common law on insider trading.<sup>49</sup> At the same time, the securities laws do not “provide a broad federal remedy for all fraud.”<sup>50</sup> Instead, Rule 10b-5 trains on a particular kind of fraud, leaving general actions for the same state courts that adjudicate fiduciary duty cases. Doctrinally, civil liability for insider trading requires that someone in possession of material, nonpublic informa-

<sup>45</sup> See, for example, *McMullin v Beran*, 765 A2d 910, 921 (Del 2000) (discussing the duty of care); *Guth v Loft*, 5 A2d 503, 510 (Del 1961) (discussing the duty of loyalty). See also *Diamond v Oreamuno*, 248 NE2d 910, 915 (NY 1969) (“[N]othing in the Federal law [ ] indicates that it was intended to limit the power of the States to fashion additional remedies to effectuate similar purposes. . . . The primary source of the law in this area ever remains that of the State which created the corporation.”).

<sup>46</sup> For the debate about what state common law might be like now absent 10b-5, compare Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 264–66 (cited in note 40) (arguing that the common law does not preclude insider trading unless trade was induced by misrepresentations by the insider or the insider violated the corporate opportunity doctrine), with Douglas M. Branson, *Choosing the Appropriate Default Rule—Insider Trading under State Law*, 45 Ala L Rev 753, 754 (1994) (arguing that there are at least five state law foundations for civil insider trading liability).

<sup>47</sup> Section 10(b) delegates to the SEC the regulation of manipulation or deception in the purchase or sale of securities. 15 USC § 78j(b) (2000). Note that the language of the statute controls the reach of Rule 10b-5. See *Ernst & Ernst v Hochfelder*, 425 US 185, 214 (1976) (recognizing that the scope of Rule 10b-5 “cannot exceed the power granted the Commission by Congress under 10b”).

<sup>48</sup> The SEC promulgated Rule 10b-5 pursuant to § 10(b) of the Exchange Act. 15 USC § 78j (2000). Rule 10b-5 says:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
  - (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
  - (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,
- in connection with the purchase or sale of any security.

17 CFR § 240.10b-5.

<sup>49</sup> For an outline of the state common law on insider trading in the 1930s, see Stephen M. Bainbridge, *Securities Law: Insider Trading* 7–23 (Foundation 1999). Despite its common law antecedents, federal law on insider trading is now firmly a creature of statute, and plaintiffs and prosecutors must base their complaints on the statutory text. See *Santa Fe Industries v Green*, 430 US 462, 472 (1977).

<sup>50</sup> *Reves*, 494 US at 61 (quotation marks and citations omitted).

tion cause another, to whom he owes a duty, to rely to his detriment on representations the first person knew to be inaccurate.<sup>51</sup> The two essential elements for the availability of big boy letters as defenses are reliance and the duty requirement. Reliance is relatively straightforward: the noninsider must have relied to his detriment on the insider's representations. The duty to disclose and the failure to disclose a material fact establish a rebuttable presumption of reliance.<sup>52</sup> The function of the big boy letter is to rebut this presumption.<sup>53</sup>

The duty requirement bears some of the responsibility for the confusion between insider trading liability and fiduciary liability.<sup>54</sup> Securities law and the law of claims trading are all in accord that the possession of inside information alone does not suffice for legal liability. One who has inside information must also be under a duty not to trade without disclosing it in order to be liable for trading without disclosure.<sup>55</sup> Although the duty in question can be a fiduciary duty, it

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<sup>51</sup> Thus the black letter elements of insider trading are: materiality, causation of reliance, reliance to the noninsider's detriment (harm), and a duty to disclose. See Bainbridge, *Securities Law: Insider Trading* at 58–63 (cited in note 49). For more on the element of reliance, see Ann Morales Olazábal, *Loss Causation in Fraud-on-the-Market Cases Post-Dura Pharmaceuticals*, 3 Berkeley Bus L J 337, 343 (2006).

<sup>52</sup> Soderquist and Gabaldon, *Securities Law* at 148 (cited in note 41) (discussing the reliance requirement in nondisclosure situations), citing *Affiliated Ute Citizens v United States*, 406 US 128 (1972) (holding that a failure to disclose material facts is enough to establish reliance) and *Shapiro v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F2d 228 (2d Cir 1974) (extending *Affiliated Ute* to situations involving anonymous market transactions).

<sup>53</sup> See Part V.B. For one case holding that big boy letters rebut this presumption, see *Rissman v Rissman*, 213 F3d 381, 384 (7th Cir 2000) (“A written anti-reliance clause precludes any claim of deceit by prior representations.”). See also Mark E. Betzen and Richard Meamber, *Rule 10b-5 and Related Considerations in Acquisition Agreements*, Jones Day Commentaries (June 2004), online at [http://www1.jonesday.com/pubs/pubs\\_detail.aspx?pubID=S1265](http://www1.jonesday.com/pubs/pubs_detail.aspx?pubID=S1265) (visited Jan 12, 2008) (addressing potential effects of common “big boy” boilerplate language).

<sup>54</sup> The Supreme Court recently furthered the conflation of insider trading liability proper and fiduciary liability. In *United States v O'Hagan*, 521 US 642 (1997), the justices expanded 10b-5 liability to include a “misappropriation” theory, according to which an insider can be liable to the source of his information if he has a fiduciary duty to that source, even if he has no duty to the party with whom he trades. *Id.* at 652, codified in 17 CFR § 240.10b5-2. The opinion does not explain why Rule 10b-5 should remedy this misappropriation, which would seem to be a straightforward violation of the law of fiduciary duties adjudicable in state court. The problem is that misappropriation, just like, for example, self-dealing by committee members, is merely a species of the wider class of violations of the fiduciary duty of loyalty and fair dealing. But the law of fiduciary duties is not the law of insider trading, and misappropriation theory confuses the two. There is therefore a latent federalism issue in this aggrandizement of federal insider trading law, for in expanding its reach it encroaches upon a traditional province of state courts. See Bainbridge, *Securities Law: Insider Trading* at 63–67 (cited in note 49). The Supreme Court has occasionally recognized the issue, see, for example, *Santa Fe*, 430 US at 473–74, but decisions such as *O'Hagan* confirm its unwillingness to apply the distinction rigorously.

<sup>55</sup> See, for example, *Chiarella v United States*, 445 US 222, 227–28 (1980) (noting that liability depends on fraud and holding that one cannot commit fraud by withholding information unless there is a duty to disclose).

does not have to be, and Justice Frankfurter famously criticized facile reliance on the presence of such a duty to find liability.<sup>56</sup>

Recall the two scenarios that Drain and Schwartz pointed to as cases for regulation: where active trading, particularly insider trading, was occurring and where parties were acquiring claims to control the reorganization or the debtor itself. One can distinguish these two situations according to the two legal regimes at issue: insider trading on the one hand and fiduciary duties on the other.<sup>57</sup> The same harms—taking advantage of a trading partner in a worse position and self-dealing—underlie the situations meriting regulation as underlie the legal regimes. Against this background understanding, the next two Parts analyze in detail the bankruptcy remedies for insider claims trading and two solutions that investors have generated to solve the problems associated with that trading: the Chinese Wall and the big boy letter.

#### IV. THE BANKRUPTCY REMEDIES

Although nothing in the Code explicitly addresses claims trading, courts have extrapolated from various provisions to provide remedies to parties that object to certain claims trades, consistent with the equitable powers of a bankruptcy court.<sup>58</sup> Though some midcentury jurisprudence made much of bankruptcy courts' powers of equity,<sup>59</sup> the contemporary view requires bankruptcy courts to exercise their equitable pow-

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<sup>56</sup> See *SEC v Chenery Corp.*, 318 US 80, 85–86 (1943) (“[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry.”). See also Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 269–70 (cited in note 40) (arguing that both actual contracts and the probable outcome absent transaction costs suggest legal rules opposite those devised by emphasizing fiduciary duties).

<sup>57</sup> Part IV illustrates the relationship between fiduciary duties and trading claims to control the reorganization.

<sup>58</sup> FRBP 3001(e) used to allow courts the power to review most trades sua sponte on substantive grounds, but Congress amended the Rule in 1991 in the wake of some bankruptcy court decisions that aggressively regulated claims trading. For an example of the pre-amendment use of this rule, see *In re Revere Copper & Brass, Inc.*, 58 BR 1, 2 (Bankr SDNY 1985) (“Bankruptcy Rule 3001(e)(2) contemplates that the court will enter the order of substitution only after a hearing on notice and further permits the court to enter such an order as is appropriate.”). Now the court merely fulfills a ministerial role and can only step in when a transferor objects to a claim transfer. See *In re Olson*, 120 F3d 98, 102 (8th Cir 1997) (holding that the language of the Rule as amended is mandatory and gives the court no role absent an objection). No court has held, however, that the amended Rule precludes the claims trading remedies themselves. This is because “the purpose of the amendment is to lessen the court’s involvement when claims are transferred,” *In re Odd Lot Trading, Inc.*, 115 BR 97, 101 (Bankr ND Ohio 1990), not the court’s ability to fashion remedies for parties who sue claims traders.

<sup>59</sup> The classic, commonly cited case for a bankruptcy court’s inherent powers of equity is *American United Mutual Life Insurance Co v City of Avon Park*, 311 US 138, 146 (1940) (“That power [to adjust the remedy] is ample for the exigencies of varying situations. It is not dependent on express statutory provision. It inheres in the jurisdiction of a court of bankruptcy.”).

ers in ways consistent with the statute.<sup>60</sup> They have done just that, deriving from the Code remedies for abusive trading by fiduciary creditors.

The cases applying the remedies illustrate that three core concerns animate the claims trading case law: (1) purchasers taking advantage of unsophisticated sellers;<sup>61</sup> (2) purchasers acquiring claims in order to manipulate the reorganization plan process;<sup>62</sup> and (3) the use of inside information that the debtor provided in confidence for a corporate purpose.<sup>63</sup> Though these concerns could apply to a great

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<sup>60</sup> See *In re Kmart Corp.*, 359 F3d 866, 871 (7th Cir 2004) (rejecting the argument that 11 USC § 105 provides free-floating authority for orders not otherwise allowed in the Code). See also Baird, *Elements of Bankruptcy* at 6–7 (cited in note 14) (arguing that § 105 of the Code reflects the equitable origins of bankruptcy, but that a judge’s particular exercises of his power under § 105 must rest on other provisions of the Code). Debate continues about the extent of the bankruptcy courts’ equitable powers. See generally Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 Am Bankr L J 1 (2006) (arguing that courts lost most of their equitable power when certain sections of the Code were repealed); Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity*, 79 Am Bankr L J 1 (2005) (arguing that a bankruptcy judge has very little inherent power and no equitable power); Marcia S. Krieger, “*The Bankruptcy Court is a Court of Equity*”: *What Does That Mean?*, 50 SC L Rev 275 (1999) (considering why a bankruptcy court is characterized as a court of equity and to what degree it can serve as one); Brian Leepson, Note & Comment, *A Case for the Use of Broad Court Equity Power to Facilitate Chapter 11 Reorganization*, 12 Bankr Dev J 775 (1996) (reviewing arguments for and against bankruptcy courts’ equitable power and arguing for a broad equity power). The view that bankruptcy courts retain equitable powers is the dominant one and consistent with the plain language of § 105 of the Code. See 11 USC § 105(a) (“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”).

<sup>61</sup> See, for example, *In re Revere Copper*, 58 BR at 2 (“One of the evils attendant upon a solicitation of assignment of claims for a cash payment . . . is that solicited creditors may be unaware of their rights and options.”).

<sup>62</sup> See, for example, *In re Applegate Property*, 133 BR 827, 835 (Bankr WD Tex 1991) (“The purchasing of claims by an affiliate or insider of the Debtor for the sole or principle [sic] purpose of blocking a competitor from purchasing such claims . . . cannot, as a matter of law, be in good faith.”).

<sup>63</sup> See, for example, *In re Allegheny International, Inc.*, 118 BR 282, 299 (Bankr WD Pa 1990) (“Japonica sought and received inside information as a proponent of a plan. This court finds as a matter of fact that Japonica is an insider and a fiduciary for purpose of this reorganization.”).

This view of core concerns both reflects Drain and Schwartz’s two scenarios most meriting application of the securities laws and accords with the Supreme Court’s concern in *Wolf v Weinstein*, 372 US 633 (1963), that fiduciaries who trade in the securities of the debtor risk two “particular dangers,” *id* at 642. Even though that case involved noncreditor insiders of the debtor, the Court’s observations remain applicable:

On the one hand, an insider is in a position to conceal from other stockholders vital information concerning the Debtor’s financial condition or prospects, which may affect the value of its securities, until after he has reaped a private profit from the use of that information. On the other hand, one who exercises control over a reorganization holds a post which might tempt him to affect or influence corporate policies—even the shaping of the very plan of reorganization—for the benefit of his own security holdings but to the detriment of the Debtor’s interests and those of its creditors and other interested groups.

Id. Importantly, the first danger is ambiguous. Commentators have described it as a “misuse of inside information by the fiduciary,” Robert C. Pozen and Judy K. Mencher, *Chinese Walls for Creditors’ Committees*, 48 Bus L 747, 753 (1993), but it is unclear what constitutes the misuse and

extent to insiders selling claims as well as purchasing them, most of the cases in the courts have involved insider purchasers.<sup>64</sup> Crucially, note that the first concern involves the insider trading theory of liability, while the other two closely match the fiduciary theory of liability. Big boy letters and Chinese Walls also map onto this distinction.<sup>65</sup>

#### A. Equitable Subordination

Section 510(c) of the Code allows a court, “under principles of equitable subordination, [to] subordinate for purposes of distribution . . . an allowed claim to . . . another allowed claim or . . . an allowed interest to . . . another allowed interest.” Equitable subordination is the most common and important of the remedies bankruptcy courts use to regulate claims trading.<sup>66</sup> The basic elements required for a court to order equitable subordination are: (1) that the claimant “engaged in some type of inequitable conduct”; (2) that the misconduct “resulted in injury to the creditors or conferred an unfair advantage on the claimant”; and (3) that equitable subordination “not be inconsistent with the provisions of the bankruptcy code.”<sup>67</sup>

The equitable subordination cases dealing with claims trading by fiduciaries all state the basic remedy: that the court may limit recovery on the claims to the amount the trader paid for them.<sup>68</sup> But the decisions issued during the Papercraft bankruptcy go into the most detail

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why. Is it the duty of the corporate insider to the corporation’s shareholders not to profit at their expense? Or is it the duty not to profit personally from inside information? The former seems preferable, given that American law has moved away from the blanket “disclose or abstain” rule of *SEC v Texas Gulf Sulphur Co*, 401 F2d 833, 849 (2d Cir 1968), which suggested that parties to a trade had to have equal information. This is not the law today. See *Moskowitz v Lopp*, 128 FRD 624, 633 (ED Pa 1989) (“Read together, *Chiarella* and *Dirks* stand for the proposition that insider liability under Rule 10b-5 is limited to investors to whom the corporate insider owes a fiduciary duty.”), citing *Chiarella v United States*, 445 US 222 (1980), and *Dirks v SEC*, 463 US 646 (1983).

<sup>64</sup> See generally, for example, *In re Pleasant Hill Partners, LP*, 163 BR 388 (Bankr ND Ga 1994); *In re Applegate Property*, 133 BR 827; *In re Cumberland Farms, Inc*, 181 BR 678 (Bankr D Mass 1995), reversed on other grounds, *Haseotes v Cumberland Farms, Inc*, 216 BR 690 (D Mass 1997).

<sup>65</sup> See Part V.

<sup>66</sup> See, for example, *In re Enron Corp*, 333 BR 205, 237 (Bankr SDNY 2005) (holding that equitable subordination applies to any claims held by a claimant where inequitable conduct took place). See also Steven O. Weise, Teresa Wilton Harmon, and Lynn A. Soukup, 2006 *Commercial Law Developments*, in *Commercial Lending and Banking Law* 1, 62–63 (ALI-ABA 2007) (claiming that equitable subordination is one of the two most common tools of bankruptcy courts).

<sup>67</sup> *Citicorp Venture Capital, Ltd v Committee of Creditors Holding Unsecured Claims*, 160 F3d 982, 986 (3d Cir 1998) (granting equitable subordination where the fiduciary purchased notes at a discount based on inside information to make a profit and influence the reorganization plan for its own gain without disclosing this information to any third parties).

<sup>68</sup> See, for example, *In re Cumberland Farms*, 181 BR at 681; *In re Gladstone Glen*, 739 F2d 1233, 1236–37 (7th Cir 1984). See also *In re Norcor Manufacturing Co*, 109 F2d 407, 411 (7th Cir 1940) (holding that a fiduciary could not purchase a claim at a discount and then claim an amount in excess of the value actually paid).

about claims trading by a creditor with inside information who was a fiduciary because he was on the debtor's board of directors.<sup>69</sup> The Papercraft cases also illustrate well the three core concerns of equitable subordination listed above: taking advantage of unsophisticated parties, controlling the reorganization, and misusing information acquired from the debtor.

The cases arose when Citicorp Venture Capital (CVC), a prepetition creditor of the debtor, Papercraft, purchased 40 percent of Papercraft's unsecured debt in order to block the debtor's reorganization plan and advance CVC's own plan.<sup>70</sup> Because CVC had named directors to the boards of Papercraft and some of its affiliated entities, it was a fiduciary of the debtor.<sup>71</sup>

Though at the time of the petition CVC held none of Papercraft's unsecured notes, CVC's representative on Papercraft's board used a seven-month delay between the filing of the Chapter 11 petition and the filing of the debtor's disclosure statement (required to confirm the debtor's plan for voting) to purchase the 40 percent stake in Papercraft's debt.<sup>72</sup> CVC's representative on the board did so without informing the creditors' committee, the bankruptcy court, or the Papercraft board of directors, and made all of the purchases through an anonymous broker.<sup>73</sup> The selling noteholders, therefore, had no idea who their buyer was. In the meantime, CVC's director orchestrated a process whereby CVC acquired material information about Papercraft that remained unavailable to the other creditors, and CVC prepared its own reorganization plan on the basis of that information.<sup>74</sup>

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<sup>69</sup> The cases, in chronological order, are: *In re Papercraft Corp*, 187 BR 486, 501–02 (Bankr WD Pa 1995) (declining to subordinate claims because no harm was proven even though the creditor controlled a board seat on the debtor's board and purchased claims without the connection); *In re Papercraft Corp*, 211 BR 813, 824, 827 (Bankr WD Pa 1997) (holding that the creditor's conduct was inequitable and should therefore be subordinated); *Citicorp*, 160 F3d at 982 (affirming the district court decision); *In re Papercraft Corp*, 247 BR 625, 632–33 (Bankr WD Pa 2000) (subordinating claims to an amount below the purchase price to compensate the other parties for the fiduciary breach); *Citicorp Venture Capital, Ltd v Committee of Creditors Holding Unsecured Claims*, 323 F3d 228, 236 (3d Cir 2003) (affirming the bankruptcy court decision).

<sup>70</sup> This account of the facts comes from the circuit court's summation. See *Citicorp*, 160 F3d at 984–86. The claims against the debtor are divided into separate classes for the purpose of voting on the plan. Any creditor with 33 percent or more of the claims in each class of claims against the debtor has a “blocking position” in the reorganization plan. See 11 USC § 1126(c) (“A class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two-thirds in amount . . . of the allowed claims.”).

<sup>71</sup> See *In re Papercraft*, 187 BR at 495 n 7.

<sup>72</sup> *Citicorp*, 160 F3d at 985. It should be noted that CVC did not play a role in creating the delay—it merely exploited the situation. *Id.* at 992. For the requirement that the debtor file a disclosure statement, see 11 USC § 1126(b).

<sup>73</sup> *Citicorp*, 160 F3d at 985.

<sup>74</sup> *Id.*

When CVC announced its plan and disclosed that it had been purchasing claims all along, the creditors' committee sued.<sup>75</sup>

Ultimately, the bankruptcy court limited CVC's recovery on the claims to the amount it paid for them and ordered it to compensate the nonselling creditors for harms its behavior had caused them.<sup>76</sup> The Papercraft saga illustrates the kind of behavior the courts use equitable subordination to combat and the harms they use it to remedy.<sup>77</sup>

The circuit court described the findings of the bankruptcy court as the "paradigm case of inequitable conduct by a fiduciary."<sup>78</sup> These included the facts that CVC purchased the claims for the "dual purpose of making a profit . . . and . . . influenc[ing] the reorganization in its own self-interest"; that CVC had "the benefit of non-public information acquired as a fiduciary"; and that CVC had not disclosed its purchasing plans or, in the case of the selling note holders, its identity "to the bankruptcy court, the Papercraft board, the Committee, or the selling note holders."<sup>79</sup> To summarize the findings: CVC engaged in inside claims trading without disclosing its purchasing plans in order to make money and control the reorganization process.

It is unclear which part of the "dual purpose" the court found more offensive—the profit-making or the control of the reorganization<sup>80</sup>—but it may not be important to resolve this ambiguity. A party's intentions, of course, frequently make a poor peg on which to hang liability. Furthermore, it is hard to believe that an entity would gain control of a reorganization in order not to make money—making money is, after all, what companies do. Numerous decisions confirm that a creditor's attempt to make money does not alone constitute objectionable behavior.<sup>81</sup> The relevant question seems to be whether the creditor profits by controlling the reorganization at the expense of its constituents—a consummate violation of the fiduciary's duty to act disinterestedly.

The circuit court's discussion of CVC's motive supports this interpretation. Rebuffing CVC's contentions of a legitimate motive, the circuit court observed that "the [bankruptcy] court found that CVC

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<sup>75</sup> Id at 986.

<sup>76</sup> See *In re Papercraft*, 247 BR at 632–33.

<sup>77</sup> It is worth noting that doctrinally, "[t]he Papercraft cases stand for the proposition that equitable subordination may go beyond disgorgement of profits." Mabey, *Legal Consequences* at 52 (cited in note 16).

<sup>78</sup> *Citicorp*, 160 F3d at 987–88.

<sup>79</sup> Id at 987.

<sup>80</sup> This ambiguity is also present in the Supreme Court's opinion in *Wolf*, 372 US at 642.

<sup>81</sup> See, for example, *In re Figter Ltd*, 118 F3d 635, 639 (9th Cir 1997) ("If a selfish motive were sufficient to condemn [ ] policies of interested parties, very few, if any, would pass muster."); *In re Mikulec Industries, Inc*, 1992 WL 170685, \*2 (WDNY) ("It is well-settled that a vote cast in a creditor's self-interest is not necessarily a vote cast in bad faith. In this sense, creditors are expected to vote selfishly—that is, consistently with their economic best interests.").

intended to profit not only from the purchase of the notes at a discount *but also* from gaining control of the reorganization.”<sup>82</sup> This statement suggests that CVC’s self-interested control of the reorganization was integral to the court’s finding that CVC’s behavior satisfied the inequitable motive element required for equitable subordination.

The circuit court listed three cognizable injuries that the Committee and Papercraft suffered. First, the “selling note holders were deprived of the ability to make a fully informed decision.”<sup>83</sup> Second, “CVC diluted the voting rights of members of the Committee . . . [and] secured a position of influence over the reorganization negotiations.”<sup>84</sup> Third, “CVC’s actions created a conflict of interest which jeopardized its ability to make decisions in the best interest of the [debtor].”<sup>85</sup> These three harms nicely illustrate the three core concerns discussed above—the first harm concerns unsophisticated or perhaps merely ignorant or deceived sellers, the second concerns abuse of the reorganization plan process, and the third concerns a use of inside information in conflict with a fiduciary duty to the debtor company. In addition, that these should be the harms bolsters the position that self-interestedly controlling the reorganization, as opposed to making money, formed the critical part of CVC’s inequitable motive. The importance of the integrity of the reorganization process appears at the end of the opinion too, when the court describes “CVC’s attempt to control the reorganization” as the harm to the nonselling creditors.<sup>86</sup>

## B. Voting Remedies

Normally, the claims that creditors have against the debtor represent votes that the creditor casts to accept or reject a reorganization plan.<sup>87</sup> When the bankruptcy court finds that a creditor fiduciary has behaved objectionably, it has recourse to remedies that diminish the voting power of a claims purchaser. These voting remedies further illustrate the centrality of the reorganization process to claims trading regulation.

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<sup>82</sup> *Citicorp*, 160 F3d at 989 (emphasis added) (reasoning that the latter intention showed that CVC did not have the best interests of the debtor in mind when it secretly purchased claims at a discount).

<sup>83</sup> *Id.* (quotation marks and citations omitted).

<sup>84</sup> *Id.* (noting that this was an unfair advantage even though “CVC ultimately did not vote its claims”).

<sup>85</sup> *Id.* at 989–90 (concluding that these three harms were together “sufficient to justify subordination”).

<sup>86</sup> *Id.* at 991–92 (remanding to the bankruptcy court for a determination of “whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the [alternative] plan”).

<sup>87</sup> See 11 USC § 1126.

The most common voting remedy is vote designation under § 1126(e).<sup>88</sup> This allows a court to “designate the vote of a fiduciary or insider who votes or procures votes in bad faith.”<sup>89</sup> The Code does not define “bad faith,” but case law has given content to the term. Several cases make clear that “enlightened self-interest” does not equal bad faith and that § 1126(e) “does not require creditors to act selflessly.”<sup>90</sup> The definitive case in this area is *In re Figter Ltd*,<sup>91</sup> which held that courts may find bad faith if the trader purchased claims “to secure some untoward advantage over other creditors for some ulterior motive.”<sup>92</sup> The *In re Figter* court offered as examples of bad faith ulterior motives the following rather dramatic examples: “[P]ure malice, . . . blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business.”<sup>93</sup>

Although the *In re Figter* case remains the legal rule, other cases furnish instructive data points, and they all suggest that acquiring a blocking position, capitalizing on inside information, and seeking to control the reorganization process in a creditor’s self-interest make the strongest case for vote designation. The most extreme case is *In re Allegheny International, Inc*,<sup>94</sup> the rhetoric and reasoning of which is somewhat outmoded, but which still furnishes an instructive example. In *In re Allegheny*, a distressed-debt investor called Japonica acquired inside information from its fiduciary relationship to the debtor (and therefore to the debtor’s creditors).<sup>95</sup> Immediately before filing its own plan proposal, Japonica bought more than enough claims to secure a blocking position.<sup>96</sup> The court was “hard pressed to characterize Japonica’s actions as merely furthering [its] own economic interests.”<sup>97</sup>

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<sup>88</sup> “[T]he court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.”

<sup>89</sup> Mabey, *Legal Consequences* at 55 (cited in note 16).

<sup>90</sup> *Id.* at 56 n 60 (collecting cases).

<sup>91</sup> 118 F3d 635 (9th Cir 1997) (holding that a creditor did not act in bad faith where it used acquired claims to protect its interests as the major creditor of the debtor and prevented a plan that may have resulted in an undesirable mix of debtors and nondebtors in a property on which the creditor held a lien).

<sup>92</sup> *Id.* at 639 (cautioning that this does not mean creditors must act with a high degree of altruism).

<sup>93</sup> *Id.* (quotation marks omitted). See also Novikoff and Gerschwer, *Selected Topics in Claims Trading* at 201–04 (cited in note 4).

<sup>94</sup> 118 BR 282 (Bankr WD Pa 1990).

<sup>95</sup> See *id.* at 298–99. See also *In re Papercraft*, 187 BR at 498 (“Upon insolvency of the corporation, the director’s fiduciary duty extends to the corporation’s creditors and is enforceable by the trustee.”).

<sup>96</sup> *In re Allegheny*, 118 BR at 286–87.

<sup>97</sup> *Id.* at 290 (noting that Japonica acquired blocking positions in two classes that had directly opposed interests to one another).

Because Japonica's actions constituted a "naked attempt to purchase votes"<sup>98</sup> in order to stage a hostile takeover of the debtor, the judge designated the votes.<sup>99</sup> Combined with cases that suggest that creditors "are entitled to act out of pure self-interest when voting their claims," *In re Allegheny* suggests that the bolder the attempt to co-opt the reorganization process, the likelier it is that there is bad faith.<sup>100</sup> A later court bolstered this impression, remarking that the "closer a proposed transaction gets to the heart of the reorganization process, the greater scrutiny the Court must give to the matter."<sup>101</sup>

A court can also view a claims purchase as an impermissible solicitation without disclosure of an acceptance or rejection of a plan, which is prohibited by § 1125(b) of the Code.<sup>102</sup> Under § 1125(b), the court can impose civil contempt, monetary, and other penalties on the claims purchaser.<sup>103</sup> In *In re Revere Copper and Brass, Inc.*,<sup>104</sup> the court found that claims purchasers with inside information that they did not disclose had solicited claims purchases from unsophisticated sellers in order to buy claims at a discount.<sup>105</sup> The opinion analogized such solicitation of claims purchases to soliciting an acceptance or rejection of a plan.<sup>106</sup> This remedy has fallen out of favor since the 1980s and origi-

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<sup>98</sup> Id at 297.

<sup>99</sup> Id at 290.

<sup>100</sup> Novikoff and Gerschwer, *Selected Topics in Claims Trading* at 204 (cited in note 4) (noting that the bad faith determination seemed to be based on the mechanics of the acquisition of claims, which evinced an ulterior motive). Other voting remedies support this conclusion. See, for example, *In re Applegate Property*, 133 BR at 835 (emphasizing in the context of a vote exclusion remedy under 11 USC § 1129(a)(10) that a creditor cannot buy claims for the purpose of preventing a competitor from buying the claims).

<sup>101</sup> *In re CGE Shattuck, LLC*, 254 BR 5, 12–13 (Bankr D NH 2000) (denying a disclosure statement for an intercreditor commitment where the commitment appeared to be a de facto reorganization plan).

<sup>102</sup> The provision requires anyone who solicits an acceptance or rejection of a plan from a holder of a claim or interest before the transmittal of a court-approved disclosure to provide that holder with a summary of the plan and a written disclosure statement, approved by the court, containing "adequate information." Section 1125(a) of the Code defines "adequate information" basically as whatever information about the debtor's financial position "would enable . . . a hypothetical investor of the relevant class to make an informed judgment about the plan."

<sup>103</sup> See Mabey, *Legal Consequences* at 55 (cited in note 16).

<sup>104</sup> 58 BR 1 (Bankr SDNY 1985).

<sup>105</sup> Phoenix solicited creditors to transfer their claims to Phoenix for 20 percent of face value. Id at 1. The court was "concerned that the assignor-creditors ha[d] not been plainly advised of their options" and could not make a good decision about whether to sell their claim. Id at 2. It appeared that Phoenix was trying to buy claims from unsophisticated parties for 20 percent of face value so it could recover around 65 percent of face value when the reorganization plan was approved. Id at 2.

<sup>106</sup> See id at 2–3 (requiring the claims purchaser to provide disclosure of the debtor's proposed reorganization plan to any future sellers and imposing a thirty-day grace period for previous sellers to revoke their sales).

nally signaled a concern with purchasers taking advantage of sellers,<sup>107</sup> but it might be applied to vote-buying similar to that at issue in *In re Allegheny*. Indeed, the *In re Allegheny* court implicitly recognized the possibility that Japonica had also violated § 1125.<sup>108</sup>

### C. Rule 2019 Disclosures

Finally, a recent opinion in the Southern District of New York's Bankruptcy Court indicates a willingness to use Rule 2019 to regulate fiduciaries.<sup>109</sup> Rule 2019(a) requires "every entity or committee representing more than one creditor or equity security holder," except for official committees, to file a statement containing, among other information, "the amounts of claims or interests owned by the entity, the members of the committee . . . , the times when acquired, the amounts paid therefor [sic], and any sales or other disposition thereof."<sup>110</sup> Crucially, the Rule also requires supplemental statements updating the positions of committee members. Rule 2019(b) permits the court to enforce this disclosure by barring parties from intervening in the case, by reversing an undisclosed transfer, or by imposing voting remedies.<sup>111</sup> In the ongoing Northwest Airlines bankruptcy, Judge Gropper forced a committee of equity holders to correct a deficient Rule 2019 statement.<sup>112</sup> He characterized the rule as designed to limit self-dealing and overreaching by unregulated committees and refused to follow previous cases watering down the rule.<sup>113</sup>

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<sup>107</sup> See Drain and Schwartz, 10 Am Bankr Inst L Rev at 578, 589 (cited in note 7) (arguing that bankruptcy courts have narrowly construed solicitation under § 1125(b) since a 1991 amendment to Rule 3001(e) aimed at limiting oversight of claims trading), citing *Century Glove, Inc v First American Bank of New York*, 860 F2d 94, 101 (3d Cir 1988) (rejecting any definition of solicitation under § 1125(b) that would limit creditor negotiations and asserting that § 1125 must be read narrowly) and *In re Clamp-All Corp*, 233 BR 198, 205–06 (Bankr D Mass 1999) (asserting that *Century Glove* is now the majority view).

<sup>108</sup> See 118 BR at 296–97.

<sup>109</sup> See *In re Northwest Airlines Corp*, 363 BR 701, 704 (Bankr SDNY 2007) (explaining that the Rule arose because of apparent deception and overreaching by unofficial committees).

<sup>110</sup> See also Resnick and Sommer, 9 *Collier on Bankruptcy* ch 2019 (cited in note 6).

<sup>111</sup> See also *id* ¶ 2019.05[1]–[2] at 2019-8 to -9.

<sup>112</sup> See *In re Northwest Airlines*, 363 BR at 704 (holding that Rule 2019 requires an unofficial committee to provide information on individual committee members, not just the committee in the aggregate). In a subsequent decision, Judge Gropper also denied the motion of the ad hoc committee to file its documents under seal. See *id* at 709 (holding that Rule 2019's purpose of allowing those potentially represented by the committee to assess the representative nature of the committee overrode any interest the committee members had in keeping the information confidential).

<sup>113</sup> See *id* at 704. Note that the members of unofficial committees may be fiduciaries of those similarly situated. *Id*; Mabey, *Legal Consequences* at 48–49 (cited in note 16). Almost no case law exists on Rule 2019, and what does exist mostly involves mass tort litigation over asbestos cases. The *In re Northwest Airlines* opinion broke new ground, and the repercussions of the holding are not yet clear. Interpreting Rule 2019 as requiring disclosures of individual creditors'

This decision, and others like it,<sup>114</sup> may portend a trend toward using Rule 2019 statements to monitor fiduciaries by requiring continuous disclosure of the claims bought and sold by informal groups of creditors.<sup>115</sup> This use of the Rule might limit the ability of hedge funds and other claims investors to participate collectively in a Chapter 11 reorganization. But the issue remains unsettled in the wake of a recent decision in the Scopac bankruptcy denying a Rule 2019 disclosure motion similar to the one Northwest Airlines had filed.<sup>116</sup>

## V. BIG BOYS AND CHINESE WALLS

### A. One Solution for Creditors on Committees: Chinese Walls

The remedies described in this Comment can apply to creditors on committees who trade in claims against the debtor.<sup>117</sup> Fear of liability under the bankruptcy remedies began to scare some major creditors in bankruptcies off committees, a situation that deprived the reorganization process of the benefit of those committees: a forum for major debtholders of the troubled firm to negotiate and plan the fu-

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claim transfers gives the Rule a certain force it lacked in the past, but as of this printing the holding has not gained wide purchase. See note 116 and accompanying text.

<sup>114</sup> See, for example, *In re Kaiser Aluminum Corp.*, 327 BR 554, 560 (D Del 2005) (affirming an order restricting access to Rule 2019 information to those who file a motion with the court); *Baron & Budd, PC v Unsecured Asbestos Claimants Committee*, 321 BR 147, 166–67 (Bankr D NJ 2005) (holding that an order requiring disclosure of any fee-sharing relationships between committee members did not exceed the scope of Rule 2019, because they are pertinent facts in connection with the employment of the entity); *In re CF Holding Corp.*, 145 BR 124, 126 (Bankr D Conn 1992) (holding that Rule 2019 was designed to cover those who act in a fiduciary capacity to those they represent and applies to attorneys who represent more than one claimant).

<sup>115</sup> See Resnick and Sommer, 9 *Collier on Bankruptcy* ¶¶ 2019.01–.02 at 2019-3 to -4 (cited in note 6). Claims traders on unofficial committees must meet the requirements of Rule 2019 over and above any Chinese Walls or big boy letters they use. It may be that Judge Gropper is responding to the comparative freedom of unofficial committees—they owe narrower fiduciary duties and are not subject to as much monitoring as official committees—by ensuring that Rule 2019 applies to rein in overreaching by their unregulated members, particularly hedge funds. See Eric B. Fisher and Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 *Am Bankr Inst J* 24, 87–88 (2007) (asking whether Rule 2019 can cover short selling when the seller does not hold the stock and also whether such coverage is desirable given that many unofficial committees include hedge fund managers). For an outline of the particular difficulties hedge funds trading in distressed debt pose to the reorganization process, see generally *id.*

<sup>116</sup> *In re Scotia Development LLC*, No 07-20027-C-11 (Bankr SD Tex, Apr 18, 2007) (unpublished order entered eight days following the denial of a motion at an April 10, 2007 hearing) (denying the motion on the grounds that the creditors opposing the motion did not constitute a committee within the meaning of Rule 2019). For the initial reaction to the *In re Northwest Airlines* decision among practitioners, see generally Paul D. Leake and Mark G. Douglas, *Ad Hoc Committee Disclosure Requirement—A Bitter Pill to Swallow for Distressed Investors*, *Bus Structuring Rev* (Jones Day May/June 2007), online at [http://www.jonesday.com/pubs/pubs\\_detail.aspx?pubID=S4311](http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4311) (visited Jan 12, 2008).

<sup>117</sup> See Part III. Recall that as fiduciaries, they may not violate their duty of loyalty by trading against the interest of their principals.

ture of the debtor. As a result, would-be committee members started to request “that bankruptcy courts pre-approve Chinese Walls . . . so as to immunize them in advance from violating their fiduciary duties as committee members if they trade in the debtor’s claims and securities.”<sup>118</sup> The court in *In re Federated Department Stores, Inc.*,<sup>119</sup> was the first to issue such a trading order,<sup>120</sup> and other courts have followed suit.<sup>121</sup> Note that courts do not *require* Chinese Walls; rather, courts *allow* parties to use Chinese Walls as defenses to the claims trading remedies. In essence, Chinese Walls are defenses that courts approve in advance. The remedies constitute the substance of the regulatory regime; the Chinese Wall simply suspends the regulation by preventing the harms that courts aim to remedy.

But Chinese Walls do not prevent all the harms associated with insider claims trading that cause courts concern. They can prevent harms from violations of the duty of loyalty because the committee members of the relevant creditor firm, insulated from the positions of the firm’s traders, cannot conduct their committee activities in the interest of the firm’s trading position. The committee members, after all, do not know what that trading position is. But Chinese Walls do not affect the relationship between a trader who already has inside information and the parties with whom he trades. Chinese Walls address fiduciary liability well but fail to guard against core insider trading liability.

A Chinese Wall is simply a name for a body of policies and procedures that separate the trading activities of a financial institution from its activities as a member of a committee. Chinese Walls typically require that:

1. The committee member “cause all of its personnel engaged in committee-related activities (‘Committee Personnel’) to execute a letter acknowledging that they may receive non-public information and that they are aware of the order and the procedures which are in effect”;

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<sup>118</sup> Novikoff and Gerschwer, *Selected Topics in Claims Trading* at 199–200 (cited in note 4).

<sup>119</sup> 1991 WL 79143 (Bankr SD Ohio).

<sup>120</sup> See *id.* at \*2 (“Ordered, that Fidelity will not be violating its fiduciary duties as a committee member and accordingly, will not be subjecting its claims to possible . . . adverse treatment by trading in securities of the Debtor . . . provided that Fidelity employs an appropriate information blocking device or ‘Chinese Wall.’”).

<sup>121</sup> See Novikoff and Gerschwer, *Selected Topics in Claims Trading* at 200 (cited in note 4) (listing several examples of bankruptcy courts issuing Chinese Wall orders). See also, for example, *In re House of Fabrics*, 1995 Bankr LEXIS 1380, \*4 (Bankr CD Cal) (“Ordered, the institutional members of the Equity Committee who engage in the trading of securities will not be violating their fiduciary duties as committee members by trading securities of the Debtor . . . provided that the Equity Committee member institutes appropriate and effective information blocking procedures.”).

2. Committee Personnel “not share non-public committee information with other employees” (with certain exceptions);
3. Committee Personnel “keep non-public [committee] information . . . in files inaccessible to other employees”;
4. Committee Personnel “receive no information regarding trades in [claims] of the debtor in advance of such trades” (except for certain customary reports);
5. “[T]he committee member’s compliance department . . . review from time to time the [Chinese] [W]all procedures . . . to insure compliance with the order and [ ] keep and maintain records of their review.”<sup>122</sup>

Courts have proven willing to issue trading orders allowing claims trading pursuant to these Chinese Walls, and there is evidence that they often allow the creditor on a committee to trade without incurring liability.<sup>123</sup>

Chinese Walls are designed to prevent a creditor firm from appropriating committee information in its own trading interest by keeping the committee members and traders in ignorance of each other. Essentially, the Chinese Wall should effectively prevent claims trading activity from driving a committee member’s behavior and encouraging the creditor to abuse and co-opt the reorganization process for its own benefit at the expense of other creditors. In addition, insofar as creditors on the committee acquire confidential information of the debtor, the Chinese Wall should keep that information off the trading desks. In other words, Chinese Walls address the two core concerns of the bankruptcy remedies that track the law of fiduciary duties: control of the reorganization process and violation of duties of confidentiality to the debtor.

But trading walls are not a panacea and there are certain harms they cannot prevent.<sup>124</sup> Although a Chinese Wall works in both directions—information can flow neither from the trader to the committee member nor from the committee member to the trader—the traders in the creditor’s firm may still acquire inside information from other sources and may still trade on the basis of this information. The firm may have a longstanding relationship with the debtor, for instance,

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<sup>122</sup> Novikoff and Gerschwer, *Selected Topics in Claims Trading* at 201 (cited in note 4).

<sup>123</sup> See, for example, *In re Federated Department Stores*, 1991 WL at \*2–3 (ordering that the creditor not suffer adverse effects for trading in debtor claims so long as it implements court-approved Chinese Wall procedures). See also Mabey, *Legal Consequences* at 58 (cited in note 16).

<sup>124</sup> See generally Carolyn E.C. Paris, *How to Draft for Corporate Finance* § 23:5.5 at 23-35 (PLI 2004) (noting that even with Chinese Walls there may still be conflicts and perceived conflicts).

that affords it access to inside information. Or the firm may be a hedge fund immersed in the industry and privy to rumors from other parties involved about the reorganization process. A recent decision in the Enron cases, denying a motion to dismiss the debtor's request for equitable subordination of certain claims, held that "equitable subordination is not limited to only those claims related to the inequitable conduct that caused the injury to the creditor class. Rather, equitable subordination can apply to any claim unrelated to any inequitable conduct held by the claimant alleged to have engaged in that conduct."<sup>125</sup>

The court made other important rulings,<sup>126</sup> but this one is the most far-reaching because it limits the potential effectiveness of Chinese Walls. On the one hand, the decision implies "that the court may subordinate claims that were purchased by claims traders working on the other side of an established Trading Wall."<sup>127</sup> On the other hand, if a claims trader buys claims of the debtor from creditors on the basis of inside information, the *Enron* decision may make the claims the committee member represents also subject to subordination. This would mean that liability originating in the relationship between a firm's claims traders and their trading partners can spread to parts of the firm on the other side of the Chinese Wall.

Some other practical problems with Chinese Walls also make it desirable to find alternatives. Even "if they 'work,' in that each group's activities judged separately were defensible, they can make the firm as a whole look foolish."<sup>128</sup> This is because, "[b]y design, 'the right hand

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<sup>125</sup> *In re Enron Corp.*, 2005 WL 3832053, \*1 (Bankr SDNY 2005).

<sup>126</sup> The other two conclusions were that: "[T]he transfer of a claim subject to equitable subordination does not free such claim from subordination in the hands of the transferee," *id.*, and "a transferee purchasing a post-petition claim cannot avail itself of the 'good faith' defense because such transferee is not a purchaser who took without knowledge of potential actions that could be brought against the purchased claim," *id.* at \*2. The validity of these conclusions is now in doubt after the district court reversed the bankruptcy court on the first one on the strangely formalistic ground that the transfers at issue were sales instead of assignments. See *In re Enron Corp.*, No 01-16034, slip op at 30-38 (SDNY, Aug 27, 2007).

<sup>127</sup> Mabey, *Legal Consequences* at 54-55 n 47 (cited in note 16).

<sup>128</sup> Paris, *How to Draft for Corporate Finance* § 23:5:5 at 23-35 (cited in note 124) (arguing that it may make sense to have a general on top of the wall making sure the firm as a whole is acting rationally).

It may not be clear that making a firm look foolish when it potentially cheats the bankruptcy system is necessarily a bad thing. After all, why should allowing firms to save face weigh in the calculus? But it is not just a matter of saving face. A firm might look foolish because it pursues investment strategies that it would never pursue if the committee members could tell the traders what they know. This is a natural cost of the Chinese Wall, on the one hand, and of insider trading laws, on the other. But if the Chinese Wall is unnecessary and a defense to the insider trading liability is available, then the firm can benefit from this information and avoid what are avoidable losses to investors, whether the firm's own in-house investment portfolio or the investments of outside customers or fund participants.

doesn't know what the left hand is doing.'"<sup>129</sup> Also, some hedge funds may be too small to erect an effective Chinese Wall. Hedge funds have become active players in the distressed-debt market and in claims trading, so this may be an important problem.<sup>130</sup>

## B. Big Boy Trading

The advent of big boy letters may be able to fill in some of these gaps in the protection provided by Chinese Walls in ways that courts and commentators have yet to appreciate. To be sure, big boy letters cannot replace Chinese Walls completely; the latter address fiduciary liability and big boy letters never can. But in certain circumstances these increasingly common agreements may be able to hone in on the core insider trading liability that Chinese Walls cannot handle. In addition, the use of big boy letters illustrates that Chinese Walls are not always necessary. When liability is more likely to arise from the other party to an inside trade, the situation does not necessarily call for a Chinese Wall.

A simple case will illustrate what big boy letters do. Imagine that a creditor holds some claims against a debtor. This creditor has some inside information that suggests that the claims he holds will go down in value. The insider creditor wants to sell and approaches another creditor with the claims. Concerned about insider trading liability (say the seller has some preexisting relationship with the purchaser that might put him under a duty to disclose), the insider offers to sell some of his claims pursuant to a big boy letter.<sup>131</sup> Note that the second creditor, of course, may also have material nonpublic information of his own that makes him want to buy. This other creditor is sophisticated enough to understand the arrangement, and he agrees to accept the risk. The parties consummate the big boy trade, each betting on the efficacy of his own information in determining the value of the claim.<sup>132</sup>

What has the big boy letter done? The agreements "are designed to limit an insider's liability under both securities laws and [the] common law,"<sup>133</sup> so they should apply equally to securities and to claims.

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<sup>129</sup> *Id.*

<sup>130</sup> See Fisher and Buck, 25 *Am Bankr Inst J* at 88 (cited in note 115).

<sup>131</sup> For some of the representations typical of a big boy letter, see note 21.

<sup>132</sup> The example should not change if the roles of buyer and seller here are reversed (and indeed, the suggestion here is that both parties might be insiders). But see Mason and Pessin, *Legal Issues in Claims Trading* at 17 (cited in note 9) (pointing out that "there is a strong argument to be made" that if the buyer has greater information, the law should not protect the seller at all, regardless of whether or not there is a big boy letter).

<sup>133</sup> Wendell H. Adair and Brett Lawrence, *Big Boy Letters: Playing It Safe after O'Hagan*, 17 *J Corp Renewal* 1, 1 (2004). For a view of big boy letters in another context—as a future nondisclosure agreement committing one party to sell stock conditional on seller behavior to another,

Both 10b-5 and common law fraud require a showing of reliance on the part of the aggrieved party. The primary function of the big boy letter is to rebut conclusively any such showing because it expressly declares that the noninsider is not relying on any representations that the letter does not expressly contain.

There is as yet little case law on big boy letters in securities trades and none on big boy letters in claims trades, primarily because they are so new. But despite their novelty, big boy language now appears in most securities trades that are not on a public exchange and in almost all claims trades.<sup>134</sup> Because the treatment of big boy letters involving both securities and claims should be roughly parallel, the securities cases should provide meaningful guidance to the use of big boy letters in claims trading.

Against a background of cases honoring contracts releasing claims in 10b-5 cases, the Second Circuit held in *Harsco v Segui*<sup>135</sup> that “parties who negotiate at arm’s length for the sale and purchase of a business can define the transaction in a writing so as to preclude a claim of fraud based on representations not made, and explicitly disclaimed, in that writing.”<sup>136</sup> The plaintiff in that case had bought the stock of an operating company pursuant to a lengthy document, with extensive representations as well as language now associated with big boy letters.<sup>137</sup> Both parties were sophisticated and well represented, and they negotiated at arm’s length.<sup>138</sup> Unlike a trade pursuant to a typical big boy letter, however, the agreement at issue in *Harsco* contained far more extensive and specific representations and warranties than the shorter big boy letter would, and provided the plaintiff with more remedies than a big boy letter would supply.<sup>139</sup> All the same, *Har-*

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without the buyer’s disclosing its inside information—see M. Todd Henderson, *Deconstructing Duff & Phelps*, 74 U Chi L Rev 1739, 1755–56 (2007).

<sup>134</sup> The LSTA includes big boy language in its standard terms for distressed debt trading documentation. See Loan Syndications and Trading Association, *User’s Guide for LSTA Distressed Debt Trading Documentation* § IV.C.2.b.20 at 19–20 (cited in note 21).

<sup>135</sup> 91 F3d 337 (2d Cir 1996).

<sup>136</sup> *Id.* at 339 (affirming a dismissal of fraud claims against a business that allegedly inflated its value in representations to a purchaser), quoted in Stephen R. Hertz, *Do Big Boy Letters Really Work?*, 3 Debevoise & Plimpton Priv Eq Rep 5, 20 (2003), online at <http://www.debevoise.com/files/Publication/2736c2ae-9f14-4dee-b653-982519a39ac1/Presentation/PublicationAttachment/aa138944-92c4-4eef-8a6e-d30d0532e511/Spring%202003.pdf> (visited Jan 12, 2008) (concluding that *Harsco* and other cases notwithstanding, it is not certain that big boy waivers would be enforced).

<sup>137</sup> See *Harsco*, 91 F3d at 340–41.

<sup>138</sup> *Id.*

<sup>139</sup> Hertz, 3 Debevoise & Plimpton Priv Eq Rep at 21 (cited in note 136) (drawing another distinction between *Harsco* and big boy letters—that big boy letters are typically done with little due diligence before signing). One might wonder why parties do not simply use *Harsco*-style agreements instead of big boy letters. One reason is that the agreement in *Harsco* was both more particularized and more generous than big boy traders would like. Big boy letters have become boilerplate in claims trades, whereas the document in *Harsco* was designed more specifically for the

*sco* and other cases argue for the enforceability of the waiver and nonreliance provisions essential to big boy letters.<sup>140</sup>

The difficulty in 10b-5 cases specifically—a difficulty that would not appear in a claims case—derives from § 29(a) of the Exchange Act,<sup>141</sup> the so-called “antiwaiver provision.” Under the statute, “[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void.”<sup>142</sup> *Harsco* is part of a live split among federal courts regarding whether this provision invalidates the waiver and nonreliance clauses that constitute part of the core protections of big boy letters.<sup>143</sup> One should not make too much of the dispute, however; even the *AES Corp v Dow Chemical Co*<sup>144</sup> court, which found that § 29(a) precludes the clauses from barring 10b-5 claims as a matter of law, still viewed them as evidence that the plaintiff did not reasonably rely on the statements of the inside trader.<sup>145</sup>

Because the § 29(a) problem is specific to the securities laws, it poses no obstacle to big boy claims trades.<sup>146</sup> The important implica-

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agreement in that case. See 91 F3d at 340. Big boy traders are also unlikely to want the remedies that the contract in *Harsco* contained. See *id* (finding that the contract allowed the termination of the deal during the diligence period if the buyer learned that any representations were false).

<sup>140</sup> See, for example, *McCormick v Fund American Companies, Inc*, 26 F3d 869, 880 (9th Cir 1994) (holding that nondisclosure of material information was not actionable because plaintiff knew of the nondisclosure); *Jensen v Kimble*, 1 F3d 1073, 1077 (10th Cir 1993) (holding that omissions were not actionable where the buyer advised the seller of the buyer’s nondisclosures).

<sup>141</sup> 15 USC § 78cc (2000).

<sup>142</sup> 15 USC § 78cc(a).

<sup>143</sup> Compare *AES Corp v Dow Chemical Co*, 325 F3d 174, 180 (3d Cir 2003) (holding that § 29(a) does invalidate such clauses); *Rogen v Ilikon Corp*, 361 F2d 260, 268 (1st Cir 1966) (same), with *Rissman v Rissman*, 213 F3d 381, 387 (7th Cir 2000) (holding, without considering § 29(a), that nonreliance clauses are valid); *Harsco*, 91 F3d at 343 (holding that, notwithstanding § 29(a), nonreliance clauses are valid).

<sup>144</sup> 325 F3d 174 (3d Cir 2003).

<sup>145</sup> *Id* at 180 (explaining that, while the provisions are evidence of nonreliance, it would eviscerate § 29(a) if they were the basis for finding nonreliance as a matter of law). See also *Hertz*, 3 Debevoise & Plimpton Priv Eq Rep at 7 (cited in note 136) (observing that the decision does not seriously undermine big boy letters because of their remaining evidentiary value for the reasonable reliance element).

<sup>146</sup> There are two ways to understand this fact with implications for the question, unexplored here, of why the securities law has an antiwaiver provision in the first place. A more limited view would be that because the parties to big boy trades in bankruptcy are usually sophisticated, they do not need the benefit of such a provision. That is, the only parties that use big boy language in claims trades are sufficiently aware of the risks they take with their trades that the courts can trust them with their decision to waive without overriding it. A more expansive view, however, would be that the usefulness of big boy letters, even when less sophisticated parties are involved, see notes 151–54 and accompanying text, argues against there being any antiwaiver provision at all in the securities law. Although the tendency here is to the more expansive view, more needs to be done on this important ancillary question.

As a matter of law, § 29(a) does not apply to big boy claims trading; and even if it did, it would not erase the evidentiary capacity of nonreliance language to defeat the presumption of

tion of these cases is that outside of the § 29(a) problem, big boy letters do preclude any liability arising from the relationship between the insider and his trading partner—the core insider trading liability as distinguished from fiduciary liability.<sup>147</sup> Big boy letters ensure that both parties to the trade understand the risks. This addresses the advantage-taking that was the third concern of the bankruptcy remedies and the harm that animates insider trading liability.<sup>148</sup>

### C. Combining Big Boys and Chinese Walls

The simple case described above suggests how big boy letters and Chinese Walls could complement each other. Despite their use by creditors on committees, big boy letters cannot immunize traders from liability for breaching their fiduciary duties to their constituent credi-

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reliance. Practically speaking, the only bite § 29(a) has is to make motions to dismiss a bit harder, forcing some defendants to wait until summary judgment.

<sup>147</sup> See Part III. This does not mean, however, that big boy letters preclude liability where the buyer in a big boy trade immediately resells the claim or security to another buyer without a big boy letter. Several “downstream” buyers have brought suit in such cases, but the most high-profile case settled before it could produce an opinion. There remains, therefore, great uncertainty as to how courts will treat this issue. See generally Jenny Anderson, *Side Deals in a Gray Area*, NY Times C1 (May 22, 2007). Nor is it clear how the SEC will react to big boy letters. The Commission muddied the waters recently by pursuing a civil action against Barclays for insider trading in several instances, some of which involved big boy letters. The SEC settled, however, and the settlement agreement does not provide much guidance on the position the Commission will take on big boy letters as such. See *SEC v Barclays Bank PLC*, Litigation Release No 20132 (May 30, 2007), online at <http://www.sec.gov/litigation/litreleases/2007/lr20132.htm> (visited Jan 12, 2008) (mentioning only that Barclays used big boy letters in some of the deals at issue). See also Karl Groskaufmanis, *Revisiting Insider Trading in the Debt Markets: Lessons for Debt Investors and Members of Committees in Bankruptcy Cases* (2007), online at <http://www.mondaq.co.uk/article.asp?articleid=49536> (visited Jan 12, 2008) (registration required) (concluding that the SEC did not defer to Barclay’s big boy letters in any way).

<sup>148</sup> Also, in a case where the insider receives his information from the debtor, he may also require the debtor’s approval of his intent to trade or risk breaching his fiduciary duty under the misappropriation theory in *United States v O’Hagan*, 521 US 642, 652–53 (1997) (expanding insider trading liability to include a “misappropriation” theory under which, even if he has no duty to the party with whom he trades, an insider with a fiduciary duty to his information’s source can be liable to that source). As long as the information is not disclosed or used against the firm or its shareholders, the debtor probably would not object and the disclosure of intent to trade should relieve the insider at least of misappropriation liability or other fiduciary liability under either the securities laws or state corporate law. Indeed, *O’Hagan* itself required even less, for the decision implied that a “trader in possession of material, nonpublic information could avoid liability under misappropriation theory by disclosing his intention to trade to the information provider without actually disclosing to the trading counterparty the nonpublic information.” Adair and Lawrence, 17 J Corp Renewal at 1 (cited in note 133). See also *O’Hagan*, 521 US at 654. In other words, even though a committee member forgoes the Chinese Wall, when he trades pursuant to a big boy letter he can still avoid breaching his duty of confidentiality to the debtor, which was one of the core concerns of the bankruptcy courts. Note that regardless of the *O’Hagan* language, common sense suggests he should still get the debtor’s approval of his trade if the debtor was the source of the inside information. After all, telling someone you intend to take his information without his consent is just as much theft as if you stole it without such “disclosure.”

tors. But remember the core concerns animating the bankruptcy remedies: manipulation of the reorganization process, the abuse of confidential information of the debtor, and investors taking advantage of unsophisticated claims holders. The *Papercraft* cases paradigmatically illustrate how the harms claims trading jurisprudence seeks to prevent revolve around these concerns.<sup>149</sup>

Chinese Walls are well suited to guard against claims trading that might harm the constituent creditors by interfering with the reorganization process—a potential fiduciary violation. The traders in a given financial firm are unable to drive the activities of the firm’s representatives on the committee because the trading order bars committee representatives from communicating with their counterparts over the Wall. For the same reason, Chinese Walls may also help, in certain circumstances, to protect against breaches of the creditor’s confidentiality duties to the debtor for the same reason.

But if the creditor merely wants to speculate in the claims during the Chapter 11 case and this speculation will not interfere with its activities in the reorganization, courts ought to find big boy letters sufficient.<sup>150</sup>

The third concern of the bankruptcy courts, that unsophisticated sellers (or buyers, for that matter) might be hurt, is something that big boy letters are designed to fix. Big boy letters usually involve sophisticated parties, so in that sense an unsophisticated claims trader would not even be in the picture. But the greater phenomenon of big boy trading should also end up helping the unsophisticated creditor, not just ignoring him. As numerous critics of insider trading laws have argued for years, when insiders trade they inject information into the market.<sup>151</sup> This influx of information ultimately helps even the small-time participant in the market because prices better reflect all the information that relevant parties know.<sup>152</sup> In addition, as long as insiders disclose their identities, even unsophisticated parties can factor the

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<sup>149</sup> See notes 69–86 and accompanying text.

<sup>150</sup> As noted above, disclosure to and approval of the debtor and even the creditors’ committee of the insider’s intent to trade should avoid the remnant of misappropriation liability. One early commentary on Chinese Walls in bankruptcy suggested that disclosure to the committee would suffice to allow a creditor on a committee to trade in the debtor’s claims. Pozen and Mencher, 28 Bus L at 754 (cited in note 63). This Comment takes the somewhat different position that a big boy letter containing the approval or consent of the source of the information should preclude most liability.

<sup>151</sup> See, for example, Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 294 (cited in note 40) (arguing that the price conveys information about the firm more effectively than disclosure when insiders are allowed to trade).

<sup>152</sup> See *id.* at 297–98 (arguing that this helps unsophisticated parties because they can free ride on the search costs of others).

risk that the insider has material, nonpublic information into the price of any trade they make with an insider.<sup>153</sup>

These are standard arguments in the larger debate about insider trading and Rule 10b-5, of course, and this Comment sympathizes with the critics of the federal regulations.<sup>154</sup> Yet in the context of claims trading the critiques have particular strength. Because few parties participate in it and it remains somewhat novel, the market in claims could benefit especially from the modification in prices that insider trading would cause. In other words, there is less information available and so the supply, even implicitly, of information that insider trading provides becomes more valuable. Also, commentators frequently worry that unsophisticated creditors lack the expertise to make sound judgments about offers to buy their claims.<sup>155</sup> If that is so, the creditors know their own ignorance and therefore the idea discussed above about the risk of inside information itself factoring into the price of a trade resonates strongly.

There are further potential side benefits to big boy transactions. Big boy trades increase liquidity in the claims markets, which provides

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<sup>153</sup> See Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J Legal Stud 801, 804 (1980) (suggesting that one theory for inside information disclosure is that it disseminates knowledge so that all investors can make better informed judgments). See also Stephen M. Bainbridge, *Corporation Law and Economics* 595 (Foundation 2002) (noting that because on impersonal exchanges the seller would still sell absent the insider, unsophisticated parties are hurt by the lack of disclosure, such as the fact that an insider is on the market).

<sup>154</sup> This debate is voluminous. The seminal work critiquing securities regulation remains Henry Manne, *Insider Trading and the Stock Market* 47–110 (Free 1966). For a small sampling of the contemporary debate, compare Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 Colum L Rev 1491, 1497 (1999) (arguing that Rule 10b-5 should not be used to regulate information disparities when it is aimed at preventing deception); Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 253–314 (cited in note 40) (arguing that the market should regulate insider trading and disclosure rules); David D. Haddock and Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 Nw U L Rev 1449, 1451 (1986) (arguing that shareholders would normally permit insider trading in exchange for paying lower wages in a Coasian world); Dennis W. Carlton and Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan L Rev 857, 894 (1983) (arguing that federal regulations are broader than those firms would negotiate privately and regulation should be left to private parties), with Mark Klock, *Mainstream Economics and the Case for Prohibiting Insider Trading*, 10 Ga St U L Rev 297, 298 (1994) (arguing that economic theory and evidence contradicts Manne's conclusion that insider trading promotes market efficiency); Gary Lawson, *The Ethics of Insider Trading*, 11 Harv J L & Pub Policy at 727 (1988) (outlining the normative foundation for condemning insider trading under a property rights view); James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 Duke L J 628, 655–57 (arguing that the current law is the correct policy and overcomes collective action and information asymmetry problems); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Modern Corporation*, 80 Mich L Rev 1051, 1053 (1982) (arguing that prohibiting insider trading could enhance business decisionmaking in corporations).

<sup>155</sup> See, for example, Elizabeth Warren and Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 Harv L Rev 1197, 1216 (2005) ("Unsophisticated creditors may voluntarily contract with a debtor for large or small amounts, but they lack the expertise required to discover and evaluate differing bankruptcy terms.").

a way for a creditor to opt out of a reorganization. A creditor may want to opt out of a reorganization because it has information that the debtor might fail or simply because it wants to put its money and energies elsewhere. Regardless, the creditor should be allowed to protect itself from the bankruptcy remedies with a big boy letter. Just because various factors in the reorganization might make one creditor nervous does not mean another would not be willing to take its place or that the other creditors in the process would want out as well. The same applies to a creditor who wants to buy into the reorganization, whether because it has information about the debtor's positive prospects or for some other reason. By hypothesis, the parties to the trade accept the risk it involves. It would therefore be sensible for bankruptcy courts to let parties do that without fear of liability if they can find a creditor who wants to sell its claims.

All of these considerations indicate that big boy letters and Chinese Walls may work well together both legally and practically, each covering the gaps left by the other. Bankruptcy courts should adjust their application of the claims trading remedies to adapt to the synergy of these two tools, just as they accommodated the use of Chinese Walls individually. There may be situations where a Chinese Wall, contrary to the assumptions prevalent today, is not necessary as a defense to the bankruptcy remedies as long as a creditor on the committee trades pursuant to big boy letters and keeps the debtor (and perhaps the constituent creditors) informed. For if the trader is content to let the reorganization proceed without manipulating it, he should not find himself under the scrutiny of bankruptcy courts concerned about the integrity of that process. The big boy letter, for its part, prevents the potential harms to trading partners that concern bankruptcy courts. Finally, even though the trader may violate his duties to the constituent creditors in a formal sense, it is unclear how, if he does not cause delay or interfere with the reorganization process, his speculative trading will harm them.<sup>156</sup>

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<sup>156</sup> Some commentators assert that when a fiduciary uses inside information for his own gain he has, ipso facto, misused it. See, for example, Mark J. Krudys, *Insider Trading by Members of Creditors' Committees—Actionable!*, 44 DePaul L Rev 99, 141–42 (1994). The Papercraft cases suggest that the primary harms worrying the courts concern the reorganization process, the debtor's confidential information, and unsophisticated parties. See notes 69–86 and accompanying text. Under *Wolf v Weinstein*, 372 US 633, 655 (1963), fiduciary liability is prophylactic and does not require actual harm. This Comment takes the position that there should have to be some harm to the creditors to whom the committee member is a fiduciary in order for insider claims trading to be actionable.

## VI. SOME POTENTIAL LESSONS OF BIG BOY LETTERS AND CHINESE WALLS FOR RULE 10B-5

This Comment began with the background debate about whether to apply the securities laws to bankruptcy claims. The current consensus that they do not apply requires that bankruptcy courts regulate claims effectively in the absence of the securities laws. Parts III–V of this Comment analyzed the law of insider trading and contemporary investor behavior to evaluate the claims trading remedies. But the resulting conclusion that bankruptcy courts and commentators have been too quick to make the Chinese Wall the only defense to the claims trading remedies suggests a line of inquiry beyond bankruptcy. For the argument rests on the distinction between insider trading behavior on the one hand, and abusive behavior by a fiduciary on the other, each the subject of either insider trading law or the law of fiduciary duties, respectively. This distinction underlies the different functions of big boy letters and Chinese Walls.

But securities law, principally but not only by widening the scope of 10b-5 liability to anyone to whom the insider has a fiduciary duty, as per *United States v O'Hagan*,<sup>157</sup> has conflated the two sources of liability. This has brought securities law afield from its intended territory—to regulate the market in financial investments—and into the province of state corporate law. This overregulation of instruments that are unarguably securities means that courts are more wary about defining too many instruments as securities, even those that seem to be securities. Scholars reflect this wariness when they warn that the alternative bankruptcy regime already covers the field and that applying the securities laws would impinge on the bankruptcy process. This Comment considers only 10b-5, but, at least in this context, a narrowing of the scope of 10b-5 would greatly reduce the potential awkwardness involved in applying it to bankruptcy claims.

The argument, then, suggests that to reestablish the distinction between liability for fiduciary violations and insider trading would allow 10b-5 to apply to the latter more cleanly. This idea is only a suggestion, of course, sketched out here to provide food for thought. But such a result might be desirable because it would treat like investments alike, ensure that cases of truly objectionable insider trading in bankruptcy receive the full brunt of the securities laws, and clear up the confusion in claims trading jurisprudence.

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<sup>157</sup> 521 US 642 (1997).

## CONCLUSION

Billions of dollars in claims trade in American bankruptcies, but the legal regime governing these markets remains uncertain. Commentators have come to something of a standstill about whether or not to apply the securities laws to claims trading. If one focuses on potential insider trading in claims, one can approach the problem with an eye fixed firmly on contemporary investor behavior. From this largely unexplored perspective, it appears that big boy letters can and should play a more important role in the scheme of regulation that bankruptcy courts apply to claims trading. Courts and commentators have assumed that Chinese Walls are the only way for creditors on committees to trade without liability under the claims trading remedies.<sup>158</sup> But if a creditor on a creditors' committee trades pursuant to a big boy letter, in certain situations bankruptcy courts ought not to impose their remedies, even without a Chinese Wall. In other words, courts should allow big boy letters to act as a separate defense to liability. The reason is that these two tools—big boy letters and Chinese Walls—fulfill different functions and prevent different harms. The dichotomy between them reflects a fundamental difference between two theories of liability in this area of the law: fiduciary duty liability and insider trading liability proper. If the bankruptcy remedies adapt to reflect this difference, they would furnish a powerful alternative to the regulation of insider trading under the securities laws. This might either justify the reluctance of courts to apply those laws to claims trading or encourage amendment of Rule 10b-5 to similarly reflect the difference.<sup>159</sup>

This argument turns on the basic recognition that core insider trading and fiduciary duties involve two distinct areas of law generat-

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<sup>158</sup> For a typical statement of the current consensus, see Fisher and Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 Am Bankr Inst J at 87 n 5 (cited in note 115) (“[E]ntities sitting on official committees [with access to inside information] cannot trade when in possession of such material, nonpublic information absent appropriate ethical screening measures isolating employees sitting on the committee from those with trading authority.”).

<sup>159</sup> One arrives at this suggestion as a result of the basic structure of this Comment. That is, under *Reves* as currently read, Rule 10b-5 does not apply to claims trading, partially because of the existence of the bankruptcy remedies. One therefore considers how well these remedies do in the absence of Rule 10b-5. In the bankruptcy remedies, the distinction between fiduciary and insider trading liability becomes apparent, and apparently useful in light of targeted investor tools like Chinese Walls and big boy letters. If one takes the importance of this distinction seriously, it seems that Rule 10b-5 itself might benefit from an amendment to reflect the distinction, thus treating trading in claims and securities, which have similar dynamics, similarly. Whether or not this might then make it easier to apply Rule 10b-5 to claims trading is another question, touched on briefly at the end of this Comment. Both possibilities result from the recognition of the importance of a distinction that the securities laws have elided, namely that between fiduciary and insider trading liability.

ing two distinct theories of liability. Chinese Walls and big boy letters preclude liability based on these two distinct theories: violations of fiduciary duty and unlawful insider trading, respectively. On the one hand, many of the bankruptcy remedies, as the Papercraft cases illustrate,<sup>160</sup> seek to remedy, in the bankruptcy context, instances of self-dealing, the quintessential violation of the fiduciary duty of loyalty. Chinese Walls are just an *ex ante*, prophylactic solution to the same problem. The conduct they are designed to prevent has no integral connection to insider trading and is the subject of garden variety corporate law claims usually heard in state courts. On the other hand, big boy letters ensure that the insider has not deceived the party with whom he trades by means of his inside information. The parties recognize the possibility of inside information and agree to accept the risk. The big boy letter therefore addresses the core concern of insider trading law, from its common law antecedents to today's Rule 10b-5.

Bankruptcy claims trading jurisprudence retains a glimmer of this distinction and bankruptcy courts might brighten it. From the hostile takeover to the poison pill, the law governing American business has evolved in the back and forth of judicial remedies, sanctions, and private innovations. Taking stock of another pair of innovations—big boy letters and Chinese Walls—helps to determine how bankruptcy courts should develop their *ex post* remedies to allow for these *ex ante* prophylactic tools. The model thus established seems to compare well to the regime currently governing insider trading in securities.

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<sup>160</sup> See notes 69–86 and accompanying text.