Commentary: Why Does MTLQQ Continue to Trade?

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As I write on October 28, 2009, the stock of Motors Liquidation Company, which trades over the counter under the symbol "MTLQQ," traded 5,421,709 shares. Motors used to be General Motors, and its common stock traded under the famous symbol "GM." The current holders of MTLQQ are former holders of GM, or purchased their stock in a series of trades from a former holder of GM.

Motors sold all of its good operating assets to "new GM" on July 10, 2009. None of the proceeds of this sale will be distributed to any of the current holders of MTLQQ. Yet, today it traded in a range between fifty-eight and sixty cents per share. Since there are 610,562,000 shares available for trading, this suggests a market cap of $362,063,000. However, this is a stock without any "intrinsic" value, to borrow a concept from Aristotle. Motors is a company with liabilities that significantly exceed its assets, and none of the holders of MTLQQ can expect to receive any distributions.

Stranger still, MTLQQ is owned almost entirely by professional investors. Despite some worries expressed by members of the financial media, there is no evidence that trading by widows and orphans, or other unsophisticated retail investors, explains the valuation and trading volumes in this stock. Instead, MTLQQ is held almost entirely by sophisticated institutional investors, plus some fast traders and day traders, who may or may not qualify as sophisticated, depending on your point of view.

So, what is going on?

The answer is that there is a substantial short position. It turns out that the short interest in MTLQQ amounts to 23,795,600 shares. This number has declined significantly over time. On June 15, 2009, just four months ago, the short interest amounted to 100,389,862 shares. On July 15, 2009, a few days after Motors sold all of its assets, squeezing the last drop of intrinsic value out of its stock, the short interest amounted to 44,890,020 shares. All of the remaining short sellers must, at some point, cover by buying back the stock. The price of MTLQQ's stock will never fall to zero until the last short seller has covered.

We will assume that all of the short sellers of MTLQQ obeyed the rules and borrowed stock at the time of these sales. The lenders of stock tend to be large institutional investors, who lend stock in order to obtain interest from short sellers. These lenders continue to collect interest, and will happily continue to lend their shares of MTLQQ, and collect interest, for some time.

After GM filed for bankruptcy, and the "old GM" stock was delisted from the New York Stock Exchange, institutional investors that had loaned GM stock to short sellers began calling their loans. They did this so they could sell their stock into the market to establish the amount of their loss on GM stock for tax purposes. As institutional investors called their loans to liquidate their long positions, short sellers were forced to cover to obtain stock to satisfy their borrows. This process will continue until all the remaining stock loans are repaid, and the short interest is eliminated. In the meantime, the short interest position continues to decline as institutional investors terminate their stock loans and short sellers cover.

The current valuation and volume in MTLQQ has been exacerbated somewhat by Rule 204T, which eliminated the last remaining opportunities to engage in "naked" short selling, which is short selling without borrowing the stock. Under the old regime, when a company finally liquidated, there would be an outstanding short position that would never be resolved. Instead, the short seller would simply promise to pay any proceeds eventually received to the purchaser, and under FINRA rules, that promise would eliminate any remaining obligations to cover. In my view, this practice defrauded the eventual purchaser, who paid value to obtain the stock, but never received it.

Rule 204T eliminated this fraud, but also required short sellers to borrow stock, limiting the supply. Other professional traders, aware that short sellers will need to cover, have purchased the stock, causing the stock price to be higher than would be the case without the existence of the short interest. My guess is that short sellers didn't anticipate this at the time they sold short, or they would have covered at an earlier time. You can expect that short sellers, having been burned once, will avoid this type of squeeze in the future.

Should we feel sorry for short sellers? Should this market be abolished? Should there be a law?

It is hard to see why. No one is being defrauded. The short sellers got in with their eyes open, as did the institutions that loaned them stock. The short sellers may be irritated at having to pay a price greater than zero for a stock they believe to be worthless, but no one is willing to sell it for zero. As short sellers are well aware, we no longer believe there is any such thing as intrinsic value, or that anyone is smart enough to figure out what it is. Instead, markets exist to resolve different opinions about value and claims on assets. As a result, short sellers are forced to

cover at the price afforded by the market. It is hard to conceive a fairer way to resolve these competing claims.

If there are any existing retail investors, they also benefit from the continuing market in MTLQQ. It gives them one last opportunity to get out. And, the short sellers who have to cover would be delighted if these retail investors, if any are left, would enter the market and sell their remaining stock because that would provide another source of cover.

MTLQQ is different than most reorganizations and liquidations because in most cases the process of determining whether or not there is an operating business worth salvaging, the liquidation of assets, and resolving competing claims on those assets, may take years. Generally, the resolution of short positions occurs long before anyone can tell what the common stock will be worth at the end.

Nonetheless, the strange case of MTLQQ is a window into the wonderful mysteries of the markets in distressed assets, which are every bit as important to our economy as the more newsworthy national stock exchanges.

We sometimes forget that securities markets have two functions. They facilitate capital formation by providing a source of liquidity for investors. People are much more willing to invest if they know their position can be rapidly liquidated. For example, it is much more stressful buying real property for investment, as compared to securities, because it is much more difficult to sell real property.

But securities markets also facilitate capital destruction, which is a necessary part of a growing economy. Unsuccessful enterprises need to be reorganized, and their remaining assets need to be reallocated to more profitable uses. Markets in the securities of bankrupt issuers serve this function. Providing a means for investors to get out provides them with capital that can be reinvested elsewhere. It is vitally important that the markets for securities of bankrupt issuers flourish and that the persons who invest in these markets understand what they are purchasing.

Recently, we have observed that some bankruptcy courts are bewildered by the fact that common stock and other securities continue to trade after an issuer has declared bankruptcy, and even after the transfer agent has closed the books and will no longer recognize transferees on the issuer's securities records. These securities are traded with "due bills," essentially contracts that promise the purchasers will receive the eventual distribution. Sometimes, these courts attempt to abolish the markets in these securities or interfere with trading in ways that set aside due bills and frustrate the legitimate claims of investors. This is a situation that cries out for the attention of the SEC and FINRA, who are assigned the task of regulating the nation's securities markets.

There should be no confusion about the reasons why securities of bankrupt issuers continue to trade. It is very difficult for anyone to determine what the assets of a liquidating company will fetch, and therefore virtually impossible to know how much will be left at the end to distribute to the issuer's remaining shareholders. As a result, there will be differences of opinion about the value of these securities, and these differences are resolved through trading.

Not only the value of securities, but the outcome of bankruptcy, is very hard to determine. General Growth and Pilgrim's Pride are examples of bankrupt issuers whose common stock had been given up for dead by most analysts. Yet, investors that held onto their common stock, or investors that purchased the stock in bankruptcy, ended up with a valuable investment in a reorganized issuer. I think this is highly unlikely in the case of Motors, but if some business emerged from the process, it would not be the first time that a phoenix has risen from the ashes of bankruptcy. It is up to investors to decide when to throw in the towel.

As is the case with any securities market, some investors are willing to wait until the amount of final distribution is determined, while others want out now. It is important to the economy that shareholders who wish to be paid an amount certain at some point in the bankruptcy process, or establish a loss for tax purposes, be allowed to sell their interests to others who are willing to bet that a larger amount will be distributed to them later. Moreover, as it the case with any investment, when some of those persons who thought more would be coming later get discouraged, they should be able to sell their interests to more optimistic investors.

For that reason, I strongly disagree with the recent Third Circuit decision in the Trump Casinos reorganization, which insisted that the issuer pay persons who owned stock when the issuer's book were closed, even though they had already sold their interests to other investors. If this decision is adopted in other jurisdictions, no one will be willing to purchase interests in bankrupt issuers. This will frustrate the process of capital reallocation, and we will all end up poorer as a result, for no good reason.

Worse yet, in the case of *Pro Elite, Inc.*, the Nevada bankruptcy court has determined to subvert our national clearing system by ignoring shareholders who hold interests in street name at the Depository Trust Corporation and purchased stock after the original bankruptcy filing. Bypassing DTC interferes with our global payments system and has vast implications for the economy. This dangerous practice needs to be nipped in the bud to avoid a massive run on stock depositories that has the potential to shut down the nation's securities markets, making the fall of Lehman Brothers seem like a walk in the park.

With its focus on capital formation, the SEC has not paid a lot of attention to the trading of securities in bankruptcy. This is a mistake. Decisions made that affect

the rights of holders in these markets have profound effects on other markets, global stock depositories and other systemically-important institutions. These are markets vital to our economy that should be fostered. No one can tell what the securities of a bankrupt issuer will ultimately be worth. But, investors that purchase these securities are entitled to know what they have purchased and be secure in their claims. Judicial or regulatory interference intended to halt trading in distressed securities or that disrupts investor expectations is bad policy that harms our national economy. Regulatory indifference is equally culpable.

The markets in the securities of bankrupt issuers represent the compost pile that fertilizes the formation and growth of future issuers. They should be tended with wisdom and care.

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