The New Bargaining Theory of Corporate Bankruptcy and Chapter 11's Renegotiation Framework

Anthony J. Casey*

Abstract

This Article introduces the New Bargaining Theory of corporate bankruptcy. In that theory, the purpose of a well-functioning corporate bankruptcy system is to solve the incomplete contracting problem that accompanies financial distress. By its very nature, financial distress is difficult to contract over—the time horizon, the number of parties engaged in strategic bargaining, and the number of contingencies involved render the possible scenarios too numerous to predict, define, and negotiate in an ex ante contract. As a result, relationships involving a distressed firm are governed by incomplete contracts that allow parties to hold each other up. Because all firms face this same value-destroying problem, pressure arises for a uniform bankruptcy solution.

In Chapter 11 that solution takes the form of a framework of bargaining rules for ex post renegotiation. This framework is designed to minimize hold-up behavior among those with interests in a distressed firm. It does so by allocating power over certain decisions to one party while then imposing evidentiary burdens, price mechanisms, and other conditions on the use of that power. The initial allocation of power and conditions is based on the law's assessment of where the hold-up risks lie. Within this framework and under the oversight of the court, the parties renegotiate their incomplete contracts.

This Article shows that widely-accepted alternative theories—which focus on a hypothetical ex ante creditors' bargain and nonbankruptcy entitlements—are wrong. Chapter 11 is not a hypothetical bargain. And a proper bankruptcy system gives no special deference to nonbankruptcy entitlements. The ex post renegotiation framework is the fundamental attribute of Chapter 11 and its sole purpose is to solve Bankruptcy's incomplete contracting problem.

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Introduction

Corporate bankruptcy law's proper purpose is to solve the incomplete contracting problem that accompanies financial distress. Chapter 11 of the Bankruptcy Code implements that purpose by facilitating a structured renegotiation that allows parties to preserve value in the face of hold-up threats. The creation of a bargaining framework for that efficient renegotiation is the fundamental attribute of Chapter 11.

Thus, contrary to the prevailing view, the purpose of bankruptcy law is not to vindicate or mimic some hypothetical ex ante bargain among creditors.[1] That idea—the Creditors' Bargain theory[2]—is, at best, a shorthand for the claim that bankruptcy law should be efficient. To be sure, in a hypothetical world of perfect information, zero transaction costs, and rational behavior, the interested parties (assuming we can define that category) would agree to efficient rules. But that is a truism. All-knowing rational actors will always bargain for the efficient outcome when bargaining costs are zero.

But what should the law do when bargaining costs are high and information is limited? That is the bankruptcy question. And the hypothetical bargain is not responsive because it assumes perfect information and zero bargaining costs. In a sense, the uncertainty of financial distress presents the problem that parties cannot write a complete contract, and the Creditors' Bargain responds by unhelpfully instructing lawmakers—who face the same uncertainty—to write a complete contract for them.

Even worse, the Creditors' Bargain framework often leads scholars to focus on the wrong questions. For example, by focusing attention on the initial bargain, the framework has attracted proposals designed to bring all creditors to the ex ante bargaining

[1] This prevailing view derives from the scholarship of Professors Baird and Jackson. See Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L. J. 857, 860 (1982) (arguing bankruptcy law should "mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante position"); Douglas G. Baird and Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829, 835-36 (1985) (the "ambition" of bankruptcy law is to replicate the hypothetical bargain). More recently, Baird has criticized the original theory. See Douglas G. Baird and Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 755 (2002); Douglas G. Baird and Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L. J. 648. 652-53 (2010).

[2] Jackson (1982), *supra* note 1 at 858.

table.[3] But the real problem for any bankruptcy contract—or legislation—is not in convening the bargainers. It is rather in writing enforceable ex ante rules in the face of uncertainty. This is a classic problem in law,[4] and the Creditors' Bargain distracts from its importance.[5]

The Creditors' Bargain theory has also nurtured the fallacy that bankruptcy law is primarily about preserving nonbankruptcy entitlements.[6] This idea—the Butner Principle[7]—is a corollary to the Creditors' Bargain and is often viewed as an additional source from which to derive bankruptcy's core purpose.[8] But this gets things wrong. The bankruptcy system

[3] See, for example, Barry E. Adler and Marcel Kahan, *The Technology of Creditor Protection*, 161 Pa. L. Rev. 1773, 1794-1809 (2013) (a mechanism to facilitate remedies against third parties); Robert K. Rasmussen, *A Menu Approach to Corporate Bankruptcy;* 71 Texas L. Rev. 51, 100-11 (1992) (a menu system to facilitate investor assent); David A. Skeel Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 Tex. L. Rev. 471, 525 (1994) (state law systems to encourage private ordering); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J. L. & Econ. 595, 630-31 (1993) (advocating private resolutions in place of mandatory rules).

[4] In contract law it leads to incomplete contracts. Oliver Hart and John Moore, *Incomplete Contracts and Renegotiation*, 56 Econometrica 755, 756 (1988); Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 92-93 (1989). In public law it leads to vague standards. Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L.J. 557, 563 (1992).

[5] Similarly, the framework attracts projects attempting to predict what creditors have or would have agreed to. That is not a relevant inquiry. See below at Part II.D.i.

[6] "Nonbankruptcy entitlements" refers to rights parties have when bankruptcy law does not apply. These rights exist by operation of statute, contract, or any other source of law unconnected with the bankruptcy system. Jackson (1982), *supra* note 1 at 858.

[7] Baird and Jackson coined the term by "grabbing onto a phrase from an otherwise forgettable Supreme Court case [*Butner v. United States*]." Thomas Jackson, *A Retrospective Look at Bankruptcy's New Frontiers,* 166 U. Pa. L. Rev. 1867, 1872 (2018) (citing *Butner v. United States*, 440 U.S. 48 (1979)). The Court's opinion in Butner presented a rather vanilla cannon of textualist interpretation: The Bankruptcy Code does not include provisions that are not in nor implied by its text or policy. *Butner v. United States*, 440 U.S. at 55. Baird and Jackson consciously transformed this idea into a broader normative statement of a core bankruptcy principle. See Jackson (2018), at 1872-73 n. 18.

[8] For the original formations of the Butner Principle, see Jackson (1982), *supra* note 1 at 859-60; Thomas H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW at 21, 28 (Harvard 1986); Douglas G. Baird and Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 110 (1984) (noting that bankruptcy is primarily focused on "recognizing nonbankruptcy entitlements"). On its predominance as a core theory, see Jackson (2018), *supra* note 7 at 1873-72 (identifying the Butner Principle as the starting point that brought clarity to the Creditors' Bargain theory); Kenneth Ayotte and David A. Skeel, Jr., *Bankruptcy Law as Liquidity Provider*, 80 U. Chi. L. Rev. 1557, 1565 (2013), (describing it as the second element of the theoretical foundation of corporate bankruptcy); Melissa B. Jacoby and Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 Yale L. J. 862, 892 (2014) (proposing a system with "careful attention to the scope of non-bankruptcy entitlements"); Melissa B. Jacoby and Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 Tex. L. Rev. 673, 682-83, 734 (2018) (deriving bankruptcy's core principles by tracing creditors' state-law entitlements); Bruce A. Markell, *Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates*, 33 Emory Bankr.

functions almost exclusively by doing the opposite of what the principle instructs—it achieves its purpose specifically by interfering with nonbankruptcy entitlements.

This fallacy—that the Butner Principle is fundamental to bankruptcy theory—arises, perhaps, from a misunderstanding of bankruptcy's efficiency goal. To be efficient, a proper bankruptcy law must take into account unintended consequences and distortions that destroy value in other states of the world. Bankruptcy law should not destroy more value (in or out of bankruptcy) than it creates. That goal does not require protecting or giving special respect to nonbankruptcy entitlements. It just provides that bankruptcy law should not be put into effect unless it creates net value. The question remains as to how and why bankruptcy law should actually create that value.[9]

All of this is to say, the law-and-economics theory of corporate bankruptcy needs to be restated. Though many scholars and lawyers invoke the Creditors' Bargain theory and the Butner Principle, very few rely on their substance being true. The building blocks of a new theory can be found in much of today's bankruptcy scholarship, which usually advocates general efficiency goals,[10] often notes the importance of ex post bargaining,[11] and sometimes notes the importance of procedure

Dev. J. 91, 127 (2016) (deriving cramdown rules from nonbankruptcy entitlements); Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money is it Anyway?*, 70 N.Y.U. L. Rev. 993, 1000 (1995) (presenting a bankruptcy theory that "starts from entitlements of the parties that exist before the bankruptcy system comes into play"); Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (is) Civil Procedure,* 61 Wash. & Lee L. Rev. 931, 934 (2004) ("[B]ankruptcy law should exist, essentially, in order to serve the interests of the holders of nonbankruptcy legal entitlements."); Juliet M. Moringiello, *When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of* Butner v. United States, 2015 U. Ill. L. Rev. 657, 665 (2015) (noting the iconic stature of the principle and that it has been cited thousands of times); Barry E. Adler, *The Questionable Axiom of* Butner v. United States in BANKRUPTCY LAW STORIES (Robert K. Rasmussen ed. 2007) (questioning the principle's place as a "cherished axiom"); David Gray Carlson, *Bankruptcy Theory and the Creditors Bargain*, 61 U. Cin. L. Rev. 453, 466 (1992) (critiquing the principle).

[9] Butner might then be a circular statement that bankruptcy law's purpose is to pursue bankruptcy goals. Jackson (2018), *supra* note 7 at 1872 n. 18 (noting that the principle yields to "a clearly defined bankruptcy-related reason for doing so"); see also Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. Chi. L. Rev., 690, 692 (1986).

[10] See Ayotte and Skeel, *supra* note 8 at 1566 (invoking the Creditors' Bargain but advocating a general "Efficiency Principle").

[11] See Daniel J. Bussel and Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 Am. Bank. L.J. 663, 669 (2009) (bankruptcy alters nonbankruptcy rights to facilitate consent); G. Eric Brunstad, Jr. and Mike Sigal, *Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in Bank of America v. 203 North Lasalle Street Partnership*, 54 Bus. Law 1475, 1483–85 (1999) (bankruptcy creates "a better decision-making environment"); Omar Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19

over substance.[12] Most scholars and lawyers also agree—at least implicitly—that corporate bankruptcy has something to do with facilitating ex post cooperation among stakeholders.[13]

I do not depart from the current literature on these basic points. The challenge is in clearing away the distracting brush of old theories to discover the full and proper theory. Thus, this Article presents and justifies the New Bargaining Theory of corporate bankruptcy and demonstrates that Chapter 11's renegotiation framework is consistent with that theory.

I present two claims, one normative and one descriptive.

The normative claim is that bankruptcy's proper purpose is to solve a specific contracting failure. That failure arises because financial distress presents uncertainty that is not contractible. For a business firm, financial distress involves too many parties with strategic bargaining incentives and too many contingencies for the firm and its creditors to define a set of rules for every scenario. When distress arises, a firm's various relationships are therefore governed by incomplete contracts.[14] The parties in those relationships can then take advantage of the incompleteness to extract individual gains from each other—to hold each other up. Any party who has specifically invested in its relationship with the debtor is vulnerable to this hold-up threat.[15]

The problem cannot be solved by ex ante rules—in a contract or in a statute. Indeed, the issue arises precisely because no one can write such rules. This is a familiar problem, but the law treats it differently here. And perhaps for good reason. The noncontractible uncertainty associated with financial distress is a recurring characteristic across all firms. Where every relationship of a certain type is incomplete and requires judicial intervention upon the occurrence of the same event, a uniform

Bankr. Dev. J. 287, 396 (2003) (bankruptcy should provide a platform for negotiation); Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 BYU L. Rev. 759, 766 (2013) (noting but critiquing the common view that bankruptcy law facilitates efficient renegotiation).

[12] See Pamela Foohey, *Jevic's Promise: Procedural Justice in Chapter 11*, 93 Wash. L. Rev. Online 128 (2018); Mooney, *supra* note 8, 934-35.

[13] See Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L. J. 1807, 1808 (1998) (bankruptcy solves a coordination problem). Baird sometimes described bankruptcy as a solution to the collective action problem facing creditors racing after assets. Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815, 827 (1987). Subsequent scholarship has, however, shown that bankruptcy reaches far beyond that problem. See below at Part I.A.

[14] Hart and Moore, *supra* 4 at 756 (describing the incomplete contract problem).

[15] Oliver Hart, *Incomplete Contracts and Control*, 107 Am. Econ. Rev. 1731, 1733 (2017); Hart and Moore, *supra* note 4 at 757.

bankruptcy system that deals with those relationships will produce consistency, efficiency, and market predictability.

The descriptive claim of this Article is that Chapter 11 provides just such a system. It creates a renegotiation framework designed to minimize the parties' ability and incentives to hold each other up. The framework imposes judicial oversight and substantive outer limits on the parties' decisions. It also allocates power over certain decisions to one party while subjecting the exercise or removal of that power to evidentiary burdens, pricing mechanisms, and other conditions targeted at proving the absence of hold-up behavior. The initial allocation of power and conditions is based on the perceived likelihood that the decision in question is subject to incomplete contracting and hold-up problems. In light of substantive uncertainty, the system relies mostly on procedural protection, giving judges wide discretion to define the bargaining parameters while leaving most substantive decisions to ex post bargaining among the parties. In a sense, the law puts in place guardrails that give the parties room to bargain but keep them from taking positions that veer toward extreme hold up.

Bankruptcy, then, is not about mimicking a hypothetical bargain. It is about facilitating an actual bargain. This is the New Bargaining Theory of corporate bankruptcy stated generally. Consistent with this theory, Chapter 11 implements a renegotiation framework to facilitate ex post bargaining. I will provide the specifics below and demonstrate that questions of cramdown, executory contracts, forum shopping, the automatic stay, third-party releases, intercreditor agreements, priority rules, and the like can all be understood and explained by a proper application of the New Bargaining Theory.

Two key features are worth highlighting now: First, ex post bargaining is front and center. That is where bankruptcy law happens. To be clear, I am not rejecting the idea of ex ante efficiency. An efficient bankruptcy system is focused on solving the ex post problem if, but only if, it can do so without creating bigger problems in other states of the world. This presents a meaningful limitation on the implementation of any bankruptcy measure. Second, Chapter 11's renegotiation framework relies heavily on judicial discretion and procedural measures that facilitate the ex post bargain. Substantive measures—including value redistribution and deviations from nonbankruptcy priority—do, however, come into play to facilitate the bargain by

realigning incentives or minimizing distortions that might otherwise occur.

Notably, I do not claim that Chapter 11 operates perfectly—judicial error and misaligned incentives do exist. But the New Bargaining Theory coherently explains the major aspects of Chapter 11 and reveals the questions necessary to assess whether it achieves its purpose. For example, it provides insight into Chapter 11's proper scope. Because the potential for hold up arises when parties have made investments specific to relationships that involve or link in some way to the going concern value of the debtor,[16] Chapter 11 should focus exclusively on regulating ex post behavior that might take advantage of those relationship-specific investments.

This Article proceeds in three parts. Part I explores the usefulness and shortcomings of the Creditors' Bargain theory, the Butner Principle, and other heuristics that have been used to describe the core purpose of bankruptcy law. Part II provides the foundation for the New Bargaining Theory of corporate bankruptcy and describes Chapter 11's renegotiation framework. Part III demonstrates the usefulness of this emerging theory and its general application throughout Chapter 11.

I. Moving Beyond the Creditors' Bargain

An interesting thing has happened to corporate bankruptcy scholarship. The Creditors' Bargain theory and the Butner Principle are widely and routinely invoked by scholars as the foundational principles of corporate bankruptcy,[17] but virtually none of those scholars believes that the theory or the principle is correct (normatively or descriptively). Indeed, most corporate bankruptcy scholars point to the Creditors' Bargain theory and the Butner Principle as their analytical foundation, but then criticize aspects of the theory and proceed to build their analysis on a more generic efficiency foundation.[18] The result is that when

[16] Hart and Moore, *supra* note 4 at 757. See below at Part II.D.

[17] See Douglas G. Baird, *Priority Matters,* 165 U. Ill. L. Rev. 785, 792 (2017) ("Framing the question as one about the hypothetical ex ante bargain among investors has been the standard trope in reorganization scholarship ever since Jackson introduced the creditors' bargain model in the early 1980s."); *id*. at 789 (noting the goal of reorganization to "respect nonbankruptcy bargain among the investors").

[18] See, for example, Ayotte and Skeel, *supra* note 8 at 1566 (invoking the Creditors' Bargain theory but rejecting what they call the "Normative Butner Principle" and suggesting an "Efficiency Principle" instead); Mark J. Roe and Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 Va. L. Rev. 1235, 1269 (2013) (noting that the Creditors' Bargain theory does not match reality on the ground); Schwartz, *supra* note 13 at 1809 (arguing that bankruptcy is just about

a scholar invokes the "Creditors' Bargain," she conveys little more than a general commitment to an efficiency analysis of bankruptcy.[19]

In this Part, I reflect on the initial appeal of the Creditors' Bargain theory and the Butner Principle and then identify their theoretical shortcomings. While the Butner Principle is often referred to as a quintessential part of the Creditors' Bargain theory,[20] I attempt to disentangle the two ideas. I argue that the Creditors' Bargain theory was a useful analytical tool for demonstrating certain important principles, but one that never provided a complete theory to explain the purpose, reach, or limitations of a corporate bankruptcy system. The Butner Principle, in contrast, was at best a misunderstood shorthand for the idea that bankruptcy law should be efficient and limited in scope. In application it provides little guidance and instead draws scholars and courts to misleading and circular inquiries.

Corporate bankruptcy scholars have also developed a series of additional heuristics and rules of thumb to further explain or supplement the Creditors' Bargain. The leading ones include the single-owner principle and the rule of general averages. These are useful for understanding some aspects of our corporate bankruptcy system, but they are not successful in stating a unifying theory. The following subsections lay out the usefulness of and limitations of the Creditors' Bargain theory, the Butner Principle, and these other heuristics. But I begin first with a word about collective action.

increasing efficiency by solving a coordination problem); Yaad Rotem, *Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law's Self-Executing Mechanisms*, 5 Berk. Bus. L. J. 79, 79 (2008) (conceding that preserving nonbankruptcy entitlements "is of course only a second order goal" and noting that the main goal is efficiency in the face of financial distress); Rasmussen, *supra* note 3 at 55 n. 7 (1992) (criticizing the Creditors' Bargain theory for overemphasizing the importance of nonbankruptcy entitlements); Scott, *supra* note 9 at 692 ("Nonetheless, it is only partially successful in rationalizing current bankruptcy law."); see also Moringiello, *supra* note 8 (criticizing the over application of the Butner Principle); Foohey, *supra* note 12 (suggesting the existing focus on efficiency gives too little consideration to issues of procedural justice); Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. Cin. L. Rev. 519, 526 (1992) (noting general skepticism as to the Creditors' Bargain theory as a positive theory of bankruptcy law).

Even one of the scholars who originally formulated the theory has moved on from its original content. Baird and Rasmussen (2002), *supra* note 1 at 755 (declaring that older model does not matter anymore); Baird and Rasmussen (2010), *supra* note 1 at 652-53 (noting that actual bankruptcy practice is at odds with the Creditors' Bargain account).

[19] Notably, Professor Dick suggests that while efficiency is the general goal of bankruptcy law and scholarship, the prevailing reliance on neoclassical and other "outmoded" assumptions has doomed the enterprise to failure. Dick, *supra* note 11 at 824.

[20] See, for example, Ayotte and Skeel, *supra* note 8 at 1565-66 (2013) (referring to the Bunter Principle as the "second element" (of two) of the Creditors' Bargain theory).

A. The Collective Action Problem

My core claim in this Part is that the Creditors' Bargain theory provides insufficient guidance in deriving a theory of corporate bankruptcy. But conditional upon having a theory of bankruptcy's purpose (derived from some other source) it does have demonstrative utility.

One obvious candidate for that theory is the collective action problem. That is certainly where Jackson and Baird often looked.[21] Indeed, one push back on my critique might be that the original Creditors' Bargain theory and the Butner Principle are not purpose theories, themselves, but are necessary limitations on a system which has a purpose of solving the collective action problem among creditors.

There is a lot going on in that statement. We can break it into two parts. First, is the purpose definition. If we understand "collective action" to encompass the broad array of ex post bargaining and cooperation problems that arise from hold up associated with financial distress, then I agree and will argue below that bankruptcy is aimed at solving that problem. And I will explain why bankruptcy law should pursue that purpose, and why the problem arises in the first place. That is not, however, the way that bankruptcy scholars define the "collective action problem." The existing literature cabins "collective action" to the narrow cooperation problem of general creditors self-interestedly racing to execute their claims on a debtor's assets.[22] To this problem, the automatic stay is the most direct response.[23]

But corporate bankruptcy is much more than that. Financial distress presents a multitude of other ex post bargaining and cooperation problems, which bankruptcy law addresses. For example, Professors Baird and Picker explain that distress presents a noncooperative-bargaining problem among senior and junior creditors that is distinct from the "collective action problem."[24] They note that to solve the bargaining problem, "[b]ankruptcy scholarship needs to go beyond examining the

[21] Jackson (2018), *supra* note 7 at 1871; Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815, 827 (1987); Douglas G. Baird and Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. Legal Studies 311, 311 (1991) (noting the traditional view that creditors face a collective action problem); Barry E. Adler, *The Creditors' Bargain Revisited*, 166 U. Pa. L. Rev. 1853, 1853-54 (2018) (describing Jackson's bargain theory as one about collective action).

[22] See, for example, Baird and Picker, *supra* note 21 at 311-13, 322; Skeel and Triantis, *supra* note 30 at 1817; Adler, *supra* note 21 at 1864.

[23] 11 U.S.C. § 362. See below at Part III.A.

[24] Baird and Picker, *supra* note 21 at 311-13, 322.

collective action problem faced by the residual owners of an insolvent firm."[25] Likewise, Professors Baird and Rasmussen describe bankruptcy's ex post coordination problem among sophisticated creditors as "quite at odds with the standard account" of the collective action problem.[26] More recently, Professor Adler distinguishes free-and-clear sales—which themselves solve a very specific cooperation problem[27]—from anything related to the "collective action problem."[28] Over the last three decades, bankruptcy law and scholarship has thus moved far beyond the idea of just solving a race to assets among general creditors.[29] Today's bankruptcy debates focus on more complex bargaining and cooperation problems.[30]

[25] Baird and Picker, *supra* note 21 at 349.

[26] Baird and Rasmussen (2010), *supra* note 1 at 653. Professors Skeel and Triantis have similarly concluded that collective action problems "are much less pressing" today and solving them no longer forms the central objective of bankruptcy. Skeel and Triantis, *supra* note 30 at 1817.

[27] Free-and-clear sales solve the hold-up problem that arises when less than all creditors agree to release their claims against a debtor even when doing so would facilitate a value-maximizing sale.

[28] Adler, *supra* note 21 at 1864. Professor Schwartz goes even further claiming that financial distress does not present collective action problems. He argues that bankruptcy law should therefore focus exclusively on facilitating liquidity injections from creditors, preventing certain preferential or fraudulent transfers, implementing voting rules for restructuring, and policing auctions for misbehavior. Alan Schwartz, *Bankruptcy Related Contracting and Bankruptcy Functions*, working paper https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2806027 at 57. Schwartz does not view any of these functions as addressing a coordination problem. Id. at 40 ("[C]oordination among creditors apparently is not a serious problem."). But all of them involve legal interventions to coordinate multiparty behavior and prevent opportunistic hold-up behavior. Voting rules, for example, are inherently addressed at coordination and are unnecessary where coordination is not a problem. The same is true of liquidity measures. See Ayotte and Skeel, supra note 8 at 1561 and 1576. And preferences and auction misbehavior are forms of hold-up behavior that arise when traditional contracting cannot prevent them. As such, all of these functions fit squarely within the New Bargaining Theory of bankruptcy. Finally, Schwartz does not explain why bankruptcy law should focus on these coordination problems and not others beyond noting the preferences of creditors who lobbied for the 1898 and 1938 bankruptcy laws. Id. at 5. The theory I present below suggests that bankruptcy law should address all bargaining and cooperation problems arising from incomplete contracts not just the ones historically favored by creditors.

[29] Douglas G. Baird, Arturo Bris, Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases,* available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=866865 at 33 (finding that most corporate bankruptcies do "nothing or close to nothing for ordinary general creditors").

[30] See, for example, Kenneth Ayotte, *Disagreement and Capital Structure Complexity*, working paper available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3276779; Dick, *supra* note 11; David A. Skeel, Jr. and George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. Pa. L. Rev. 1777, 1781-83 (2018); Kenneth Ayotte, Anthony J. Casey, and David A. Skeel, Jr., *Bankruptcy on the Side*, 112 Nw. L. Rev. 255, 257-58 (2017); Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 Am. Bank. L. J. 593, 593-95 (2017).

Second, the statement above suggests a role for the Creditors' Bargain and the Bunter Principle in setting a limit on any bankruptcy theory. But, for the reasons stated in the next subsection, the Creditors' Bargain theory and the Butner Principle do not add meaningful limitations to any bankruptcy theory. The Creditors' Bargain model merely states that bankruptcy's purpose (whatever it is) should be efficient and the Butner Principle merely states that that purpose should be its own limitation.

B. The Creditors' Bargain Theory

It is difficult today to separate the Butner Principle from the Creditors' Bargain. They are often coupled together in bankruptcy law and scholarship, but they are distinct concepts. The Creditors' Bargain theory is a model whereby one "view[s] bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante position."[31] The Butner Principle, in its most commonly cited form, provides that bankruptcy law should give special deference to—and avoid interfering with—entitlements and rights that are created by non-bankruptcy law.[32]

Nothing about the Creditors' Bargain theory necessitates the Butner Principle. Nor is the Butner Principle helpful in understanding a hypothetical ex ante agreement among creditors. For this reason, I refer it to it as the Butner Fallacy. Nonetheless, the Butner Fallacy has repeatedly been justified as a quintessential element of the Creditors' Bargain.[33] Indeed, the first articulation of the Creditors' Bargain theory was focused almost exclusively on explaining and justifying bankruptcy law's "substantial respect to non-bankruptcy entitlements."[34]

But—because they are separate concepts—I will start my discussion by bracketing the Butner Fallacy and exploring the independent model within the Creditors' Bargain theory, looking at its utility and limitations.

i. <u>Demonstrative Utility</u>

[31] Jackson (1982), *supra* note 1 at 860.

[32] Jackson (1982), *supra* note 1 at 907; Baird and Jackson, *supra* note 8 at 100; Ayotte and Skeel, *supra* note 8 at 1564-65.

[33] See *supra* note 8.

[34] Jackson (1982), *supra* note 1 at 859 (citing *Butner v. United States* 440 U.S. 48, 54 (1979).

The Creditors' Bargain model is useful in two ways. To start, it helps demonstrate financial concepts and efficiency dynamics. More specifically, the model demonstrates that ex post legal interventions will be priced into and can affect ex ante bargaining. In this way, a creditor who benefits from a legal intervention that redistributes ex post value may actually be worse off if you take a dynamic view across time. For example, the Creditors' Bargain is often invoked for the following idea: Imagine all creditors bargaining with full information over the rules that will apply in bankruptcy. We can predict that they will first bargain for rules that expand the pie the most and then they will agree on prices and other methods to divide the surplus created by the expansion. As a corollary, we can also predict that if one creditor proposes a rule that will increase her share of the bankruptcy estate, she will be charged an ex ante fee by the other creditors to offset that ex post distribution.[35]

This is a salient version of a more complicated point: Among sophisticated rational actors, initial investment decisions and prices take into account expectations about ultimate returns. If a legal change reduces the expected payout for a creditor in bankruptcy, that creditor will charge a higher interest rate up front.[36] But – because *all* creditors take expected returns into account[37] – legal rules that merely alter distributions among

[35] Lucian Arye Bebchuk and Jesse M. Fried, *The Uneasy Case for Priority of Secured Claims in Bankruptcy*, 105 Yale L. J. 857, 881-82 (1996).

[36] Id.

[37] Later work criticized this part of the Creditor's Bargain theory by pointing out that some creditors may not be able to adjust interest rates to account for expected returns. Douglas Baird, *A World without Bankruptcy*, 50 Law and Cont. Prob., 173, 180 (1987) (noting that tort victims cannot adjust interest rates); Bebchuk and Fried, *supra* note 35 at 895-902 (modeling the problems nonadjusting creditors pose for the Creditors' Bargain theory); Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 Yale L. J. 806, 808–09 (2009) (showing how value can be extracted from nonadjusting creditors); Elizabeth Warren and Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: and Empirical Intervention*, 118 Harv. L. Rev. 1197, 1203 (2005); These nonadjusting or maladjusting creditors receive the same interest rate regardless of their expected payouts in bankruptcy. Tort victims are the most obvious group of nonadjusting creditors. Some think employees and small vendors may also belong to this category. Regulatory creditors may also fall into this category. See Joshua Macey and Jackson Salovaara, *Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law*, 71 Stan. L. Rev. 879, 887 (showing that coal companies' "ability to siphon off regulatory obligations" has allowed them to provide below market returns to regulatory creditors).Virtually everyone agrees that the problem of nonadjusting creditors requires separate attention—and perhaps separate treatment—in bankruptcy. There is disagreement, however, about the size of the problem in most cases. Compare Warren and Westbrook, *supra* at 1221-22, 1236 (finding the problem to be large), with Robert K. Rasmussen, *Empirically Bankrupt*, 2007 Col. Bus. L. Rev. 179, 181-84 (2007) (questioning Warren and Westbrook's results); see also. Baird, Bris, and Zhu, *supra* note 29 at 33 (finding that most bankruptcy proceedings have little to do with the rights of nonadjusting creditors).

creditors without otherwise changing the size of the pie do not affect the firm's value.[38] The creditor who is favored (in expectation) by a rule that applies in bankruptcy will charge a lower interest rate, the creditor who is disfavored by the rule will charge a higher interest rate, and the debtor will face the same cost of capital.[39] No value is lost, and everyone ends up in the same (expected) position. In designing the system, we should therefore only care about rules that increase or decrease the size of the pie, not those that change how the parties divide it.

The takeaway is that the only changes that matter are those that create (or eliminate) inefficiencies. Thus, a distribution rule that also distorted the incentives of those running the business *would* matter. For example, a bankruptcy rule that inflates distributions to management could cause managers to inefficiently expend resources in order to cause a bankruptcy filing.[40] That rule would reduce the value of the firm and constrain its ex ante ability to raise capital.[41] By focusing our attention on a hypothetical ex ante bargain, the model highlights this important interaction between ex post and ex ante efficiency.

The Creditors' Bargain model can also provide rhetorical justification for the perhaps less-than-intuitive idea that bankruptcy law should interfere with private ordering to achieve its efficiency goal.[42] The rhetorical move is to tie the efficiency goal to the ideal private order. The law is framed not as interfering with private ordering, but as vindicating the order that creditors would agree to if they privately bargained over it.

There is not much substance there. But the rhetoric is important. The idea is that bankruptcy law provides a set of rules that interfere with private rights but only when those private rights are misfiring. If bankruptcy law does that efficiently, the bargain model points out that the creditors can allocate any benefits achieved by adjusting their ex ante prices. Thus, while bankruptcy law is—at its core—a federal law that intervenes in state law and private ordering among creditors, the model shows that the benefits of that intervention run to those same creditors.

[38] This all follows from the Modigliani-Miller theorem. Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261, 268–71 (1958).

[39] Id.; Bebchuk and Fried, *supra* note 35 at 881.

[40] See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 Yale L. J. 573, 592 (1998).

[41] Barry E. Adler, *Game-Theoretic Bankruptcy,* 41 J. L. Stud. 209, 214 (2012).

[42] This idea is likely less controversial today that it was in the early days of law and economics. But it certainly still has its critics. See Schwartz, *supra* note 3 at 630; Schwartz *supra* note 28 at 56.

In this way, the Creditors' Bargain model was useful in explaining why creditors should not object in principle to a paternalistic attempt to solve their coordination problem. But—as I will discuss in the next section—it does not explain why bankruptcy law focuses on solving that particular problem and not others or how it should do so.

ii. Limitations: Purpose and Scope

Despite its demonstrative utility, the Creditors' Bargain model is not a complete theory of bankruptcy. While it illustrates a generic efficiency argument for maximizing the welfare of stakeholders, the model of an ex ante agreement among creditors proves both unnecessary and unhelpful in defining the substance and scope of that welfare-maximizing purpose.

As noted, the model helps to justify government intervention by demonstrating why creditors would prefer a law that is efficient—they prefer to take their slices from a larger pie. But any model starting with rational actors who enter an agreement in a world of perfect information and no transaction costs will arrive inescapably at the solution that maximizes the welfare of those rational actors.[43] That is a mere nod toward the goal of welfare-maximizing efficiency.[44]

And yet even if we embrace the efficiency purpose as given—which I do in this Article[45]—we still have to answer fundamental questions about whose welfare we are maximizing and within what parameters. For starters, why should bankruptcy law maximize the value of those who have claims against the debtor's assets[46] and not others who are affected by the debtor's business, or even total outsiders? This question has divided bankruptcy

[43] This is really just the Coase theorem. Without transaction costs, bargaining will lead to the socially efficient outcome. Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1, 15 (1960). When transaction costs do exist, the law may need to step in to achieve efficiency. *Id*. at 16-19.

[44] In the more general law-and-economics context—independent of bankruptcy—others have pointed out that hypothetical-contracts frameworks do not add anything to general ideas of efficiency. Jules Coleman, RISK AND WRONGS, at 169 (1992) ("[T]here appears to be nothing expressed by the concept of hypothetical consent that is not already captured in the idea of rational self-interest.").

[45] Consistent with most law-and-economics approaches, I embrace the idea of maximizing welfare. My primary goal is to propose a workable welfarist theory. I do not here undertake a more fundamental defense of the general law-and-economics welfarist approach.

[46] Baird and Jackson use the word "creditors" to encompass all those with claims against the debtor's estate. See Jackson (2018), *supra* note 7 at 1872 ("In retrospect, I might have better labeled it as a 'claimants' bargain' or something broader.").

scholars for years.[47] The Creditors' Bargain avoids the question by assumption—if the purpose is to mirror a creditors' bargain, then the creditors are the focus.

But why not mirror an ideal bargain between all affected parties? If bankruptcy is intended to solve an ex ante bargaining problem among creditors, why shouldn't it solve other ex ante bargaining problems related to a debtor's distress? If we can imagine a bargain that includes all possible creditors, we can also imagine a bargain that incudes employees, consumers, and communities with an interest (or the possibility of an interest) in the long-term success (or failure) of the debtor firm. And that bargain could take into account all of their interests, even those that do not take the form of a claim against assets—a consumer's interest in cheap goods, a local government's interest in tax revenue, a stakeholder's interest in maximizing its other investments in competing firms, any interest affected by any externality of the firm's actions. As long as we assume transaction costs are zero, we can come to an imagined bargain that includes enough transfer payments to achieve an efficient outcome that maximizes the value of all interests across all conceivable parties.

Unless one intends bankruptcy to implement a theory of general welfare, one needs to define a concrete purpose for the system and then develop a partition to limit the scope of actions taken to achieve that purpose.[48] One has to define what is—for lack of a better term—bankruptcy stuff and what is not.

The Creditors' Bargain model fails at drawing this partition as a descriptive and normative matter. Descriptively it gets things wrong.[49] It identifies the claims against the estate as bankruptcy stuff when virtually all corporate bankruptcy systems in the world draw the partition more broadly than that.[50]

[47] See, for example, Donald Korobkin, *Contractarian and Normative Foundations of Bankruptcy Law,* 71 Tex. L. Rev. 541, 572-75 (arguing for an approach to the Creditors' Bargain that includes all affected parties).

[48] On the importance and challenges in drawing this partition, see Douglas G. Baird, Anthony J. Casey, and Randal C. Picker, *The Bankruptcy Partition*, 166 U. Pa. L. Rev. 1675, 1677 (2018); see also Vincent S.J. Buccola, *The Bankruptcy Firm*, 167 U. Pa. L. Rev. Online 1 (2019).

[49] See sources cited *supra* note 18.

[50] See Baird, Casey, and Picker, *supra* note 48 at 1684-86 (demonstrating the ways in which bankruptcy power reaches beyond merely resolving claims against the estate). The same is true of corporate insolvency systems around the world. See, for example, Horst Eidenmueller, Comparative Corporate Insolvency Law, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2799863 (exploring the English, French, German, and American systems systems); Singapore's Bold New Restructuring Laws Take Effect, https://www.bakermckenzie.com/en/insight/publications/2017/06/singapore-restructuring-laws-take-effect.

Normatively, the model never explains why one *should* draw the partition where it does, why the law should focus on the interests of claimants and not the interests of anyone who has a nonclaim interest affected by the debtor. And without an answer to that question, we have no theory. This deficiency of theory manifests itself regularly in debates about whether new disputes—like third-party releases—fall within or without bankruptcy's partition.[51]

No doubt, many readers familiar with the Creditors' Bargain literature are objecting at this point. Surely, they will say, the Creditors' Bargain theory does tell us where and why to draw the partition: We must maximize the value not of generic interests in the world but of nonbankruptcy entitlements against the debtor. And we must do so in the way that least interferes with those interests. And the reason for doing so? That brings us to the Butner Fallacy.

C. The Butner Fallacy

Lacking a purpose and a limiting principle, the Creditors' Bargain model spawned a specious scope limitation that is often mistaken for a core purpose. For nearly four decades, the Creditors' Bargain model—beyond stating the generic efficiency principle—has focused on the question of preserving and protecting substantive rights that exist outside of the bankruptcy system.[52] The idea takes its name from *Butner v. United States*[53] (which, incidentally, does not actually require that bankruptcy law provide any special respect for nonbankruptcy substantive rights).[54]

The assumption that connects the Creditors' Bargain to the Butner Fallacy is that creditors would – if they could – bargain for rules that vindicate their substantive ex ante entitlements. Thus, according to some versions of the Butner Fallacy, ex post

[51] See Baird, Casey, and Picker, *supra* note 48 at 1686-90.

[52] See *supra* note 8.

[53] 440 U.S. 48 (1979).

[54] See *supra* note 7. Far from suggesting that bankruptcy law should not interfere with nonbankruptcy rights, the Court in *Butner* explicitly stated that the Bankruptcy Clause of the constitution granted Congress the authority to alter nonbankruptcy rights:

> The constitutional authority of Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United State" would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by a property in a bankrupt estate.

Id. at 54. It was only because the Bankruptcy Code was silent on the matter that the Court deferred to state law. This is a familiar interpretive move whereby the Court does not lightly presume that Congress has interfered with or preempted state law.

bankruptcy laws can only reach matters that preserve those ex ante entitlements.[55]

This is both circular and wrong. It is circular—or at least self-contradicting—because it relies on nonbankruptcy entitlements to tell us when the law should interfere with nonbankruptcy entitlements. We are imagining a bargain where the parties are writing rules for what to do when their nonbankruptcy agreements are misfiring. Then, to limit the scope of those rules, we are told to respect those nonbankruptcy agreements as much as possible. So when should we supplant those nonbankruptcy rights? When doing so will vindicate the nonbankruptcy rights. But, then, which nonbankruptcy rights do we vindicate, and which do we supplant?

The problem in answering these questions is that the corporate bankruptcy system is a system of laws that suspends, eradicates, or otherwise interferes with substantive rights that would exist outside of bankruptcy. This is true of virtually every key provision of the Bankruptcy Code.[56] The automatic stay prevents the enforcement of contracts.[57] The cramdown provisions prevent a secured creditor from foreclosing on its collateral.[58] The sale provisions allow the sale of assets free and clear of interests that would otherwise attach to the assets.[59] The contract-assumption provisions allow a debtor to enforce contracts where it would otherwise be in default.[60]

Thus, the Butner Fallacy is a prescription that bankruptcy law should not interfere with non-bankruptcy entitlements unless it should. As Professor Moringiello has pointed out, in this framing the principle has no content.[61] The idea parses out to an admonition that bankruptcy law controls substantive rights only when it serves a bankruptcy purpose. This does nothing more than highlight the idea that bankruptcy law should have a purpose.

D. The Creditors' Bargain and the Butner Fallacy as Distractions

[55] See, for example, Jacoby and Janger (2017), *supra* note 8 at 676 (arguing that bankruptcy law is derived from nonbankruptcy entitlements); Mooney *supra* note 8 at 934 (arguing that bankruptcy law exists to serve nonbankruptcy entitlements).

[56] And most key provisions of corporate insolvency laws in other countries. See Eidenmueller, *supra* note 50.

[57] 11 U.S.C. § 362.

[58] 11 U.S.C. § 1129(b).

[59] 11 U.S.C. § 363(f).

[60] 11 U.S.C. § 365.

[61] Moringiello, *supra* note 8 at 659.

i. The False Promise of "Real-World" Agreements

A common move among judges, scholars, and lawyers is to justify (or refute) bankruptcy outcomes by pointing to evidence of real-world agreements that match (or contradict) the proposed outcome.[62] They suggest that if we cannot see creditors in the real world adopting such rules, then we cannot satisfy the Creditors' Bargain model.[63] How, they ask, can we say parties would bargain for something when we see them bargaining for the opposite?

This misses the point. If you believe the Creditors' Bargain theory, we only see parties bargaining in a world where we have already stipulated that they cannot bargain efficiently to their desired outcome, and we only see them bargaining in the shadow of a mandatory bankruptcy system that forces a hypothetical bargain on them to protect them from their own bad bargain.[64] That tells us little about what they would choose if they were rationally designing a system in a perfect world.

We want to know the efficient rule or—if one must frame it in bargaining terms—the rule that would have resulted from a pristine bargain that exists nowhere in the world. The fact that creditors in the real world act strategically and possess incomplete and asymmetric information should surprise no one. Their actual agreements and their stated preferences are therefore poor evidence of the rules that we should adopt to fix contracting failures among them.

ii. Trying to Solve the Wrong Problem

The Creditors' Bargain theory also misleads because it entices scholars to think that we can solve bankruptcy's problems by facilitating communication in order to make an explicit ex ante bargain possible. For example, some have proposed that we could solve the bargaining problem by helping debtors adopt custom-made bankruptcy rules that are transparent to counterparties and affected parties.[65] This transparency would allow the law to

[62] See, for example, Barry A. Adler and George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 Am. Bankr. L. J. 563, 583 (2017) (deriving bankruptcy option value from the terms of loan agreements); see also Jacoby and Janger (2017), *supra* note 8 at 676 (deriving optimal bankruptcy rules from nonbankruptcy rights); Jacoby and Janger (2014), *supra* note 8 at 892 (same).

[63] Adler and Triantis, *supra* note 62 at 584 (looking to "real world" debt contracts as evidence of optimal bankruptcy rules); Schwartz, supra note 28 at 4 and 55 (building an analysis on the motivations of creditors).

[64] Anthony J. Casey and Edward R. Morrison, Beyond Options, working paper available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2855954 at 6.

[65] See Adler and Kahan, *supra* note 3 at 1794-1809; Rasmussen, *supra* note 3 at 100-11 (1992); Skeel, *supra* note 3 at 525; see also Barry E. Adler, *Financial and Political*

infer contractual assent much like it does with mortgages and security interests.

But the real problem lies beyond the creditors' logistical ability to bargain with each other. As recent scholarship has pointed out, even small numbers of creditors in an explicit bargain will write incomplete contracts that produce inefficient results when financial distress arises.[66] The real problem stems from uncertainty and complexity about the distressed state of the world. By its very nature, financial distress is hard to contract over. The time horizon, the number of parties, their incentives to bargain strategically, and the number of contingencies render the possible scenarios too numerous to define and negotiate.[67] Moreover, the dynamic nature of markets in distress requires flexibility that would be stifled by hard-edged ex ante rules.[68]

As discussed below, this presents an incomplete contracting problem to which bankruptcy law responds.[69] Because this is an incomplete contracting problem, it cannot be solved by facilitating private contracts and ex ante bargains or by adopting technology that allows disperse creditors to express assent to a specific substantive bankruptcy regime.

E. Other Incomplete Heuristics

Over the years, the academy has produced other heuristics to explain or supplement the Creditors' Bargain theory.

Theories of American Bankruptcy, 45 Stan. L. Rev. 311, 322-23 (1993) (examining investor choice proposals); see also Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L. J. 1807 (1998) (arguing generally for rules that facilitate private contracting); Skeel and Triantis, *supra* note 30 at 1817 (urging bankruptcy law to take ex ante contracting more seriously).

[66] Professor Ayotte's work is the most groundbreaking on this issue. See Kenneth Ayotte, *On the Mandatory Stay of Secured Creditors in Bankruptcy*, working paper available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3060748; Ayotte, *supra* note 30; Ayotte, Casey, and Skeel, *supra* note 30.

[67] See, Thomas H. Jackson and Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 166 (1989) ("[T]he creditors' bargain of necessity involves long-term relationships in which many of the contingencies that influence business prospects are uncertain and highly interactive."); see also Baird and Rasmussen (2010), *supra* note 1 at 652 ("In short, the new world of corporate reorganizations has more heterogeneous creditors whose rights against the business are deeply fragmented.").

[68] The same can be said about attempts to regulate bailouts and other government action in times of systemic financial distress. See Anthony J. Casey and Eric A. Posner, *A Framework for Bailout Regulation,* 91 Notre Dame L. Rev. 479, 536 (2015); see also Iman Anabtawi and Steven L. Schwarcz, *Regulating* Ex Post*: How Law Can Address the Inevitability of Financial Failure*, 92 Tex. L. Rev. 75 (2013); Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 Fla. L. Rev. 1349 (2011).

[69] See below at Part II.A-B.

The most prominent is the Sole Owner Principle.[70] Like the hypothetical bargain, this is another way of demonstrating the importance of efficiency. If we imagine a rational sole owner making decisions—instead of a group of creditors costlessly bargaining—we again arrive inevitably at the efficient outcome that maximizes the value of all interests that we imagine that person to own. Rational owners maximize the value of the things they own.

But this raises, once again, the thorny question of scope: Sole owner of what? The legal entity? The economic enterprise? All stakes? All interests? The community and market as a whole?

Moreover, the question in bankruptcy is how to solve a bargaining problem that arises with hold-up threats in distress.[71] But a single owner won't have anyone with whom to bargain, and so it makes little sense to ask what that owner would do to solve the problem.

One might instead ask what substantive rule the single owner would follow. But if we are writing the law in the face of uncertainty about financial distress, we cannot specify that substantive rule ex ante.[72] Instead, we need procedural rules that will move the parties' ex post decisions toward the correct substantive choice—which the court cannot verify.[73] No single owner would bother considering the content of such procedural rules.

Another popular heuristic is the rule of general averages.[74] This heuristic is sometimes used to expand or enhance the Creditors' Bargain model by explaining why the creditors might agree to share risk when distress arrives.[75] Comparing the bankrupt debtor to a ship foundering at sea, the idea is that bankruptcy law might follow admiralty law's rule that all stakeholders "contribute thereafter to the general average expense according to their percentage of ownership."[76]

This adds two aspects to the Creditors' Bargain. First, it introduces the important idea of uncertainty. And second, it introduces agency costs. Because the captain of a foundering ship

[70] See Jackson, *supra* note 8 at 12; Skeel and Triantis, *supra* note 30 at 1778; Ayotte and Skeel, *supra* note 8 at 1563; Baird, *supra* note 40 at 582; Baird and Jackson, *supra* note 8 at 121.

[71] See below at Part II.A.

[72] See below at Part II.A.ii.

[73] See below at Part II.A-B.

[74] Scott, *supra* note 9 at 692; Jackson and Scott, *supra* note 67 at 189-90, 199, 202.

[75] Jackson and Scott, *supra* note 67 at 156-57.

[76] Jackson and Scott, *supra* note 67 at 171 (citing Grant C. Gilmore and Charles L. Black, THE LAW OF ADMIRALTY 244 (2d ed. 1975)).

will be making decisions for the benefit of others in an uncertain environment, the best the law can do is align incentives to "dissipate the captain's conflict between self-interest and duty at the moment of sacrifice."[77] So too might the law of bankruptcy create rules to dissipate the debtor's conflict.

This framing generally resembles the bankruptcy problem. Faced with uncertainty, the law wants to give ex post agents the right incentives. But no one has shown that general average contribution is the best way to do that. Nor is general average contribution a common method deployed as a solution by actual bankruptcy laws.[78]

Doubtless there are other analogies that one could draw. Indeed, any comparison to an area of the law that deals with ex ante regulation of ex post discretion is likely to resemble a generic description of the bankruptcy problem.[79] The key, however, is to move from these generic heuristics and analogies to a fuller theory describing the specific problems and solutions as they actually arise in corporate bankruptcy.

II. Discovering the New Bargaining Theory of Corporate Bankruptcy

The New Bargaining Theory provides that bankruptcy law's purpose is to minimize the value destroyed by the incomplete contracting problem that parties face with regard to financial distress. Chapter 11 attempts to this, if imperfectly, by facilitating a structured bargaining space where the relevant parties renegotiate their relationship. That bargaining space constrains the parties procedurally and substantively in ways that are targeted at minimizing their ability and incentive to hold each other up by deviating from the welfare maximizing course of action.

[77] Scott, *supra* note 9 at 702.

[78] See below Part II.B-C. See also David Skeel, *The Empty Idea of "Equality of Creditors,"* 166 Penn. L. Rev. 699, 701(2017) (noting that equal contribution and recovery is not the practice on the ground and that "Bankruptcy courts often bless arrangement that give one group of general creditors starkly different treatment than other groups."). The prevalence of secured debt and priority further detracts from any claims that Chapter 11 implements a rule of general averages.

[79] Bailout literature comes first to mind. See sources cited *supra* note 68. Analogies to the famous Alaska Packers case and duress would also work. *Alaska Packer Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902). Professor Buccola has recently suggested a similar analogy between bankruptcy and tort law's private necessity doctrine from *Vincent v. Lake Erie Transportation Co.* 109 Minn. 456, 124 N.W. 221 (1910). Vincent S.J. Buccola, *Bankruptcy's Cathedral: Property Rules, Liability Rules, and Distress*, __ Nw. L. Rev. __ (2020) (forthcoming).

The reason an entire field of law exists to address this problem—rather than the application of something like routine contract law—is the ubiquity of the problem. An overwhelming majority of business relationships suffer from the same incomplete contracting problem at the moment financial distress arises.[80] As a result, a system of uniform procedures has arisen to deal with the value destruction associated with that problem. Indeed, if one imagines a world without bankruptcy law[81] or observes financial markets that exist in jurisdictions without a functioning bankruptcy system, it is not surprising that the incomplete contracting problem would produce pressures requiring a judicial or legislative solution.[82]

Recognizing bankruptcy law's purpose also sheds light on the scope of a proper bankruptcy system. Bankruptcy law is targeted specifically at solving hold-up problems related to the incomplete contracting problem that arises with financial distress. This means that bankruptcy law will be worried about ex post behavior that opportunistically uses incompleteness to extract value. Parties are vulnerable to hold up when they have made relationship-specific investments.[83] Thus, bankruptcy measures

[80] Baird and Rasmussen (2010), *supra* note 1 at 698; Jackson and Scott, *supra* note 67 at 166.

[81] See Baird, *supra* note 37 at 184 (imagining such a world and noting that creditors would self-interestedly destroy value).

[82] For example, India only recently adopted a unified corporate insolvency system. The demands for reform leading to its adoption were in response to problems that fit the hold-up model presented in this paper. Kristin Van Zwieten, *Corporate Rescue In India: The Influence of the Courts*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2466329 (2014) (describing two decades of sustained calls for reform); Rajeswari Sengupta, Anjali Sharma, and Susan Thomas, *Evolution of the Insolvency Framework for non-financial Firms in India*, available at http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf (describing stalled development of financial markets as a result of "the absence of a coherent and effective mechanism for resolving insolvency); Nimrit Kang and Nitin Nayar, *The Evolution of Corporate Bankruptcy Law in India*, ICRA Bulletin on Money and Finance (2003-2004) (noting the need for reform in the absence of a "single and integrated policy on corporate bankruptcy"). Calls for insolvency reform in France and the Czech Republic presented similar themes. See, for example, Sophie Vermeille, *How French Bankruptcy Law has Failed to Adapt to the Evolution of the Economy and Finance,* available at https://www.law.ox.ac.uk/events/how-french-bankruptcy-law-has-failed-adapt-evolution-economy-and-finance ("French law has never perceived bankruptcy law as an extension of the negotiations of the parties."); Jeffrey A. McGehee *Insolvency Law Reform in the Czech Republic – A Timely Opportunity that Hopefully Will not be Wasted* available at https://www.squirepattonboggs.com/en/insights/publications/2004/11/insolvency-law-reform-in-the-czech-republic--a-t__ (2004) ("It is an unfortunate and widely recognized reality that existing Czech insolvency law is an inadequate solution for financially distressed business enterprises.").

[83] Hart and Moore, *supra* note 4 at 757; Steven Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q. J. Econ. 121, 123 (1984); Sanford J. Grossman and Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J.

will properly target actions involving and affecting investments specific to relationships that involve or link in some way to the debtor or the debtor's going concern.[84] Attempts to fix other problems, while potentially valid, are not bankruptcy measures.[85]

In this Part, I explore these theoretical points in detail. First, I present the incomplete contracting problem that bankruptcy law attempts to solve. Second, I describe the structured bargaining space and procedures for renegotiation that Chapter 11 implements to solve that problem. Third, I explore how this system balances ex ante and ex post concerns. Finally, I discuss how the New Bargaining Theory informs the proper scope of Chapter 11.

A. Bankruptcy's Incomplete Contract

There are two types of incomplete contracts: obligationally incomplete and contingently incomplete.[86] Obligationally incomplete contracts have legal gaps. They are missing terms and do not provide instructions as to how the parties and the courts should respond to certain states of the world.[87] Contingently incomplete contracts, on the other hand, provide instructions but ones that misfire in certain states of the world.[88] The terms provide instructions, but when the relevant contingency arises those instructions are not the ones that the parties intended and they fail to realize the potential gains from trade between the parties.[89]

Incomplete contracts of both types arise when the costs of writing terms to cover all contingencies are too high. The parties are bargaining with each other, but they cannot write the necessary terms. Costs might result from a lack of information—the parties cannot predict or define the relevant contingencies—

Pol. Econ. 691, 695-97 (1986); Patrick W. Schmitz, *The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory,* 53 Bull. Econ. Res. 1, 15(2001).

[84] The idea of relationship-specific investment is closely tied up with the notion of going concern value. Going concern value exists when assets are worth more together than apart. Relationship-specific investment is an investment in assets that are worth more as part of an ongoing relationship. Thus, it is a way to create going concern value.

[85] As many have recognized, using bankruptcy law to address nonbankruptcy problems can obscure both proper bankruptcy policies and the proper nonbankruptcy solutions to those problems. See, for example, Baird, *supra* note 40 at 592.

[86] Ian Ayres and Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules,* 101 Yale L.J. 729, 729 (defining obligationally incomplete contracts).

[87] Id. at 729 (defining operationally incomplete contracts).

[88] Id. (defining contingently incomplete contracts).

[89] Id.

or from bargaining failure—the parties play strategic games that prevent them from agreeing to the optimal term.[90]

When a relationship is governed by an incomplete contract, the parties can evade the spirit of their initial agreements and take advantage of unforeseen contingencies or misfiring terms to extract value from each other. This is the hold-up problem.[91]

Stated informally, one party can threaten ex post action that will destroy value in a contractual relationship.[92] To demonstrate the idea, imagine a contract between A and B. If a certain contingency arises, A might take action Y that will destroy the value in their relationship. The contract between them is incomplete in that it does not prohibit such action. The incompleteness might arise because the parties did not predict the contingency, or they could not or did not define it in the contract, or because they cannot verify its occurrence to a court.

In any event, Party A might then threaten to take action Y unless B pays a ransom. Imagine also that B has expended resources that are only valuable if her relationship with A continues. Having made these relationship-specific investments, B is willing to pay the ransom to A in order to preserve the relationship. Party A is using the incompleteness—which allows the threat—to extract a hold-up payment.[93]

The threat of this ex post hold up, in turn, distorts the parties' ex ante interaction.[94] Fearing hold up, they either do not enter into the relationship at all or they limit their relationship-specific investment in it over time.[95] In the remainder of this sub-section I demonstrate how this theory applies in the bankruptcy context.

i. The Problem of Financial Distress

Financial distress is common. But its contours and causes are difficult to predict with any reasonable degree of certainty.

Generally, financial distress exists when a firm cannot finance new projects that have net positive value.[96] Because investors should be eager to fund profitable endeavors, financial distress implies a market imperfection and the opportunity for successful legal intervention. The usual suspects for this

[90] See Ayres and Gertner, *supra* note 86 at 733 (demonstrating how strategic bargaining can lead to incomplete contracts).

[91] Hart, *supra* note 15 at 1733.

[92] Id.

[93] Id.

[94] Id at 1741.

[95] Id.; Hart and Moore, *supra* note 4. Grossman and Hart, *supra* note 83.

[96] Barry E. Adler, Douglas G. Baird, and Thomas H. Jackson, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY, 4TH ED. (2007) 26-29.

imperfection are debt overhang, asymmetric information, and illiquid capital markets.[97]

Debt overhang arises when existing payment obligations get in the way of new financing.[98] A firm cannot raise new money for valuable projects because the future revenues from those projects are already claimed by existing creditors.

Asymmetric information and illiquid capital markets present a slightly different problem. Here, the debtor cannot convince the market to provide capital for valuable new projects—either because it cannot convince investors that it has good projects and is a good credit risk,[99] or because capital and credit markets are generally frozen.[100]

In a world of perfect ex post bargaining, these problems go away. For debt overhang, the debtor renegotiates its old relationships to allow new investments to take priority. The new projects increase the value of the firm and everyone is better off.[101] The various parties with an interest in the debtor reach a bargain to coordinate their behavior, expand the pie, and split the surplus.[102] For asymmetric information, insiders with full information could agree to self-finance the firm's future projects[103] or to sell the firm to an insider.[104]

Bargaining is, however, hindered because the parties have an incentive to hold out in an attempt to extract value from each other. In many cases, these hold out attempts will prevent a negotiated outcome altogether. With multi-party negotiations,

[97] See Ayotte and Skeel, *supra* note 8 (describing these three phenomena).

[98] See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. Fin. Econ. 147, 149 (1977); Ayotte and Skeel, *supra* note 8 at 1570-71 (explaining debt overhang); Adler and Triantis, *supra* note 63 at 579 (providing an example to illustrate the debt overhang problem).

[99] See Ayotte and Skeel, *supra* note 8 at 1579-85.

[100] This was the case, for example, during part of the Great Financial Crisis. Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008,* 23 J. Econ. Persp. 77, 91-92 (2009) (explaining the causes of liquidity dry-ups).

[101] See Ayotte and Skeel, supra note 8 at 1576.

[102] Without bargaining costs, the parties can always bargain to achieve this mutually beneficial outcome. See Coase, *supra* note 43 at 2-15.

[103] This assumes they have access to the necessary funds, which is likely true with banks that are prepetition lenders. Indeed, prepetition bank lenders very often provide financing for Chapter 11 reorganizations. Sandeep Dahiya, Kose John, Manju Puri, Gabriel Ramirez, *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. Fin. Econ. 259, 265 (2003) (finding 58% of loans in a sample were provided by prepetition lenders).

[104] Or they might agree to other solutions aimed at creating liquidity, like allowing the debtor to access cash or other assets belonging to its affiliates. For an example of this measure being facilitated by a court order rather than by negotiation, see *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 61 (Bankr. S.D.N.Y. 2009) (where the court allowed the debtor to upstream cash from subsidiaries to the parent company to provide liquidity to affiliate entities).

the hold out incentives will lead to a collapse in bargaining where no deal is ever struck. The problem is that for every proposed deal, at least one creditor can do better by holding out. Things are even more tenuous when the parties' varied interest are complex and difficult for others to ascertain, or when the parties place different valuations on assets or projects.[105]

But even where the parties do reach a negotiated outcome, the hold out incentives are problematic. Say, for example, only one party holds out. The parties may reach a Coasean bargain that preserves the firm simply by agreeing that the other stakeholders will pay a ransom to the hold out. In one sense, this is a fine outcome. The firm is preserved and the ransom is just a transfer of value. But there is a separate ex ante cost with respect to investment in the firm. The next time a potential stakeholder is investing in a relationship with a debtor, that investor will reflect on the possibility that when distress arises it will have to pay a ransom to a hold-out creditor to maintain the value of that relationship. Anticipating this result, the potential stakeholder will be reluctant to make the ex ante investment, thus reducing the sources of relationship-specific investment for all firms.

This is not a case where, ex ante, one stakeholder will charge more and another will charge less and total cost will remain constant. Rather, the credible hold outs are likely to be those who have not made relationship-specific investments, whereas those paying the ransom will be those who have. The result is a reduction in relationship-specific investment. To put it another way, hold outs in bankruptcy extract the greatest value when others have made investment that only have value when the debtor's going concern is preserved, and that provides a powerful incentive against making those investments.[106]

ii. The Incompleteness of Contractual Responses

One of the two main claims in this of this Article is that Chapter 11 provides bargaining parameters that are intended to move the parties—somewhat coercively—toward the ex post bargains necessary to preserve the firm while minimizing their

[105] See Baird and Rasmussen, *supra* note at 694 (describing how bargaining among sophisticated parties can collapse even when transactions costs are low because of problems stemming from "an empty core, radical disagreements about valuation, or strategic bargaining" and how it can be difficult to ascertain which of these is the problem in a given case).

[106] Prices and markets could adjust for this if each creditor provided equal amounts of relationship-specific investments, but that is an untenable equilibrium.

hold-up threats.[107] An alternative system—the one envisioned by contractarians and Creditors' Bargain theorists—might use ex ante rules in a contract or in legislation to strictly bind the relevant parties to take certain actions when financial distress arises. For example, creditors could agree to a defined trigger that automatically converts their claims to equity in order to eliminate debt overhang,[108] or they could agree to a trigger that creates an automatic commitment for certain creditors to provide a new loan.[109]

The difficulty for those mechanisms lies in the ex ante choice and definition of the precise remedial measures and the contingencies that will trigger them. The preceding subsection described distress generally, but every firm is distressed in its own way. Overhang and illiquidity might be caused by failed expansion, a cyclical downturn, technological change, a systemic liquidity shock, a supply shock, a demand shock, new competition, bad management, asymmetric information, or any combination of these or the many other possible candidates.

Moreover, the state of affairs when distress hits can take many forms. The creditors may include banks, vendors, hedge funds, or tort victims. They may be secured or unsecured. They may include many layers of priority or few. They may be dispersed or consolidated. They may include employees and competitors. They may have bought or sold claims to or from other claimants.[110] They may have conflicting investments.[111] They may hold hedged positions or complex financial derivatives like credit default swaps.[112] They may need cash immediately or they may

[107] For example, reorganization plans facilitated by Chapter 11 (11 U.S. § 1121-29) globally restructure relationships; debtor-in-possession financing (11 U.S.C § 364) and cramdown (11 U.S.C. § 1129(b)) coerce bargains to self-finance; various forms of partial consolidation across entities allow for affiliate financing (see, for example, *In re Gen. Growth Props., Inc.*, 409 B.R. at 61); and free-and-clear sales (11 U.S.C. § 363(f)) often result in sales to insiders.

[108] Professor Adler pioneered this idea. See Adler, *supra* note 65 at 312.

[109] See Ayotte and Skeel, *supra* note 8 at 1594 (exploring the idea of coerced loan commitments).

[110] Victoria Ivashina, Benjamin Iverson, and David C. Smith, *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings*, 119 J. Fin. Econ. 316 (2015); Jared Ellias, *Bankruptcy Claims Trading*, 15 J. Emp. Legal Studies 772, 795 (2018) (noting that claims trading is a pervasive feature of Chapter 11); Edith Hotchkiss and Robert Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1883 at 4; Anthony J. Casey, *Auction Design for Claims Trading*, 22 Am. Bankr. Inst. L. Rev. 133, 133-34 (2014).

[111] See, for example, *DISH Network Corp. v. DBSD N. Am., Inc.*, 634 F. 3d 79, 104 (2d Cir. 2011) (designating the vote of a creditor that also held significant investment in a direct competitor of the debtor).

[112] Baird and Rasmussen (2010), *supra* note 1 at 678-86.

be reluctant to cash out their interests for regulatory reasons.[113] They may be parties to agreements with other creditors that dictate their actions when distress arises.[114]

Finally, different constituencies may have invested deeply in the relationships that need to be renegotiated in bankruptcy. The debtor may face financial concerns, regulatory pressures, union negotiations, community pressures, or a declining customer base. Each of these problems implicates a different set of relationships as the subject for renegotiation.

In times of distress, the proper response for each party in these relationships turns on the specific characteristics of the entire constellation of interests. The best way to choose among and implement a reorganization, going-concern sale, or liquidation, will turn on the state of the market, the causes of distress, and the relationships that exist between the parties. The specific causes of distress will impact the willingness and ability of outsiders to provide new capital and of insiders to take a haircut or forbear on enforcing claims.[115] The specific agreements and relationships that exist at the time of distress will affect the creditors' ability and incentives to bargain toward an optimal outcome.[116] And so on.

If we imagine claimants bargaining ex ante, they will face insurmountable challenges.[117] Limits on information and time as well as the parties' incentives to bargain strategically will get in the way of their attempts to write contingent substantive rules for every distress situation. Similarly, attempts to write ex ante rules into legislation will be limited by the legislators' ability to predict and define contingencies. This is why the Creditors' Bargain model and the proposed solutions in its wake fall short.[118]

[113] See, for example, *In re RTJJ, Inc.,* No. 11-32050, 2013 WL 462003, at *15 (Bankr. W.D.N.C. Feb. 6, 2013) ("Under pressure from federal regulators, Community One seeks to rid itself of this nonperforming loan, at any cost. Its aims are noneconomic—at least as to this Debtor—and are destructive.").

[114] See, for example, *In re RadioShack Corp*., 550 B.R. 700, 703-05 (Bankr. D. Del. 2016) (noting a dispute arising out of a web intercreditor agreements that dictated the relationships between multiple creditors).

[115] For example, a cyclical downturn in the industry will limit investment from industry players and any sale to a strategic buyer. Andrei Shleifer and Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. Fin. 1343, 1344-45 (1992).

[116] Baird and Rasmussen (2010), *supra* note 1 at 687.

[117] Baird and Rasmussen (2010), *supra* note 1 at 698 ("the agreements will be incomplete and some recourse to gap-filling is necessary").

[118] This weakness in hypothetical bargaining solutions has been recognized for decades in the more general context of incomplete contracts. Ian Ayres and Robert Gertner, *supra* note 86 at 733 n. 17 (1992) (noting calls to move away from "hypothetical contract" approaches and "a growing consensus among contract scholars that default rules

The legislators can no more write the complete contract than the parties themselves.

Moreover, such a hypothetical complete contract—even if it could be written—will often produce *inefficient* outcomes because it fails to account for asymmetric information and strategic bargaining. As others have noted in the non-bankruptcy context, "When the parties have asymmetric information, however, the hypothetical contract standard fails to provide an effective framework for choosing efficient rules."[119] The framework fails because it assumes away the bargaining costs that are at core of the problem it is trying to solve.[120]

Also falling short are mechanisms aimed at bringing the creditors together to write a complete contract. If, for example, every debtor could opt in to its own customized set of bankruptcy rules and the law could facilitate the assent of all current and future creditors, those rules would still be incomplete because of strategic bargaining and limited information.

iii. The Need for a Bankruptcy-Specific Solution

Incomplete contracts are not a unique bankruptcy problem. Many contracts (and most legislation) are incomplete and raise questions about how to correct for gaps and otherwise incomplete terms.[121]

The law might, then, treat incomplete contracts in financial distress the same as any other incomplete contract. That entails

should not simply be the hypothetical contract that parties would choose in a world without transaction costs"); see also David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation,* 89 Mich. L. Rev. 1815, 1815 (1991) (noting that the hypothetical-contract framework is often "incorrect, perhaps even incoherent").

[119] Ayres and Gertner, *supra* note 86 at 733.

[120] To add some detail, imagine there are two types of creditors dealing with the debtor: A and B. The debtor cannot distinguish between them. In a perfect world, the debtor would pay A a certain price for an A-type contract and B a certain price for a B-type contract. But the parties withhold information and bargain strategically making it impossible to reach that outcome. Now imagine the law provides an immutable default rule that applies A-type rules to A and B-type rules to B. The debtor still cannot distinguish A and B ex ante. What price should the debtor pay to any given creditor? Moreover, we have now added a new wrinkle to the problem. Do all the parties have symmetric information about the default rules? If not, that could intensify strategic bargaining. You can add complications by assuming the creditors are the ones who cannot distinguish type or by assuming that parties can switch their type in response to the rule and so on. The point is that the rule that the hypothetical bargain produces does not solve the problems presented by the real bargain in these cases. Id. at 765.

[121] Ayres and Gertner, *supra* note 86 at 730-32 (describing how contracts are incomplete and require gap filling and reviewing scholarship on the problem); Kaplow, *supra* note 4 at 563 (describing the incompleteness problem for legislation).

a mixture of judicial gap filling[122] and enforcing terms as written. This is an imperfect response. When judges do not intervene, the incompleteness will remain.[123] And even when judges do intervene, they will fill gaps imperfectly and may be unable to verify the information necessary to enforce a contract.[124]

Similarly, lawmakers might write a law that approximates a hypothetical *incomplete* contract and let courts enforce that. That contract would probably be short and say something like, "The parties must behave reasonably in favor of efficiency when distress arises."[125]

Either approach would rely on the courts to fill the substantive gaps and would likely lead to different prescriptive outcomes from those advocated by the conventional law-and-economics theories of corporate bankruptcy.[126]

Chapter 11 does not take these approaches. There are at least two reasons for this. First, courts would be particularly bad at filling substantive gaps in times of financial distress. Courts are not expert at strategic business planning or financial structuring—especially not within an emergency timeframe. Not only does financial distress pose uncertainty, it does so in a context that requires decisions to be made fast. Firms in financial distress are often bleeding cash and their viability disappears quickly.[127] To be sure, the idea that a debtor business is a melting ice cube and that any delay threatens its viability is overplayed in bankruptcy courts.[128] Lawyers will argue that the court must decide in a matter of days. The reality is more like weeks or

[122] I will use "gap filling" to refer to a court directly filling in a missing term or rewriting a term that is at odds with the parties' interests. Ayres and Gertner, *supra* note 86 at 730-31 (noting that courts fill gaps both for "obligationally incomplete" and for "contingently incomplete" contracts).

[123] Parties may try to create private solutions. Scholars have suggested some private ordering measures to reduce hold-up problems associated with incomplete contracts. See, for example, Grossman and Hart, *supra* note 83; Hart and Moore, *supra* note 4. But most of those are not available in the corporate bankruptcy context. It is not feasible, for example, for a firm to integrate with all of its claimants.

[124] Ayres and Gertner, *supra* note 86 at 733 (noting the difficulty for courts to fill gaps).

[125] As an aside, it is interesting that the Creditors' Bargain literature rarely talks about whether the hypothetical contract is complete or incomplete, rule-based or standard-based, or whether it assumes perfect information of the bargainers.

[126] For example, criticisms of ex post judicial discretion interfering with ex ante contracting would be less powerful in cases like *General Growth* and *RadioShack*. See discussion below at Part II.C.

[127] See Jacoby and Janger, *supra* note 8 at 865 (noting that "[f]inancially distressed companies can melt like ice cubes").

[128] Id. at 865-676 (noting the prevalence and overuse of the melting ice cube argument); Lynn M. LoPucki and Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1, 30-31 (2007) (same).

months. But the *years* that courts often take to fill substantive gaps in other cases are not available in a corporate reorganization.

Second, this problem is ubiquitous. Virtually all firms that enter financial distress and need to be reorganized face major incomplete contracting problems. Of course, if the firm has totally failed and has no going concern value, it can be liquidated easily. But firms that go into Chapter 11 reorganization are navigating questions of how to preserve going concern value in the face of claims by multiple parties with different interests in the firm's survival.[129] Those parties naturally have different views and different incentives for how to achieve the best reorganization outcome. This state of affairs poses complicated questions of valuation, control, and vision to which their contracts provide incomplete answers.

The ubiquity of the problem begs for a standardized solution. Given a class of relationships that routinely raise an incomplete contracting problem that the courts are bad at solving substantively, it makes sense to adopt a uniform procedural solution that reduces hold up and increases predictability. If courts will inevitably be involved when distress arises, the law can add value by providing a procedural framework for that involvement. There is little risk of market distortion in legislating a court-supervised procedure over a set of relationships that will require deep judicial intervention in any event. Indeed, the law can reduce distortions if it adds predictability and reduces errors. If courts are error prone in substantive gap filling, bankruptcy law can prescribe mechanisms that address incompleteness but constrain substantive gap filling as much as possible.

Moreover, resting that system in one central (federal) court increases predictability and reduces forum shopping that would otherwise result.[130] There are also economies of scale in using a uniform mechanism to address incomplete contracting in the context of financial distress. With corporate bankruptcy, the hold-up problem is front and center in virtually every case and it is always triggered by the same thing: financial distress. There is a

[129] Baird and Rasmussen (2010), *supra* note 1 651-53.

[130] One must not, however, be too optimistic. Forum shopping is reduced, but it is surely not eliminated by moving cases into the federal system. Parties can still use variations in the way different federal bankruptcy courts apply the law to extract value from each other. See Laura Napoli Coordes, *The Geography of Bankruptcy*, 68 Vand. L. Rev. 381, 384-87 (2015).

unique efficiency,[131] then, in funneling this entire class of cases into one uniform system in one court that specializes in resolving this type of hold-up problem.[132] As the courts gets better at policing hold up, the system becomes more efficient and more predictable.[133]

This also suggests that a uniform government system might be preferable to private arbitration systems where the economies of scale might be lost, repeat players – like banks – might take advantage of asymmetric knowledge and their relationships with the private arbitrators, or strategic bargaining might otherwise lead to incomplete arbitration contacts.[134]

The same cannot be said of the judicial regulation of incomplete contract disputes generally. While most contracts are incomplete in some way, not all contract disputes present problems related to that incompleteness. Nor do all incomplete contracts present hold-up problems related to relationship-specific investment or going concern value. The volume of general contract disputes that present procedurally similar hold-up problems is likely not high enough to justify a special uniform system of laws and a specialized court to resolve those problems. Moreover, even if such a court did exist it would be difficult at the beginning of each litigation to distinguish the hold-up cases from the other general contract disputes in order to select cases into the specialized court.

Looking beyond the United States adds support to this story. As financial markets around the world develop faster than local insolvency law, incomplete contracting problems related to financial distress produce pressures that demand solutions of the

[131] The choice of whether to judicially regulate incomplete contracts always poses a cost comparison between the costs of allowing parties to simply live with the contracts as written and the costs of judicial involvement. Ayres and Gertner, *supra* note 86 at 734 (noting the "horse race" between the competing costs). The economies presented here reduce the costs on the judicial involvement side of the equation and make it more cost effective to judicially regulate incomplete contracts problems here than elsewhere.

[132] This does imply that bankruptcy courts must be vigilant about dismissing cases that are not in this class because they are not related to financial distress or hold up. This requires a robust good-faith filing rule. See *In re Integrated Telecom Express, Inc.,* 384 F.3d 108, 119 (3d Cir. 2004) (describing good-faith-filing rules).

[133] There will be growing pains when a country first adopts a bankruptcy system as its judges develop this expertise or if they assign bankruptcy matters to non-specialized courts. See, e.g. Andy Mukherjee, *India's Bankruptcy Gets a Dose of Common Sense*, Bloomberg.com July 17, 2019 available at https://www.bloomberg.com/opinion/articles/2019-07-18/india-s-creaking-bankruptcies-get-lubrication (noting that judges had misapplied India's new bankruptcy law necessitating a bold and quick amendment to clarify the law).

[134] See Ayers and Gertner, *supra* note 4 at 64 (describing the difficulties in writing complete arbitration contracts).

sort described in this Article. Some jurisdictions allow those pressures to build, only to see dysfunction and hold up grow along with varied calls for reform.[135] In a financial system without a functioning insolvency law, the bankruptcy state of nature is likely to take one of two extreme forms. Either creditors are left free to enforce contract terms harshly and formalistically[136] or courts ignore contracts altogether and focus on ex post rescue measures without regard to the distortions those measures might create.[137] Both options allow for hold up, either by the creditors or by equity and management.

A contractarian might object that the relevant parties should be free to choose their own contract terms, even if those terms are vague and incomplete. The question still remains, however, as to how a court should deal with that incompleteness and the unintended consequences of those agreements. Bankruptcy law has emerged as a tool for doing that. It is likely that most parties would prefer such a system if it provides more predictability and less hold-up opportunity than the bankruptcy state of nature, which provides no uniform guidance to or constraint on those filling the gaps and correcting for incompleteness. But even if the parties do not prefer a standard uniform system of bankruptcy law, once they enter into incomplete contracts it is consistent with an efficiency principle to funnel their disputes through a uniform system to avoid inconsistencies, externalities, market inefficiencies, and the waste of judicial resources that would otherwise occur.

B. Chapter 11's Renegotiation Framework

We turn now to Chapter 11's specific approach to solving the hold-up problem associated with financial distress.[138] Consistent

[135] See sources cited *supra* note 82.

[136] There are historical examples of this. Elena Cirmizi, Leora Klapper, and Mahesh Uttamchandani, *The Challenges of Bankruptcy Reform*, 27 The World Bank Res. Observer, 185, 189-90 (2012) (noting that harsh pro-creditor formalism in nineteenth century France and Italy resulted in lower returns for creditors).

[137] This is the more likely dysfunction today. For example, Professor Van Zwieten chronicles the Indian story where judges' ex post "pro-revival" interventions—"motivated by broader concerns, including the desire to strengthen the industrial sector in newly independent India, and an anxiety to protect workers of sick industrial companies from unemployment"—led to delay, inefficiency, dysfunction and ultimately the need for reform. Van Zwieten, *supra* note 82 at 8-9.

[138] Some relationships that relate to financial distress do not fall under the scope of Chapter 11—although the theory in the New Bargaining Theory suggests that they should. The ways that those relationships play out provide powerful examples of the incomplete contracting problem and the potential value of the bankruptcy solution. For example, the credit default swaps market is full of examples of ex post hold up. See, for example, Matt Levine, *Direct Listings Are a Thing Now, Also Bathroom Meetings, Sears*

with the New Bargaining Theory, Chapter 11 treats the relationship between those who have an interest in a financially distressed debtor as governed by an incomplete contract. Where there is little reason to suspect that terms will misfire—because the parties had full ex ante information or because the efficient outcome is not affected by contingencies—the law takes those terms as they are and enforces them.[139] Where the terms might be expected to misfire, Chapter 11 implements a structured renegotiation framework. Rather than fill the gaps with specific substantive provisions or remove incomplete terms, the code uses a set of parameters to encourage renegotiation and limit the parties' incentives and opportunities to engage in hold up.[140]

In some sense, the system is filling in the gaps in these contracts, but instead of having a judge do it, the parties negotiate the gap-filling terms applicable in distress under the court's oversight and within the law's parameters.[141] Chapter 11 sets up substantive and procedural guardrails that are intended to direct the parties toward an optimal bargain with minimal hold up. It consolidates bargaining power by consolidating parties and their interests into classes and other groupings. It then rules out

CDS and Bank Culture, available at https://www.bloomberg.com/opinion/articles/2019-01-11/direct-listings-are-a-thing-now (January 11, 2019) (noting the ex post manipulation of bond prices that are used in calculating CDS payouts related to the Sears bankruptcy and explaining the difficulty in writing a better ex ante contract); Matt Levine, *RadioShack Is Running on Credit Derivatives*, available at https://www.bloomberg.com/opinion/articles/2014-12-18/radioshack-is-running-on-credit-derivatives (Dec. 18, 2014) (same for RadioShack); see also Andrew Verstein, *Benchmark Manipulation*, 56 Bost. Col. L. Rev. 215 (2015) (exploring ex post benchmark manipulation generally).

[139] In this sense, the New Bargaining Theory and the renegotiation framework supports a soft version of Butner not as a principle but as a weak rule of thumb. In the absence of any evidence of hold up, non-bankruptcy provisions should remain intact. That is true simply because in the absence of hold-up there is no role for bankruptcy law.

[140] The specific contours of the structure can be found throughout the Chapter 11 and include committee representation, § 1102, the creation of creditor classes, § 1122, disclosure and solicitation rules, § 1125, voting rules, § 1126, the exclusive power of the debtor to propose a plan, § 1121, minimum plan requirements such as feasibility and the best interest of the creditors test, § 1129(a), and cramdown rules, §1129(b). Other aspects can be found in judicial interpretations of the code through case law. These aspects are discussed in detail in this sub-section and below in notes 224 through 228.

[141] Professors Skeel and Triantis make note of the role of rules and standards and renegotiation in bankruptcy theory, but they place more trust in ex ante contracting than Chapter 11 does. This might be the strongest normative critique of Chapter 11's renegotiation framework: Bankruptcy law makes the wrong empirical assessment about the difficulty in ex ante contracting and the ability to constrain ex post contracting. Skeel and Triantis, *supra* note 30 at 1816. I am more optimistic that our bankruptcy system usually gets it right. The important point is that the New Bargaining Theory identifies this as *the* key empirical question in assessing Chapter 11. It is a difficult question to answer. Comparing the experiences in markets in other jurisdictions around the world might begin to provide some guidance.

bargaining positions that are either clearly inefficient or are very likely to lead to hold up. And for close issues, it requires the parties to subject their renegotiation maneuvers to procedural scrutiny and valuation to limit the possibility of hold up (this is where most of bankruptcy law happens).

In taking this approach, the law accepts that the court cannot know precisely if ex post interventions are efficient.[142] As noted throughout this Article, the idea of what is efficient and inefficient is dynamic. Bankruptcy law takes into account the possibility that rules in bankruptcy will have costs outside of bankruptcy. The key is to measure the benefits of a bankruptcy mechanism against the costs it creates outside of bankruptcy by distorting behavior. Because it is difficult for anyone—and especially courts—to measure these costs and benefits exactly, the law implements a proxy system with bargaining and pricing mechanisms where parties must either present extreme evidence to support a bankruptcy intervention or pay an estimate of a market price in exchange for invoking the intervention.

More specifically, Chapter 11—through specific provisions or through the discretion of judges—sets certain default rules and then gives different parties power to alter those rules. But it subjects that power to market prices and evidentiary burdens to show good faith or efficiency. A default rule is set. Then the party against whom the rule operates is given power to alter that rule. That power, however, is subject to a pricing system or evidentiary obligation. Sometimes the party altering the rule must pay a price or meet a burden to do so. Other times the other party can pay to negate an altering rule and maintain the default. The allocation of payment obligations and burdens and the precise nature of the altering rules are determined based on rough predictions about the relative likelihoods regarding the sources of hold up. Once the Bankruptcy Code or court sets these prices and evidentiary burdens, the parties then renegotiate their relationship under court supervision.

[142] Various scholars have recognized this problem. Adler and Triantis, *supra* note 63 at 582; Skeel and Triantis, *supra* note 30 at 1783, 1816; Ayotte and Skeel, *supra* note 8 at 1557; Anthony J. Casey and Edward R. Morrison, *Beyond Options*, working paper available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2855954; see also Lucian Arye Bebchuk and Randal Picker, *Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital*, at 2-4 (1993) available at https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1073&context=law_and_economics (noting the importance of measuring the ex ante effects of ex post interventions).

We can think of this regime as "cramdown for everything" because its functioning is clearest in the familiar cramdown provisions of the Bankruptcy Code.[143] Foreclosure rights are ripe for hold up because the parties cannot contract over all of the possible contingencies involved—things like the value of the asset being foreclosed, its importance to the firm's going concern, volatility, information asymmetries that affect the availability of financing for the asset, and the creditor's own liquidity constraints. The Bankruptcy Code therefore allows a debtor the power to alter the default rule and deprive a creditor of its foreclosure right in a plan of reorganization. This ensures that the secured creditor cannot use an incomplete foreclosure contract to hold up the debtor and other creditors by threatening to withdraw a key asset in distress.

But the Bankruptcy Code also imposes constraints on the debtors' power. To deprive a secured creditor of its foreclosure right, a debtor must do one of three things in a reorganization plan.[144] First, the debtor can give the creditor the proceeds of a sale of the asset if the creditor is allowed to bid in the sale.[145] This ensures that the ultimate buyer values the asset more than the secured creditor, eliminating the debtor's opportunity to use the threat of a sale to extract value from the creditor. The creditor either gets the asset or gets paid more than its subjective value of the asset.

Second, the debtor can "cram down" the secured creditor by providing it with a new lien and payments that are valued against what a new loan on similar terms would cost the debtor on the market.[146] This ensures that cramdown will not give the debtor better than market terms, thus reducing the debtor's incentive and ability to use cramdown threats to extract value in the form of below market terms from the creditor.[147] The only benefit the debtor gets from cramdown is eliminating the transaction costs

[143] 11 U.S.C. § 1129(b).

[144] 11 U.S.C. § 1129(b).

[145] 11 U.S.C. § 1129(b)(2)(A)(ii) and 11 U.S.C. § 363(k).

[146] 11 U.S.C. § 1129(b)(2)(A)(i). This is my view of the proper reading of the statute. Anthony J. Casey, *Bankruptcy's Endowment Effect*, 33 Emory Bankr. Dev. J. 141, 170 (2016). The Second Circuit has adopted this approach, but the question is unsettled in the courts. *Matter of MPM Silicones, L.L.C.*, 874 F.3d 787, 800-01(2d Cir. 2017).

[147] See Casey, *supra* note 146 at 161. *MPM Silicones, L.L.C.*, 874 F.3d at 792 and 800 (debtor threatened to cram down an interest rate $150 million below the market rate to extract procedural concessions).

and asymmetric information problems associated with finding a new loan.[148]

Third, the debtor can provide the creditor with some form of compensation that is the "indubitable equivalent" of the creditors' contract right.[149] This ensures that the court can allow for unusual solutions that are efficient and avoid the possibility of a secured creditor holding up the debtor by insisting on foreclosure when some other better solution is "indubitably" available. That last standard—"indubitable"—imposes a high burden because in most cases the court will not be able to measure the equivalence with precision.[150]

Thus, the parties must negotiate their way to payment, sale, foreclosure, a new lien, or something else. The alternative to a negotiated agreement is in the hands of one party—the party who might be held up by the default rule—who chooses between the default rule or an alteration subject to paying some value or meeting some burden of proof. Chapter 11 puts in place these guardrails to make certain outcomes easier or harder for parties to force on each other depending on how much the system trusts the court to protect against misbehavior by the party advocating that outcome.[151] Because the debtor has the power to alter the default rule and cram a plan down on creditors—which becomes the alternative to a negotiated agreement—the debtor bears the burden of (1) providing an auction where the creditor is allowed to bid, (2) providing new loan terms that it can prove match the market, or (3) proving that it is providing an indubitable equivalent of the right that is being altered.

As another example, the Bankruptcy Code implements a similar but more crude approach to the assumption of executory contracts.[152] Because the stakes are lower, the code requires a more approximate measure of the market price, requiring the debtor to cure all past defaults in order to assume a contract.[153]

[148] This does require the court to estimate the market value of the new loan. Evidence of that value is often available. See, for example, *Matter of MPM Silicones, L.L.C*, No. 14-22503-rdd, 2014 WL 4436335, at *11, 25–29 (Bankr. S.D.N.Y. Sept. 9, 2014).

[149] 11 U.S.C. § 1129(b)(2)(A)(iii).

[150] Douglas G. Baird and Anthony J. Casey, *Bankruptcy Step Zero*, 2012 S Ct Rev 203, 220 (noting that the courts' discretion is limited by the standard of indubitable equivalence to avoid erroneous dilution of a creditor's claim).

[151] The system operates as a set of altering rules customized to the law's expectations about hold-up behavior. For more on altering rules, see Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L. J. 2032 (2012) (developing a theory of altering rules).

[152] 11 U.S.C. § 365. A similar analysis applies to questions about critical vendor orders. See below at note 224.

[153] 11 U.S.C. § 365(b)(1)(A).

Bankruptcy law thus allows a debtor to enforce executory contracts that it has breached.[154] This right ensures that the counterparty cannot use a technical breach to hold up the debtor by withdrawing a key agreement from the debtor's relationships. But the debtor must first cure all past defaults.[155] This serves as a price that roughly estimates the market value of the breached contract terms. It ensures that the debtor does not use bankruptcy to hold up the creditor by ignoring the value of substantive obligations in their relationship.[156]

Throughout the code, there are price and burden allocations like this that allow a party to pay a cramdown price of sorts to alter a rule that would otherwise apply. The code implements this framework where the underlying terms of the parties' relationships are expected to misfire and provide hold-up opportunity. The prices and other limiting principles give the court comfort that the likelihood of abuse by the party altering those terms is low. Within the parameters set by these rights, prices, and limitations, the parties find their negotiating positions and bargain with each other. Thus, Chapter 11 implements default rules, and then layers on altering rules[157] in the form of prices or other undertakings required to demonstrate a reduced risk of hold up.[158]

C. The Balance between Ex Ante and Ex Post Concerns

Like the law of general averages, the New Bargaining Theory and Chapter 11's renegotiation framework take into account ex ante incentives. In the admiralty context, you could, of course, achieve the efficient ex post outcome by transferring title to all cargo to the captain (or any decision maker) at the moment the ship hits distress.[159] This would efficiently align ex post control

[154] 11 U.S.C. § 365.

[155] 11 U.S.C. § 365(b)(1)(A).

[156] This analysis suggests a justification for the current rule. It provides a counterargument to Professor Skeel's proposal to do away with the requirement that the debtor cure prebankruptcy defaults. See David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors"*, 166 U. Pa. L. Rev. 699, 721-22 (2017).

[157] For more on the theory of altering rules, see Ian Ayres, *supra* note 151.

[158] Examples exist throughout the Bankruptcy Code. I discuss two major examples in Part III. Another prominent nonprice example is the requirement that a plan of reorganization have one impaired class of creditors vote in favor of it. 11 U.S.C. § 1129(a)(10). This is intended to reduce—but certainly does not eliminate—the risk that a proposed plan is an inefficient hold-up maneuver asserted against impaired creditors. This purpose of § 1129(a)(10) is clear. In practice it is not difficult to circumvent and may do very little.

[159] In bankruptcy, Professor Adler has made a proposal like this that gives complete ownership to a creditor class when distress hits. See Adler, *supra* note 65.

and ownership. But few would advocate for that law. The captain would do everything she could to lead the ship to distress and others would be reluctant to even bring cargo onto the ship. Similarly, few would advocate giving the ownership of all cargo to the poorest passenger when distress arises to achieve general redistributive justice. In addition to being one of the worst possible means for redistributing wealth, this measure would also distort predistress incentives by causing the poorest passenger to favor distress and distort ex ante incentives by driving other passengers out of shipping markets and perhaps leading captains to reject poor passengers altogether.

Chapter 11 likewise considers the impact of its interventions on ex ante and predistress incentives. But unlike the law of general averages, it does not implement a blanket rule of average contribution.[160] Rather it encourages the "passengers" to negotiate over their contributions under court supervision and within certain parameters.[161]

In all of this, there is no reason to think interventions that focus on ex post outcomes are per se inefficient. Consider the high-profile bankruptcy of General Growth Properties.[162] The court's ruling in that case has been criticized for ignoring ex ante contracts in the service of ex post value maximization.[163] To provide a short summary, in 2009, General Growth Properties faced a liquidity crisis. The firm had a profitable business, but it owed balloon payments on loans that it could not refinance in the midst of the Great Financial Crisis. A bankruptcy filing for the whole enterprise—parent and subsidiaries—provided a solution.[164]

There was one problem, the subsidiaries of the business were set up to be bankruptcy remote.[165] The legal structure of the

[160] See, for example, Skeel, *supra* note 78 at 701 (noting the lack of equality norms in Chapter 11 practice).

[161] This is a form of coerced ex tempore contracting. See Andrew Verstein, *Ex Tempore Contracting*, 55 Wm. & Mary L. Rev. 1869, 1881-86 (2014) (introducing the concept of privately agreed to ex tempore contracting).

[162] *In re Gen. Growth Props., Inc*., 409 B.R 43 (Bankr. S.D.N.Y. 2009).

[163] See, for example, Brian M. Resnick and Steven C. Krause, *Not So Bankruptcy-Remote SPEs and* In re General Growth Properties, Inc., 28 Am. Bankr. Inst. J. 60 (2009) (noting that the case "was viewed by many market participants as inconsistent with the protections thought to be provided to lenders in structured finance transactions involving bankruptcy-remote vehicles in the event of a bankruptcy of their corporate parent"); W. Rodney Clement Jr. and H. Scott Miller, *General Growth: Special Purpose Entities (Barely) Survive First Bankruptcy Test, Prob. & Prop*., Mar.–Apr. 2011, at 31, 32; Jesse Cook-Dubin, *New York Bankruptcy Court Topples Contractual Barriers to Filing Chapter 11*: *Part II*, 28 Am. Bankr. Inst. J. 16 (2010).

[164] *Gen. Growth Props*., 409 B.R. at 54-55.

[165] Id. at 63-64.

subsidiary entities, their corporate governance documents, and their agreements with lenders ostensibly prevented them from filing for bankruptcy.[166] The parent caused the subsidiaries to file bankruptcy anyway.[167] The creditors of the subsidiary entities challenged this maneuver.[168] In the end, the bankruptcy court allowed the filings notwithstanding the agreements set up to prevent them.[169] Critics predicted that this would lead to an increase in ex ante interest rates as creditors no longer trusted the enforceability of their agreements.[170] There is no evidence that such increase ever occurred.

One might even predict the opposite result. At the end of the day, the General Growth bankruptcy was a great success story.[171] All stakeholders' claims were paid in full, equity retained its value, and the company was successfully reorganized.[172] It might actually demonstrate that courts are good at determining when hard-edged contract terms misfire. Perhaps the case was evidence that courts will ignore those terms if, but only if, someone has made a sufficient showing that the terms are inefficient, that they are being invoked as a hold-up maneuver, that deviating from them won't create hold up on the other side, and that an appropriate pricing mechanism has been implemented.[173] The court may have reached a high degree of confidence in its conclusion that the creditors of the subsidiaries were using an incomplete contract to hold up the firm and extract individual gains from the enterprise.

[166] Id.

[167] Id. at 54-55.

[168] Id. at 55.

[169] Id. at 69.

[170] See Resnick and Krause, *supra* note 163.

[171] Ilaina Jonas, *General Growth Cleared to Exit Bankruptcy*, Reuters (Oct. 21, 2010) (noting the success of the reorganization)

[172] Id. (noting the full payment of bonds and an equity value of $5.2 billion).

[173] The court did require some significant proof on these matters. *In re Gen. Growth Props., Inc.*, 409 B.R. at 63 (noting that the ruling produced "no sacrifice of fundamental rights"); at 65 (noting the irony of the opportunistic use of "leverage" by the party trying to enforce the contract terms); at 67-70 (repeatedly noting the "good faith" of the debtor); at 69 (noting the other bankruptcy measures available to creditors to limit the debtors attempts to hold them up); at 55 (noting that the order allowing use of cash "had various forms of adequate protection… such as the payment of interest at the non-default rate, continued maintenance of the [subsidiary] properties, a replacement lien on the cash being upstreamed… and a second priority lien on certain other properties"). The court may have simply concluded that it is worth saving this one company in this unique set of circumstances because lenders will know that the threshold for such intervention is sufficiently high to avoid market distortions. But counterexamples may appear if courts are not vigilant about hold up. For example, in *Matter of MPM Silicones, L.L.C.*, the court allowed the debtor to exercise ex post control over interest rates to extract concessions and value from creditors before the opinion was reversed on appeal. 874 F.3d at 787.

Indeed, if one thinks that bankruptcy disputes are rare relative to the number of firms operating in the market and if Chapter 11's renegotiation framework is good at excluding extreme bad faith positions, then one might conclude that Chapter 11 could interfere with all kinds of nonbankruptcy entitlements to create ex post value without imposing distortionary costs on the market. The actions and statements of judges in recent bankruptcy cases are consistent with this analysis. As one prominent bankruptcy judge recently explained, bankruptcy courts are reluctant to enforce contract terms that allow a creditor to opportunistically extract extra value, noting that "bankruptcy courts have, in a variety of different contexts, struggled mightily and usually successfully to avoid giving a party a windfall."[174]

The question in all of this is how much we trust the process to identify these things. Chapter 11 relies heavily on the parties and finds comfort when sophisticated parties have bargained vigorously toward an arm's length resolution.[175] And judges do require a high level of confidence before exercising their discretion to achieve ex post value.[176] If we think this setup gets things wrong, then Chapter 11 does not work well. If we think the courts have a good process for ruling out extreme behavior, keeping the parties within the guardrails, and operating within an acceptable margin of error, then Chapter 11 is successful.

*   *   *

[174] Judge Brendan Shannon, *ABI's 200th Podcast Features Judge and Academics Discussing Side Agreements in Corporate Bankruptcy*, at 27:48 available at https://www.abi.org/podcasts/abis-200th-podcast-features-judge-and-academics-discussing-side-agreements-in-corporate (2017); see also Ayotte, Casey, and Skeel, *supra* note 30 at 269-72 (providing a detailed analysis of the RadioShack bankruptcy suggesting that the court may have interpreted contract rights to avoid hold up and facilitate an efficient sale of assets). See also *In re Lyondell Chem. Co*., 402 B.R. 571, 594 (Bankr. S.D.N.Y. 2009) ("There will sometimes be a harm requiring judicial intervention where the needs and concerns of other creditors simply trump commercial predictability.").

[175] Ayotte, Casey, and Skeel, *supra* note 30 at 286 (noting that the system depends on the bargaining positions of sophisticated creditors to provide benefits to the estate as a whole); Douglas G. Baird, *Bankruptcy's Quiet Revolution*, draft available at https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2435&context=law_and_economics at 17 ("Bankruptcy is designed so that the most active and vigilant creditors protect others at the same priority level.").

[176] See, for example, the discussion *supra* note 173 presenting the thorough nature of the judicial inquiry in the *General Growth* case. See also Shannon, *supra* note 174 at 27:48 (discussing the considerations of bankruptcy judges in dealing with contract terms that present "windfalls" in various cases).

One final and important critique of Chapter 11's renegotiation framework might be that destroying value ex post is actually a good thing. As many—including me—have pointed out, there is a positive disciplining effect from destroying value in bankruptcy.[177] Parties have an incentive to avoid distress if they will be punished when distress arises.[178] Creditors can use that incentive as a substitute for monitoring the debtor or each other.[179]

One could imagine a rule that allows the use of bankruptcy penalties but only if the court is sure that the penalty clause is a substitute for monitoring. Penalties like this work by making control and payment rights state contingent.[180] But what if the specifics of that contingency are themselves noncontractible? Defining the different states that trigger the contingency might be very difficult and that is where the renegotiation framework comes in. Bankruptcy law might treat state-contingent penalty terms as incomplete contracts that may or may not provide the opportunity for hold up depending on how things have played out in a specific case.

There is good reason to think state-contingent penalty terms are, indeed, incomplete. The tradeoff between the value preserved through ex post intervention and the ex ante discipline created by ex post penalties will always be uncertain. To put it another way, which is the first order problem—the ex ante incentives or the ex post coordination?[181] Parties cannot know the answers to these questions when they initially write their contracts. They would have to know the actual cause of distress. For example, can one really posit that General Growth, Kodak, American Airlines, Calpine, Toy "R" Us, United Airlines, and the like all would have avoided distress if only the decision makers had known that

[177] See Douglas G. Baird and Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 Col. L. Rev. 1, 9 (2013).

[178] Philippe Aghion and Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 Rev. Econ. Stud. 473, 490-91 (1992).

[179] Id.

[180] Id.; Patrick Bolton and David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. Pol. Econ. 1, 5–8 (1996); Jaime F. Zender, *Optimal Financial Instruments*, 46 J. Fin. 1645, 1647 (1991). This academic theory may play a minor role in practice. There are other means of punishing managers, and equity is usually wiped out in bankruptcy. The prime question in practice is whether to penalize junior creditors. Unless junior creditors are calling the shots (at least indirectly) before bankruptcy, there is little sense in punishing them after the filing. Indirect action would arise if the junior creditors were the optimal monitors. Then the penalties on them would be a way for senior creditors to "monitor the monitors."

[181] Professor Ayotte's models have flagged a similar problem. See Ayotte, *supra* note 66; Ayotte, *supra* note 30.

bankruptcy would be more severe? On the other side of the equation, would the reorganization values have been much lower if some creditors were allowed to inflict more pain on others when distress arose? The answer is likely different for each debtor. An optimal approach would be to say that if misbehavior is likely to have occurred and may have contributed to the distress, then and only then do we want to enforce reasonable penalty terms. And it may be that judges—even though they are not great at knowing exactly how to substantively restructure a company's finances—are pretty good at implementing Chapter 11's renegotiation framework and using its guardrails to detect when distress is a result of poorly disciplined management or uncontrollable market forces and which penalty terms are worth enforcing.

D. A Limited Scope

Because bankruptcy law is not a general welfare system, it should not address problems unrelated to distress. This conceptual limitation has several justifications: 1) doctrinal reasons grounded in constitutional law and federalism;[182] 2) institutional reasons grounded in a view of the appropriate authority for making those decisions;[183] and 3) efficiency reasons concerned with distorting incentives of parties in filing, avoiding, or pursuing bankruptcy.[184]

Saying that bankruptcy law is limited in scope and should address bankruptcy matters is not the same as the Butner Principle. Bankruptcy law should be directed at bankruptcy matters. But once you have identified a bankruptcy issue, nothing

[182] Mooney, *supra* note 8 at 960-62, 977-78; Thomas E. Plank, *Bankruptcy and Federalism*, 71 Fordham L. Rev. 1063 (2002); Robert H. George, *Bankruptcy for Nonbankruptcy Purposes: Are There any Limits?*, 6 Rev. Litig. 95, 128 (1987).

[183] George, *supra* note 182 at 128.

[184] Baird, *supra* note 40 at 592 n. 58 ("The basic idea is a straightforward one: If there are two different legal regimes, parties will invest considerable energy in finding the legal regime that most favors them. A rule that applies only in bankruptcy necessarily invites some parties to resolve the issue someplace else. Resources are wasted in the battle over where the fight takes place. More importantly, when the non-bankruptcy forum is actually used, any substantive policy put in place only in the bankruptcy forum will be irrelevant."). Though it is not a corporate issue, the parking-ticket-and-bankruptcy debacle in Chicago is a great example of this. A discriminatory parking-enforcement policy in Chicago has led thousands of black debtors to file for Chapter 13 bankruptcy simply because it provides the only relief to parking-ticket enforcement. This has swamped the bankruptcy courts, imported the racial disparities that exist in parking enforcement into the bankruptcy system, and cost black drivers thousands of dollars in legal fees. It is abundantly clear that a fix to the parking ticket system independent of bankruptcy law would be better. Edward R. Morrison and Antoine Uettwiller, *Consumer Bankruptcy Pathologies* 173 J. Inst. & Theoretical Econ. 174 (2017); Anthony J. Casey, *Consumer Bankruptcy Pathologies: Comment on Morrison and Uettwiller*, 173 J. Inst. & Theoretical Econ. 197 (2017).

about the New Bargaining Theory requires special deference to nonbankruptcy rights. Rather, as demonstrated in the previous section, the theory merely requires that any measure implemented to create value in bankruptcy must not destroy more value by distorting incentives in other states of the world.

True enough one way that value can be destroyed is through forum shopping where parties expend resources to manufacture a bankruptcy to change nonbankruptcy entitlements.[185] But the New Bargaining Theory shows us that the only relevant question is whether the costs imposed by forum shopping outweigh the benefits created by reducing other forms of hold up. Butner asks the question but provides nothing in the way of answers.

The New Bargaining Theory on the other hand instructs that the farther the parties' interests are away from a relationship involving the debtors' assets the more skeptical the law should be in assuming that it can alter those interests to the collective benefit of all interested parties without causing collateral damage. Thus, bankruptcy law generally does not take into account a creditors' outside interests such as investments in a competitor when implementing bankruptcy's purpose.[186] Likewise, it generally does not alter the interests of those with no connections to the debtor.

The economics literature on incomplete contracting allows us to state this idea more formally. Incomplete contracting leads to hold-up problems when parties have made relationship-specific investments.[187] Thus, the bankruptcy solution to incomplete contracting over financial distress is only relevant to situations where the parties have made such investments.

Parties who have no direct or indirect relationship with the debtor have made no investments specific to a relationship affected by the debtor's financial distress and are—by definition—not subject to an incomplete contracting problem with regard to that distress. On the other hand, those who have non-claim relationships with the debtor might still be included in the partition if they have invested specifically in those relationships or if those relationships affect the debtor's going concern value.

The scope of bankruptcy is, then, the set of relationships where going concern value is implicated and parties have made relationship-specific investments that are affected by the debtor's distress. Importantly, this suggests a broader scope than the

[185] Baird, *supra* note 40 at 592 n. 58.
[186] See Baird, Casey, and Picker, *supra* note 48 at 1683.
[187] See above at Part II.A.iii.

Creditors' Bargain theory and a broader scope than some courts have been willing to adopt. The interest of non-claimants who have made such investments will be relevant to and subject to the bankruptcy power.[188]

Likewise, contracts that are not directly with the debtor but reflect specific investments in the debtors' network of relationships or going concern value will be bankruptcy matters. For example, consider the question of non-consensual third-party releases. Third-party releases are provisions in reorganization plans that release one party from liability on a claim held by another party even when the debtor is not a party to the claims.[189] The controversy arises when the party holding the claim does not consent to the release.[190] The New Bargaining Theory suggests that the bankruptcy courts can release claims between creditors if 1) those claims are connected to the creditors' relationship with the debtor and 2) doing so prevents hold up and facilitates efficient ex post bargaining.[191] Of course, consistent with the New Bargaining Theory, there also needs to be a check on the converse hold-up behavior that could arise from *allowing* such releases. That check will take the form of a cramdown payment from the debtor's estate to the party being forced to provide the release.[192] The appropriate amount of that payment will be an estimate of the market value of the released claim. Alternatively, the court could request indubitable proof that the released claims have de minimis value or that the debtor is not using the releases to extract hold-up value. Once the court sets the price and evidentiary burdens, then the parties can begin their bargaining. These measures reduce the potential for debtors to use third-party releases as a form of hold up.

Relatedly, the New Bargaining Theory suggests that intercreditor agreements—which often bind creditors to abstain from certain procedural maneuvers in a bankruptcy proceeding—

[188] The most likely expansion will be along the dimension of human capital, which is a major relationship-specific investment associated with most firms. See Margaret Blair, *Firm-Specific Human Capital and Theories of the Firm*, in EMPLOYEES AND CORPORATE GOVERNANCE at 58 (Eds. Margaret Blair and Mark Roe) (1999). In practice courts are inconsistent in how much consideration they give to these kinds of interests.

[189] See *In re Dow Corning Corp.,* 280 F.3d 648, 658 (6th Cir. 2002) (defining third-party releases).

[190] Id.

[191] One court has applied a standard similar to this in the related context of staying third-party litigation. *Fisher v. Apostolou*, 155 F.3d 876, 882 (7th Cir. 1998) (staying litigation that was sufficiently related to the debtor and when not granting the stay could allow one party to derail the reorganization proceedings).

[192] See Baird, Casey, and Picker, *supra* note 48 at 1688 (raising the possibility of requiring such a payment).

should fall under the bankruptcy umbrella even when the debtor is not a party and even when the agreements contain forum selection clauses suggesting otherwise. In practice, the hold-up risk in intercreditor agreements is high.[193] As a result, courts should not enforce them specifically unless the party seeking enforcement meets a very high evidentiary threshold to show that there is no value extraction.[194] But consistent with the analysis above, the court should impose a market price on the party seeking to escape enforcement. That price should take the form of expectation damages.[195] Once again, this system reduces the opportunities for hold up on both sides.

III. Additional Applications: Cramdown for Everything

As noted above, bankruptcy's cramdown provisions provide a clear example of the New Bargaining Theory at work in Chapter 11's renegotiation framework.[196] Along the way, I have also demonstrated the theory's application to simple questions like executory contracts[197] and more cutting-edge problems like third-party releases and intercreditor agreements.[198] But the theory is broadly applicable. One can march through the core features of bankruptcy law to see this. In this Part, I provide three additional examples.[199] I begin with the straightforward but core example of the automatic stay. I then turn to an example where the theory can resolve a recent split among courts. I conclude with the more complex problems of priority rules and the new value exception.

A. Further Proof of Concept: The Automatic Stay

The automatic stay is one of bankruptcy's central provisions.[200] It directly addresses the classic "collective action" problem.[201] That problem is one particular type of hold up, and the Bankruptcy Code responds to it by implementing default rules along with special altering rules that impose price and evidentiary burdens to reduce the risk of hold up.

[193] I have shown in prior work that parties can use intercreditor agreements to extract value from the debtor's estate. See Ayotte, Casey, and Skeel, *supra* note 30 at 284-85; see also Shannon, *supra* note 174 (noting that parties use intercreditor agreements to extract windfalls).

[194] Id. at 287-90.

[195] Id. at 287-90.

[196] See above at Part II.B.

[197] See above at Part II.B.

[198] See above at Part II.D.

[199] See also *infra* notes 224-228.

[200] 11 U.S.C. § 362.

[201] See above at Part I.A. for a discussion of "collective action."

The Bankruptcy Code's default rule is that actions to enforce or recover on prepetition claims or to obtain possession of property from the estate are prohibited during bankruptcy.[202] But the Bankruptcy Code allows a party to alter that rule if it can show that its interest is not adequately protected,[203] or where it can show it is enforcing an ownership right in property that is not necessary for the debtor to effectively reorganize.[204]

These rules track the analysis presented above. Because contracts are incomplete, parties have the ability to enforce claims against a debtor in financial distress even when those claims will destroy value. A complete contract would provide specific situations when individual enforcement is allowed because it does not destroy value and specific situations where it is not allowed because it does. But ex ante uncertainty and strategic bargaining are too high for the parties to write that contract. As a result, parties can use the incompleteness to threaten to enforce claims in a way that will destroy ex post value. That threat allows them to extract value from the estate.[205]

To combat this threat of hold up, the code's default rule prohibits claimants from exercising their rights. But that default rule itself creates a converse risk of hold up. The debtor can extract value from a claimant by threatening to eliminate its enforcement right with a bankruptcy filing. And so, the code allows the claimant to alter the default rule by meeting one of two requirements. First, the claimant can demand adequate protection for its interest from the debtor. This imposes a price of sorts that the debtor must pay to maintain the default rule. That price is set at an amount that ensures that the debtor is not using the automatic stay to extract value from the claimant.[206] Second, the claimant can lift the stay if it can meet a high evidentiary burden of showing that it is enforcing an ownership right that will not have a negative effect on the debtor's reorganization. This amounts to an evidentiary showing that the claimant is not trying

[202] 11 U.S.C. § 362(a)(1), (2), (3) & (6).

[203] 11 U.S.C. § 362(d)(1).

[204] 11 U.S.C. § 362(d)(2).

[205] See, for example, *Chrysler LLC v. Plastech Engineered Prods., Inc*., 382 B.R. 90, 110-11 (Bankr. E.D. Mich. 2008) (refusing to lift the automatic stay where a claimant was threatening an action that would shut down the debtor's business); *United Airlines, Inc. v. U.S. Bank N.A.,* 406 F.3d 918, 925 (7th Cir. 2005) (noting that a creditor's threat to use a special statutory provision excepting aircraft from the automatic stay will result in "tough bargaining" and allow the creditor to extract value from the estate).

[206] See, for example, *In re Rogers*, 239 B.R. 883, 886 (Bankr. E.D.Tex. 1999) (noting that adequate protection is set by a "pragmatic and synthetic" balancing of all relevant factors to determine the risk that the creditor will lose value by the continuation of the stay).

to hold up the debtor. If the property is not necessary to an effective reorganization, then the threat to enforce against it has no hold-up value.

Collective action is but one variety of the hold-up problem associated with financial distress. Many others exist. I turn now to some of those other problems.

B. Court Splits: Sections 363(f) and 365(h)

Recently, courts have struggled over an ambiguity in the Bankruptcy Code regarding the fate of leases in an asset sale.[207] Section 363(f) of the code allows the debtor to sell its assets free-and-clear of a stakeholder's interests.[208] But section 365(h) provides that even if a debtor rejects a lease, the lessee retains its rights to use and possession under the lease.[209] The question, then, is what happens to a lessee when the debtor sells the leased property under section 363(f)? Is the sale free and clear of the lease under section 363(f) or does the lessee retain its rights under section 365(h) after the sale?

The statutory language is complicated and ambiguous at best, and courts have split on the appropriate reading. The renegotiation framework provides policy guidance. Section 365(h) is addressed at reducing a hold-up threat. Lessees often make very large investments that are specific to their lease. A debtor who can threaten to terminate a lessee by filing bankruptcy, has powerful hold-up leverage. As a result, the Bankruptcy Code prohibits that action. It even implements a complex pricing mechanism to balance the dual risks of hold up.[210]

On the other hand, section 363(f) is also addressed at reducing a hold-up threat. Often the only way to reorganize a debtor is through a free-and-clear sale. To give one lessee the ability to veto that sale would create an enormous hold-up opportunity. Moreover, the sale through a competitive auction—which is itself a market-price test—reduces any risk that the debtor is attempting to hold up the lessee.[211] While it is likely that a debtor

[207] *In re Spanish Peaks*, 2017 WL 2979660 (9th Cir. 2017); *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC,* 327 F.3d 537 (7th Cir. 2003); *In re Dishi & Sons v. Bay Condos LLC,* 510 Bankr. 696 (S.D.N.Y. 2014).

[208] 11 U.S.C. § 363(f).

[209] 11 U.S.C. § 365(h)(1)(A)(ii).

[210] The lessee must pay rent, can offset any damages caused be the debtor's nonperformance of obligations, but does not otherwise have a right to collect those damages. 11 U.S.C. § 365(h)(1)(A)-(B).

[211] The code also includes a catch all provision allowing the court to intervene where the sale is suspect. 11 U.S.C. § 363(e) (directing the court to prohibit a sale "as is necessary to provide adequate protection" of a stakeholder's interest).

might use a bankruptcy filing to terminate a lease, it is much less likely that it would sell its business to do so. Thus, as long as there is no evidence that sale is a sham, the rule that best constrains hold up on both sides is one that allows a sale free and clear of leases with appropriate market tests and compensation requirements.

C. Major Questions: Priority Rules and the New Value Exception

The Butner Fallacy and the Creditor's Bargain are probably most pernicious when it comes to debates about priority rules in bankruptcy. Priority rules dictate the order in which creditors are paid from the value that results after a bankrupt debtor is reorganized. In theory, the current bankruptcy system requires "absolute priority," which means that creditors are paid strictly in order of their nonbankruptcy priorities as if the firm was being liquidated.[212] In reality, absolute priority is a rough guideline from which outcomes often deviate.[213]

For decades, scholars have argued about whether absolute priority is essential to a proper functioning bankruptcy system. Some scholars have proposed an alternative regime known as "relative priority," which would allow junior creditors to share in the future value of the reorganized debtor.[214] The American Bankruptcy Institute has recently entered the fray with a proposal to adopt its own version of relative priority.[215]

Too often the debates about these priority schemes devolve to an inquiry about nonbankruptcy entitlements and whether one rule is required by the Creditors' Bargain. The conventional argument for absolute priority is that the only way to respect nonbankruptcy entitlements is to pay the creditors as if the debtor firm is being liquidated.[216] Others have countered that absolute priority unnecessarily terminates junior investors' future interests even though the debtor is not actually

[212] Walter J. Blum and Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganization*, 41 U. Chi. L. Rev. 651, 654 (1974) ("[B]efore a class of investors can participate in a reorganization, all more senior classes must be compensated in full for their claims, measured on the basis of their priorities upon involuntary liquidation.").

[213] Bebchuk and Fried, *supra* note 35 at 911-13 (noting the deviations from absolute priority); Roe and Tung, *supra* note 18 at 1269 (same).

[214] Baird, *supra* note 17 at 789-806 (describing relative priority and its appeal).

[215] Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, 2012–2014: Final Report and Recommendations, 208-09 (2014).

[216] Alan Schwartz*, A Normative Theory of Business Bankruptcy*, 91 Va. L. Rev. 1199, 1202 (2005); Barry E. Adler and Ian Ayres*, A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 Yale L. J. 83, 88–90 (2001); Jackson, *supra* note 1 at 869 (the creditors' bargain "requires respecting a secured creditor's ability to be paid first").

liquidated.[217] A relative priority system that kept those future interests alive might, they argue, be more consistent with the Creditors' Bargain.[218]

These debates are not focused on the right question. The right question is whether one system does a better job at reducing the hold-up problem. Any system that allows the debtor to file bankruptcy to significantly reduce the value of a senior creditor's claim would create incentives for debtors and junior investors to threaten a bankruptcy filing in order to extract a hold-up payment. On the other hand, a bankruptcy rule that entitles secured creditors to destroy significant option value that belongs to junior creditors would also lead to a hold-up problem.

As we have seen throughout this Article, the New Bargaining Theory provides that bankruptcy law should implement a default rule that can be altered subject to pricing mechanisms and evidentiary burdens. The most obvious default rule—which is consistent with either absolute or relative priority—is that the debtor must pay a senior secured creditor at least what that creditor would have received in a nonbankruptcy foreclosure.[219] Setting that rule ensures that the debtor cannot hold up senior creditors by threatening bankruptcy as a means to underpay them.[220]

But—within a coherent renegotiation framework—this baseline can be altered if the debtor meets certain requirements. A proper priority rule might include exceptions for rare cases when one party can show that another party is indubitably asserting its priority rights as part of a hold-up threat. Another exception might allow small deviations when the parties advocating them can show—by evidence or market tests—that those deviations are efficient and not part of a hold-up attempt.

The "new value exception" to priority that courts apply in Chapter 11 matches that last category of exceptions. The new

[217] Jacoby and Janger (2018), *supra* note 8 at 678-81 (arguing against absolute priority and in favor of a relative-priority-like "equitable realization" based on nonbankruptcy entitlements); Jacoby and Janger (2014), *supra* note 8 at 913 (noting that sales under absolute priority terminate junior creditors' interest in the future value of the firm); Baird, *supra* note 17 at 793; Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*; 78 U. Chi. L. Rev. 759, 764-65 (2011).

[218] Casey, *supra* note 217 at 773.

[219] I have argued elsewhere for this baseline payment as part of a relative priority mechanism. Casey, *supra* note 217 at 765.

[220] This analysis suggests that a recent controversial case was wrongfully decided. The court in *In re Sunnyslope Housing Limited Partnership* interpreted the Bankruptcy Code to allow the debtor to confirm a plan that left the secured creditor holding a lien that was worth less than the foreclosure value of its claim. *In re Sunnyslope Housing Limited Partnership*, 859 F.3d 637 (9th Cir. 2017).

value case law provides that old equity owners of an insolvent firm can only take a stake in the reorganized firm if they pay for that stake and if the payment is market tested.[221] Once again, the rule operates to curb hold up on both sides. Old equity owners often exercise control in the bankruptcy process, especially in smaller firms where they serve as managers. There is a constant risk that they will use that control to hold up other stakeholders. On the flip side, the owners, managers, and founders of a debtor firm might be valuable components of its going concern and it might be in the interest of the whole estate to include them in the reorganization. If one creditor could absolutely veto the owners' involvement going forward, that creditor would possess a threat to derail the whole process. By allowing the owners' involvement only after a robust market test, the new value exception implements Chapter 11's renegotiation framework to navigate between these two threats.[222]

Notably, the priority guidance in this part provides a range of solutions that might take the form of modified absolute or relative priority. The key takeaway is that the New Bargaining Theory does not require one specific form of priority. Rather it simply gives us parameters or guardrails within which any chosen priority regime must operate. Notably, the American Bankruptcy Institute's relative priority proposal does not explicitly include a requirement that the debtor's estate pay senior creditors an amount equal to the nonbankruptcy liquidation value of their

[221] *Bank of America Nat'l Trust & Savings Ass'n v. 203 N LaSalle Street P'Ship*, 526 U.S. 434, 437 (1999); see also Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 Am. Bankr. L. J. 387 (1998) (describing the new value exception); Douglas G. Baird and Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 S. Ct. Rev. 393 (same).

[222] This analysis is important for bankruptcy systems in other countries as well. For example, questions about new value and owner involvement in reorganization have been front and center in debates about bankruptcy reforms in India. After India introduced its bankruptcy reform in 2016, there was concern that owners were planning to use their control of the firm to hold up creditors and remain in control of firms after reorganization. Deepshikha Sikarwar, *Big Tweak in Insolvency Law on the Cards, Defaulters May be Barred from Bidding*, The Economic Times, Nov. 14, 2017, available at https://economictimes.indiatimes.com/news/economy/policy/big-tweak-in-insolvency-law-on-cards-defaulters-may-be-barred-from-bidding/articleshow/61634341.cms. In response, the government amended the statute to prohibit the original owners of a firm from participating in the reorganization. Litigants challenged the controversial provision's validity in court. On January 25, 2019, the Indian Supreme Court upheld the validity of the entire bankruptcy law including the amendment. Samanwaya Rautray, *Supreme Court Upholds Bankruptcy Code, Rejects Promoters' Challenges*, The Economic Times, Jan. 22, 2019, available at https://economictimes.indiatimes.com/news/economy/policy/supreme-court-upholds-insolvency-law-in-entirety/articleshow/67683544.cms.

claims.[223] Without that requirement, it is inconsistent with the New Bargaining Theory and the renegotiation framework.

Conclusion

The Creditors' Bargain cannot bear its status as the core theory of bankruptcy. At best it is an analogy for the idea that we should do what is efficient across all states of the world, and Butner is a mere statement that bankruptcy law should pursue bankruptcy purposes. These ideas do not state a full theory. And yet, over the years, the Creditors' Bargain and the Butner Fallacy have overgrown other ideas within bankruptcy scholarship. This Article is an attempt to clear the brush and discover corporate bankruptcy's fundamental theory.

The New Bargaining Theory that emerges is one where corporate bankruptcy's purpose is to solve the ubiquitous incomplete contracting problem associated with financial distress. In Chapter 11 the solution takes the form of a structured renegotiation framework. The framework allows parties to renegotiate their relationships within a system that allocates certain decision powers, places prices and evidentiary burdens on the exercise of those powers, and then subjects the resulting decisions to high-level judicial oversight. The specifics of this framework are targeted at reducing the worst and most likely instances of hold up that can block coordinated renegotiation efforts.

As I noted above, the New Bargaining Theory and its manifestation in Chapter 11's renegotiation framework are broadly applicable to explain bankruptcy's core features and to resolve its thorniest problems. While I gave various examples, space does not permit a full catalog of applications. A similar analysis can be applied to other questions that have challenged

[223] Am. Bankr. Inst. Comm'n To Study the Reform of Chapter 11, 2012–2014: Final Report and Recommendations, 208-09, 218 (2014).

courts, like critical vendor orders,[224] settlements,[225] gifting,[226] debtor-in-possession financing,[227] and opt out mechanisms.[228]

The strong normative claim of this Article is that bankruptcy law's proper purpose is to solve the hold-up problem. The descriptive claim is that Chapter 11 attempts to do this by implementing a structured renegotiation framework. A remaining normative question is whether Chapter 11 succeeds at this purpose. This Article's main contribution is to help identify

[224] See *In re Kmart*, 359 F.3d 866 (7th Cir. 2004). Critical vendor orders allow the debtor to pay a chosen vendor on prepetition claims—ahead of other creditors—to entice the vendor to continue doing business with the debtor. The result is similar to what happens when a debtor assumes an executory contract under 11 U.S.C. § 365. See above at Part II.B. The relationship continues, and the counterparty gets paid ahead of other creditors. But there are two difference. First, the counterparty has the option of walking away. The debtor cannot coercively extend the relationship. Second, the debtor must meet a higher burden in proving that the vendor is critical. *Kmart*, 359 F.3d at 866. Chapter 11's renegotiation framework can explain this approach. A relationship counterparty can hold up a debtor even when their relationship is not a formal contract. But without the contract, the converse risk of a debtor using bankruptcy to hold up the counterparty is exacerbated. Evidence about the purpose and intended duration of the relationship is scant, and a debtor who could coercively extend the relationship might use a bankruptcy filing to extract value. On the other hand, the relationship might have value and so the law allows the debtor to pay to extend it—even over the objection of other creditors. Those objections may be attempts to block the payment just to hold up the estate. Again, we worry also about converse debtor misbehavior and hold up in the form of funneling value from the estate to one vendor. And so, the law requires the debtor to make a high evidentiary showing that the payment is efficient and not part of a hold-up scheme. Id. at 873 ("[I]t is necessary to show not only that the disfavored creditors will be as well off with reorganization as with liquidation … but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued.").

[225] *Czyzewski v. Jevic Holding Corp*., 580 U.S._._ •••, 137 S. Ct. 973 (2017). In addressing the question of whether a debtor can agree to receive a settlement payment that requires it to alter the payment priority of creditors, the Supreme Court narrowly ruled that such alterations are prohibited when they are part of a dismissal order or other final disposition of the case. Id. at 984-86. Consistent with the analysis throughout this Article, final dispositions are likely to be the situations where hold-up risk is at its highest. The Court left open the possibilities of interim alterations where the hold-up risk is lower, and where the debtor can meet an evidentiary burden of showing that the alteration "would 'enable a successful reorganization and make even disfavored creditors better off.'" Id. at 985 (quoting *In re Kmart*, 359 F.3d at 872). Consistent with the New Bargaining Theory's focus on relationship-specific investments, the court also pointed out that the prohibited alterations "do[] not preserve the debtor as a going concern, … [and] do[] not protect reliance interests." Id. at 986.

[226] *In re ICL Holding Co., Inc.,* 802 F.3d 547 (3d Cir. 2015) (allowing side payments, or gifts, that violated priority rules in a case where the harm to the disfavored creditor was likely insignificant).

[227] Transcript of Final Hearing on Motion for Post-Petition Financing, *In re Lyondell Chem. Co.*, No. 09-10023 (REG) (Bankr. S.D.N.Y. Feb. 27, 2009) (approving a debtor-in-possession loan that included extreme terms drastically altering nonbankruptcy rights and shifting power to creditors because it was evident that no other source of funding existed and the alternative was liquidation).

[228] *In re Franchise Services of N. America, Inc.* 891 F.3d 198 (5th. Cir. 2018) (approving a structure that allowed one stakeholder the power to veto a bankruptcy filing without discussion of the possibility of hold-up or the impact that such veto would have on renegotiation).

the metrics by which to answer that question. Future empirical research should test whether 1) Chapter 11 does in fact reduce hold-up costs and 2) whether it does better than alternative regimes. The answers may depend on the competency of bankruptcy judges, the appropriateness of the law's guardrails, and simply how good the parties are at exploiting hold-up opportunities. No doubt, these questions will also require comparative studies of the existing and emerging frameworks implemented by other jurisdictions.

A tentative answer might be that Chapter 11 does reduce hold up, at least compared to a bankruptcy state of nature. It is worth noting, however, that such a claim will only be true if courts have the ability to accurately set or market test the necessary prices within the framework. Throughout this Article, I have discussed pricing mechanisms by which the courts test the efficiency and hold-up risks associated with certain decisions. For those price tests to work, the court needs to value the relevant assets, claims, and outcomes. This may be the Achilles heel of Chapter 11's renegotiation framework. Judicial valuation is messy and imperfect.[229] That said, it is not completely broken, and it can be fixed.[230] If anything, the analysis I have presented highlights the importance of research and reform agendas that focus on valuation procedures and methodologies as the key to improving the functioning of Chapter 11.

[229] See Kenneth Ayotte and Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. Pa. L. Rev. 1819 (2018); Diane Lourdes Dick, *Valuation in Chapter 11: The Dangers of an Implicit Market Test*, 2017 U. Ill. L. Rev. 1487, 1501 (2017); Douglas G. Baird and Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1953 (2006); Anthony J. Casey and Julia Simon-Kerr, *A Simple Theory of Complex Valuation*, 113 Mich. L. Rev. 1175, 1177 (2015); Keith Sharfman, *Valuation Averaging: A New Procedure for Resolving Valuation Disputes,* 88 Minn. L. Rev. 357, 358–60 (2003).

[230] See Dick, *supra* note 229 at 1501-02 (considering proposals to improve valuation); Casey and Simon-Kerr, *supra* note 229 at 1198-1210 (proposing a new approach to judicial valuation); Sharfman, *supra* note 229 at 372-77 (same).