Looking Under the Rock:
Disclosure of Bankruptcy Issues Under the Securities Laws

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I. INTRODUCTION

Bankruptcy and securities law\(^1\) intersect along one of the wilder frontiers in modern business law.\(^2\) While bankruptcy has always been a risk faced by investors, and has been mentioned as such in standard securities law disclosure, that risk has not generally been perceived as a complex one requiring special kinds of disclosure. Rather, the standard disclosure has tended to take a conclusory form to the effect that the business is walking along a ledge and that there is a small but nontrivial risk that it might fall off. Disclosure of this kind treats bankruptcy simply as an end point, a worst-case scenario.\(^3\)

Bankruptcy has become a risk that is too common and complex to be treated as a simple black box for securities law disclosure purposes. This is true, even in bankruptcy-remote disclosure, for initial issues with high leverage, special structures, or other characteristics raising bankruptcy risk, or whose purported remoteness from bankruptcy may be particularly sensitive to certain aspects of the bankruptcy process.\(^4\) It becomes even more important for securities whose issuers are in more immediate danger of insolvency. Here, the disclosure becomes especially important to enable the holders of the securities to make appropriate decisions in workout situations, and for the smooth and

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\(^2\) The level of flux is well illustrated by the continuing controversy over the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, 109 Stat. 737, passed by Congress over President Clinton's veto on December 22, 1995. Although this Act will raise some obstacles to bringing private securities actions in general, it does not materially affect the concerns of this Article. See infra notes 113–18 and accompanying text.


\(^4\) See infra notes 142–213 and accompanying text.
equitable functioning of the bankruptcy reorganization process if the issuer invokes Chapter 11.\textsuperscript{5}

Securities investors must now consider both greater risks of bankruptcy and new kinds of bankruptcy risks. These risks have been created by factors that include the dynamics of Chapter 11 restructuring, the use of securities to finance transactions with special bankruptcy risks, such as leveraged buyouts ("LBOs"), and the creation of new and complex instruments such as asset-backed securities, which may have special sensitivities to bankruptcy.

Disclosure has a major role to play in dealing with these issues, but bankruptcy-oriented disclosure is currently inadequate to meet the needs of investors both before and after the filing of a bankruptcy petition. The problems with bankruptcy-oriented disclosure reflect the fact that both securities law and bankruptcy law follow incomplete models. The imperfections of both models are highlighted by their interaction.

The securities laws have adopted mandatory disclosure as the central mechanism for insuring the integrity of the securities markets.\textsuperscript{6} As currently structured and enforced, they reflect the strong influence of the Efficient Capital Market Hypothesis ("ECMH"), which posits that the markets are efficient, reflecting all publicly available information in securities prices.\textsuperscript{7} This model tends to consider disclosure primarily in terms of the most efficient securities markets—those for common stock. Moreover, its primary viewpoint deals with the simplest case in trading common stock: the initial public offering, though that may be updated by continuing disclosure requirements under the 1934 Act.\textsuperscript{8} Within this framework, it is particularly difficult to consider bankruptcy as anything but an endpoint.

Bankruptcy law, on the other hand, has not completely abandoned its early paradigm as a simple process for liquidating the assets of a debtor and distributing them to a body of creditors divided, if at all, only into secured and unsecured categories. Its reorganization provisions, still not completely integrated into this paradigm, provide a "one size fits all" approach that does not recognize that those who hold claims against large, publicly held corporations with intricate structures of debt and equity securities have special disclosure needs distinct from those who hold claims against smaller, simpler entities.

\textsuperscript{5} See infra notes 235–57 and accompanying text.


\textsuperscript{7} See infra notes 18–23 and accompanying text.

\textsuperscript{8} See Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. REV. 1047, 1052 (1995) (noting that mandatory disclosure evolved more as a response to agency problems than as an aid to efficiency in the securities markets).
Anomalies that arise in considering appropriate disclosure of bankruptcy risks highlight the inadequacy of both models where bankruptcy and securities law come together. Investors now have choices to make in situations that diverge widely from the securities law paradigm of initial public offerings for common stock. They must consider securities with characteristics strongly different from simple equity, and they must make choices concerning securities they already own, in markets that are much thinner than equity markets. They cannot make appropriate decisions concerning insolvency risks—both in terms of valuing securities, and in terms of exercising voting rights—unless they are properly informed. Effective disclosure policy should force securities issuers and those assisting them in the offering process to consider appropriate insolvency-related disclosure, both at the initial point of issue, and as risks evolve over time.

This may become particularly difficult as the ingenuity of Wall Street in creating new types of securities runs past the foresight of legislators and courts in dealing with the insolvency of their issuers. This further complicates the disclosure puzzle: Where new kinds of financial instruments are involved, establishing rights and obligations that have not yet been sorted through by statute or by litigation, what kind of disclosure of the risks that they pose is appropriate? In turn, this leads to the even more vexed, and yet central, issue of circularity: For complex and untested new security structures, such as are frequently found with asset-backed securities, disclosure of the possibility that a structure will fail in bankruptcy may in fact help to precipitate that event when a bankruptcy court actually considers the issue.\(^9\) Circularity is a deep anomaly in the entire framework of disclosure, and the large volume of securities subject to it make it more than a minor curiosity.

These questions are important because interaction between securities law and bankruptcy is both close and reciprocal. Not only is appropriate disclosure of bankruptcy issues needed in order fully to implement the policies behind securities regulation, but it is also important for the proper function of bankruptcy reorganization. Although it is clear that, where part of the solicitation for a prepackaged Chapter 11 reorganization is conducted before bankruptcy, proper securities law disclosure is required,\(^10\) it is less clear exactly what disclosure is appropriate, and the circumstances of the prepackaged Chapter 11 invite disclosure abuses by management. Even in conventional workouts and Chapter 11 cases, proper prebankruptcy disclosure may be important to protect security holders from exploitation by claim-purchasing “vultures,” and otherwise to insure that they are properly informed

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9 See infra notes 214–34 and accompanying text.
of their rights in bankruptcy. 11

Deciding what disclosure is appropriate, in all of the above contexts, poses some particularly obstinate problems. One is dealing with an issue that securities disclosure law already confronts in other contexts: the problem of requiring disclosure of "soft" information, i.e., forward-looking and opinion-based information, as opposed to more concrete data on past performance. 12

Another related problem is that of cost. Even if this problem is limited to direct cost, securities law disclosure is already expensive, and additional disclosure requirements will add to this cost. This problem is aggravated by the fact that financially fragile entities—the ones most likely to be required to make enhanced bankruptcy disclosure—may be those least able to bear the cost.

Moreover, there are significant indirect costs attached to disclosure. The process of SEC review of proposed disclosure may cause delays that can be crucial in the transactional context. Furthermore, in our litigious society, new disclosure requirements invite new and costly litigation. More generally, if other direct and indirect costs reach too high a level, they may become significant barriers to entry to the regulated markets, raising overall costs of credit, sending potential issuers into other capital markets, and possibly impairing the liquidity of the regulated markets.

Disclosure costs, both direct and indirect, must be seriously considered in relation to the projected benefits of disclosure. 13 In this context, it is worthwhile to examine possible lower-cost alternatives, such as the rating process. A careful review of possible substitutes for mandatory disclosure shows, however, that while each may be a valuable adjunct to mandatory disclosure, it remains indispensable, particularly in the context of potential strategic behavior by management as a corporation approaches insolvency.

This leaves the question of what disclosure is appropriate. In general, appropriate disclosure must provide investors with sufficient information to value their securities and otherwise to decide how best to act with respect to known risks posed by the bankruptcy process. This type of disclosure will give different answers at different times and for different types of securities.

This Article seeks to establish a basic framework for dealing with bankruptcy issues in securities disclosure, including situations where

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12 See infra notes 106-129 and accompanying text.

bankruptcy is not yet in plain sight. Part II will discuss securities law disclosure policies with respect to insolvency. Part III will discuss whether, in view of the costs imposed by mandatory securities law disclosure, there may be cheaper substitutes available, and will evaluate possible substitutes. Part IV examines the problems inherent in securities law disclosure of bankruptcy-related risk in situations where bankruptcy is not yet imminent. These include the central problem of circularity. Part V will discuss continuing disclosure requirements and their consequences, particularly in the situation where a corporation is already contemplating insolvency. Part VI will discuss the proper allocation of liabilities incurred for failures in disclosure and the difficulties inherent in establishing such liabilities.

II. SECURITIES REGULATION AND THE RISKS OF FINANCIAL DISTRESS

Securities regulation requires initial and, in most cases, continuing disclosure of substantially all information that an investor would be likely to consider important in deciding whether to buy, sell, or hold a given issue or issues. This information includes not only the expected return on an investment, but the risks faced by the issuer and holder of the securities in question. These risks, and the appropriate degree to which they must be disclosed, will differ depending upon whether the issuer is floating freely or circling the drain. Having said this, however, the question of what disclosure is appropriate for a particular security and its respective issuer at any particular time may involve difficulties that require substantial analysis.

A. Securities Regulatory Policy and the Looming Fact of Bankruptcy

1. The Disclosure Paradigm for Federal Securities Regulation

The federal securities laws are primarily intended to assure full and fair disclosure to investors. Federal securities regulation, unlike certain state regulatory schemes, deliberately avoids most policing of the merit of publicly offered securities and instead seeks to promote and protect fair and efficient

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15 This has slipped in some minor ways in recent years, with attempts to deal with perceived abuses such as blank-check offerings and aggressive sales of “penny” stocks. See, e.g., JENNINGS ET AL., supra note 1, at 261–63. Nonetheless, the overall philosophy of the federal securities laws remains committed to disclosure, as opposed to merit regulation. See
securities markets. It leaves to the markets most decisions concerning the merits of the securities sold there.\textsuperscript{16}

This disclosure-oriented regulatory structure is designed to accomplish a number of purposes. It is intended to give individual investors fair access to information about publicly traded securities. This means both freedom from fraud and manipulation and relatively equal access to information, regardless of the investors' means and relationship to issuers. Moreover, it is designed to maximize the availability of accurate and up-to-date information concerning securities and their issuers to the more general markets for securities.\textsuperscript{17}

As currently formulated, this scheme relies to a substantial degree on the notion that the securities markets are efficient. This means that, as formulated under the prevailing "semistrong" form of the ECMH,\textsuperscript{18} market prices quickly and completely incorporate substantially all publicly available information on the securities being priced.\textsuperscript{19} A consequence of this is that incomplete, erroneous, or fraudulent information will lead to inappropriate prices. This will not only cause direct injury to investors in particular transactions, but will reduce the willingness of outside investors to participate, injuring market liquidity and the effectiveness of the markets in assuring the efficient allocation of capital.\textsuperscript{20}

The regulatory structure, in reliance on this model, is designed to insure that investors without inside information on particular issuers or their securities will be willing to invest without fear of deception or manipulation and that the


\textsuperscript{18} The hypothesis, borrowed from financial economics, takes three forms as most widely understood: weak, semistrong, and strong. The weak form holds that current prices incorporate all prior price information, so that future prices cannot be predicted based on past prices. The strong form, by contrast, holds that securities prices incorporate all information, whether or not publicly available. See Michael P. Dooley, \textit{Fundamentals of Corporation Law} 474-79 (1995).


\textsuperscript{20} See infra notes 24 and accompanying text.
markets will thus be effective in allocating capital to its most efficient users. Although subject to both theoretical and empirical criticism, the ECMH has generally been accepted by the SEC and the courts, as well as by most commentators in the field. Both SEC regulations and interpretive decisional law, particularly over the last two decades, view delivery of unmanipulated issuer information to commodity-type securities markets as the primary mechanism of securities regulation.

The disclosure duties established by this overall scheme of regulation have three major components. The first two consist of positive duties established pursuant to overall schemes of registration: the obligation to make full and fair disclosure when new securities are sold on public markets, chiefly established by the 1933 Act and the Trust Indenture Act; and the duty to assure fair trading conditions in the ongoing secondary markets for securities, chiefly by requiring continuing accurate disclosure of material information, pursuant to the provisions of the 1934 Act and SEC regulations promulgated thereunder. All of these provisions establish minimum standards for information that must be disclosed in registration materials and by registered issuers. They also establish liability for failure to comply with the disclosure requirements. These requirements are imposed with comparatively little regard for the transaction costs of compliance, although the SEC has made some concessions to offerings by small business.

Aside from relatively limited exemptions from the registration process, comparatively recent SEC regulations have made registration easier for certain small business issuers, beginning in 1982 with the availability of Form S-18 for certain offerings of $7.5 million or less in securities. Currently, the SEC has defined a special category of “small business issuers” to include certain businesses with annual revenues of up to $25 million. Issuers in this category are entitled to make certain offerings on Forms SB-1 and SB-2, which have somewhat less onerous financial reporting requirements than more conventional forms. On the other hand, for offerings that do not meet the requirements for these simplified forms, smaller, less seasoned businesses may actually incur higher registration costs than larger, older ones, because they may have to use the more elaborate Form S-1 rather than the somewhat simplified S-3. Larger issuers may also save on certain costs through mechanisms such as the shelf registration process established by Rule 415. Regardless of which form is used, however, the issuer’s ability to pay has little to do with the demands

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22 See, e.g., Gilson & Kraakman, supra note 19, at 549-51.


24 Aside from relatively limited exemptions from the registration process, comparatively recent SEC regulations have made registration easier for certain small business issuers, beginning in 1982 with the availability of Form S-18 for certain offerings of $7.5 million or less in securities. See 17 C.F.R. § 239.28 (1982). Currently, the SEC has defined a special category of “small business issuers” to include certain businesses with annual revenues of up to $25 million. See Rule 405, 17 C.F.R. § 230.405 (1996). Issuers in this category are entitled to make certain offerings on Forms SB-1 and SB-2, which have somewhat less onerous financial reporting requirements than more conventional forms. See Regulation S-B, 17 C.F.R. §§ 228.10, 239.9, .10 (1996). On the other hand, for offerings that do not meet the requirements for these simplified forms, smaller, less seasoned businesses may actually incur higher registration costs than larger, older ones, because they may have to use the more elaborate Form S-1 rather than the somewhat simplified S-3. Larger issuers may also save on certain costs through mechanisms such as the shelf registration process established by Rule 415, 17 C.F.R. § 230.415 (1996). Regardless of which form is used, however, the issuer’s ability to pay has little to do with the demands
duty not to engage in fraudulent or manipulative practices. The most famous expression of this set of duties is in Rule 10b-5, promulgated pursuant to section 10(b) of the 1934 Act. The antifraud rules apply to a substantially wider spectrum of transactions, including sales of securities well after their initial registration, and to persons involved in the sale of securities whose registration is not required by the 1933 Act or otherwise.

2. Insolvency and the Disclosure Paradigm

Insolvency introduces a threadbare patch into this fabric of disclosure. Even for issuers remote from insolvency, markets for debt securities are less liquid and otherwise differ significantly from the commodity-like equity markets assumed by the ECMH. Reorganizations, including workouts conducted in the shadow of bankruptcy and full-fledged Chapter 11 cases, diverge even more sharply from the model. They operate in drastically thinner and less transparent markets for securities of financially troubled issuers than the markets contemplated by the ECMH, with fewer actual and potential participants and substantially increased asymmetry of information between potential buyers and sellers. Reorganizations thus cast significant doubt on whether disclosure policies appropriate to general markets are adequate to meet the needs of investors in financially troubled issuers.

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27 See, e.g., United States v. Olson, 22 F.3d 783, 785 (8th Cir. 1994) (antifraud provisions apply even to private sales of securities to sophisticated buyers). Section 12(2) of the 1933 Act, 15 U.S.C. § 77l(2), also forbids misrepresentations and material omissions in the sale of securities, whether or not their registration is required by the 1933 Act. See, e.g., Metromedia Co. v. Fugazy, 983 F.2d 350, 360–61 (2d Cir. 1992). It is not as widely used as section 10(b) of the 1934 Act and Rule 10b-5, however, because courts have tended to limit its applicability to the initial distribution of securities. See Gustafson v. Alloyd Co. Inc., 115 S. Ct. 1061, 1070-71 (1995). For a criticism of the controversial Gustafson decision, see Brian E. Burns, Comment, Red Means Green: The Disruption of the Statutory Construction Process in Gustafson to Harmonize Section 12(2) and Rule 10b-5 Private Liability Actions Under the Federal Securities Laws, 57 OHIO ST. L.J. (forthcoming Nov. 1996). See also Cox Et Al., supra note 1, at 654-55.
28 See, e.g., Coffee & Klein, supra note 3, at 1217–18.
29 See id. at 1218–20; Anne Schwimmer, Drexel Diaspora: The People Who Drove the Juggernaut, One Year Later, INVESTMENT DEALERS' DIG., Feb. 11, 1991 (the junk bond market has been “traditionally thin”).
30 See, e.g., Ockerman v. May Zima & Co., 27 F.3d 1151, 1158–60 (6th Cir. 1994) (fraud on the market presumption does not apply when market for a securities issue is not
Where the securities laws are designed to provide someone buying claims against or interests in an entity with information on the way in which the business operates—and throws off income—based on its initial and ongoing relationships, bankruptcy produces fundamental alterations in those relationships. The greater the probability that bankruptcy will not simply end the relationships, but change them in an ongoing way, the greater the problem for securities disclosure.

Simple financially-oriented disclosure that treats bankruptcy as a mere end-point does not satisfactorily address this new complexity of insolvency risk. Workout and reorganization dynamics reflect attempts to restructure the debtor's obligations in ways that will permit it to continue operating its business. Ideally, this will create advantages for creditors as well as management and equity holders, because it will preserve the going concern value of corporate property instead of disposing of it at fire sale prices. Unlike liquidation, the negotiated restructuring process, in or out of bankruptcy, alters the rights for which security holders originally bargained in important and nonuniform ways.

How a given class of security holders will fare in a workout or reorganization depends to a considerable degree on how effectively it can overcome collective action problems that obstruct class members' participation in negotiating the restructuring. Collective action problems are the factors that make it difficult for groups containing more than a few members to act on matters of common interest to them, absent coercion or special organizational devices to enable them to act together. The larger the group, the more it will fail to optimize the value of rights belonging to the group in common. This is true even though all members of the group are both rational and self-interested. The phenomenon occurs because, inter alia, each member of a large group will stand to gain only a small portion of a common good if it is obtained. Because the costs of seeking the common good may be substantial and individual group members will prefer to avoid paying their share if they can, the costs and risks imposed on a few members if they act to seek the common good will tend to outweigh what they stand to gain on success. Weighing their own costs and risks against their potential share of the common good, rational group members will not act, and the group as a whole will forego the common good.\footnote{See \textit{Mark S. Scarberry et al., Business Reorganization in Bankruptcy} 3–4 (1996).}

\footnote{31 See \textit{Mark S. Scarberry et al., Business Reorganization in Bankruptcy} 3–4 (1996).}

\footnote{32 See \textit{Mancur Olson, Jr., The Logic of Collective Action: Public Goods and the Theory of Groups} 2, 9–12, 14–16, 21, \textit{passim} (1965).}
LOOKING UNDER THE ROCK

In the context of workouts and reorganizations, a central collective action problem is that if there are many creditors in a particular class whose claims on average are relatively small, they will have difficulty retaining common representation unless they can agree on a mechanism for sharing the heavy costs of legal action across the entire group. Chapter 11 of the Bankruptcy Code\(^\text{33}\) provides a statutory mechanism to deal with this problem in the reorganization context: the appointment of creditors’ committees, whose members are compensated out of the bankruptcy estate.\(^\text{34}\) The committee system does not always work well, because of factors such as conflicts among creditors appointed to committee membership, but it is still superior to the absence of any such mechanism for nonbankruptcy workouts.\(^\text{35}\)

The collective action problems imperfectly dealt with by the committee system create difficulties both for investors and for the fairness of the bankruptcy process itself. Important elements in the Chapter 11 statutory scheme of reorganization give debtor management not only the right to continue managing a reorganizing entity,\(^\text{36}\) but important rights such as an exclusive period during which only management may formulate and present a plan of reorganization.\(^\text{37}\) This gives management initiative in the reorganization process that may potentially be used to the disadvantage of security holders, and especially the holders of unsecured debt. This magnifies the collective action problems that security holders face in negotiating with management. While some commentators have reacted to the imbalance between management and creditors by proposing simply to do away with Chapter 11,\(^\text{38}\) experience

\(^{33}\) Codified as Title 11, U.S.C.

\(^{34}\) See 11 U.S.C. §§ 328(a), 330, 1102, 1103 (1994).


suggests that this would not only result in unnecessary liquidations, but might in fact result in even greater disparity of treatment between larger and smaller creditors. Better-informed security holders will be better positioned to take advantage of rights already present, at least in the letter of the Bankruptcy Code, in order to secure more equitable treatment.

B. Bankruptcy Loses Its Innocence

To understand the kinds of bankruptcy risk that must be considered for disclosure under the securities laws, one must understand the ways in which the bankruptcy process may affect the interests of security holders. Originally—and in the model on which traditional securities law disclosure of bankruptcy risk was based—this was not terribly complicated; it followed the pattern still seen in Chapter 7 liquidations. An insolvent corporation that filed a bankruptcy petition was taken over by a trustee in bankruptcy. The trustee then sold its assets as expeditiously as possible, and finally distributed the proceeds to those with claims against the debtor according to a schedule of priorities established primarily by prebankruptcy contracts between the debtor and the claimants against it.39

This simple liquidation model provided the exclusive insolvency relief under the Bankruptcy Act (the “former Act”) as originally enacted in 1898.40 During the Great Depression, Congress added reorganization provisions to the former Act,41 but these were not frequently used for large corporations with publicly held securities. The primary reason for this was that under the former

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41 Before 1933, reorganizations existed, but were conducted as equity receiverships under nonbankruptcy law. Reorganization was gradually taken under the wing of the former Act during the Depression, beginning with section 77, 47 Stat. 1474–82 (1933), and providing for railroad reorganization; section 77B, 48 Stat. 911 (1934), providing for reorganizations of certain nonrailroad businesses; and the Chandler Act, Pub. L. No. 75-696, 52 Stat. 840 (1938) (formerly codified at scattered sections of 11 U.S.C. and repealed in 1978), which superseded section 77B and formally added Chapters X and XI to the former Act as its provisions for reorganizing enterprises other than railroads. See generally, James Angell McLaughlin, Aspects of the Chandler Bill to Amend the Bankruptcy Act, 4 U. CHI. L. REV. 369 (1937); Eugene V. Rostow & Lloyd N. Cutler, Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act, 48 YALE L.J. 1334 (1939).
Act, cases involving the reorganization of publicly held corporations took place mostly within the rigid framework of former Chapter X, with management superseded by a trustee and mandatory supervision by the SEC to protect public investors.

The cumbersome nature of former Chapter X, and its displacement of management, made it a last resort. It was rarely used in the years after the Great Depression, except for a few very large cases. While vagueness in the former Act led to some use of former Chapter XI to reorganize publicly held corporations, cases of this sort involving corporations in or near the Fortune 500 size range were not at all routine during the period between the Great Depression and the launch of the Bankruptcy Code in 1979.

This was changed substantially by the Bankruptcy Reform Act of 1978, whose principal part, known to its devotees as the "Bankruptcy Code," has superseded the former Act as the statute governing federal bankruptcy. Reorganization under Chapter 11 of the Bankruptcy Code has transformed bankruptcy into a more complex process than its traditional role as a means for winding up failed businesses, or even as a haven for the financially distressed. This transformation carries with it the risk that public security holders will become involved in issuer bankruptcies more frequently and in less cut-and-dried ways. The changes not only raise problems with the established framework of disclosure, but raise substantial questions as to the completeness of the disclosure model now established for securities regulation.

Moreover, reorganizations, though they have varied in frequency with the business cycle, have increased in frequency and become an important and enduring part of the legal landscape. No business can be described as bankruptcy-proof—neither a small business nor a "Fortune 500" corporation. Even more significant for considerations of securities law disclosure, the proliferation of complex new types of securities and the evolving dynamics of reorganization mean that the consequences of bankruptcy are not just that one's capital will softly and suddenly vanish away, but that it will be changed in strange and wonderful ways that may be subject to considerable manipulation.

Securities law has been further pushed toward consideration of bankruptcy as ever smaller companies turn to securities markets, rather than institutional

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lenders, to raise capital. The growth of the junk bond market during the 1980s both expanded the number of securities issuers, and, by increasing their leverage, increased their susceptibility to bankruptcy. The trend toward using the securities markets for raising capital that would traditionally have been obtained from institutional lenders promises to continue and expand, bringing a new stratum of securities issuers into the markets.

Bankruptcy risks are also increasing because bankruptcy is more likely to be employed in situations where, in the past, a debtor corporation would have resisted its use. With management not displaced by the reorganization process and the stigma of bankruptcy gone, Chapter 11 becomes a powerful tactic—and bargaining chip—in the general arsenal of corporate litigation. This means, inter alia, that in situations where financially distressed businesses might previously have tried to work out their problems with creditors short of bankruptcy, Chapter 11 reorganization offers important incentives to force creditor negotiations into bankruptcy court. This is further aggravated by the Bankruptcy Code's endorsement of a procedure not previously available to

46 Original issue junk bonds (as opposed to "fallen angels" that lost investment-grade ratings as their issuers fell on hard times) have only become common since 1977. See, e.g., Paul Asquith et al., Original Issue High Yield Bonds: Aging Analyses of Defaults, Exchanges, and Calls, 44 J. Fin. 923, 926 (1989); Robert A. Taggart, Jr., The Growth of the "Junk Bond" Market and Its Role in Financing Takeovers, in MERGERS AND ACQUISITIONS 5, 8 (Alan J. Auerbach ed., 1988).


48 In fact, structured finance techniques such as assembling pools of receivables into transferable packages have become sufficiently pervasive that they are now being used in the transfer of obligations between institutions, with instruments on the margins of being classified as securities. See, e.g., Resolution Trust Co. v. Stone, 998 F.2d 1534, 1538–40 (10th Cir. 1993) (packages of auto loan receivables sold to financial institutions held not to be securities for purposes of 1933 Act).

49 See Lawrence Zuckerman, Secréte Property Empires Made Public by Stock Sales, N.Y. TIMES, July 8, 1994, at A1 (real estate operations traditionally run as private family-held corporations increasingly turning to public equity markets, exposing them to securities disclosure rules).
publicly held corporations: the "prepackaged" Chapter 11, which combines some of the advantages of workouts, notably avoidance of many of the transaction costs and delays of a Chapter 11 reorganization, with Chapter 11 advantages such as the ability to force minority creditors to accept a debt restructuring. The prepackaged Chapter 11 has increasingly become a fact of life that securities holders must face in situations where nonbankruptcy restructuring would have been the most likely means of first aid for the financially disabled.

Under Chapter 11 of the Bankruptcy Code, bankruptcy has lost both its stigma and most of the features that made former Chapter X unattractive to corporate management. Its use in reorganizing large, publicly held corporations has consequently become substantially more frequent. While it is supposed to create a forum in which the debtor corporation and its creditors can compromise claims in ways satisfactory to both, it may give management opportunities for manipulation that are not only disadvantageous to creditors generally, but which may create special risks for small and diverse creditors such as security holders. This is true not only after commencement of the bankruptcy process, but also as it looms in the background, because a debtor corporation need not even prove technical insolvency before availing itself of the Chapter 11 process. Its management thus not only has substantial control in reorganization, but has enormous discretion to decide if and when to file a petition, giving it major leverage in dealing with creditors in workout situations prior to bankruptcy.

Under present Chapter 11, unlike former Chapter X, a corporation's management normally remains in control as "debtor in possession" ("DIP")

50 This procedure, prepackaging, developed as an informal practice under Chapter XI of the former Act; but former Chapter XI, unlike Chapter 11 of the Bankruptcy Code, was intended for use by privately held debtors. See H.R. Rep. No. 95-595, at 410 (1977), reprinted in 1978 U.S.C.C.A.N. 5963.

51 See In re Southland Corp., 124 B.R. 211, 212 (Bankr. N.D. Tex. 1991) (prepackaged bankruptcy case); Coffee & Klein, supra note 3, at 1209-10; Mendales, supra note 35, at 1219-20, 1282-86.

52 See infra notes 240-43 and accompanying text.

53 See, e.g., Coffee & Klein, supra note 3, at 1209-10.

54 See LoPucki & Whitford, supra note 35, at 675.

55 See 11 U.S.C. §§ 109, 301 (1994); United States v. Huebner, 48 F.3d 376, 379 (9th Cir.); cert. denied, 116 S. Ct. 71 (1994). There is a court-made doctrine allowing a bankruptcy court to dismiss a petition filed in bad faith, but it is rarely invoked except where bankruptcy is used solely as a delaying tactic in single-asset cases, and will not usually succeed against a debtor that, while possibly solvent, has genuine cash-flow problems or other financial distress.
during a reorganization. It is the only party that normally has the right, over the first 120 days of the case, to propose a plan of reorganization, and it has the initiative with respect to all transactions that the debtor engages in during reorganization, though the court must normally approve those transactions outside the ordinary course of business.

Securities holders, as creditors or interest holders, have important rights in this process, both with respect to the course that it follows and its conclusion. The most important of these include the rights to form committees to negotiate with management, to offer legal objections to actions proposed by management, and to vote for or against proposed plans of reorganization. For too many security holders, however, collective action problems—chiefly the costs of obtaining information and acting together on such information—preclude them from effectively exercising these rights.

The net result of the complexities of the Chapter 11 bargaining process is that, although the absolute priority rule for distribution of the debtor's assets nominally governs in the same way as in classic liquidations, there are in fact substantial deviations in actual distributions. Unsecured creditors often receive less than they would if the absolute priority rule were strictly applied, with stockholders receiving distributions that would be barred by the rule. Even more important, the share that any class of creditors (or, for that matter, shareholders) will receive in a plan of reorganization depends to some degree on the success of that class in overcoming its collective action problems to obtain vigorous representation in the bargaining that goes into formulating and confirming a plan of reorganization.

III. POSSIBLE SUBSTITUTES FOR MANDATORY DISCLOSURE

Mandatory disclosure, particularly under the SEC's formal registration requirements, can be a blunt instrument. It tends to be inflexible and slow to

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56 See 11 U.S.C. §§ 1101(a), 1107 (1994). The court may order the displacement of management by a Chapter 11 trustee, but this is unusual, and requires a showing of serious misconduct such as fraud or "gross mismanagement of the affairs of the debtor." See 11 U.S.C. § 1104(a) (1994).
62 See id. at 141–43, 149, 165–66, passim.
63 See, e.g., id. at 161–64; LoPucki & Whitford, supra note 35, at 737, 745–47.
adapt to change, including new kinds of issues. Moreover, it imposes significant costs upon an issuer, including SEC registration charges, fees to highly paid professionals, and, in the transactional process, costs imposed by delay inherent in the registration process. These costs may be particularly onerous in the context of bankruptcy-related disclosure, since this disclosure will be particularly important for financially weak issuers. It is thus important, before imposing new disclosure duties, to consider whether adequate substitutes are available at materially less cost.

The question of dealing with bankruptcy disclosure does not resolve itself into a simple dichotomy between fully mandatory disclosure and a total absence thereof. Rather, it is worth considering various forms of direct and indirect voluntary disclosure as potential alternatives to mandatory disclosure. Voluntary disclosure, it might be argued, is most suitable to the needs of the market. It will be flexible, fitting the needs of a particular set of issuers, security holders, and potential holders better than the blunt instrument of mandatory disclosure. A close examination of voluntary disclosure, however, reveals that it can be effective only insofar as it supplements a more general regime of mandatory disclosure.

A. Direct Voluntary Disclosure

One of the most obvious alternatives to mandatory disclosure is voluntary disclosure by the issuer or its underwriters, along lines roughly parallel to those now followed by the mandatory disclosure system, but more closely tailored to the needs of particular issuers and their markets. Some critics of mandatory disclosure have argued that market forces—chiefly acting through underwriters whose reputation depends on their reputation for reliably disclosing information on the securities they sell—will push issuers into this kind of full and fair disclosure, without the need for the prolonged bureaucratic exchanges required by federal securities law.

Even if one disputes the idea that voluntary disclosure (by itself or in combination with the indirect forms of disclosure described below) should generally supplant mandatory disclosure, one can argue that, given the costs of each incremental datum of mandatory disclosure, the special kinds of disclosure

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65 See infra notes 180-82 and accompanying text.
dealing with the burgeoning complications of Chapter 11 are best dealt with in this fashion. Advocates of this position can point to the assistance given by underwriters to issuers that have encountered difficulty after their securities were marketed, in working out their problems short of actual bankruptcy. One of the primary motivations of the underwriters in so acting has been to protect their reputations, which could be damaged by their sale of securities that entangled their holders in bankruptcy.\footnote{See CONNIE BRUCK, THE PREDATORS' BALL 74–77 (1989); Mendales, supra note 35, at 1271; see also, In re Southland Corp., 124 B.R. 1211, 1213 (Bankr. N.D. Tex. 1991) (underwriter acted as financial adviser to issuer on restructuring its debt); Asquith et al., supra note 46, at 933–34; Gilson & Kraakman, supra note 19, at 620–21.}

There are, however, serious problems with this position. Underwriters' aid to issuers that have encountered post-issue difficulties tends to underline, rather than undo, insufficient explanation of risk in initial disclosure to investors. In fact, the exchange offers aided by underwriters in this context have often been prejudicial to investors, pushing them toward agreeing to exchange offers more disadvantageous to them than bankruptcy.\footnote{See, e.g., Coffee & Klein, supra note 3, at 1212–13.} More fundamentally, the incentives to issuers and underwriters to voluntarily disclose bankruptcy risks in advance of real financial trouble tend to be outweighed by incentives to do the reverse, particularly costs and pressure to sell securities during brief windows of opportunity in volatile markets.\footnote{See, e.g., Banoff, supra note 19, at 149.} The short time horizons of such transactions tend to push participants to apply high discount factors to risks, particularly if the risks are as intangible as damage to reputation.

B. Indirect Forms of Voluntary Disclosure

Indirect forms of voluntary disclosure exist in several forms, which, singly and in combination, can both help in the transmission of voluntary disclosure to the market and can also serve as independent sources of information on securities issuers. Moreover, the indirect forms can enhance, or detract from, investor confidence in voluntary disclosure by providing at least somewhat independent checks on its accuracy. The most widely used of these sources is the rating system.

1. Ratings and How They Work

An even more important possible substitute for mandatory disclosure is the rating system.\footnote{See, e.g., In re Worlds of Wonder Securities Litigation, 814 F. Supp. 850, 864} Ratings, at first glance, appear to be a particularly plausible...
substitute for mandatory disclosure, because they are already so used for
certain kinds of securities, including short-term corporate debt in the form of
commercial paper.\textsuperscript{71}

Securities ratings are formulated privately, although they have increasingly
been incorporated in certain aspects of regulatory law,\textsuperscript{72} especially statutes
concerning asset-backed securities such as the Secondary Mortgage Market
Enhancement Act of 1984.\textsuperscript{73} A few rating firms, dominated by Standard &
Poor’s and Moody’s,\textsuperscript{74} set standards, investigate issuers, evaluate their
offerings, and publish the resulting ratings.\textsuperscript{75} Both issuers and their securities
are rated; different securities issued by the same issuer will carry different
ratings according to the rater’s judgment of their ability to fulfill their
contractual promises to holders. Moreover, issuers and their securities are often
rated by more than one agency at a time, sometimes with inconsistent results.\textsuperscript{76}

2. Why Ratings Are Imperfect Substitutes for Disclosure

Ratings, while a useful adjunct to disclosure, cannot adequately substitute
for it on most bankruptcy issues. There are several reasons for this. Rating
agencies are primarily concerned with the risk of default itself, rather than the
complications that attend reorganization.\textsuperscript{77} They are not well prepared to
inform investors of the risks and rights involved in a workout or Chapter 11
case.

Even more basically, the rating process itself depends on the adequacy of
mandatory disclosure in ways that could not easily be replaced by privately
agreed upon contractual duties.\textsuperscript{78} Insofar as this is the case, ratings are one of
the means by which disclosure is communicated to the markets, rather than a

\textsuperscript{71} See JENNINGS ET AL., supra note 1, at 6–7.
\textsuperscript{73} Pub. L. No. 98-440, 98 Stat. 1689 (codified in scattered sections of 12 U.S.C. and
\textsuperscript{74} See Gregory Husisian, Note, What Standard of Care Should Govern the World’s
Shortest Editorials?: An Analysis of Bond Rating Agency Liability, 75 CORNELL L. REV.
411, 421 (1990); Rating the Rating Agencies, supra note 72, at 53.
\textsuperscript{75} See, e.g., SHAPIRO, supra note 47, at 612–16.
\textsuperscript{76} See, e.g., Husisian, supra note 74, at 411.
\textsuperscript{77} See, e.g., id. at 412–13.
\textsuperscript{78} See, e.g., id. at 412 n.7.
substitute for securities law disclosure.\textsuperscript{79}

The rating process, moreover, insulates the market from important issuer information in ways that do not apply to parties charged with specific mandatory disclosure duties. A basic problem is analogous to the reduction in fidelity that occurs when one copies a prior recording: each successive generation of recordings is less faithful to the original than its predecessor. The rating process, in being conducted by persons who owe no legally recognized duties to the issuer, and who work chiefly with secondary sources of information, without a norm of making independent investigations, risks this problem.\textsuperscript{80}

Ratings tend to aggregate data in ways that tend to preclude the transmission of important information on the special bankruptcy risks inherent in certain types of instruments or their issuers. Rating agencies rate large numbers of different issues and cannot study any particular one with the depth that those charged with specific disclosure duties can. A particular rating indicates that, in the rater's opinion, a security falls within a particular band of risk.\textsuperscript{81} It cannot, inter alia, provide the kind of issuer-specific information to holders that may help them to overcome collective action problems in the reorganization process.

Additionally, the rating system does not provide the kind of potential liability that creates adequate incentives for the kind of full disclosure that the securities laws demand. Rating agencies make exceedingly difficult targets for bankruptcy-affected security holders.\textsuperscript{82} The agencies, and their attorneys, have neither due diligence obligations under the 1933 Act, nor assigned duties for continuing reporting under the 1934 Act. It is even questionable whether, under most circumstances, they owe the kind of fiduciary duties to issuers that would impose upon them the duty to disclose issuer information or refrain from trading on such information under the 1934 Act.\textsuperscript{83} Absent these duties, it is difficult to impose securities law liability on them at all, given the stringent scienter requirements for liability under the antifraud provisions of the 1934 Act.\textsuperscript{84} Moreover, given that the agencies are primarily processors rather than

\textsuperscript{79} The rating agencies themselves are concerned by this, and are disquieted by movement, in other countries as well as the United States, toward making their ratings a substitute for mandatory disclosure. See Rating the Rating Agencies, supra note 72, at 53.

\textsuperscript{80} See, e.g., Husisian, supra note 74, at 422–24, 437–38.

\textsuperscript{81} See, e.g., id. at 454–55; Rating the Rating Agencies, supra note 72, at 54.

\textsuperscript{82} See, e.g., Husisian, supra, note 74, at 413–14, 424 n.56, 427, 442–44.


\textsuperscript{84} See, e.g., In re Towers Financial Corp. Noteholders Litigation, 1996 WL 393579, at *11 (S.D.N.Y. 1996); First Equity Corp. of Fla. v. Standard & Poor’s Corp., 869 F.2d
providers of information, the costs of imputing new liabilities to them appear to exceed the benefits.

Some recent developments have begun to change this, and the changes could lead to changes in this analysis. The rating agencies have increasingly become direct participants in the process of securities registration by the regulators and legislation concerning securities regulation. Initially, this process, at the regulatory level, absolved the issuers of securities with investment-grade ratings from some disclosure requirements. This development has perhaps gone furthest in the disclosure process for mortgage-backed securities, the oldest and still best-developed class of asset-backed securities discussed in this Article. The Secondary Mortgage Market Enhancement Act, by making certain legal entitlements for mortgage-backed securities contingent upon their being rated in one of the two highest categories by at least one nationally recognized rating organization, began the process of statutory recognition for a direct rating agency role in the disclosure process.

The rating agencies, meanwhile, have made an important change in their status which makes them look more like other professionals with legally recognized roles in the process of securities issuance and less like independent journalists: they have begun to collect fees from issuers for rating particular securities issues. All of this could conceivably create a specific enough duty on the part of the rating agencies to make them more vulnerable than in their more traditional role as a purely private analytical service without direct involvement in the process of regulated disclosure. Generally, however, the traditional difficulty of recovery from rating agencies, and the increasing resistance of both Congress and the courts to extend securities law liability to new parties, will effectively insulate them from the pressure for completeness and accuracy that would make their work effective substitutes for mandatory disclosure.

175 (2d Cir. 1989) (applying general standards of liability for common law fraud); Pittman v. Dow Jones & Co., 662 F. Supp. 921 (E.D. La.) (same), aff'd, 834 F.2d 1171 (5th Cir. 1987).

85 See 17 C.F.R. § 230 (1993); Rating the Rating Agencies, supra note 72, at 53.

86 See infra notes 188–224 and accompanying text.


89 See Rating the Rating Agencies, supra note 72, at 54; Husisian, supra note 74, at 433.

C. Other Substitutes for Mandatory Disclosure

Although the rating mechanism is by far the most important third-party substitute for mandatory securities law disclosure in current use, other substitutes exist whose use might in theory be extended to take up more of the role otherwise played by mandatory disclosure.

1. The Financial Press

The financial press has always played a major role in transmitting corporate information to the public. It did so before public securities regulation was instituted and even before formal private rating systems were introduced, and it now helps to transmit ratings to the investing public. One may therefore ask whether, in combination with the rating process and aided by modern technology, it might be an efficient, market-based channel for disclosure of newly important kinds of information—such as insolvency-oriented material—in a more efficient way than the blunt instrument of mandatory disclosure.

To some degree, the financial press already plays a limited role in bankruptcy disclosure. A frequent reader will become broadly familiar with the mechanics of reorganization, with the financial difficulties affecting particular corporations, and with important developments such as the filing of a bankruptcy petition.

For more specific information, however, the financial press suffers from most of the same infirmities as rating agencies when viewed as a substitute for disclosure. Like the agencies, it is primarily a processor rather than an originator of information. It has even less incentive to cover small issuers and has limitations of space to which the rating agencies are not subject. Like the agencies, it has no legal duties in terms of coverage and, given First Amendment considerations, it may be even more difficult to impose liabilities upon it for error, absent deliberate fraud.

2. Professional Analysts

Professional analysts complement rating agencies and the financial press in

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91 See, e.g., Husisian, supra note 74, at 416 n.27; Lowenstein, supra note 6, at 1352–53.

obtaining information on securities and their issuers and processing it for dissemination to the investing public. They play a substantial role in integrating disclosed information with other information relevant to the status of issuers and their securities and in conveying all of this information to the markets.

Professional analysts, however, are largely an adjunct to disclosure rather than a substitute for it. Their work relies upon mandatory disclosure and would be more difficult and subject to greater uncertainty in its absence. Furthermore, since they are usually employed by securities firms who depend heavily on underwriting business from issuers, they are subject to heavy pressures from the companies that they follow to weight their analyses favorably, at least to the extent of avoiding negative recommendations. Insolvency-related analysis becomes particularly difficult given these pressures, and the problem becomes still worse in the absence of the safeguards provided by mandatory disclosure.

Even if one disregards these limitations, analysts would still be far from an adequate substitute for mandatory disclosure, because analysts tend to follow only a comparatively small fraction of the issuers with publicly held securities. This fraction has tended to shrink in recent years, and the added difficulties of obtaining information in a world without mandatory disclosure could be expected to reduce it further still.

3. Insiders and Other Traders

Trading, and particularly insider transactions, furnish another potential source of information, because the prices at which insiders and other traders with access to their information trade will serve to transmit at least some of their knowledge to the more general market. Transactions of this kind may thus provide important clues to the risks underlying the securities being traded by insiders. Even with current restrictions on insider trading in equity

93 See, e.g., Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6235, 20 SEC Docket 1339 (Sept. 2, 1980); Gilson & Kraakman, supra note 19, at 569; Lowenstein, supra note 6, at 1354.


97 See Gilson & Kraakman, supra note 19, at 572; Easterbrook & Fischel, supra note 64, at 681.

98 See Easterbrook & Fischel, supra note 64, at 689; see generally MANNE, supra note
securities, insider transactions provide significant clues to corporate events. It has been argued that removing the restrictions on insider trading would in fact provide useful information and thus improve the efficiency of the securities markets. The question is even more complex for corporate debt, because liability has not yet been imposed for insider trading in debt. Strong arguments have been made for doing so, however, and it appears that the law may be moving in that direction.\textsuperscript{99}

Insider transactions do provide some information on the overall condition of an issuer and on what persons who presumably have the most information believe to be appropriate prices for certain securities. Insiders, however, may have motives for trading other than immediate direct profit—motives that may be in direct conflict with those of other investors—and the prices they are willing to give or take on securities aggregate information even more impenetrably than ratings. Moreover, transactions in corporate debt which, as we shall see, pose more disclosure problems than those in equity, are especially problematic because the markets for debt are much thinner and their prices less transparent than those in the equity markets.\textsuperscript{100}

\textbf{IV. Disclosure Issues: Before Bankruptcy Is Imminent}

Given the incompleteness of potential substitutes, it appears that mandatory disclosure is needed for at least some bankruptcy-related information. One must next consider when and to what extent this kind of disclosure should be required. This will vary from situation to situation, to maximize the cost-effectiveness of disclosure.

The first category that needs to be considered consists of initial securities offerings by businesses that are not in immediate financial danger. Even here, it is possible that careful consideration of insolvency-related issues will indicate that bankruptcy-oriented disclosure is appropriate. The best time to consider appropriate disclosure is while the form and structure of a new security are being established. In most cases, this is well before the issuer must actually consider filing a bankruptcy petition.\textsuperscript{101} While this kind of consideration may

\begin{itemize}
\item \textsuperscript{100} See, e.g., Jennings et al., supra note 1, at 11; Banoff, supra note 19, at 151.
\item \textsuperscript{101} However, this is not necessarily true. Securities issued pursuant to transactions
\end{itemize}
show no particular need for special insolvency-related disclosure, the mere process of considering the issues—and, perhaps, at least a perfunctory check with bankruptcy-experienced counsel—may lead to detection and circumvention of problems that could otherwise lead to major problems later.102

Ironically, the standards for disclosure accompanying the issuance of securities outside of bankruptcy are substantially more rigorous than those arising from the issuance of securities pursuant to a Chapter 11 plan of reorganization. The former securities are subject to full securities law disclosure requirements, while the latter are protected by the “safe harbor”103 provisions of the Bankruptcy Code104 and therefore require approval only by the bankruptcy court under the less exacting disclosure rules of the Bankruptcy Code itself.105

A. How Much Disclosure of Bankruptcy Issues Should the Securities Laws Require?

The goal of making any new disclosure requirements cost-effective implies that the first question to consider for any given security is whether the bankruptcy process itself creates special risks to its holders, beyond the general risk of nonpayment that traditional financial disclosure contemplates. To the extent that special risks of this kind are present, we must also consider the difficulty of reporting them with sufficient precision to be meaningful to investors and the securities markets, and the degree to which the benefits of examining and describing them would exceed the benefits gained from giving them a pass.

1. General Principles: Hard or Soft Information?

The securities laws require an issuer to make complete and accurate disclosure of material information of concern to purchasers of its securities.106 There is no question that this duty applies to “hard” information, i.e., objectively verifiable information concerning a security such as the rights that it

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102 See, e.g., Easterbrook & Fischel, supra note 64, at 699.
105 See Mendales, supra note 35, at 1276–82.
gives its holder against the issuer and holders of competing securities; objective information concerning the issuer's business such as its lines of business, lawsuits by and against it; and accounting data concerning its assets, debts, profits, losses, and other indicia of past performance. The duty does not, however, require the disclosure of all information concerning a particular security, even at the time the security is issued. The courts, in fact, have been concerned lest issuers overwhelm investors with "an avalanche of trivial information."

Concern on the part of regulators and the courts that certain nondeceptive information should not be disclosed is not limited to trivia. A far more difficult issue concerns "soft" information, i.e., information subject to a substantial degree of uncertainty, particularly opinions and forward-looking information such as financial projections. Soft information poses uniquely difficult disclosure problems because the very uncertainty that distinguishes it from hard information makes it difficult, and often undesirable, to impose liability if the projections fail to materialize. Moreover, since the uncertainty makes it more difficult for noninsiders to evaluate and more subject to manipulation by insiders, its disclosure may be as deceptive as its omission.

110 See Basic Inc., 485 U.S. at 232 (where impact of an event on a corporation's future is "contingent or speculative in nature," it is difficult to determine whether omission of information concerning it is material); see also, Kowal v. MCI Communications Corp., 16 F.3d 1271, 1276-77 (D.C. Cir. 1994) (citing Isquith v. Middle South Utilities, Inc., 847 F.2d 186, 203 (5th Cir. 1988)) (reasonable investors do not understand projections to be guarantees of future performance).
111 Based on these characteristics, the SEC actually opposed disclosure of most soft information until 1973. See Krim v. BancTexas Group, Inc., 989 F.2d 1435, 1446-47 (5th Cir. 1993) (there is no duty to disclose an economic forecast, and prospectus projections are
Securities lawyers, and particularly the SEC, have struggled with soft information for a long time. Originally, the potentially deceptive nature of much of this kind of information led the SEC to actually bar its disclosure. Since the 1970s, however, these views have changed radically, and the SEC’s position has gone from reluctance to tolerance to a new stance in which a great deal of soft evidence must be disclosed, chiefly in the form of the statement now formally required under the heading, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (“MD & A”).

Nonetheless, given the inherent uncertainty of soft information, and the fact that reasonable investors understand such uncertainty to exist, Congress, the SEC, and the courts have expressed increasing reluctance to impose liability for errors in disclosure of this kind, unless actually made in bad faith or with deceptive intent. The controversial Private Securities Reform Act of 1995 (the “PSRA”) creates a limited safe harbor for forward-looking pronouncements to the extent that they are accompanied by “meaningful cautionary statements.” The SEC’s less controversial Rule 175 anticipated this by providing a safe harbor in the context of 1933 Act disclosure, although the congressional sponsors of the PSRA expressed doubt that the rule went far enough in curbing what they considered to be abusive securities litigation. Moreover, the courts, to some degree anticipating the PSRA, had already created the “bespeaks caution” doctrine, limiting liability for forward-looking information: securities fraud will not be found if a prospectus contains specific information indicating reasons for investor caution, despite broad optimism by management.

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112 See, e.g., Coffee, supra note 109, at 22, 24; Lowenstein, supra note 6, at 1349–50.
118 See Saltzberg v. TM Sterling/Austin Assoc., Ltd., Fed. Sec. L. Rep. (CCH) ¶ 98,616 (11th Cir. Feb. 16, 1995); Moorhead v. Merrill Lynch, 949 F.2d 243, 245 (8th Cir. 1991); Sinay v. Lamson & Sessions Co., 948 F.2d 1037, 1040 (6th Cir. 1991); Polin
Bankruptcy-related disclosure creates special problems under the hard-soft dichotomy. At first glance, most information concerning the mechanics of an issuer’s potential bankruptcy would appear to be soft, especially if a bankruptcy filing is not under immediate contemplation. More careful analysis, however, reveals that information on this subject breaks down into a mixture of hard and soft data, and even the soft components may be both important to investors and capable of being reported in a meaningful way.\footnote{Gilson & Kraakman, supra note 19, at 549, 562 n.42 (distinguishing “soft” from “very soft” information).}

The contours of bankruptcy law as they apply to the reorganization of a particular entity are, for the most part, well-defined, and thus can be said to constitute hard information. This is true even where the outcome of a particular bankruptcy case, or of a proceeding within it, may be uncertain. Important information includes both general facts about reorganization and facts particular to a given issuer and even to specific outstanding securities. The closer an issuer actually is to bankruptcy, the “harder” the latter information will be. As we shall see,\footnote{See infra text accompanying notes 130–163.} the need for particular kinds of disclosure will vary issue by issue; even hard information appropriate for disclosure in one context—such as for securities with particular bankruptcy sensitivities—may be inappropriate for other circumstances, such as an initial offering of common stock by a financially sound issuer.

2. Tax Disclosure and the Bankruptcy Analogy

Requiring an evaluation of bankruptcy issues for purposes of securities law disclosure does not involve introducing a radically new kind of disclosure. A substantial body of law has already grown up concerning the mandatory disclosure of a similar issue: the tax law characteristics of securities.\footnote{See, e.g., Reg. S-K, Item 405, 17 C.F.R. § 229.405 (1996); Pension & Inv. Assocs. of Am., Inc., SEC No-Action Letter, 1991 WL 290533 (Jan. 25, 1977).}

Disclosure of the tax characteristics of securities has long been required and provides a useful model for study in formulating policy toward the equally abstruse risks posed by bankruptcy law, although bankruptcy adds some
complexity all its own.

Tax disclosure also consists of disclosure concerning the application of a dense set of legal rules to a factual situation. Moreover, like bankruptcy disclosure, it is forward-looking, involves substantial degrees of uncertainty concerning the legal treatment of certain transactions, and thus includes both hard and soft information. Experience in formulating appropriate tax disclosure can thus be helpful in deciding what bankruptcy disclosure is appropriate, particularly where new types of securities are being issued.

3. Appropriate Disclosure for Bankruptcy Concerns

Bankruptcy disclosure necessarily incorporates both hard and soft information. In combining the two, the general rule should be that disclosure is appropriate in any situation in which information available to the issuer raises a reasonable probability that bankruptcy would materially change the entitlements of security holders from their contractual entitlements on liquidation. This disclosure is not limited to a readily predictable sequence of events, as that rarely exists: what is needed is sufficient disclosure concerning the range of possible outcomes for the holders of particular securities as to materially improve the ability of holders to properly evaluate their rights in a potential workout or reorganization. When, as in the initial public offering paradigm on which most of the securities laws are based, securities are issued in a nonworkout situation and the securities lack any special sensitivity to bankruptcy, the disclosure of a full panoply of bankruptcy options may not add materially to the ability of potential holders to evaluate their rights, and would therefore be inappropriate.

In other situations, disclosure of bankruptcy-related information, going beyond simple data concerning financial weakness, will be not only feasible but necessary. These situations include those in which the issuer’s ability to continue in business without major financial adjustments is questionable, those involving a transaction or transactions that could be subject to attack in the event of the issuer’s insolvency, and those in which the securities issued may have structural sensitivity to bankruptcy. In the first category, issuers may be weakened based on business conditions or their own financial structure. Here, mere disclosure of financial weakness may be insufficient if a corporate management is considering financial restructuring, in or out of bankruptcy, which would be likely to change the position of the security holders with respect to the corporation or the holders of other claims against it.

The second category includes securities issued on less than a clean slate. The securities may have been issued pursuant to a transaction, such as an LBO,
that would raise questions on the issuer's bankruptcy. The securities may have had no direct connection with a transaction of that kind, but the issuer may previously have engaged in such transactions, raising questions about its securities, or the issuer may be contemplating a transaction that would create problems for its security holders.

Bankruptcy disclosure may also be needed because of the way in which the securities themselves are structured. This is true even if the securities are issued with high investment-grade ratings, if the high ratings are based not on the underlying financial strength of the issuer (or, in the case of structured finance instruments, the parent of the entity for whose ultimate benefit the securities are being issued) but on a structure designed to protect the security holders from the beneficial issuer's bankruptcy. If securities are sold on the premise that they offer buyers a high degree of safety, it is important to disclose aspects of the underlying structure that may be challenged in bankruptcy. Disclosure of this kind should deal not only with well-established principles of bankruptcy law but, in the case of novel structures, with indeterminacy—i.e., that a given structure does not enjoy the imprimatur of the Bankruptcy Code and has not yet been tested at the appellate level in a bankruptcy case.

Apart from disclosure specific to a particular issue or issuer, bankruptcy disclosure, where reorganization is a real possibility, should inform investors of certain basic mechanics of the reorganization process that will enable them better to understand their risks and rights therein. The general facts that would be important include a general description of the reorganization process, and particularly the role that creditors—including securities holders—play in negotiating a plan of reorganization. The committee system is particularly important here including, for junior securities, the right to ask the bankruptcy court to approve the organization of official, estate-supported committees for holders of securities with interests opposed to those of a general creditors' committee. Equity committees are most common in this category, but courts also have approved committees for creditors with special interests, such as subordinated debt. New forms of securities with special bankruptcy sensitivity (e.g., asset-backed securities) are likely to fall into the latter category.

It will also generally be appropriate to provide at least a general description of the system by which claimants are called upon to approve a plan of reorganization. While this is important both in prebankruptcy and postbankruptcy reorganization maneuvering, the Bankruptcy Code, in its

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122 Leveraged buyouts may lead to bankruptcy challenges against subsequently issued debt securities under provisions such as Bankruptcy Code section 548, 11 U.S.C. § 548 (1994). See infra text accompanying notes 145–57.

123 See infra text accompanying notes 188–213.

paradigmatic neglect of the holders of securities in large corporate entities, largely fails to consider their interests in this context. In fairness, the Bankruptcy Code could hardly be expected to provide for disclosure in the course of a prepetition workout, since its provisions cannot be invoked until a petition is actually filed. Nonetheless, provisions of the Bankruptcy Code that necessarily cast a shadow on the workout process, such as the Bankruptcy Code’s requirement that a plan of reorganization be approved by each class of creditors, are material information to security holders confronted with a prebankruptcy exchange offer, and it is therefore appropriate to require their discussion in securities law disclosure.

The Bankruptcy Code can be more fairly charged with deficiency as it governs the informational position of securities holders after the issuer files a reorganization petition. Here, the Bankruptcy Code does not provide for direct substantial disclosure (other than notification to creditors on when they must file claims) until late in the process when a plan has already been negotiated and is being submitted to creditors and interest holders for approval. This reduces the ability of all but the largest securities holders to organize committees other than the main creditors’ committee to monitor the activities of committee members who nominally represent them, and to exercise their rights as parties in interest to object to transactions proposed by the DIP that would affect their interests.

B. Bankruptcy, the Securities Laws, and Equity Securities

The first set of disclosure issues arising at the interface between the Bankruptcy Code and the securities laws concerns the appropriate disclosure of bankruptcy risks under the securities laws at the time of a securities offering made before the issuer has had to face cash-flow problems or other difficulties.

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125 See 11 U.S.C. §§ 1126, 1129(a)(7)–(8) (1994) (approval of claims by a class of creditors requires approval by more than half the voting members of the class holding at least two thirds of the amount of the class’s claims; a class of “interests” [equity holders] needs approval by at least two thirds of the amount of interests held by voting class members).
129 See, e.g., 11 U.S.C. § 1109(b) (1994); Western Auto Supply Co. v. Savage Arms, Inc. (In re Savage Indus., Inc.), 43 F.3d 714, 720–21 (1st Cir. 1994) (“parties in interest,” for bankruptcy purposes, include all entities whose interests might be adversely affected by a proposed action, and have right to notice and to object before court can approve such action).
that raise the possibility of a workout or bankruptcy. This is not a difficult problem for garden-variety issuers of equity securities.

Bankruptcy risks faced by common shareholders in most situations do not differ substantially from nonbankruptcy risks: they cannot be paid dividends if the corporation is bankrupt, but corporate law in most states will bar directors from declaring dividends even outside bankruptcy if minimum requirements such as solvency are unmet. If the business fails, they may receive a share of its assets only after creditors are paid in full, a rule that bankruptcy law also respects. Their primary concerns, therefore, are with risks to the overall business, and bankruptcy adds no special risks requiring disclosure in addition to normal financial disclosure.

For preferred shareholders, bankruptcy risks begin to diverge, although the degree of difference depends on the position of the preferred in the issuer’s overall financial structure, and any special characteristics that may be built into it. Bankruptcy, or insolvency under nonbankruptcy corporate law, will bar holders from any distributions by the issuer, including both dividends and distributions of principal under mandatory redemption provisions.

Disclosure of specific risk factors applying to any security registered under the 1933 Act is required not just generally by section 11 of the 1933 Act, but specifically by Regulation S-K. See 17 C.F.R. § 229.503(c) (1996).

In this Article “garden-variety” refers to traditional forms of common and preferred stock. An increasing amount of equity, however, has taken on characteristics that tend to exclude it from this category, particularly as it assumes more debt-like characteristics. One such exception to the general rule concerns certain asset-backed securities that take the form of equity interests in certain pools of assets. See infra text accompanying notes 188–213.

See, e.g., CAL. CORP. CODE § 500(b) (West 1990) (corporation may make no distribution to shareholders if bankruptcy insolvent). N.Y. BUS. CORP. LAW § 510(a) (McKinney 1986) (corporation may not distribute property to shareholders if insolvent or if the distribution would render it insolvent); MODEL BUS. CORP. ACT § 6.40(c) (1991) (distributions to shareholders precluded if corporation is insolvent). Delaware is somewhat unusual in permitting distributions on common stock out of current profits (an unlikely circumstance if the corporation is insolvent) if the issuer is current on preferred stock dividends. See DEL. CODE ANN. tit. 8, § 170 (1991). Once the debtor has filed for bankruptcy, distributions to stockholders are additionally precluded by 11 U.S.C. §§ 363, 549, 1107 (1994).


See 11 U.S.C. §§ 501(a), 726(a)(6), 1129(a)(7), 1129(b) (1994). While Chapter 7 bankruptcy dictates the same absolute priority rule as state law, Chapter 11, if anything, reduces the risks faced by equity holders, because it increases the chance that they will be paid something even if they would be ineligible for any distribution under absolute priority. See supra notes 61–63 and accompanying text.

None of the statutory provisions cited supra note 134, distinguishes between
however, does not represent any change from normal requirements of state law for corporate distributions, so that no special bankruptcy disclosure is needed. Moreover, bankruptcy will preserve preferred shareholders’ order of priority for distribution of the issuer’s assets—after creditors, but before common shareholders.  

Bankruptcy may, however, have two different kinds of effects on the rights of preferred shareholders: short-term, over the course of the reorganization, and long-term, as a result of a confirmed plan. The short-term effects may make it harder for preferred shareholders to assert some of their contractual remedies against the issuer for failure to declare one or more dividends scheduled under the terms of the preferred offering. Remedies typically include the right to elect certain directors after the board’s failure to declare scheduled preferred dividends for a number of calendar quarters specified in the corporate charter provisions authorizing issue of the preferred stock. While preferred stockholders attempting to exercise such remedies will probably have to ask permission from the bankruptcy court to do so, most remedies short of actual distributions are likely to be allowed, since bankruptcy courts try to protect stockholders’ rights as far as possible within a reorganization case. Therefore, unless a preferred stock issue incorporates put rights or other rights to distributions of property, or some genuinely unusual elements, e.g., provisions that attempt to protect holders by means such as a reservation of security interests, short-term effects are likely to be limited to a delay while permission is obtained from the bankruptcy court.

Long-term effects may be more serious. In a workout, or a reorganization with sufficient assets for some distribution to equity, a plan of reorganization may give preferred holders significantly less, vis-à-vis junior security holders, than the absolute priority rule would normally indicate. If there are a significant number of preferred holders, collective action problems may place them at a disadvantage with respect to common shareholders in terms of negotiating favorable plan provisions. Therefore, while disclosure absent financial weakness or other special circumstances might simply inform preferred holders that their contractual rights might be altered in bankruptcy, common and preferred shares insofar as they preclude distributions during the insolvency or bankruptcy of the issuer.

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140 See supra notes 61–63 and accompanying text.
disclosure on the approach to bankruptcy should take into account special circumstances that a reorganization of the issuer would entail, and should inform them, inter alia, of their right to ask the bankruptcy court for the appointment of a special, estate-supported committee to represent their position.\textsuperscript{141}

C. Bankruptcy Disclosure for Debt Securities

More difficult bankruptcy disclosure problems arise in the context of debt instruments. Debt instruments have evolved along a wide spectrum, with immense variation in complexity and degree of risk. They tend to be far more subject to idiosyncratic contractual provisions than are common stocks, the normal paradigm for securities law disclosure. Markets for debt securities are thinner than those for equity securities even absent bankruptcy considerations, and the approach of insolvency makes them even less liquid.\textsuperscript{142} Moreover, debt securities, more than equity securities, are subject to modification in the workout process and under the impact of extra-statutory dynamics in Chapter 11 reorganizations; their holders, in order to take advantage of their statutory rights, are more dependent upon adequate information.

1. Garden-Variety Debt and the Standard Restructuring Model

A great deal of corporate debt should not require elaborate bankruptcy-related disclosure at the time of initial offering. By analogy to the equity issues discussed above, we may call this garden-variety debt. To fit this model, debt should involve a financially strong issuer, with a simple capital structure, that is, ample equity in proportion to debt, and few layers of debt, with covenants to prevent management from changing this structure without debtholders’ consent,\textsuperscript{143} and nothing in the corporation’s history that might raise questions about new transactions.\textsuperscript{144} In this case, it is unlikely that there will be readily foreseeable risks that a restructuring would significantly change the nature of debtholders’ claims against the issuer and their priority with respect to other claims. Thus, workout or reorganization risks involving securities of this kind


\textsuperscript{142} See supra text accompanying notes 28–30.


\textsuperscript{144} It is possible that an issuer or its predecessor in interest may have engaged in prior transactions, such as an LBO, that might raise questions as to the enforceability of new debt, and related provisions such as security agreements, in bankruptcy. \textit{See infra} notes 145–57 and accompanying text.
do not vary sufficiently from the risks of simple failure to be worth the additional costs imposed by special bankruptcy disclosure.

2. Departures from the Standard Model

Where issuers and financial structure begin to depart from the simple model discussed above, insolvency risks begin to diverge more markedly from those of the securities laws general model. As this divergence grows, more sophisticated insolvency-related disclosure becomes both desirable and cost-effective.

a. Transactions Raising Bankruptcy Issues: Fraudulent Transfer and Related Risks

While normal securities law disclosure is based on the paradigm of the initial public offering, this may not fit the circumstances of securities and issuers that, because of transactions occurring prior to or simultaneously with an offering, may have special sensitivities to bankruptcy. LBOs and leveraged recapitalizations are among the most often discussed transactions raising bankruptcy issues. Other kinds of transactions that could raise similar questions include spin-offs intended to separate unencumbered assets from assets subject to potentially large claims, as in the case of divestitures currently being contemplated by major producers of tobacco products, or the disposition of property subject to significant environmental liabilities.

Securities issued in the LBO context and similar transactions may be

subject to important bankruptcy risk factors. The most important of these is that the corporate obligations underlying securities of this kind may be vulnerable to avoidance under the fraudulent transfer laws.

The trustee in bankruptcy and, in reorganizations under Chapter 11, the DIP, is empowered by the Bankruptcy Code to avoid fraudulent transfers made by the debtor prior to the bankruptcy petition. A transfer may be avoided as fraudulent, regardless of the actual intent of the transferor, if it was made for less than reasonably equivalent value and the transferor was insolvent or had “unreasonably small capital” at the time of the transfer or as a result

146 The same fraudulent transfer analysis that applies to LBOs also applies to leveraged recapitalizations. Transactions of this kind also became common during the late 1980s, usually as a defensive measure employed by a target subject to a takeover bid. Like LBOs, they replace a large proportion of a corporation’s equity with debt. In a leveraged recapitalization, shareholders do not sell out their interests. Instead, the issuing corporation borrows to pay shareholders a large one-time dividend. Although the amounts paid may be close to the amounts paid to shareholders in an LBO, they retain their shares (now generally referred to as “stubs”), entitling them to equity interests in a corporation whose equity has been drastically reduced. See Harvey L. Pitt et al., Tender Offers: Offensive and Defensive Tactics, and the Business Judgment Rule, in CONTESTS FOR CORPORATE CONTROL 1991, at 196–203 (PLI Law & Practice Course Handbook Series No. 730, 1991).

147 The term “DIP” designates the management of a debtor reorganizing under the Bankruptcy Code. Pursuant to Chapter 11 of the Bankruptcy Code, a debtor in bankruptcy normally continues to be run by its prebankruptcy management, which assumes most of the rights and duties of a trustee in bankruptcy under 11 U.S.C. §§ 1101(1), 1107(a), 1108 (1994). See U.S. Brass & Copper Co. v. Caplan (In re Century Brass Prods.), 22 F.3d 37, 39–40 (2d Cir. 1994) (Bankruptcy Code section 1107 gives DIP the trustee’s power to avoid preferences); Breeden v. Catron (In re Catron), 158 B.R. 629, 633 (E.D. Va. 1993) (DIP stands in trustee’s shoes in every way); see also Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 355 (1985) (dictum that DIP management has trustee’s fiduciary duties). See also infra note 197 and accompanying text.

148 The trustee may act under Bankruptcy Code section 548, 11 U.S.C. § 548 (1994), which creates a specific cause of action in bankruptcy for the avoidance of fraudulent transfers, or, under Bankruptcy Code section 544(b), 11 U.S.C. § 544(b) (1994), may challenge transfers under applicable state fraudulent transfer law. State law may be preferable because of longer limitations periods. Bankruptcy Code section 548 provides a reachback period of one year prior to the filing of the bankruptcy petition. 11 U.S.C. § 548 (1994). The Uniform Fraudulent Transfer Act (“U.F.T.A.”), on the other hand, provides a general limitations period of four years, U.F.T.A. § 9(b) (1984), and permits a creditor to challenge a deliberately fraudulent transfer within a year after the creditor discovered (or should have discovered) the fraudulent transaction. Other state statutes, such as the Uniform Fraudulent Conveyance Act (“U.F.C.A.”), have other limitations periods.

149 Neither the Bankruptcy Code nor the Uniform Fraudulent Transfer Act defines the term “unreasonably small capital,” and one of the key problems in contemporary fraudulent transfer law is deciding what constitutes unreasonably small capital for a particular debtor.
of the transaction.\textsuperscript{150} For purposes of fraudulent transfer law, transfers include the incurrence of obligations and the granting of security interests.\textsuperscript{151}

In an LBO, a target corporation is acquired by an entity (which may include members of the target corporation’s management) that borrows most of the funds used to pay the target’s stockholders. Usually, the target and the acquiring entity then legally merge and the corporation becomes liable for funds used for its own acquisition.\textsuperscript{152} Moreover, senior acquisition debt is normally secured by liens on assets of the target.\textsuperscript{153} Arguably, since the obligations and the liens securing them are created to obtain funds that are used not for the corporation’s own benefit but for that of its former stockholders, their creation involves a transfer by the corporation in exchange for less than reasonably equivalent value.\textsuperscript{154} The other element required for characterizing the transfer as fraudulent may then be found if the corporation was rendered insolvent by the transaction, or left with “unreasonably small capital” for its business.\textsuperscript{155} While such a financial state may be apparent from the corporation’s subsequent bankruptcy, it is difficult to prove in actual litigation.\textsuperscript{156} Therefore, a fraudulent transfer challenge to an LBO poses the risks that securities issued to finance an LBO—including securities issued by a post-acquisition corporate entity to retire institutional debt—will face challenges to the validity of the debtor’s obligations to the security holders and to the validity of any security interests supporting such obligations.\textsuperscript{157}


\textsuperscript{152} \textit{See Fraudulent Conveyances, supra} note 145, at 3–4.


\textsuperscript{155} See 11 U.S.C. § 548(a)(2)(B) (1994). The U.F.T.A. uses the substantially equivalent phrase “was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were too small in relation to the business or transaction.” U.F.T.A. § 4(a)(2)(i) (1984). Its predecessor statute, the U.F.C.A., still in effect in several states, including New York, \textit{see} N.Y. DEBT. & CRED. LAW §§ 270–81, uses the phrase “unreasonably small capital.” U.F.C.A. § 5 (1918).

\textsuperscript{156} See \textit{Moody,} 971 F.2d at 1072–75, 1076 (post-LBO bankruptcy held caused by unforeseeable decline in sales rather than lack of capital).

\textsuperscript{157} See, \textit{e.g.}, Smyser, \textit{supra} note 143, at 810–11.
b. Junk Bonds

Junk bonds\textsuperscript{158} pose several different kinds of risks. The most obvious are the credit risks that have resulted in their classification as "junk," \textit{i.e.}, factors reducing the probability that holders will receive timely payments of principal and interest. Such factors do not change significantly as a matter of bankruptcy policy, and so credit risks in and of themselves require no special bankruptcy disclosure.

The credit risks may, however, be so high that a workout or bankruptcy reorganization is a readily foreseeable rather than a purely theoretical risk.\textsuperscript{159} This would place the issuer in the category of financial instability described below. For junk bond holders, this will require not only simple disclosure that there is high risk of nonpayment, but that the promised high yields that form the chief inducement to acquire junk bonds might well face sharp reduction in the workout or reorganization process.\textsuperscript{160} It could also require special descriptions of the dynamics of the insolvency process, including the fact that holders may have interests opposed to those of other creditors and, in the event of insolvency, might be well advised to demand a special committee of their own.\textsuperscript{161}

Moreover, junk bond holders may face special risks in the event of their issuer's bankruptcy. These are risks created by the bankruptcy process when applied to particular characteristics of certain junk bond issues. They include all the risks inherent in the transactional history of the issues, as where the junk bonds were issued pursuant to an LBO.\textsuperscript{162}

Additionally, these bondholders may face special risks, beyond those facing the holders of other securities issued pursuant to the same transactions. A key risk of this kind is that their securities, which they purchased under the label "debt," may be recharacterized by the bankruptcy court as equity.\textsuperscript{163}

\textsuperscript{158} For purposes of this Article, junk bonds will be defined as securities, denominated as debt, that either have not been rated, or which have been rated at less than investment grade by one or more of the national securities rating organizations.

\textsuperscript{159} See, \textit{e.g.}, BRUCK, \textit{supra} note 67, at 74–75.

\textsuperscript{160} See, \textit{e.g.}, \textit{id.} at 73–77; Aaron Pressman, \textit{A New Calculus Speeds Bankruptcy Disputes: Republic Health's Prepackaged Reorganization}, \textit{INVESTMENT DEALERS' DIG.}, Dec. 24, 1990, at 20.

\textsuperscript{161} See supra notes 59–63 and accompanying text.

\textsuperscript{162} See supra notes 145–57 and accompanying text.

result of this would be that they could find themselves subordinated to the claims of all creditors of the debtor, and not merely to those senior creditors to whom the junk bonds were expressly subordinated.

c. Environmental Issues

Environmental issues have become matters of great concern to investors, not only as a matter of public policy, but because liabilities under state and federal environmental law can be so massive as to constitute major risks to a corporation's financial stability. Federal statutes such as CERCLA, and their state counterparts impose virtually unlimited costs for cleaning up property contaminated by toxic substances upon past and present owners and managers of the sites in question. The liability is without fault, and defenses are limited. Risks of this kind, though often arcane, can involve such enormous liabilities that the SEC now requires issuers to disclose environmental risks as part of standard disclosure under the securities laws.

What has not been generally recognized to date is that, beyond general risks to investors, environmental liabilities have come to pose increasing hazards to creditors in the bankruptcy context. These risks are particularly

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164 Over 32,000 hazardous waste sites have now been discovered across the United States, and an eventual total of 75,000 has been estimated. Total estimated cleanup costs now exceed $1 trillion. See Philip H. Abelson, Remediation of Hazardous Waste Sites, 255 SCIENCE 901 (1992).


noteworthy because they are not always readily ascertained from straightforward application of the Bankruptcy Code to an analysis of nonbankruptcy liabilities under environmental law, but result from the dynamics of the bankruptcy process and major inconsistencies between the ways in which bankruptcy and environmental law contemplate the assessment of liabilities. The Bankruptcy Code, recognizing that reorganizations are likely to fail unless all claims against the reorganizing debtor can be quickly assessed, provides for the bankruptcy court to estimate the amounts of contingent and unliquidated claims so that the case may be expeditiously concluded. Environmental statutes such as CERCLA, on the other hand, do not take the competing claims of other creditors into account, nor the fact that all creditors, including environmental claimants such as the Environmental Protection Agency, may suffer if a reorganization fails. They contemplate assessment of liability on a delayed basis, after the full costs of cleanup have been determined.

Moreover, partly because of the inconsistencies in the ways in which the two bodies of law view liabilities, the priority of environmental claims as compared to the claims of other creditors is uncertain in ways that are not at all clear from the statutory text. The Bankruptcy Code does not give environmental claims a priority over general unsecured claims, although states and the federal government are free to enact statutes giving environmental agencies liens to secure environmental cleanup costs. Courts, however, have been dealing with cleanup claims by state and federal agencies in ways that threaten to create priority over the claims of other creditors,


despite absence of a statutory priority in the Bankruptcy Code or liens backed by public filings that would otherwise put third-party creditors on notice.\textsuperscript{173}

The most severe danger of this sort is that courts may require the bankruptcy estate to pay the full costs of a cleanup of toxic waste, rather than treating it as just another claim to be paid pro rata with other claims of equal statutory priority, giving such costs a superpriority\textsuperscript{174} that is not provided for by the Bankruptcy Code or principles of debtor-creditor law governing recovery by creditors outside of bankruptcy.\textsuperscript{175} The effect of this would be to deprive other creditors of most or all of the recovery from the bankruptcy estate to which they would otherwise be entitled, without the advance notice provided by a U.C.C. or other public lien filing.\textsuperscript{176} Even without going so far, a court may hold environmental cleanup claims asserted after the commencement of the case to be entitled to administrative expense priority.\textsuperscript{177} Such priority would place such claims ahead of those of general creditors, including debenture holders. It could also make it substantially more difficult to formulate and confirm a plan of reorganization, thereby increasing the risk of a liquidation in which security holders would receive little or nothing.\textsuperscript{178}

The drastic extent of the potential harm to securities holders indicates that this is exactly the sort of material information requiring disclosure. Here, the risks apply not only to the context of a Chapter 11 reorganization, but also to a liquidation under Chapter 7.\textsuperscript{179} Disclosure concerning both possibilities is therefore appropriate in any circumstances where bankruptcy is a real option for management to consider.

\textsuperscript{173} Although there is no provision in federal law for "superliens" that prime existing liens, at least nine states have provided for such liens. See Mirsky et al., supra note 168, at 688–89.


\textsuperscript{175} See, e.g., Torwico Elecs., Inc. v. New Jersey, Dep't of Envtl. Protection, 8 F.3d 146, 150–51 (3d Cir. 1993); Alan B. Miller & Jeffrey L. Tannenbaum, Bankruptcy, Nat'l L.J., June 20, 1994, at B4.


\textsuperscript{178} See Mirsky et al., supra note 168, at 655.

d. Where Financial Instability Is Present at the Time of Issue

Even in the absence of special transaction or structural characteristics posing particular bankruptcy risks, appropriate disclosure becomes a complex question when, at the time securities are issued, the issuer is financially frail. In this situation, disclosure may easily be underinclusive or overinclusive, and we must consider, given the high degree of uncertainty attaching to investment in this situation, just how precisely disclosure needs to deal with all attendant risks in order to be acceptable.

It is important to understand in this context that this set of problems applies not just to the normal paradigm of an initial public offering where the issuer is genuinely new to the securities markets, but also to cases where the offering follows a prior history with lingering consequences, such as a workout, prior Chapter 11, or a highly leveraged transaction. In all of these cases, although additional problems may arise from the prior history, such as fraudulent transfer issues resulting from a highly leveraged transaction, the basic analysis is similar: the issuer is frail enough that a purchaser of its securities must consider a workout or bankruptcy as a short-term possibility. Here, the analysis is similar to that for continuing disclosure by a distressed issuer of outstanding securities, except that the standard for disclosure is substantially stricter: the due diligence and negligence standard of section 11 of the 1933 Act, rather than the scienter standard of Rule 10b-5.

3. Legal Opinions on Solvency-Related Issues

The proliferation of bankruptcy-sensitive transactions and securities has generated new demand for special opinions by attorneys on solvency-related issues in connection with the issuance of securities. This is a substantial change from earlier practice, in which attorneys generally excepted bankruptcy risks from opinions. While many attorneys would still prefer to limit their opinions to nonbankruptcy law—not just because bankruptcy law is arcane, but because it includes greater elements of uncertainty than the issues on which corporate lawyers prefer to opine—they are with increasing frequency being asked to give opinions on the bankruptcy consequences of particular transactions. This is

180 See supra notes 135–143 and accompanying text.
181 See infra notes 227–242 and accompanying text.
183 See MacLachlan, supra note 168, at 36 (RTC studying possible liability of Latham & Watkins for opinion there was little risk in LBO where there were substantial environmental issues); Andrew Blum, Awaiting Word from SEC: Asbestos Cases Turn on
especially true in the case of asset-backed securities, where favorable opinions by issuers' counsel on issues such as the "true sale" of receivables,\footnote{See infra notes 206–13 and accompanying text.} and the safety of a finance subsidiary from being substantively consolidated with its parent in a bankruptcy of the latter,\footnote{See infra notes 201–205 and accompanying text.} are required by rating agencies as preconditions for high investment-grade ratings.

It is difficult, but not impossible, to impose liability upon attorneys for legal opinions.\footnote{See, e.g., Eisenberg v. Gagnon, 766 F.2d 770, 779-84 (3d Cir. 1985); Kline v. First W. Gov't Sec. Inc., 794 F. Supp. 542, 550 (E.D. Pa. 1992), aff'd in part and rev'd in part, 24 F.3d 480, 492 (3d Cir. 1994) (plaintiffs held to have stated Rule 10b-5 claims against law firm based on certain statements in opinion letter); Stevens v. Equidyne Extractive Indus., 694 F. Supp. 1057, 1064 (S.D.N.Y. 1988). But see Kline v. First W. Gov't. See. Inc., 24 F.3d 480, 486–87 (3d Cir. 1994) (triable issue of fact raised by firm opinion on forward contract investments).} Bankruptcy-related opinions rendered for purposes of securities issuance may, however, involve special elements that put them outside the normal run of legal opinions. Opinions of this kind play a more central role in the issue of securities with special bankruptcy sensitivity than do more traditional opinions in the issue of more traditional securities. Rather than simply being a certification that routine tasks have been handled properly, these opinions are an essential element in assembling a custom-designed structure, and other elements indispensable to the marketing of such securities, such as their ratings by major agencies, depend on them in nonroutine ways.\footnote{See, e.g., Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, Structured Financing Techniques, 50 Bus. LAW. 527, 529–32 (1995) [hereinafter Structured Financing]; The Tribar Opinion Committee, Special Report by the Tribar Opinion Committee: Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions, 46 Bus. LAW. 718, 720 (1991) [hereinafter Tribar Opinion Committee Report].}

Bankruptcy disclosure therefore needs to deal directly with opinions of this kind. Not only are the conclusions of such opinions material, but their degree of certainty—or the absence thereof—should also be disclosed. The degree to which an opinion has been qualified, and the basis for such qualification—such as the absence of controlling authority—may be as significant as the accounting information that has traditionally played a central role in disclosure. Moreover, circumstances relevant to the process of giving the opinion should also be disclosed, including positions held by attorneys as officers or directors of the issuer, the fact that a law firm has declined to give an opinion, or circumstances accompanying a change in issuer's counsel during the course of an offering.

D. Structured Finance and the Mysterious Art of Bankruptcy-Proofing

Structured finance, like junk bonds, emerged from obscurity into the daylight of Wall Street during the 1980s. Structured finance instruments, however, are marketed as a kind of financial mirror image to junk bonds: they are sold primarily on the basis of safety, usually with the highest possible ratings. An essential element of these high ratings is the premise that properly structured securities of this type are supposed to be "bankruptcy-proof," that is, cash flow to their holders will continue even if the entity for whose benefit they are issued winds up in Chapter 11 or worse.

1. Bankruptcy-Sensitive Securities: Asset-Backed Securities

Certain types of securities may be particularly sensitive to risks arising from the bankruptcy process itself. Asset-backed securities are among the most important securities of this kind.

Although any security in which the issuer's obligation is supported by a security interest in real or personal property may be described as an "asset-backed security," the term can be used to designate two very different types of security: (1) conventional bonds backed by security interests in real or personal property; and (2) the recently developed types of securities that look primarily to the cash flow from specific pools of interest-earning assets, rather than to earnings from general corporate operations, for payment of principal and interest. These include mortgage-backed securities and similar securities backed by pools of loans secured by personalty such as automobiles and farm equipment, and by assignment of accounts receivable such as credit card balances. Wall Street argot often refers to the general field of designing and issuing such securities as "structured finance," largely because it attempts to use corporate structure to isolate the assets used to back the securities from

189 See Hudson van Eck, supra note 188, at 583.
191 See generally SCHWARCZ, supra note 190.
Both types of securities are offered to investors as safer instruments, that is, more certain as to payment of principal and interest, than obligations of their issuers not backed by specific assets. The safety of both, however, is significantly affected by the structure of the bankruptcy reorganization process.\textsuperscript{193} Certain aspects of the very features designed to provide greater safety to holders of the instruments may be especially sensitive to the powers available to some of the likely participants in a reorganization case, or to the dynamics of such a case.

Because of this, the focus of bankruptcy disclosure needs to be on those aspects of bankruptcy that add uncertainty to investors’ prospects of payment of principal and interest on their instruments. This is not to say that such disclosure should simply run a parade of horribles before investors, since that might in itself either mislead as to real risks or anaesthetize investors into disregarding risks entirely. Rather, it should discuss aspects of the bankruptcy process—not only as to statutory or otherwise settled law, but also the dynamics of the reorganization process—which could reduce or delay otherwise assured recovery. If the law in the area is unsettled, which is highly probable for the newer types of structured securities, then that fact is clearly material to the issue of whether the structuring will be effective in assuring the securities’ intended safety in the face of the bankruptcy process.

\section*{2. Traditional Secured Obligations}

The Bankruptcy Code recognizes the priority of traditional secured obligations, provided that the security interests are properly perfected.\textsuperscript{194} Nonetheless, bankruptcy creates special risks for holders of such instruments, going well beyond the generic risk that the collateral securing the obligations will not be adequate to pay principal and interest on the debt.

The most straightforward risks arise from the way in which bankruptcy

\begin{footnotesize}
\begin{enumerate}
\item See id. at 1–2, 10–16; see also Linda Grant Williams, \textit{Real Estate Law}, Nat’l L.J., Aug. 26, 1994, at B5. For convenience, this general category of asset-backed securities will hereinafter be referred to as “structured securities.”
\item The issues discussed in the text that follows concern the reorganization process under Bankruptcy Code Chapter 11 only, and not the liquidation process under Chapter 7. Under Chapter 7, properly perfected security interests are not disturbed, pursuant to Bankruptcy Code section 506, and the problems of delay and potential substitution will be significantly less serious because the trustee is primarily concerned with quick liquidation of the debtor’s assets, rather than continuing to operate the debtor’s business.
\end{enumerate}
\end{footnotesize}
tests the adequacy of the perfection of the creditors' security interests. Since bankruptcy's prevailing norm for distribution is that all creditors should share pro rata in the bankruptcy estate, deviations from creditor equality such as those resulting from security interests are construed narrowly. Therefore, the trustee in bankruptcy is given the power to avoid any security interest that is not adequately perfected under the law of the jurisdiction in which the security interest was created.\footnote{See \textit{11 U.S.C.} § 544(a) (1994).} Moreover, a security interest may be avoidable as a preference if perfection was not substantially simultaneous with the transaction, and if it occurred within ninety days prior to the filing of the bankruptcy petition.\footnote{See \textit{11 U.S.C.} § 547(b) (1994).} In a Chapter 11 reorganization, the DIP has substantially the same avoiding powers as the trustee in bankruptcy.\footnote{See \textit{11 U.S.C.} § 1107(a) (1994); \textit{U.S. Brass & Copper Co. v. Caplan (In re Century Brass Prods.)}, 22 F.3d 37, 39–40 (2d Cir. 1994) (\textit{11 U.S.C.} § 1107 gives the DIP the trustee's power to avoid preferences). Unless otherwise expressly stated, all references to the "trustee" in this Article also refer to the DIP in a Chapter 11 reorganization.}

The avoiding powers are not likely, however, to be the most important threat to holders of secured debt in bankruptcy. Perfection is a largely ministerial task that should not be difficult if those charged with it act with minimal competence. If there are potential problems, though, as where the property subject to the security interest is located in a state where rules governing perfection are problematic, such problems should be disclosed.

Other problems may be more serious. Delay is likely to pose a problem to secured creditors in most bankruptcy cases. Secured creditors are barred from seizing their collateral by the automatic stay in bankruptcy,\footnote{See \textit{11 U.S.C.} § 362(a) (1994).} and the delay that this causes may be lengthy in reorganization cases. Delay may be particularly serious in situations where collateral is subject to quick deterioration in value. Although the Bankruptcy Code gives creditors the right to ask the court to lift the stay to let them seize their collateral in such cases,\footnote{See \textit{11 U.S.C.} §§ 361, 362(d)–(f) (1994). The Bankruptcy Code gives secured creditors the right to have the stay lifted for "cause," (including lack of "adequate protection" as defined in \textit{11 U.S.C.} § 361 of their interests) or if they can show that the debtor has no equity in the property concerned and that it is not necessary to the debtor's reorganization.} stay litigation is uncertain in outcome and involves substantial transaction costs.

Other risks are less likely to occur, but may be more serious where they do occur. This is particularly true of the trustee's power, with consent of the bankruptcy court, to substitute collateral.\footnote{See \textit{11 U.S.C.} §§ 361(2), 364(d) (1994); \textit{Resources Unlimited, Inc. v. Envtl. Waste Control, Inc.}, 158 B.R. 998, 999 (N.D. Ind. 1993) (ordering debtor to use cash
tempting to a DIP looking for liquid assets with which to finance a reorganization. Although substituted collateral is supposed to have the same value as that which it replaced, it is possible that it could have certain characteristics that would be particularly undesirable to the holders of asset-backed securities, such as lower liquidity and different cash-flow characteristics.

3. Structured Finance Instruments

Bankruptcy risks are even more important in the relatively new field of structured finance. In fact, one of the chief reasons for the "structuring" in question is an attempt to minimize insolvency risks: to remove holders of an instrument of this kind from involvement in the insolvency of the entities for whose ultimate benefit the instruments issue. The object is to obtain a higher rating—and hence a lower cost of credit—than the parent could obtain for any securities it might issue. The structuring consists of establishing finance subsidiaries isolated from their parents to a degree that is intended to isolate such subsidiaries from their parents' bankruptcy. The finance subsidiaries are the actual issuers of the securities in question, although their parents are the intended beneficiaries of such financing. Isolating the subsidiaries from their parents' bankruptcy is designed to permit them to receive higher ratings (and collateral for environmental cleanup, providing secured creditor can receive "adequate protection").

201 In this context, the term "insolvency" is more appropriate than the narrower term "bankruptcy," because many of the corporate parents whose needs are being financed through these techniques are banks, savings and loan associations, and other financial institutions that are barred from becoming debtors under the Bankruptcy Code pursuant to 11 U.S.C. § 109(b), (d) (1994). These institutions' insolvency is governed by other bodies of law, including both federal law, see, e.g., the Financial Institutions Reform, Recovery, & Enforcement Act ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified at various sections of 12 U.S.C.); and state law, see, e.g., N.Y. Banking Law § 606 (1990). Although it has been held that bank receivership and analogous means for reorganizing or winding up other financial institutions have different purposes than bankruptcy, see, e.g., Corbin v. Federal Res. Bank of N.Y., 629 F.2d 233, 236 (2d Cir. 1980), the techniques used to attempt to isolate such institutions from special-purpose finance subsidiaries used to issue asset-backed securities are substantially the same as in cases where the parent may become a debtor under the Bankruptcy Code.

202 While this is normally prospective, i.e., an attempt to make sure that assets collateralizing structured securities do not become part of the parent's bankruptcy estate should it file a bankruptcy petition, structured finance techniques have even been used to issue investment-grade rated securities collateralized by receivables of debtors already in Chapter 11 (e.g., Allied Stores). See SCHWARCZ, supra note 190, at 40-45.
therefore lower interest rates) for their debt (or, in some cases, preferred stock) than their parents would be able to receive.

**a. Isolating the Special Purpose Entity: The Mechanics of Nonconsolidation**

One of the important structuring techniques used to enhance the ratings of asset-backed instruments is to attempt to isolate the nominal issuer of the instruments from the entity for whose ultimate benefit they are being issued. This normally takes the form of what has been termed a "special purpose entity": a trust or special-purpose finance subsidiary controlled by the parent entity, which is contractually barred from incurring obligations other than to the holders of the asset-backed instruments.

The purpose of establishing such a subsidiary is to create an entity not subject to the claims of creditors other than the holders of the structured finance instruments. The financial distress of its parent, therefore, is intended to have little effect upon the holders of such instruments. The assets collateralizing these instruments will not be subject to the claims of the parent's creditors, and the parent's bankruptcy need not involve a bankruptcy filing for the subsidiary.

A key threat to this structure is the bankruptcy doctrine of substantive consolidation. In bankruptcy, a legally distinct parent and its subsidiaries may, under certain circumstances, have their assets and liabilities pooled as if they were a single entity. Obviously, this would undo the entire purpose of creating a separate issuing entity, and rating services therefore require, as a prerequisite for a premium rating for structured securities, a legal opinion that a finance subsidiary should not be substantively consolidated with its parent in the event of the latter's bankruptcy.

With this objective in mind, finance subsidiaries are designed to minimize the risk of this kind of bankruptcy treatment. The design normally reflects substantive consolidation case law, and typically requires measures to insure more than purely nominal financial and administrative independence of the finance subsidiary, including offices and officers separate from that of the parent. Issuers' counsel are typically expected to back their design with the requisite nonconsolidation opinions.

Both designs and opinions of this sort have weaknesses that need to be

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203 See Tribar Opinion Committee Report, supra note 187, at 725.
204 See, e.g., Federal Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 58 (2d Cir. 1992); 5 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY § 1100.06, at 1100-33 (Laurence P. King ed., 15th ed. 1996).
reflected in securities law disclosure. Securities of this kind are given top
ratings and sold as “bankruptcy-proof,” relying substantially on
nonconsolidation opinions. Unfortunately, opinions of this kind rest on a
structure of largely untested assumptions. Substantive consolidation is a form
of nonstatutory equitable relief that courts impose on a case-by-case basis; it is
difficult to predict that a court will rule on a given structure in a given way,
particularly when actual operation of a corporate structure may differ
substantially from its original paper design. Moreover, structured securities of
this sort are new enough that there are still few, if any, actual tests of them in
litigation. While the structures may in fact turn out to be perfectly good, buyers
of securities of this kind should be informed that a particular structure has not
been tested in court.

b. Isolating the Collateral: The Fabulous “True Sale” and the U.C.C.

Another important element in the isolation of the nominal issuer from the
corporate beneficiary concerns the nature of the assets underlying the securities
in question. These are generally pools of income-producing instruments such as
mortgages and automobile loans, which the corporate parent transfers to its
finance subsidiary at closing. The problem concerns the nature of their
transfer from the ultimate corporate beneficiary to the finance subsidiary that is
the nominal issuer of the securities.

Since the primary object of structuring the transaction is to isolate the
issuing subsidiary from a bankruptcy of its parent, rating agencies are
especially concerned that the income-producing instruments transferred from
the parent to the finance subsidiary have been sold, rather than merely
hypothecated. If a transaction could be characterized as a secured loan, then the
corporate parent would retain an interest in them, which would become an asset
of its bankruptcy estate. In that event, the subsidiary could not alienate them
without approval of the bankruptcy court, and the assets could not be said to
have been truly isolated from its bankruptcy.

Therefore, in structuring transactions of this kind, rating agencies normally

\[206\] Many types of income-producing instruments may be assembled into pools to
provide the cash flow for asset-backed securities. While mortgages were the first
instruments thus used, and are still predominantly used, the structured finance industry has
steadily expanded the varieties of instruments that may thus be used, from car loans to
credit card receivables, and now even trade receivables. See, e.g., BT Securities Corp.
advertisements for Gaylord Receivables Master Trust and Weirton Steel Corp., Trade-

\[207\] See SCHWARTZ, supra note 190, at 28–31.
insist that the transfer be characterized as a "true sale." Unfortunately, while the consequences of the distinction between a sale and a transfer for security may be significant in bankruptcy, the U.C.C. does not draw a clear line between a true sale and a transfer for security, where the subject matter of the transaction consists of accounts or chattel paper—categories that include the income-producing property typically used to provide payment streams to holders of structured finance instruments. The same steps are taken to perfect a sale of such instruments as to perfect a loan transaction with a security interest in them. The situation is similar to the difficulty that exists in distinguishing between a lease of personal property and a sale on credit in which the seller retains a security interest in the goods sold.

This creates a significant uncertainty in a supposedly "bankruptcy-proof" structure. Absent statutory support for a clear distinction between a true sale and a secured transaction, lawyers structuring securities backed by pools of receivables try to give their structures characteristics of absolute transfer, so that a bankruptcy court reviewing a transaction would be likely to consider it a sale rather than a transfer for security. Unfortunately, there is little case law available to support such characterization. Nonetheless, favorable ratings for such securitizations normally require legal opinions to the effect that a court considering the transaction would, or at least would be likely to, hold it to be a true sale rather than a secured transaction.

4. The Problem of Corner-Cutting

The uncertainty of both of these techniques is increased by the propensity of certain issuers to attempt to have their cake and eat it: to achieve the sought-after isolation from bankruptcy without incurring the requisite costs and loss of control. Indeed, some of the "enhancements" added to packages of receivables or similar sources of cash flow to make them more attractive to investors may

208 See id. at 28–29.

209 Under U.C.C. section 9-105(1)(b), "chattel paper" means a writing or set of writings evidencing both a monetary obligation and a supporting security interest in, or lease of, specific personal property. The pools of receivables such as car loans that make up collateral for a large portion of the structured finance instruments on the securities markets fit this definition. U.C.C. section 9-105(1)(d) provides that for U.C.C. purposes, the term "debtor" includes not only a person who owes payment or other performance on an obligation secured by accounts or chattel paper, but also a seller of accounts or chattel paper.

210 See U.C.C. §§ 9-102(1)(b), 9-105(c), (d), (m), 9-302 cmt. 5, 9-308.

undermine their isolation from the bankruptcy of transferors. For example, the purported seller of a pool of receivables may retain some of the risk of default by the underlying debtors. The retention of risk tends to undermine the attempt to characterize the transfer as absolute, giving it more of the substance of a secured loan.

Competition among underwriters and among bond counsel may further aggravate this problem, particularly given the increasingly short time horizons imposed by volatile market conditions. Prospective underwriters and counsel eager for business may compete to accept flimsier structures, applying high discounts to the chance of future liability if the structures should fail at an unpredictably distant economic downturn.

This may have particularly unfortunate effects if the ultimate beneficiary does end up in bankruptcy. Ultimately, all structures that are intended to isolate a finance subsidiary from the ultimate beneficiary of its securities is intended to separate some of the beneficiary's best assets from its general creditors. Each of the remedies discussed above—substantive consolidation, recharacterization of true sales as secured loans, etc.—thus collapses analytically into the original model of fraudulent transfer avoidance. Each is thus an equitable remedy, more likely to be applied to undo a transaction if the parties to the transaction have behaved inequitably toward innocent third parties—in this case creditors of the corporate parent, whose ability to collect on their claims is weakened by the transfer of liquid assets to finance subsidiaries. Corner-cutting, in which the beneficiary attempts to overreach, will therefore make it far more likely that at least one of these equitable remedies will actually be applied.

One of the advantages of requiring a high level of disclosure in this context, aside from alerting purchasers of the securities to problems such as the indeterminacy of existing law, is its effect on corner-cutting. A high standard of disclosure will have the effect of forcing a high level of due diligence with respect to the legal structure in question, particularly on the part of underwriters and their counsel, and will also tend to motivate SEC staff to ask questions concerning unfamiliar structures. This strict legal scrutiny appears to be one of the most effective means to control corner-cutting.

E. Circularity

As noted above, the federal securities laws are primarily disclosure statutes. In the bankruptcy context, however, a unique problem lurks at the

213 See infra notes 283–88 and accompanying text.
center of the disclosure labyrinth. This may be called the problem of circularity: the risk that disclosure may become a self-fulfilling prophecy. In the absence of clear guidance from the Bankruptcy Code and Rules, the bankruptcy court may be tempted to rely on the “parade of horribles” in the disclosure documents prepared for the issue in question, in deciding how to characterize them for bankruptcy purposes.\footnote{See \textit{In re} Chateaugay Corp., 109 B.R. 51, 56 (Bankr. S.D.N.Y. 1990) (citing disclosure material on bankruptcy risks in holding original issue discount not payable, and in calculating amount of original issue discount), \textit{aff'd}, 130 B.R. 403, 405 (S.D.N.Y. 1991), \textit{aff'd in part and rev'd in part on other grounds}, 961 F.2d 378 (2d Cir. 1992); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988) (holding controlling shareholders liable in part because they had been legally advised of possible characterization of LBO as fraudulent transfer).\n\footnote{Indus. Inc. v. Green, 430 U.S. 462, 477–78 (1977)); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); COX ET AL., supra note 1, at 14.}}

Such reliance creates a tension between securities and bankruptcy law that requires a solution that will best serve the purposes of both. Where potential securities purchasers must be informed of possible alternative legal implications of an undeveloped area of the law, securities lawyers should not be deterred from thoughtfully enumerating the risks posed by a possible legal characterization, for fear that a bankruptcy court may base a later adverse holding on the fact that the securities holders were warned of it in the disclosure materials.

Circularity is further complicated by what may be called its strong and weak forms. The strong form, as discussed above, is the problem that the disclosure may itself become the basis for adverse legal characterization. It is a special case of the weak form, which ultimately presents more difficult problems. Weak form circularity consists of the total set of problems that an issuer may incur as the result of securities law disclosure of insolvency, its approach, and its effects upon corporate obligations. It includes risks that disclosure may precipitate adverse actions by creditors, and that detailed disclosure on the weaknesses of a structure will form a road map for litigation for potential plaintiffs contemplating targets of opportunity.

Since strong form circularity is a more straightforward problem, it is helpful to consider it first. Its less convoluted nature does not make it less serious, but does make it more amenable to remedy.

1. \textit{In the Fraudulent Transfer Context}

The litigation of corporate fraudulent transfer issues has become increasingly common in recent years. This has been especially true in cases
where bankruptcy occurs in the wake of transactions such as LBOs. Prebankruptcy transfers may be avoided by a bankruptcy court as constructively fraudulent, or as fraudulent by actual intent to hinder, delay, or defraud creditors. The consequences of a finding that a transfer was fraudulent by actual intent may be substantially harsher than if it is merely found to be constructively fraudulent. The problem of circularity arises because disclosure of the risk of fraudulent transfer avoidance in offering materials might render the transfers fraudulent not just constructively but by actual intent.

There are two important consequences of such a finding. The first is that a finding of actual intent might be easier for a trustee in bankruptcy to establish than a finding that the challenged transaction was constructively fraudulent. This is because the latter finding requires difficult factual proofs of the elements of a constructively fraudulent transfer—i.e., that the debtor was insolvent at the time of the transfer or was rendered insolvent thereby, and that the debtor received less than reasonably equivalent value in exchange for the transfer. The proofs are difficult because they require the plaintiff to value the debtor's assets at the time of the transaction, and to establish that benefits—including indirect and intangible benefits—received by the debtor as a result of the transaction, were worth substantially less than the obligations that it thereby incurred.

The second important consequence of a finding of actual intent is that the

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216 See notes 143–57 and accompanying text.

217 A transfer may be avoidable as constructively fraudulent under most modern fraudulent transfer law, including the U.F.C.A., the U.F.T.A., and Bankruptcy Code section 548. Under such provisions generally, a transfer may be avoided as fraudulent without regard to the intentions of the parties if at least two elements are present in the transaction. The first is that the transferor received less than reasonably equivalent value in exchange for the transfer. The second may be any of the following: the transferor was insolvent (in the bankruptcy sense) at the time of the transfer, or was thereby rendered insolvent; the transfer left the transferor with less than adequate capital for its business or a transaction in which it intended to engage; or at the time of the transfer, it intended or expected to incur debts beyond its ability to repay. See 11 U.S.C. § 548(a)(2) (1994); U.F.C.A. §§ 2–6; U.F.T.A. §§ 2, 4(a)(2), 5(a).


219 For example, the transferee of a constructively fraudulent transfer is entitled to a lien on property turned over to the estate on fraudulent transfer avoidance for any value given to the debtor; this is not available to a transferee who does not take in good faith. See 11 U.S.C. §§ 548(c), 550(d)(1) (1994).


defendant may be treated more harshly than in the case of a finding of constructive fraud. In cases of constructive fraud, the transferee who is forced to disgorge transferred property is entitled to a lien on property turned over to the trustee, in the amount that the defendant transferred to the debtor in exchange for the avoided transfer.\footnote{See 11 U.S.C. § 548(c) (1994); U.F.C.A. § 9(2); U.F.T.A. § 8(d).} If the fraud is found to be by actual intent, on the other hand, the defendant, on turning over the property in question to the trustee, keeps nothing.\footnote{See, e.g., United States v. Tabor Court Realty, 803 F.2d 1288, 1304 (3d Cir. 1986).}

2. Classification of Securities as Debt or Equity

With respect to junk bonds, the circularity problem relates directly to the issue of whether the debt status of such securities is to be honored in bankruptcy, or whether they are to be reclassified as equity by the bankruptcy court.\footnote{See generally Mendales, supra note 163.} The securities may have characteristics such that the danger of reclassification is real. If so, that is the kind of risk factor that ought to be disclosed in offering materials under the securities laws. The danger, however, is that a bankruptcy court, after the fact, would view the disclosure of the risk in the offering materials as evidence of intent, and thus another factor to be weighed in favor of reclassification.

3. In the Environmental Context

As noted above,\footnote{See supra notes 164–79 and accompanying text.} environmental liabilities not only create enormous potential liabilities, but may be factors both in precipitating bankruptcy and in creating special risks within the context of a bankruptcy case.

Environmental liabilities interact with bankruptcy in several ways. The most obvious is that environmental liabilities may be an important cause of bankruptcy. More difficult problems, however, are created by the fact that courts dealing with bankruptcy cases have not been good at allocating environmental liabilities according to the normal rules for distribution of bankruptcy estates among creditors. This means that creditors of debtors with environmental problems may not be able to count upon receiving the distributions which they might expect and to which they might otherwise be entitled under the Bankruptcy Code.

In this context, as in others, circularity comes to pose special problems because liabilities under environmental law may be affected by disclosure of the

\footnote{See 11 U.S.C. § 548(c) (1994); U.F.C.A. § 9(2); U.F.T.A. § 8(d).}
problems in question. Liability under CERCLA may be based on ownership or operation of property used for treating or disposing of toxic waste.\[226\] Liability is without fault, and may apply to a secured lender who takes title to the property on foreclosure, or to a lender who participates in management of a debtor operating it.\[227\] The only significant defense against such liability is based on "innocent landowner" status.\[228\] Disclosure of risks under the securities laws could help to undermine the assertion of this defense.

4. Dealing with Circularity

The strong form of the circularity problem appears amenable to resolution along the lines adopted by the U.C.C. for transactions such as leases and consignments, that exist on the frontiers between secured transactions and transactions covered by bodies of law other than U.C.C. Article 9. Parties to a transaction may, for example, intend it to be a lease of personal property. Such a transaction, if a "true" lease, is outside the scope of Article 9, and does not require the parties to file an Article 9 financing statement in order to protect the lessor's interest in the property against third parties such as a trustee in bankruptcy.

A lease of personal property, however, may be hard to distinguish from a security interest coming within the scope of Article 9.\[229\] If a third party later attacks the lessor's interest, and a court determines that the parties have in fact created a security interest rather than a lease, the lessor would be treated as an unsecured creditor if he or she has not filed a proper financing statement under Article 9.\[230\]

Given the absence of a clear line between leases and security transactions, Article 9 has adopted an elegant solution to the dilemma of the lessor who is concerned that the transaction may not be a lease, but is afraid that if he or she files a protective financing statement, that act will be used as evidence that the parties in fact intended to create a security interest. Article 9 permits a lessor in this position\[231\] to file an "informational" financing statement that will protect his priority should a court find that the parties created a security interest rather than a lease. To guard against the circularity problem in this context, Article 9

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\[227\] See Mirsky et al., supra note 168, at 633-34.


\[229\] For the difficulties inherent in distinguishing between a lease of and a security interest in personal property, see U.C.C. § 1-201(37) cmt. 37 (1995).


\[231\] Presumably, the lessor does not wish to be found the "lessor" of two evils.
provides that the filing of an informational document of this kind shall not of itself constitute evidence that the parties intended to create a security interest.\textsuperscript{232}

Similarly, a court considering the problem of circularity in disclosure of bankruptcy risks under the securities laws should find, as a matter of public policy, that disclosure of a particular risk factor does not constitute a binding legal characterization of the matter in question with regard to nonsecurities law. Although a statutory provision to this effect, along lines similar to U.C.C. section 9-408, would be preferable, in terms of certainty and clarity, to reliance on widely-scattered bankruptcy courts, asking the latter to do so prior to the adoption of a statute does not ask them to exceed their authority. Courts in many different jurisdictions have, for example, long followed similar principles of public policy in holding evidence of subsequent repairs or improvements inadmissible to prove a tort defendant negligent.\textsuperscript{233}

The weak form of the circularity problem is more difficult. The threat of insolvency naturally spurs creditors to recover on obligations to them by whatever means come to hand. New financial structures invite testing by litigation, particularly if a structure is being used to obtain a higher credit rating than its ultimate beneficiary would otherwise receive. The very weakness of the ultimate beneficiary that compels using structures of this kind indicates that it may be vulnerable to bankruptcy—and in that event, absent prior testing, a wealthy finance subsidiary is the kind of target that a bankruptcy trustee, acting for general creditors, is likely to find inviting.

Ultimately, the intractability of these considerations suggests a general weakness in the whole fabric of disclosure as presently conceived.\textsuperscript{234} Discrete


\textsuperscript{233} This rule (which has developed several exceptions not relevant here) has been established by courts in most U.S. jurisdictions, and often codified by statute, including Federal. Rule of Evidence. 407. Originally, the primary justification for the rule was that a subsequent repair or improvement was irrelevant to the defendant’s negligence at the time of the tort. The public policy justification for the rule has developed more recently, holding that if this kind of evidence is not excluded, potential defendants would be deterred from making repairs or improvements after an accident. See, e.g., Ault v. International Harvester Co., 528 P.2d 1148, 1150-52 (Cal. 1974) (en banc); Good v. A.B. Chance Co., 565 P.2d 217, 223–24 (Colo. Ct. App. 1977); City of Miami Beach v. Wolfe, 83 So. 2d 774, 776 (Fla. 1955); Judson F. Falknor, Extrinsic Policies Affecting Admissibility, 10 Rutgers L. Rev. 574, 590–91 (1956).

\textsuperscript{234} It may appropriately be analogized to Russell’s Paradox. Appreciation of Russell’s Paradox helped lead to Kurt Gödel’s more general proof of the incompleteness of formal axiomatic systems. Russell’s Paradox may be stated as follows: Consider the class of all classes that are not members of themselves. Is it a member of itself? If it is, then it is not; if it is not, then it is. See generally, Bertrand Russell & Alfred North Whitehead,
instances of circularity, such as the strong form, are amenable to solution; the
two general set of problems, described here as the weak form of circularity,
requires particular solutions appropriate to particular sets of facts. The most
general statement that one can make is simply that courts should be sensitive to
the problem, and should be particularly reluctant to impose securities law
liability for failure to disclose in situations where an issuer has made good faith
efforts to balance appropriate disclosure with the risks created by that
disclosure.

PRINCIPIA MATHEMATICA (2d ed. 1927). The paradox, considered in the context of formal
logical systems, demonstrates the difficulties that arise in such systems when they attempt to
make statements about themselves. G"odel exploited these problems arising from self-
reference in formulating his proof. The theorem that he proved states that, in the context of
number theory, there exist well-formed statements that can neither be proven nor disproven
within the axioms and procedures of formal arithmetic. This theorem can be broadly
generalized to hold that for any nontrivial formal axiomatic system, there exist well-formed
statements that may neither be proven nor disproven within the axioms and procedures of
the system. See, e.g., ROGER PENROSE, THE EMPEROR'S NEW MIND 99-108 (1989);
DOUGLAS HOFSTADTER, G"ODEL, ESCHER, BACH: AN ETERNAL GOLDEN BRAID (1979); see
also, John M. Rogers & Robert E. Molzon, Some Lessons About the Law from Self-
Referential Problems in Mathematics, 90 MICH. L. REV. 992 (1992); Bertolt Brecht, Das
Lied von der Unz"ul"anglichkeit Menschlichen Strebens, in DIE DREIGROSCHENOPER 77
(Suhrkamp Verlag ed. 1955) ("Ja, renn' nur nach dem Gl"uck/Doeh renee nicht zu
sehr/Denn alle rennen nach dem Gl"uck/Das Gl"uck rennt hinterher," roughly translated
"Yes, run after happiness, but don't run too hard. For everyone runs after happiness—but
happiness is running behind them"). The problem of circularity, particularly in its more
general weak form, arises from the same nucleus of self-reference that lies at the core of
Russell's Paradox and the G"odel incompleteness theorem. It should be noted that this is not
a claim that securities law, even insofar as it interacts with bankruptcy, is limited by
G"odel incompleteness; securities law is not a closed formal axiomatic system subject to the
theorem. The analogy is instructive, however, because circularity reflects the special
anomalies inherent where self-reference occurs. Problems arising from circularity have
been noted in other bodies of law, as with the problem of infinite regress seen in conflicts of
law under the rubric of rensvoi. The analogy to incompleteness in formal logic is also helpful
in understanding the context of securities law disclosure when viewed in the light of its real
world consequences. The problem of incompleteness, while it precludes a complete formal
theory of mathematics, does not bar the use of mathematics in understanding the world. In
the same way, the existence of circularity does not prove that effective securities law
disclosure is impossible, but demonstrates the intractability of the problem of formulating
general rules to deal with all disclosure problems, or even the subset of disclosure problems
arising from the insolvency or potential insolvency of a securities issuer.
V. THE CORPORATE EVENT HORIZON: DISCLOSURE ON THE APPROACH TO BANKRUPTCY

...Man sieht vom Galgenberg die Welt anders an, und sieht andere Dingen als andre.\textsuperscript{235}

As the financial state of an entity with outstanding securities evolves over time, and particularly when it encounters difficulties that may threaten insolvency, disclosure problems take on new dimensions. The normal disclosure paradigm of the initial public offering to a general, liquid securities market becomes less applicable; troubled issuers are attractive to fewer investors who do not already hold their securities, and informational asymmetries between buyers and sellers grow substantially.\textsuperscript{236}

Substantive disclosure needs also change in this new environment. Correct disclosure becomes not just a matter of correctly reporting business conditions affecting the issuer's ability to pay its obligations under nonbankruptcy law, but implicates changes in the rights of control that may be essential for effective implementation of the goals of the reorganization process. Where common shareholders have exclusive voting rights in the standard model, preferred shareholders may acquire them as dividends are missed,\textsuperscript{237} and bondholders may acquire them as the issuer's situation passes from stressed normal operations to workout to bankruptcy.\textsuperscript{238} Even when these rights are not created by contract, for example, in the indentures that establish the issuer's obligations to holders of its debt securities, they may be established informally in the workout negotiation process, and formally by bankruptcy law in a Chapter 11 reorganization. This last aspect of evolving control rights has been insufficiently appreciated in the past, based on the discontinuity between normal corporate operation and bankruptcy law. Absent correct disclosure, holders of debt securities have tended to undervalue—and lose—rights to which they should have been entitled.\textsuperscript{239}

The question of what constitutes appropriate disclosure is particularly difficult, however, because the question of cost becomes especially critical in this context. The financially troubled corporation is less able to afford disclosure costs than the average issuer, and it is therefore important to avoid

\textsuperscript{235}Christian Morgenstern, ALLE GALGENLIEDER 15 (Insel Taschenbuch ed. 1947). Roughly translated, "One looks at the world differently from the gallows hill, and one perceives different things differently."

\textsuperscript{236}See, e.g., Coffee & Klein, supra note 3, at 1217–20.

\textsuperscript{237}See, e.g., HENN & ALEXANDER, supra note 137, at 498–99.

\textsuperscript{238}See, e.g., id. at 381–82, 501.

\textsuperscript{239}See generally Lowenstein, supra note 6, at 1357–58.
imposing costs that could further jeopardize a successful workout or reorganization, unless the benefits of the disclosure are clearly worth the added risk.

A. The Need for Appropriate Disclosure

The approach to bankruptcy creates special disclosure requirements for several reasons. Security holders' need for adequate information rises as their level of risk increases, particularly since the approach to bankruptcy tends to be especially productive of rumors. Without adequate information, they may become prey to "vultures," selling their stakes for substantially less than real value.\textsuperscript{240} Appropriate disclosure will thus help to level the playing field between ordinary investors and specialists, and reduce incentives for improper insider conduct.\textsuperscript{241}

Moreover, appropriate disclosure will help stakeholders to make better decisions where asymmetry of information may have its most drastic consequences: in dealing with management. This is true both on the approach to bankruptcy, in deciding whether to support management workout proposals, and in a Chapter 11 reorganization. In both cases, good information is important both substantively, in helping investors appraise the value of their claims, and procedurally, in advising them of their rights in the course of a workout or bankruptcy. It may, for example, help them to overcome collective action problems normally inherent in the position of scattered claimants with relatively small interests by forming committees.\textsuperscript{242} The limited empirical data on hand indicate, as might be expected, that investors who organize committees tend to recover better proportions of their claims than those who do not.\textsuperscript{243}

B. Continuing Disclosure and Bankruptcy Issues

The 1933 Act primarily deals with the initial distribution of securities. Disclosure obligations do not end there, however. At that point, the 1934 Act, which is primarily concerned with trading of securities on the secondary

\textsuperscript{240} See, e.g., Coffee & Klein, supra note 3, at 1209 n.7, 1214, 1218–20, 1223.


\textsuperscript{242} See supra notes 32–34 and accompanying text.

\textsuperscript{243} See generally LoPucki & Whitford, supra note 35; LoPucki & Whitford, supra note 61.
markets, imposes continuing disclosure requirements, requiring issuers to update information at regular intervals and to report particular events of major significance. The disclosure of material information, whether or not intended as disclosure for purposes of securities regulation, gives rise to continuing responsibilities: even though correct when initially made, it will tend to become misleading over time if not adequately updated.244

1. Regular Reporting Under the 1934 Act

The 1934 Act adds significantly to the disclosure duties of the issuers of registered securities. Apart from initial registration, they are required to engage in continuous disclosure to investors concerning their financial condition. This begins with quarterly and annual reports. Moreover, and this is particularly important for purposes of insolvency disclosure, continuous reporting responsibility also includes disclosure outside the framework of normal periodic reporting when events occur that are of central importance to the registrants.245 Additionally, issuers who are required to register under the 1934 Act are subject to special disclosure intended to properly inform security holders about their rights in corporate governance, including the proxy rules,246 which control disclosure in the process of proxy solicitation, and the Williams Act,247 controlling disclosure in the context of tender offers.

2. Reporting on the Onset of Distress: Trigger Points

A key issue that issuers must face in deciding when insolvency-related disclosure must be made is when, if such disclosure was not appropriate under the 1933 Act at the time of issue, circumstances have changed to a point at


245 The 1934 Act provides for registration independent of the registration requirements of the 1933 Act. Section 12(g)(1) of the 1934 Act, 15 U.S.C. § 78l(g)(1), requires an issuer to register an issue of equity securities when it has more than 500 record holders and the issuer has total assets over $5 million. Under 1934 Act section 13(a), 15 U.S.C. § 78m(a), an entity registering securities under the 1934 Act becomes a “reporting company” and must comply with the Act’s periodic reporting requirement. While this alone would probably suffice to make most issuers reporting companies, 1934 Act section 15(d) and Regulation 15D close a possible loophole by making all entities that register securities under the 1933 Act comply with the 1934 Act’s periodic reporting requirements. See, e.g., LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 198-99 (3d ed. 1993).


247 82 Stat. 456 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f)).
which management and its advisors must consider making such disclosure. Clearly, it is required at the time management actually decides to make an exchange offer or to file for bankruptcy; however, as we have seen, disclosure will usually need to be made well before this point if it is to be truly effective.

Important trigger points will often be set by the issuer’s contracts, both with its security holders and its institutional lenders. Contracts of this kind normally establish events of default, and these include not just actual failure to make required payments, but early warning default events based on the debtor’s financial condition falling below certain preset levels. Where it becomes reasonably clear that a debtor will enter default on one or more of its contractual obligations, absent the occurrence of a contingency such as the sale of property outside the ordinary course of business, it seems reasonable to conclude that the debtor has entered the penumbra of insolvency, and the time has become ripe for appropriate disclosure. Defaults that will create this kind of trigger point include not just debt obligations, but preferred stock dividends whose omission would impose contractual restrictions on the issuer’s conduct.

Even where this kind of contractual default is not in sight, other events may signal the transition from ordinary course of business to threatened insolvency. This includes matters of public record, such as press reports and the institution of lawsuits, and less public matters such as the disruption of relationships with key creditors, including institutional lenders and major suppliers. A key creditor’s refusal to renew a line of credit will provide a signal of this kind.

Ultimately, the identification of transition points may depend on factors other than discrete events. On this, as on every other important responsibility of corporate management, no mechanical algorithm will provide all the answers; managers and their professional advisers will have to exercise informed and skilled judgment. In some ways, this responsibility may prove useful for reasons going beyond disclosure: it may force managers to take early warnings of insolvency seriously and induce them to act more promptly than they might otherwise do.

3. Timing the Reporting of Workout and Bankruptcy Events

Reporting events relating to financial distress poses some difficult questions. While the 1934 Act and related regulations unambiguously require timely reporting of major corporate decisions such as a debtor’s decision to file

\[\textit{\cite{Nielsen v. Greenwood, 849 F. Supp. 1233, 1238-39 (N.D. Ill. 1994)} (making financial ratios such as cash flow to fixed charges conditions of default and of blocking payments on subordinated obligations).}\]

\[\textit{\cite{Lowenstein, supra note 6, at 1357-58}.}\]
a Chapter 11 petition, quick reporting of events of this kind can create major difficulties.²⁵⁰ Trade creditors, for example, are likely to cut off credit to a debtor for the period between the announcement of a decision of this kind and the actual filing of the petition, because credit granted during an interim period will be a prepetition claim and therefore entitled to a lower bankruptcy priority than claims accrued after a Chapter 11 petition. While no issue of this kind will be raised if the announcement is made simultaneously with the filing, what of authorization by a corporate board to file a petition contingent upon certain events? This may be particularly important in the context of a workout accompanied by a prepackaged Chapter 11 plan.

C. Special Problems of Disclosure on the Approach to Bankruptcy

1. The Transformation of Disclosure Needs

The balance of concerns that dictate what disclosure is appropriate changes markedly as a corporation crosses the threshold from business as usual to the edge of insolvency. The transition from solvency to insolvency is, from the viewpoint of securities regulation, a transition from a general to a more restricted market. Securities issued by a corporation on the spiral toward insolvency are less attractive to a more general public, as potential purchasers dwindle toward a small number of “vultures.” At the same time, as the market becomes thinner, holders of the securities are in greater need of accurate information as to their alternative courses of action.²⁵¹

2. Control of Insider Misconduct

Potential insider misconduct becomes particularly troubling as a corporate debtor approaches insolvency. Collective action problems give insiders particularly great leverage over debtholders in this context, both in workouts and in bankruptcy reorganization.²⁵² Moreover, although considerations of residual interest in an insolvent entity and legal rights such as debtholder voting in the confirmation of reorganization plans put debtholders in a role more like that traditionally ascribed to common shareholders, courts have been slow to impose insider trading liability for transactions in debt securities.

The best approach here appears to be a unified one of placing insider misconduct, both in contemplation of bankruptcy and after the filing of a

²⁵⁰ See supra notes 214–34 and accompanying text (discussing circularity).
²⁵¹ See supra notes 19, 146.
²⁵² See supra note 32.
bankruptcy petition, under securities law, with the primary enforcement jurisdiction given to the SEC. In this context, a relatively slight modification of securities law will be effective in dealing with the problem: during the one-year period prior to the filing of a bankruptcy petition, and at any time thereafter, insider transactions with respect to all securities of a debtor corporation should be treated in the same way as insider transactions with respect to equity securities are currently treated.

The principal civil deterrents to insider misconduct in connection with a bankruptcy case are ill-suited to deal with this kind of insider misconduct. The most significant of these is equitable subordination under Bankruptcy Code section 510(c), pursuant to which a creditor who has acted inequitably (particularly through misuse of an insider position) with regard to other creditors can have its claim subordinated by order of the bankruptcy court to those creditors disadvantaged by its actions. Insider misconduct, however, may not directly concern claims against the debtor, and their subordination may not create a deterrent proportional to the seriousness of the conduct. Moreover, equitable subordination motions normally require initiation by the creditors adversely affected and are difficult and expensive to prosecute.

The Bankruptcy Code and associated legislation also provide certain criminal penalties for bankruptcy fraud, but this tends to be defined in ways that have little applicability to the kind of insider misconduct just described. Moreover, responsibility for identifying and prosecuting bankruptcy fraud lies primarily with the U.S. Trustee, whose authority is stretched too thinly in having responsibility for monitoring misconduct in all bankruptcy cases before it—not just the rarefied category of insider misconduct in large corporate reorganizations—and the local U.S. Attorney in the relevant district, who

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255 See Benjamin v. Diamond (In re Mobile Steel), 563 F.2d 692, 698-99 (5th Cir. 1977).
256 See, e.g., 18 U.S.C. §§ 152-153 (1994) (criminal penalties provided for, inter alia, fraudulent concealment of property of a debtor’s estate; rendering a false oath, statement or account in connection with a bankruptcy case; filing false claims in a bankruptcy case; fraudulently receiving property from a debtor after a case is filed; fraudulently offering, giving, or receiving compensation for acting or forbearing to act in a bankruptcy case; fraudulently transferring or concealing property of a debtor in connection with a bankruptcy case or with intent to defeat the purposes of the Bankruptcy Code; destroying, falsifying, concealing, or mutilating records of a debtor, or withholding such records from a court officer or other official entitled to their possession; or embezzlement of property of a bankruptcy estate).
257 See, e.g., Mendales, supra note 35, at 1242-43, 1309.
may be far too busy with violent or drug-related crime to pursue offenses of
this kind.

Here, securities law appears to provide a far more effective way of dealing
with insider misconduct than bankruptcy law. The law of insider trading is
highly developed, and needs comparatively little modification to be an effective
tool in the bankruptcy context. Moreover, the tools available for enforcement
are far superior; the SEC is far better equipped than any actor in the
bankruptcy system to investigate and deal with insider misconduct, which
strongly resembles insider misconduct in nonbankruptcy securities matters.

3. Special Considerations on Cost

Bankruptcy-oriented disclosure, particularly for a financially troubled
corporation, involves special considerations of cost going beyond those that
apply for other securities disclosure. These concerns must be given great
weight, because imposing new costs at too high a level could be the last straw
in forcing a business that might otherwise have achieved an out-of-court
workout in bankruptcy.258

Generally, however, aside from what should be a general concern that
disclosure be cost-effective, worry about cost should not prevent requiring
more elaborate disclosure of bankruptcy-related risk for a financially troubled
issuer. For one thing, it is in this context that it is most crucial for investors to
be informed of their rights in a possible bankruptcy of their issuer. Only high-
quality information on this will permit them to appropriately value exchange
offers, as opposed to their likely entitlements in a bankruptcy, and will prevent
them from being stampeded into accepting disadvantageous settlement offers
based on the mere threat of bankruptcy as an alternative. Moreover, complete
and accurate information here will maximize their ability to properly exercise
their rights as creditors in a reorganization—rights that the Bankruptcy Code
itself does not require a debtor to disclose to its creditors until the actual
circulation of disclosure statements concerning proposed plans of
reorganization late in the Chapter 11 process.259

D. Disclosure Responsibilities on Filing for Bankruptcy

Filing a bankruptcy petition is an irrevocable transition point for an issuer,
which places it under an entirely new body of substantive and disclosure law:
that imposed by the Bankruptcy Code. The problem at the transition, from the

258 See Scarberry et al., supra note 31, at 227–36.
point of view of disclosure policy, is to insure that investors are meaningfully aware of their rights under the new order, without imposing unnecessary costs on the corporate debtor or adding to investor confusion through deliberate or inadvertent obscurity.

Ironically, the Bankruptcy Code does not expressly provide for corporate-oriented disclosure in this context. Following its original paradigm as a procedure for liquidating the property of an individual or closely held business, it does not provide for public notice at the commencement of a bankruptcy case other than to specify filings that must be made with the bankruptcy court. Security holders receive notices as holders of claims or interests, and not, prior to the release of a Chapter 11 disclosure statement as to a plan already negotiated and being presented to them for approval, as potential participants in negotiating the plan. For securities law, on the other hand, bankruptcy is an event that a corporation with continuing disclosure responsibilities must report, but the extent of its reporting requirements is unclear.

The critical nature of the event dictates that a policy be established for disclosure in this context. Moreover, it is desirable that responsibility be apportioned to one body of law or another, rather than being shared. This is true both for the convenience of investors in the debtor corporation, and to avoid confusion based on inconsistent disclosure—a risk that is amplified by the possibility that bankruptcy and corporate disclosure may be drafted by two different sets of differently specialized lawyers.

E. Entering the Central Singularity: Disclosure Under the Securities Laws After a Bankruptcy Filing

After the filing of a Chapter 11 petition, disclosure anomalies increase. Among other things, continuous reporting obligations under the 1934 Act are not changed by the fact of reorganization, although bankruptcy law imposes its own disclosure responsibilities. Moreover, the problem of cost looms larger. Cash is precious to a reorganizing corporation, and each incremental expense increases the probability that the reorganization will fail. The ultimate bearer of these costs, therefore, may be less the debtor itself than its creditors.

While it is clear from the foregoing analysis that more disclosure is necessary, even after a bankruptcy filing, than the Bankruptcy Code currently

requires, the problem of cost makes it undesirable to continue requiring the full normal panoply of securities disclosure, as if the bankruptcy filing had not taken place. Statutes provide a blunt instrument for balancing this tension, so that amendment of the 1934 Act to change reporting requirements for corporations in Chapter 11 will not, of itself, suffice. A better solution, taking advantage of the flexibility of administrative rule-making, would be to authorize the SEC to modify ongoing disclosure rules for corporations that are operating under Chapter 11 protection. Moreover, given the broad spectrum of differing financial conditions of corporations in Chapter 11, it appears desirable to give the SEC staff additional flexibility in enforcing disclosure regulations for reporting entities while the latter are reorganizing under Chapter 11.

VI. LIABILITY: INCENTIVES AND THE LAW OF DISCLOSURE

The foregoing discussion of appropriate disclosure of bankruptcy risks would be incomplete without some consideration of the liabilities that may be imposed for nondisclosure. Absent proper allocation of liabilities, both existing incentives and business and legal cultures will tend to operate against disclosure.

While new disclosure standards make little sense without allocating responsibilities and corresponding liabilities for the disclosure, one must also be concerned with creating costs, in the form of unnecessary litigation and inappropriate or excessive liabilities, that could exceed the benefits of improved disclosure. It is therefore important to consider what parties are most appropriately subject to new responsibilities for disclosure and what the limits of their potential liability should be.

A. The Costs of Enforcing Higher Standards of Disclosure

New bankruptcy disclosure requirements may not be cheap. They could impose substantial direct costs, particularly in terms of legal fees imposed on issuers, and administrative costs created by expanding the role of the SEC. Moreover, they may impose even more substantial indirect costs, particularly in the form of new litigation. If new disclosure responsibilities are to be created, therefore, special care is needed to assure that they will be cost-effective.

264 See generally Mendales, supra note 35, at 1304–05.
B. Allocating Liability

The securities laws establish a broad spectrum of parties liable for failures in disclosure. Moreover, there are important differences in the types of liability: criminal liability for violations of the antifraud provisions of the securities law; civil liability in SEC-initiated proceedings, generally for injunctive relief; and, most important, civil liability to purchasers and holders of affected securities, usually in damages.

These liabilities are important not just to those who may be subject to them, but to the effectiveness of the disclosure process. Liability is what gives teeth to the regulatory regime. Failure to impose liability on important actors, or imposition of liability on inappropriate actors or to an inappropriate degree, may cause serious distortions of the process.

1. Issuers

Normally, issuers are primary targets for nondisclosure liability, both in terms of SEC-initiated injunctive actions and damage or rescission actions by private plaintiffs. They are, for example, the only parties without a due diligence defense for negligent nondisclosure under the 1933 Act.

Unlike the situations involving securities law liability outside of bankruptcy, issuers do not make good targets for enforcement by private plaintiffs in disclosure-related cases involving insolvency-related issues. This is because, for bankruptcy-related disclosure to come into question, an issuer will have to be bankrupt. It will thus not be a deep pocket to start with; and bankruptcy principles will impose barriers to recovery beyond basic lack of financial capacity.

First, claims of this type will, for bankruptcy purposes, be prepetition claims, that is, claims that arose at or before the filing of the bankruptcy

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267 See 15 U.S.C. §§ 77k(a), 77l(a), (1994); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196–97 (1976) (a private remedy for violation of section 10 (b) of the 1934 Act and Rule 10b-5 has been created by case law).
269 Issuers are normally primary targets for suits based on material misrepresentations or omissions from a securities registration statement, since they are not given the “due diligence” defense available to other parties under § 11(b) of the 1933 Act. See 15 U.S.C. § 77n(b) (1994).
petition.\textsuperscript{270} This means that parties holding them will be barred by the automatic stay in bankruptcy from asserting them during the course of the bankruptcy case, except as claims filed with the bankruptcy court.\textsuperscript{271} If the bankruptcy is a Chapter 7 liquidation, this will be the end of the story for the security holders, since there will be no corporate entity surviving the bankruptcy against whom to assert their claims.\textsuperscript{272}

Even in the event of a successful Chapter 11 case, holders of claims of this kind will not normally be able to assert them against a reorganized successor to the issuer after bankruptcy, because the confirmation of a reorganization plan normally discharges the debtor from substantially all debts except insofar as the plan provides for them.\textsuperscript{273}

The claims will be assertable in the issuer’s bankruptcy case. This, however, is unlikely to be a boon to claimholders, since they will be subordinated to the claims of holders of equal or equivalent seniority.\textsuperscript{274} Any claims based on securities law violations will thus not normally improve their positions over those represented by the mere holding of the securities in question.

The one exception to this rule would exist if purchasers of the securities in question could prove actual fraud by the issuer in the offering. Under Bankruptcy Code sections 523(a)(2) and 1141(d)(2),\textsuperscript{275} such proof, if made pursuant to a complaint filed on a timely basis with the bankruptcy court, could result in the holders’ claims being declared nondischargeable.\textsuperscript{276} This would not affect their priority in the reorganization case itself, but would permit the holders to assert their claims against the reorganized entity after confirmation.

\textsuperscript{273} See 11 U.S.C. § 1141(d) (1994). The most important exception to this rule is the situation in which the debtor confirms a liquidating plan of reorganization—the functional equivalent of a Chapter 7, but in which the debtor’s management or a group agreed upon by creditors, rather than a Chapter 7 trustee, supervises the liquidation, and where the liquidation process itself attempts to maximize value beyond the level of a Chapter 7 fire sale. 11 U.S.C. § 1141(d)(3) (1994) denies a discharge in Chapter 11 to a liquidating debtor.
of its plan. Proof would be difficult, however, because the elements that must
be established for nondischargeability are even harder to establish than the
sciente required to establish securities law liability under section 10(b) of the
1934 Act and Rule 10b-5.\footnote{277}

2. Affiliates of Issuers

Persons affiliated with a bankrupt issuer will provide much more effective
targets for private securities law litigation over improper or omitted
bankruptcy-related disclosure. They are attractive as targets not only because
the factors that make the debtor itself uninteresting do not apply to them, but
because actions against them may proceed despite the debtor's own
bankruptcy.\footnote{278} Litigation against persons other than the debtor in a Chapter 11
case is not barred by the automatic stay in bankruptcy,\footnote{279} and courts are
reluctant to extend the stay to include persons affiliated with the debtor barring
compelling circumstances.

Persons who have control over a corporate issuer are particularly at risk in
this context.\footnote{280} This potential liability is not limited to persons with actual
control, but extends to those with potential power to influence the issuer's actions.\footnote{281} It includes those with formal positions giving them this kind of

\footnote{277}{For the elements that must be established for nondischargeability, see 11 U.S.C.
§ 727(a) (1994). For the requirements under section 10(b) and Rule 10b-5, see Aaron v.
SEC, 446 U.S. 680 (1980); Santa Fe Indus. v. Green, 430 U.S. 462 (1977); Ernst & Ernst
v. Hochfelder, 425 U.S. 185 (1976); see also, Joseph A. Grundfest, Disimplying Private
HARV. L. REV. 961 (1994).}

\footnote{278}{See, e.g., In re Worlds of Wonder Sec. Litig., 814 F. Supp. 850 (N.D. Cal. 1993)
(plaintiff holders of securities of bankrupt corporation named officers, directors, large
shareholders, underwriters, and auditors as defendants), aff'd in pertinent part, 35 F.3d
1407, 1428 (9th Cir. 1994).}

\footnote{279}{See 11 U.S.C. § 362(a) (1994).}

\footnote{280}{See section 15 of the 1933 Act, 15 U.S.C. § 77o (1988); 1934 Act, section 20(a),
1130, 1138–39 (7th Cir. 1992) (control person liability will be found if the person in
question actually exercised general control over the entity principally liable, or if the person
had power or ability to control the transaction or activity in question); Harrison v. Dean
Witter Reynolds, Inc., 974 F.2d 873, 880–81 (7th Cir. 1992); Damato v. Merrill Lynch,
Pierce, Fenner & Smith, Inc., 878 F. Supp. 1156, 1160 (N.D. Ill. 1995) (power to control
activity in question needed to establish control person liability therefrom); Bomarko, Inc. v.
Assault on Securities Act Section 12(2), 105 HARV. L. REV. 908, 911–13 (1992).}

\footnote{281}{See In re Chambers Dev. Sec. Litig., 848 F. Supp. 602, 618 (W.D. Pa. 1994).}
potential power, such as officers and directors— including outside directors—and it may extend to others as well, including professionals working with an issuer. This responsibility applies to directors whether or not they actually sign the registration statement for a particular securities issue; their chief defense against liability for incomplete or defective disclosure is due diligence.

3. Underwriters

Underwriters will be among the most appropriate targets for allocation of liability for failures in disclosure, particularly under section 11 of the 1933 Act. They are among the best parties to monitor issuer disclosure, both because of their accustomed role in due diligence, and because of their gatekeeper position in allowing issuers to get their securities to market. Moreover, their position gives them the deepest pockets of any group of potential defendants in private securities litigation, giving them both ample means and incentives to make sure that disclosure is done correctly.

Section 11(a)(5) of the 1933 Act makes underwriters liable to purchasers of securities registered under the Act for any material misstatement or omission in a registration statement. The chief defense available to a defendant underwriter against such liability is that of “due diligence”: that it had made a “reasonable investigation,” which gave it no reason to believe that the registration statement contained a material misstatement or omission. The due diligence defense is further modified by the issue of whether the defendant is entitled to rely upon experts. Its usefulness lies chiefly in the incentives that it gives underwriters, who have important bargaining power in dealing

282 It should be noted, however, that merely holding a particular corporate office will not, in and of itself, give rise to control person liability under section 20(a) of the 1934 Act. See Wool v. Tandem Computers, Inc., 818 F.2d 1433 (9th Cir. 1987); In re Cryomedical Sciences, Inc. Sec. Litig., 884 F. Supp. 1001, 1020 (D. Md. 1995).


289 See Dannenberg, 50 F.3d at 623 (underwriter need not conduct due diligence for “expertised” part of prospectus).
with issuers, to monitor issuer disclosure and assure that it is correct.

It is particularly helpful to give underwriters this kind of responsibility in connection with bankruptcy-oriented disclosure, because their business gives them the kind of expertise that particular issuers may lack as to the effectiveness of particular financial structures and their bankruptcy risk over time. A particular issuer may never have issued asset-backed securities before; its underwriters will have seen many such issues, and may in fact have devised particular structures and therefore be better acquainted with the particular risks that a given structure will impose on a given issuer. Moreover, an underwriter's experience over time will tend to acquaint it with examples of failed structures, and this experience too qualifies it as a party well-suited to ascertain, and disclose, appropriate risk.

Underwriters' liability is also important in this context because it will serve to counter pressures on them, in the context of an increasingly competitive market for their services, to look the other way when issuers cut corners on disclosure. Moreover, particularly with respect to disclosure of structural weaknesses in securities with special sensitivity to insolvency, it will give them important incentives to think on a long-term basis, countering pressures, from factors such as market volatility and competitive pressures to constantly introduce new variations on securities structures, to think only of the near term.

4. Issuers' Counsel and Other Experts

a. Issuers' Counsel

Issuers' counsel are also good parties to whom to assign disclosure responsibilities enforced by potential liabilities, though it will be more difficult to impose liability upon them than upon underwriters.290 There are several possible bases for such liability, despite the Supreme Court's recent action in cutting off more than thirty years of doctrine on aiding and abetting liability.291 The surviving forms of potential liability include primary liability under the 1933 Act and primary liability under the 1934 Act, particularly section 10(b) and Rule 10b-5.292 Moreover, professionals who assist a securities transaction,

292 See id. at 1455; Ackerman v. Schwartz, 947 F.2d 841, 846–49 (7th Cir. 1991) (Rule 10b-5 claim stated against attorney who consented to distribution of opinion letter to agents of investors, where opinion letter may have contained reckless misrepresentation).
such as attorneys and accountants, even though not themselves named as defendants, may be liable for contribution to actual defendants, if the professionals' conduct could serve as a basis for direct liability.\textsuperscript{293}

Attorney liability for securities law violations has long been controversial. Although the federal securities laws do not impose the degree of explicit regulation on attorneys that they do on accountants, the SEC has attempted to regulate attorneys engaged in securities practice, and encountered severe resistance in the process.\textsuperscript{294}

Nonetheless, issuers' counsel are highly appropriate parties to rely upon for pushing issuers to appropriate disclosure, and therefore for bearing the risk of nondisclosure. They have ultimate legal responsibility for ascertaining the likely consequences of a particular security structure. Moreover, they may be the only parties with continuing responsibility to monitor the legal consequences of a deteriorating issuer financial position over time.

Imposing liability upon them may also be appropriate because of factors governing them that, absent liability, may provide incentives for them to err on the side of nondisclosure. These include what may be called cultural lag: a failure to keep up with legal evolution both in bankruptcy law and in the new types of securities that may be affected by it. Moreover, as with underwriters, the market for legal services has evolved in ways that, without corrective liability, provide incentives for corner-cutting. As the market for corporate legal advice has become more competitive, severe pressures have been exerted both on the charges that lawyers may make for their services and on their ability to resist issuer pressure to sugarcoat disclosure. Potential liability for failure to disclose is one of the few factors likely to be effective as a counterweight to these pressures.

b. Other Experts

Issuers' counsel present a special case. The considerations that may impose liability on them will, in most cases, also apply to other experts whose advice is used in preparing disclosure materials. Accountants appear most frequently in this expert role, but other specialists whom the issuer and its underwriters rely on, such as nonunderwriter financial advisers, are subject to similar considerations.\textsuperscript{295}

\textsuperscript{293} See Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 297 (1993).


\textsuperscript{295} See Ockerman v. May Zima & Co., 27 F.3d 1151, 1153, 1161-62 (6th Cir. 1994)
5. Underwriters’ Counsel

While underwriters’ counsel play an essential role in their clients’ monitoring of issuer compliance with disclosure standards, they do not appear to be good parties to whom to allocate new direct disclosure liabilities under the securities laws. Their disclosure compliance appears to be most effectively assured by indirect liability, by way of malpractice claims asserted by clients who have incurred liability through their negligence.296

There are several reasons why it does not appear to be effective to allocate new direct liabilities to them. It is unlikely that the requisite privity exists for liability to securities holders in most circumstances, although the underwriting context raises interesting ethical problems for counsel. Courts have generally been reluctant to allow the kind of open-ended liability that could be created if privity were to be ignored, and the sophistication of the clients in this situation appears to assure that potential malpractice claims will be sufficient to assure adequate quality control.

6. Other Creditors of Issuers

Other creditors of the issuer—especially institutional lenders—could be targeted for potential liability as deep pockets if they have, in the course of the debtor-creditor relationship, made themselves insiders of the debtor. Lender liability, however, has proven difficult to establish,297 and there are no cases in which the asserted basis of liability depended upon the securities laws. Here, the remoteness of potentially liable parties from involvement in securities transactions argues against creating new duties in them, at least in their capacity as creditors. The costs of imposing such duties would seem clearly to outweigh any benefits.

C. Limitations on Liability

Not only the allocation of liability among the various actors in the disclosure process, but also its extent, needs to be regulated in order to assure

(feasibility consultant for retirement facility held potentially liable for misrepresentations in offering materials).


297 See, e.g., Cara Corp. v. Continental Bank (In re Cara Corp.), 148 B.R. 760, 773-75 (E.D. Pa. 1992) (debtor failed to prove that lender had acquired control sufficient to put it under fiduciary duty to disclose to create lender liability).
that the costs of disclosure requirements do not exceed its benefits. If new liabilities mean no more than an open-ended invitation to new litigation, with boilerplate complaints ground out every time an issuer finds itself in financial distress, new disclosure requirements will be worse than useless.

One of the distinguishing characteristics of the evolution of bankruptcy risks that requires disclosure of the kind discussed here is that it has been rapid and requires a substantial degree of technical sophistication. It is therefore important that, where new liabilities are to be based upon new regulations, the regulations be specific, and that they be regularly updated to assure that liabilities are consistent with actual market developments. Moreover, to the extent that private remedies are to be allowed, it appears desirable that the SEC be authorized by statute to define their scope and extent; in some circumstances, where the agency decides that it should have exclusive jurisdiction to bring actions, it should be permitted so to limit available remedies.298

VII. CONCLUSION

Bankruptcy, like other fields in which the law has evolved rapidly in recent years,299 requires corresponding adaptation by securities disclosure law if the latter is to accomplish its own purposes. Treating bankruptcy as a mere endpoint no longer accurately reflects the risks and opportunities faced by investors in many situations concerning publicly held securities. Rather, investors will need to know the ways in which the values of their investments may be affected by the bankruptcy process and, in some cases, by their own participation in that process. While mandatory disclosure will impose certain costs both on issuers and investors, none of the potential substitutes for such disclosure can completely take its place. In fact, these potential substitutes, particularly securities ratings, analysts, and the financial press, will function more efficiently with a more sophisticated structure of mandatory disclosure.

Bankruptcy and workouts, for their part, will enjoy reciprocal benefits from greater sophistication in securities law disclosure. Investors will be better able to exercise their rights in both, making workouts more practicable in some cases where Chapter 11 reorganizations would otherwise be needed, and aiding in the formulation of more efficient and equitable plans of reorganization in cases where Chapter 11 proves indispensable. In some cases, better understanding on the part of participants may lead to more timely pulling of the plug on unsalvageable enterprises, resulting in fewer “Bleak House”

298 See generally Grundfest, supra note 277.
299 One of these fields is environmental law. See supra notes 164–79 and accompanying text.
situations in which transaction costs run amok to consume funds that might otherwise be returned to investors.

Finally, it should be stressed that this set of problems and proposed solutions is not static, but rapidly evolving. Accordingly, the adequacy of disclosure rules will require regulators to be nimble in keeping up to date with new types of securities and developments in reorganization, and in being flexible, willing and able to amend and apply disclosure rules in ways that maximize cost effectiveness for the entire process.
