Printed in U.S.A.
Vol. 114, No. 3

BANKRUPTCY'S CATHEDRAL: PROPERTY RULES, LIABILITY RULES, AND DISTRESS

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ABSTRACT—What justifies corporate bankruptcy law in the modern economy? For forty years, economically oriented theorists have rationalized bankruptcy as an antidote to potential coordination failures associated with a company's financial distress. But the sophistication of financial contracting and the depth of capital markets today threaten the practical plausibility, if not the theoretical soundness, of the conventional model. This Article sets out a framework for assessing bankruptcy law that accounts for changes in the technology of corporate finance. It then applies the framework to three important artifacts of contemporary American bankruptcy practice, pointing toward a radically streamlined vision of the field. Bankruptcy's virtue, I contend, lies in its capacity to replace "property rules" that may protect investors efficiently when a company is financially healthy with "liability rules" more appropriate for distress. In domains where investors are unable to arrange state-contingent toggling rules, bankruptcy law can do it for them. This agenda plausibly justifies two important uses of Chapter 11—to effect prepackaged plans of reorganization and conclude going-concern sales—but casts doubt on what many suppose to be the *sine qua non* of bankruptcy, the automatic stay. More broadly, the analysis suggests that an "essential" bankruptcy law would look very different, and do much less, than the law we know.

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INTRODUCTION

What good can corporate bankruptcy law do? The dominant economic approach to that question, the "creditors' bargain" paradigm, starts with the observation that when a company becomes illiquid, its creditors' inability to coordinate their responses can put a sound enterprise at risk.[1] Each creditor, unsure how others will behave, may find it privately advantageous to secure her own recovery even if the result is to hobble the business and make the creditors worse off as a group.[2] Bankruptcy law can solve the creditors' collective-action problem. It can halt their individual efforts and impose a structured negotiation, potentially preserving valuable opportunities.[3] And that, according to the creditors' bargain model, is all bankruptcy can usefully do.[4] The model's parsimonious nature has always suggested a critical attitude toward real-world bankruptcy laws. But, because it posits a world in which

[1] *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 861–65 (1982). Of course, this observation long predates the law and economics revolution. *See, e.g.*, John Lowell, *Conflict of Laws as Applied to Assignments for Creditors*, 1 HARV. L. REV. 259, 264 (1888) (identifying the creditors' "race of diligence" as a problem for law to solve).

[2] Jackson, *supra* note 1, at 862. The "run on the bank" is an example of the problem.

[3] *Id.* at 864–65. I use "bankruptcy law" in a generic sense to refer to any mandatory, distress-specific body of law, whether or not promulgated under Article I's Bankruptcy Power. U.S. CONST. art. I, § 8.

[4] Vincent S.J. Buccola, *The Janus Faces of Reorganization Law*, 44 J. CORP. L. 1, 5–9 (2018) (discussing other normative approaches to corporate bankruptcy).

investors cannot easily solve problems on their own, the theory has typically been taken to justify the most basic features of Chapter 11.[5]

A reappraisal of the law's merits is due. Anticipation of the fortieth anniversary of the Bankruptcy Code has spurred discussion among practitioners and scholars alike about the reform of Chapter 11.[6] For the most part, debates have concerned the desirability of marginal adjustments—potential fixes for the problematic by-products of evolving reorganization practice. And properly so. But a wider view is also instructive. Indeed, a wider view is needed to orient reform projects toward a proper end—if not for the sake of clear thinking itself. With respect to the American system, at least, the conventional defense of bankruptcy no longer looks plausible.

Profound changes in the capital markets drive the need to reassess. A bankruptcy system is useful only if the problems it solves are bigger than the costs the system itself imposes. However realistic this prospect may once have seemed, the development of financial markets makes it increasingly hard to swallow. Well-capitalized investment funds devoted to amassing the debt of distressed businesses or acquiring such businesses outright alleviate problems arising from fragmented ownership to a degree unimaginable not long ago.[7] At the same time, the hierarchical capital structures favored by companies nearing distress have blunted the incentives that give rise to creditor runs.[8] In combination, these developments seem to leave precious

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[5] For critical discussion of the model's premises and implications, see, e.g., Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 311 (1993) [hereinafter Adler, *American Corporate Bankruptcy*] ("Accepted wisdom is that bankruptcy protects an insolvent debtor's assets from its creditors who would otherwise dismantle the debtor in a frenzied attempt to collect on their loans."); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647 (1992) (describing leading scholars who "assume that creditors who face a troubled debtor face a common pool problem, and that bankruptcy law exists to overcome it"); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 78–79 (1992) ("Chapter 11 and its historical antecedents traditionally have been justified on the grounds that it is at times better to keep a corporation together than to sell it off piecemeal."). Note, however, that Professor Adler has always been doubtful on the truth of the matter asserted. *See, e.g.*, Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 351 (1997) [hereinafter Adler, *Corporate Insolvency*] (describing the collective-action problem as "largely illusory").

[6] *See, e.g.*, AM. BANKR. INST. COMM'N TO STUDY THE REFORM OF CHAPTER 11, 2012–2014, FINAL REPORT & RECOMMENDATIONS (2014) [hereinafter ABI COMM'N REPORT]; William W. Bratton & David A. Skeel, Jr., *Foreword: Bankruptcy's New and Old Frontiers*, 166 U. PA. L. REV. 1571 (2018) (introducing symposium on future of Chapter 11); Ralph Brubaker et al., *Reforming Chapter 11 Bankruptcy Reorganizations*, 2015 U. ILL. L. REV. 507, 507–08 (introducing symposium).

[7] *See infra* notes 41–49 and accompanying text. A long-time observer of the sector estimates that roughly $500 billion was in distress-dedicated investment funds at the start of 2018. Edward I. Altman & Robert Benhenni, *The Anatomy of Distressed Debt Markets*, 11 ANN. REV. FIN. ECON. (forthcoming 2019) (manuscript at 7), https://ssrn.com/a=3251580 [https://perma.cc/M32X-SUXZ].

[8] A capital structure is "hierarchical" to the extent it prioritizes among investors, with high-priority creditors being entitled to recover in full before junior creditors are paid. *See infra* notes 50–56 and accompanying text.

little for a coercive legal apparatus to do.[9] What we need, then, is an account of bankruptcy that takes the law's obsolescence seriously.[10]

This Article takes up that challenge. More specifically, it pursues two analytical aims: first, to set out a framework for assessing bankruptcy law that accounts dynamically for changes in prevailing patterns of corporate finance; and second, to illustrate the framework's application by evaluating three of the most important artifacts of contemporary American bankruptcy. The Article's ambitions are thus practical as well as theoretical. With respect to contemporary practice, its conclusions are mixed. The analysis suggests that some legal interventions altering background governance rules may be valuable notwithstanding the capacities of modern financial contracting. Calls to do away with corporate bankruptcy law altogether thus appear excessively blunt in addition to being politically unrealistic. But much less of familiar practice survives scrutiny than most observers, including many associated with the creditors' bargain approach, seem to think.

The framework developed in this Article is organized around Judge Calabresi and Professor Melamed's famous distinction between alternative means of protecting entitlements—what they dubbed "property" and "liability" rules.[11] According to this scheme, a person's entitlement is backed by a property rule insofar as voluntary exchange alone can extinguish it. Mutual consent sets the price. In contrast, a person's entitlement is secured by a liability rule if another can extinguish it unilaterally by paying an officially determined price as compensation.[12]

Both kinds of rules have their place in the complex web of a business organization. The motivating insight here is that a company's financial distress can make liability rules relatively more attractive.

This Article argues that bankruptcy law is potentially valuable insofar as it can toggle from property to liability rules in domains where legal or

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[9] I am not the first to note the pressure that market institutions have put on normative economic models of bankruptcy. Skepticism about the law's continued utility appears in the literature as early as the 1990s. *See, e.g.*, Adler, *American Corporate Bankruptcy*, *supra* note 5; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 778 (2002). But in the years since, the valence of market trends then in their infancy has only become more pronounced. *Cf.* Alan Schwartz, *Bankruptcy Related Contracting and Bankruptcy Functions* 5, 5, 51–52 (Yale L. & Econ., Research Paper No. 553, 2017), https://ssrn.com/a=2806027 [https://perma.cc/3T6G-DH35] ("The normative question . . . is what kind of bankruptcy law is needed to enforce the capital structures that actually exist.").

[10] For recent gestures in this direction, see Schwartz, *supra* note 9, at 56–57; Barry E. Adler, *The Creditors' Bargain Revisited*, 166 U. PA. L. REV. 1853, 1864–65 (2018).

[11] *See generally* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

[12] *Id.* at 1105–06. The liability rule concept has often been associated with a jury or judge's compensatory damages award. But what is essential to the notion of the liability rule is only that an entitlement's price be set by a third-party process rather than second-party consent. A judge's or bureaucrat's role can be more or less central to the process. *See infra* notes 76–78 and accompanying text.

practical impediments prevent investors from arranging their own, "tailored" toggles.[13] More precisely, a bankruptcy intervention can improve on corporate and commercial law in situations where: (1) an investor's economic interests are protected by a property rule in the ordinary course; (2) the property rule is efficient in the ordinary course; (3) a liability rule is efficient in distress; (4) bankruptcy intervenes to toggle from property to liability rule; and (5) investors would have difficulty arranging their own distress-specific rule toggle.

This framework has two advantages over existing normative models. First, it offers a high-resolution lens with which to identify the relationships financial distress is most apt to affect and, therefore, the places where distress-specific legal intervention might be most useful. Second, the approach offered here explicitly indexes the rationale for bankruptcy law to contingent facts about financial contracting.[14] It brings financial markets inside the model, so to speak, yielding the highly plausible result that an efficient bankruptcy law will have wider scope in jurisdictions with relatively underdeveloped capital markets and narrower scope in more developed markets.

To illustrate the framework's tractability, I apply it to three uses of bankruptcy central to modern Chapter 11 practice—effecting a prepackaged plan (prepack), concluding a going-concern sale, and taking advantage of the automatic stay. Consistent with much commentary, I find that prepacks and going-concern sales can enhance investors' returns relative to nonbankruptcy alternatives.[15] This is not to say the way these transactions are handled under current law and practice is ideal. The subtle balance needed to reach a judgment about that question is beyond this Article's remit. But it is to say there are sound reasons for bankruptcy law to alter investors' legal rights in a manner broadly consistent with Chapter 11's actual interventions in these cases.

My analysis is less sanguine about the automatic stay.[16] Most commentators think of the stay as the bedrock of bankruptcy law.[17] But the way it modifies secured creditors' rights is hard to square with the wide range

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[13] *See infra* notes 73–91 and accompanying text.

[14] It should be clear that I am not trying to scrap existing theory. After all, the core creditors' bargain story has bankruptcy solve the creditor run precisely by subverting the property rule associated with ordinary debt collection processes. *See supra* notes 1–4 and accompanying text. The aim is to refine the theory, to make it more tractable and tie it to existing market technologies.

[15] *See infra* notes 92–145 and accompanying text.

[16] *See infra* notes 146–161 and accompanying text.

[17] *See, e.g.*, Anthony J. Casey, The New Bargaining Theory of Corporate Bankruptcy and Chapter 11's Renegotiation Framework (2019) (unpublished manuscript at 45), https://ssrn.com/a=3353871 [https://perma.cc/Z2RD-GH2B] ("The automatic stay is one of bankruptcy's central provisions. It directly addresses the classic 'collective action' problem.").

of financing options on offer in today's credit markets. Security interests give creditors two things: a priority right to repayment (up to the value of collateral) and a right to foreclose unilaterally in case of default.[18] The foreclosure right is a kind of property rule, and so one might think of its modification as consistent with the criteria I have outlined. But as I will explain, businesses can arrange their own state-contingent conditions on foreclosure, and there is little reason to think the law can systematically improve on that choice.

These applications of the general normative framework are, of course, only illustrative. An exhaustive accounting of Chapter 11 would need to examine its interventions one by one. Rules concerning postpetition financing,[19] the avoidance of prepetition transactions,[20] and the assumption and assignment of executory contracts and leases are only a few of the most obvious places to look.[21] Nevertheless, this Article's analysis points toward a dramatically stripped-down bankruptcy law, in which the judicial role is primarily to certify the existence of conditions warranting property-to-liability rule toggles and the fairness of extraordinary transactions that could not be consummated without them. In this vision, no general jurisdiction over the debtor's affairs is contemplated. No specialized bar would be needed, no secret handshakes. A debtor subject to all of the ordinary, background rules of corporate and commercial law would simply propose a transaction designed to resolve financial distress that, absent one or more property-to-liability rule toggles, would have a hard time getting sufficient investor buy-in; and the bankruptcy judge would simply decide whether the toggle is justified and the transaction otherwise fair to investors.

The Article will proceed in four Parts. Part I describes in greater detail the conventional economic account of corporate bankruptcy and shows how capital market developments imply a practical, rather than theoretical, critique of that account. Parts II and III form the Article's analytical heart. Part II develops criteria for evaluating bankruptcy's interventions in corporate affairs, and Part III examines their application to three uses of Chapter 11. Part IV, drawing out implications of the main analysis, proposes and discusses the merits of an alternative and radically streamlined vision of corporate bankruptcy.

[18] *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 860–61 (1996) (describing the "priority" and "repossessory" functions of liens under state law).

[19] 11 U.S.C. §§ 364, 507 (2012).

[20] *Id.* §§ 544–48.

[21] *Id.* § 365.

I. WHAT'S WRONG WITH THE CURRENT PICTURE?

The traditional economic approach understands bankruptcy law as a solution to investor coordination failures associated with a company's financial distress. The analytic and normative power of this view has influenced a generation of scholars, lawyers, and judges. But dramatic changes in the capital markets in recent decades cast doubt on the empirical significance of the coordination failures bankruptcy is supposed to solve and, more specifically, on the notion that their resolution in general is worth the costs a bankruptcy system inevitably imposes. This Part sketches the development of the extant economic model of bankruptcy. It then introduces a critique of the model's practical utility under contemporary market conditions, motivating the question at this Article's core—what, if anything, is bankruptcy law good for today?

A. The Creditors' Bargain Framework

The function of corporate bankruptcy law, at the most fundamental level, is to redefine the rights and obligations of investors in firms brought within the law's compass. Before a petition is filed there is a complex web of legal relations. After a petition is filed there is still a complex web of legal relations, only modified by the Bankruptcy Code's substantive terms. Posing the matter this way suggests a puzzle. Organizational law, such as corporate or partnership law, together with all the other sources of commercially important legal rules—debtor–creditor law, labor law, contract law, and so on—jointly and completely specify defeasible rights to control and enjoy the fruits of business.[22] Bankruptcy edits what can be thought of as a complex control algorithm.[23] The question is why: How could altering legal relations in this way be useful?

The modern theory of corporate bankruptcy law's economic justification began in the early 1980s with Thomas Jackson. Professor Jackson argued that bankruptcy's value lay in its capacity to preserve operationally sound but heavily indebted businesses.[24] In particular, he argued, bankruptcy could solve a distinctive common-pool problem faced by

[22] *See* Vincent S.J. Buccola, *Opportunism and Internal Affairs*, 93 TUL. L. REV. 339, 382–83 (2018). A firm, as a legal matter, is probably best understood as a synthesis of these multiple bodies of law. *See* ERIC W. ORTS, BUSINESS PERSONS: A LEGAL THEORY OF THE FIRM 53–78 (2013) (remarking on indispensability of agency, contract, and property law for understanding business firms); Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 L. & CONTEMP. PROBS. 109, 128–29 (2004).

[23] For a recent attempt to spell out something like this vision of bankruptcy law, see Douglas G. Baird et al., *The Bankruptcy Partition*, 166 U. PA. L. REV. 1675 (2018).

[24] *See* Jackson, *supra* note 1, at 865, 872–76; THOMAS H. JACKSON, THE LOGIC & LIMITS OF BANKRUPTCY LAW 7–19 (1986).

the creditors of a financially distressed business. Without a way to coordinate, each creditor may find it privately advantageous to foreclose on collateral or otherwise arrange a preferential repayment before other creditors do likewise. The aggregate effect of these individual collection activities—of the creditors' race of diligence—may be to disrupt the debtor's business even where collective forbearance would leave the investors better off as a group.[25]

Suppose, for example, that Acme Bounce House Corporation owes $10 to each of its 100 creditors with repayment due next year. Acme's investors expect the company to then be worth only $800, however—not enough to pay its debts in full. Each creditor thus has an incentive to try to withdraw her investment, since $10 is more than $8. But the net effect may be to shut down operations. If Acme's piecemeal liquidation of its magic castles to the parents of enthusiastic toddlers will fetch only $300, then the creditors' inability to compromise will collectively cause them to lose $500. Payment in full is better than a haircut, but a small haircut is better than a big one.

Bankruptcy offers a solution. Its centerpieces, the automatic stay[26] and the trustee's avoidance powers,[27] suspend the collection rights creditors enjoy under ordinary law and, in so doing, facilitate coordination and the commercially sensible disposition of the business. At the same time, these basic rules also save investors from incurring deadweight losses associated with their jockeying for position.[28] Bankruptcy law at its best could thus provide the fruit of what Jackson and others who developed the idea called the "creditors' bargain"—the agreement investors would make ex ante, if they could bargain cheaply, about what to do in the event of financial distress ex post.[29]

In recent years, the reach of the creditors' bargain model has been expanded. Professors Ayotte and Skeel have shown that investor coordination failures can lead not only to the premature liquidation of economically viable firms, but also to the failure of distressed firms to take

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[25] JACKSON, *supra* note 24, at 11–13.

[26] 11 U.S.C. § 362(a) (2012). The stay stops creditors from seeking to recover their claims outside the bankruptcy process. *Id.*

[27] *Id.* §§ 544–48. The trustee is empowered to avoid certain transfers made in the lead-up to bankruptcy. *Id.* § 544. The prospect of avoidance reduces incentives to lobby for an early distribution and, by so doing, complements the automatic stay.

[28] For discussion of the costs of efforts to "jump" the payment priority line, see Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1273–75 (2013).

[29] Professors Jackson and Baird were the leading early proponents of the creditors' bargain model. For an account of their early efforts, see Thomas H. Jackson, *A Retrospective Look at Bankruptcy's New Frontiers*, 166 U. PA. L. REV. 1867, 1871–77 (2018).

advantage of new, profitable investment opportunities.[30] Debt overhang is the prime culprit.[31] If a company's creditors cannot agree to subordinate their claims to those who might provide new capital, the old debt—the "overhang"—can block access to financing even for projects everyone believes to be cost-justified.[32] To illustrate, return to the Acme case. Suppose the company can grow to a more efficient scale if it can raise $200 for more inventory and to pay additional workers. Additional capacity will with equal probability either generate $500 more income or else go to waste. In expectation, increasing inventory will thus yield $250 at a cost of only $200. It is a good investment. But Acme will not be able to sell equity to finance it.[33] A new investor would take nothing if the project fails (all $800 going to the original creditors) and only $300 if it succeeds ($1000 going to the creditors), for an expected loss of $50. The creditors would collectively be better off if they could agree to subordinate themselves and so encourage the new investment, but in a mirror image of the creditor run, each acting alone may do best setting aside the common interest. Bankruptcy comes to the rescue with a variety of doctrines that allow the issuance of new, senior debt.[34]

B. An Institutional Competence Critique

Lurking behind the creditors' bargain model is a conceptual trade-off between a world with bankruptcy and a world without. The importance of the problems a distress-specific, judicially mediated legal regime can solve must be weighed against the costs it imposes. The costs are of two kinds. Most obvious are the administrative and professional expenses a bankruptcy regime entails. Subtler, but probably as important, are the costs of faulty judgment, for each virtue of bankruptcy law has a correlative vice. The automatic stay, for example, can protect viable companies from inefficient, piecemeal liquidation, but it can also delay the breakup of doomed, money-losing businesses.[35] In a similar fashion, bankruptcy's liquidity-enhancing mechanisms can promote valuable new investment, but they can also

[30] *See* Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1560–61 (2013).

[31] *Id.* at 1570–79. Note that Ayotte and Skeel also discuss adverse selection extensively. *See id.* at 1579–85, 1594–99.

[32] *Id.* at 1570–72; *see also* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149–55 (1977).

[33] The arithmetic is simplest with equity financing, but the dynamic holds for all flavors of new capital investment on par with or junior to existing debt. The precondition to debt overhang is only that the borrower cannot issue senior debt.

[34] Ayotte & Skeel, *supra* note 30, at 1589–1601.

[35] For a discussion and model of competing considerations, see Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356, 358–68 (2001).

enscence complacent or incompetent managers, effectively forcing creditors to throw good money after bad.[36] The correct balance eludes *a priori* reasoning. Practical judgment is called for. The value of a bankruptcy regime thus depends in large part on the accuracy with which it distinguishes hopeful from hopeless cases.[37]

The institutions of modern corporate finance suggest a reason to doubt the competence of a judiciary to make the needed distinction. To see why, start with the observation that a business's investors, and other market participants, are apt to have a better sense of its prospects than a generalist judge can hope to quickly muster. Industry- and firm-specific knowledge are crucial to determining which operations are worth saving or which new investments are worth making. The reason for a judge to intervene is not her superior knowledge of operational or investment policy. It is rather that, due to bargaining frictions, some fraction of companies that should get a longer leash will not. This logic suggests, however, that the number of such cases will dwindle as bargaining frictions are reduced. Investors' private information will increasingly be reflected in outcomes, and judicial intervention will increasingly be a mistake.

This is arguably where we are today. The coordination problems to which bankruptcy ostensibly responds depend on the coincidence of financial distress and fragmented control rights. If a company has enough cash to pay all the claims against it, or if it has only a single creditor (who is for that reason indifferent about which claims will be paid), then bankruptcy has nothing to do. One without the other—distress *or* fragmentation—raises questions for ordinary corporate governance but not especially for bankruptcy. A major effect of the deep pools of capital and sophisticated contracting technologies that characterize modern financial markets has been precisely to concentrate control rights when distress looms.

[36] Ayotte and Skeel readily acknowledge this point. *See* Ayotte & Skeel, *supra* note 30, at 1576–77, 1589, 1611–13 ("We have seen that honoring nonbankruptcy rights can lead to underinvestment, but deviating from them can lead to overinvestment."). For analysis of this trade-off in the context of debtor-in-possession financing, see George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993).

[37] The quintessential advertisement for distress-specific legal intervention, the railroad of the late nineteenth and early twentieth centuries, obscures the difficulty because it presents such an easy calculus. Railroad investors, being numerous and dispersed throughout America and Europe, faced obvious coordination difficulties. And it took no great financial genius to see that the railroads were worth more together than broken apart. The extreme specificity of their assets—steel rails, wooden ties, and long and narrow tracts of real estate ill-suited for use other than as a right-of-way—implied that liquidation would almost always be suboptimal. Blocking creditors' collection efforts therefore posed little risk of delaying asset redeployment. The railroad reorganizations were, of course, accomplished mainly through receivership rather than bankruptcy, but the principles at work are similar. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 101–27 (2001) (describing how the principles of the receivership made their way into bankruptcy law in the 1930s).

Many of the relevant developments were becoming visible by the early 2000s, when Professors Baird and Rasmussen famously proclaimed "the end of bankruptcy."[38] As empirical forecasters, they get mixed marks.[39] But underlying their account of the demise of traditional Chapter 11 practice was an abiding normative insight. In highly developed capital markets, one should expect that distress-specific judicial intervention to supplant ordinary legal norms and institutions will do more harm than good. The trends toward increased liquidity and contractual sophistication have only accelerated. What emerges, then, is an institutional-competence critique of Chapter 11 and similar regimes. The question is how, if at all, bankruptcy law can usefully intervene in markets increasingly geared to prevent the coincidence of fragmentation and financial distress and to resolve the coincidence when it occurs.[40]

1. Ex post Markets: Resolution

Two artifacts of modern capital markets tend to reduce fragmentation when distress might undermine sound investment policy: a distress-specific buyout market and a secondary market for the securities and loans of distressed companies. Of these, the buyout market is probably the more important development.[41] Its roots date to the aftermath of the takeover boom of the 1980s. When the high-yield debt used to finance many of the largest takeovers began to sour, the consequence was a large volume of distressed debt issued by fundamentally promising companies. Novelty spurred specialization, and in the 1990s the first distress-focused private equity groups emerged. They have proliferated since then, in both size and numbers, so that today even the largest distressed companies are prospects.[42]

In the simplest transaction, a distressed company auctions its assets as a bloc to the highest bidder. The sale does two things. It turns the distressed company into a pile of cash (which can then be distributed to investors), and

[38] Baird & Rasmussen, *supra* note 9, at 751. Professors Baird and Rasmussen framed their account as an empirical reckoning with the disappearance of traditional Chapter 11 cases. *Id.* at 751–52. But insofar as they sought to ascribe an economic logic to the trend they observed, they also (inevitably) were lodging a challenge to the normative foundations of that practice. *Id.* at 788–89.

[39] Consistent with their account, traditional Chapter 11, in which debtors lingered in bankruptcy and used the automatic stay and interest-free financing (among other perks) as leverage to extract creditor concessions, have vanished from the scene. On the other hand, the wave of going-concern sales Baird and Rasmussen documented seems to have abated to some degree. *See infra* note 119.

[40] *See* Schwartz *supra* note 9, at 53 (observing that existing normative economic approach posits a large-N set of creditors who cannot coordinate and asking, given the unreality of that picture today, "What functions should a bankruptcy system perform when the system is not solving a coordination problem among creditors?").

[41] *See, e.g.*, Bratton & Skeel, *supra* note 6, at 1592–93 (calling attention to funds' ability to acquire even very large distressed businesses).

[42] For historical background, see RAJAY BAGARIA, HIGH YIELD DEBT: AN INSIDER'S GUIDE TO THE MARKETPLACE 5–13 (2016).

it preserves the business in the hands of the acquirer, who then can decide whether to keep things as they are, break up the firm, invest in new projects—whatever makes most sense. In a competitive acquisition market, a going-concern sale will fetch something close to the value of the business's expected future earnings. In the Acme case, for example, an auction would raise close to $800 for distribution to the creditors—far more than the $300 they would get in a piecemeal liquidation and approximately what they would get if they could agree among themselves to forbear. The creditors' bargain model teaches that bankruptcy can improve investment decisions by overcoming fragmentation. But this is just what an acquisition does, only on the acquirer's dime rather than a judge's say-so.[43]

The development of liquid secondary markets in distressed debt, while perhaps less revolutionary than the buyout market, has also tended to reduce fragmentation.[44] Some of the funds operating in these markets trade in and out of positions rapidly in search of trading profits. But others aim to assemble blocs of securities or loans with an eye to influencing restructuring negotiations.[45] In most cases, a very few financial institutions come to the fore—all sophisticated repeat players.[46] Suppose that just two of Acme's creditors managed each to buy up half of the company's debt. A forbearance strategy would now dominate, since half of Acme's year-end cash if neither creditor demands repayment ($400) is more than the total proceeds of a liquidation ($300). More generally, a liquid debt market increases the

[43] Commentators have registered complaints about the mechanics of going-concern sales in current practice, *see infra* note 121, but do not dispute their capacity to provide liquidity.

[44] *See, e.g.*, Victoria Ivashina et al., *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings*, 119 J. FIN. ECON. 316, 317 (2016). For early recognition that distressed debt trading could in practice amount to a market for control, see generally Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401 (1997). This market for control is akin to that found in M&A practice. *See, e.g.*, David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 921 (2003).

[45] *See, e.g.*, Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 82–97 (2008) (surveying investment practices of distressed debt investors).

[46] *Cf.* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 652 (2010). Debt trading *during* bankruptcy has long been a controversial subject primarily due to fears that active trading could undermine the stability needed to administer Chapter 11 proceedings efficiently. *See, e.g.*, Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. FIN. & COM. L. 23, 23 (2009); Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 732 (2008); Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 72–75 (2009); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1686 (1996); *see also* Ivashina et al., *supra* note 44, at 317, 334 (finding that increased concentration in debt ownership that occurs *during* bankruptcy correlates with higher risk of liquidation). But a recent study finds that much of the concentration in activist investor debt holdings occurs before or at the outset of bankruptcy. Jared A. Ellias, *Bankruptcy Claims Trading*, 15 J. EMPIRICAL LEGAL STUD. 772, 774 (2018). Although bonds trade frequently during bankruptcy's pendency, activist blocs are generally stable during the interval when important dispositions are negotiated. *See id.*

likelihood that a value-maximizing deal on investment policy will be struck by reducing the number of people at the bargaining table.[47] This dynamic does not guarantee a favorable outcome. No bargaining framework is foolproof against bluff and bluster, and distressed markets have, it must be said, attracted masters of both arts. But concentration should in theory and seems in fact to foster dealmaking.[48] The widespread use of restructuring support agreements (RSAs), which bind the debtor and major creditors to a vision of reorganization, is one observable fruit of increased debt concentration.[49]

2. Ex ante Planning: Prevention

The growth of secured lending has in large measure allowed investors who fear the prospect of distress-induced coordination failures to prevent fragmentation. Around the turn of the millennium, a series of technological, capital market, and legal changes conspired to create financing patterns rarely seen before.[50] Large secured credit facilities began to crown distressed companies' capital structures.[51] Two features define these facilities: breadth and specificity. Their collateral base is broad, typically extending to substantially all of the borrower's assets.[52] And their terms are specific, credit

[47] At the limit, where one fund buys all of the paper, control rights are perfectly unified as in a going-concern sale.

[48] *See* William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597, 1642–46 (2018) (finding that increased concentration of debtholders has made out-of-court workouts more likely to succeed); Ivashina et al., *supra* note 44, at 317 (finding that concentration of debtholders predicts prepackaged or prearranged bankruptcy and shorter durations of bankruptcy cases).

[49] *See generally* Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017) (discussing RSAs).

[50] The story has been well told. For early accounts of the change, see generally Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006); Baird & Rasmussen, *supra* note 9; Skeel, *supra* note 44; Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 12 AM. BANKR. INST. J. 12, 52 (2003).

[51] With the rise of second-lien financing, secured debt comprises even more of the liabilities of distressed companies. *See, e.g.*, Mark Jenkins & David C. Smith, Creditor Conflict and the Efficiency of Corporate Reorganization (2014) (unpublished manuscript at 3), https://ssrn.com/a=2444700 [https://perma.cc/D6WQ-GNY3] (finding that the share of secured debt of Moody's-rated bankruptcy filers increased from forty-five percent to seventy percent in the period from 1991 to 2012).

[52] Some scholars, Professors Jacoby and Janger most forcefully, have questioned the legal possibility of secured creditors obtaining an interest in debtors' going-concern value that is enforceable in bankruptcy. *See* Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673, 678–80 (2018); Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 918–22 (2014) [hereinafter Jacoby & Janger, *Ice Cube Bonds*]; Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589, 595–600; *see also* Michelle M. Harner, *The Value of Soft Variables in Corporate Reorganizations*, 2015 U. ILL. L. REV. 509, 511–13 (arguing that "soft variables" on which liens cannot be asserted are part of going-concern value). Their read of the law is debatable. *See, e.g.*, Douglas G. Baird, *The Rights of Secured Creditors after* ResCap, 2015 U. ILL. L. REV. 849, 857–58 ("As long as a creditor has a senior security interest in everything at the moment the petition was filed, any increase in value during the bankruptcy belongs to this creditor."); Christopher W. Frost, *Secured Credit and Effective Entity Priority*, 51 CONN. L. REV. (forthcoming 2019) (manuscript at 5–6, 11–14),

agreements running to hundreds of pages.[53]

In combination, these features imply the possibility of a hierarchical capital structure in which the most senior creditors call the shots. The violation of any of a host of elaborate covenants permits the lenders to accelerate repayment obligations.[54] This they only rarely do.[55] But they can use leverage deriving from their authority to force balance-sheet problems into the open before they metastasize. The upshot is that a single group of lenders with shared financial interest has the ability to turn the liquidity tap on and off, and this in turn can help to prevent creditor-run and debt-overhang problems from arising.[56]

Race of diligence. Senior lenders' acceleration rights and security interest imply that they will be first in right to a large fraction of the debtor's assets should junior investors precipitate a run by seeking to withdraw their investments. If, that is, junior investors seek to withdraw in more than a de minimis fashion, then the lenders can call their loan and make good their own claims before sharing any scraps with those who precipitated the crisis.

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https://ssrn.com/a=3225212 [https://perma.cc/KQ7T-T45A] (citing cases supporting the theory that a secured creditor's blanket lien gives it a protected interest "in the value of the entire entity").

[53] For an excellent guide to modern credit agreements, see MICHAEL BELLUCCI & JEROME MCCLUSKEY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE (Rev. 2d ed. 2017).

[54] *See* Baird & Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, *supra* note 50, at 1211–12; Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 115 (2009). "Covenant lite" loans, which eschew onerous financial maintenance requirements, became standard before the financial crisis of 2007. Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Contracting*, 88 N.Y.U. L. REV. 51, 53–54 (2013). After disappearing for a few years, they have once again become standard in the leveraged loan market. *See, e.g.*, Bo Becker & Victoria Ivashina, Covenant-Light Contracts and Creditor Coordination (2016) (unpublished manuscript at 1), https://ssrn.com/a=2871887 [https://perma.cc/Y73A-CG8L] (noting that seventy percent of leveraged loans closed in 2015 were covenant-lite). The existence of covenant-lite contracts does not, however, weaken the descriptive point. There may be good reasons for the strictness of standard covenants to vary over time. *See, e.g.*, Choi & Triantis, *supra*, at 55–56 (linking trends in covenants to changes in interest rates). A trend toward sophistication and liquidity in financial markets does not always imply enhanced creditor control. It implies instead enhanced capacity to allocate control on a state-contingent basis if circumstances warrant it.

[55] The empirical evidence suggests that distressed borrowers routinely violate covenants but that banks usually respond by renegotiating terms. *See, e.g.*, David J. Denis & Jing Wang, *Debt Covenant Renegotiations and Creditor Control Rights*, 113 J. FIN. ECON. 348, 349 (2014) (finding restrictive or financial covenants are modified in fifty-three percent of debt contracts); Michael R. Roberts, *The Role of Dynamic Renegotiation and Asymmetric Information in Financial Contracting*, 116 J. FIN. ECON. 61, 62 (2015) (finding over seventy-five percent of covenant breaches are followed by renegotiation); Michael R. Roberts & Amir Sufi, *Renegotiation of Financial Contracts: Evidence from Private Credit Agreements*, 93 J. FIN. ECON. 159, 160 (2009) (reporting that over ninety percent of public companies' private credit agreements with stated maturities of a year or longer are renegotiated before the original stated maturity).

[56] Where there are multiple tranches of secured debt, an intercreditor agreement frequently allocates control rights to the first-lien lenders. For discussion of intercreditor agreements, see generally Kenneth Ayotte et al., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255 (2017); Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U. ILL. L. REV. 721; David A. Skeel, Jr. & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777, 1799–1811 (2018).

Because this dynamic is common knowledge, junior investors have correspondingly little reason to undermine the lenders' effective control.[57] Recall the Acme case and suppose that a senior bank now holds $500 of the company's $1000 of debt, the junior creditors holding the rest in equal shares. If junior creditors' collection efforts were to force a liquidation, the proceeds—$300 in our hypothetical—would go entirely to the bank. The junior creditors would get nothing. Better to wait.

Debt overhang. The lenders' senior status positions them to advance (or at least acquiesce in) new financing where warranted. Debt inhibits new financing only to the extent old debtholders are able to capture some of the value of any new investment. In the Acme hypothetical we considered above, for example, equity financing was impossible because the new project, if successful, would benefit old creditors in the first instance. Senior lenders do not face that problem, because the proceeds of any new investment will go first to pay their own claims.

To be sure, senior lenders' incentives are imperfectly aligned with those of junior investors.[58] Senior lenders may, for example, be overly eager to arrange an asset sale and insufficiently concerned with maximizing the proceeds from such a sale if one should occur.[59] But investors appear to prefer hierarchical capital structures in distress. The available statistical evidence suggests that companies tend, as their fortunes deteriorate, to replace unsecured debt with bank-led secured credit facilities.[60] That is, they move away from capital structures that would yield fragmented control rights in distress toward those that reduce fragmentation.

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To sum up: If ex post coordination failures justify bankruptcy, despite Chapter 11's costs, then what stands when, as today, market conditions allow investors to resolve distress-induced coordination problems without judicial

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[57] *See* Picker, *supra* note 5, at 657 (showing that security interest can make unsecured creditors' race to levy on collateral futile); Bebchuk & Fried, *supra* note 18, at 876 n.65 (noting same).

[58] On the existence and size of this conflict, see generally Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009).

[59] Lenders' recoveries are capped at the amount they are owed. They therefore have reason to advocate a sale—a reckoning that cuts off volatility—if the sale is expected to generate at least the amount of the loan. Since the potential proceeds of delay flow to junior claimants, lenders have reason to push for a fast rather than a value-maximizing sale process. *See generally id.*

[60] *See id.* at 518 (observing, in a sample of large Chapter 11s during Qs 3 and 4 of 2001, "an eleven-fold increase in secured debt . . . during the one to two years preceding the bankruptcy filing"); Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242, 4243–4244 (2010) (finding that, as credit quality deteriorates, firms increasingly finance operations with secured bank debt rather than arm's-length unsecured debt); *see also* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 629 n.15 (1997) (noting the near-total absence of secured credit "from the balance sheets of the most creditworthy companies"). Businesses generally have a relationship with a single bank lender. Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255, 284 (2009).

aid, and when contracting technologies allow them in most respects to prevent distress-induced coordination problems from arising at all?

II. BANKRUPTCY'S CATHEDRAL

My answer to this difficulty is that bankruptcy law has a useful role to play, even with modern financial markets being what they are, insofar as it can allocate control rights on a state-contingent basis. That is, bankruptcy law can toggle authority over the use of capital. In domains where investors cannot themselves arrange a toggle, bankruptcy can replace control rules suitable for flush times with those more suitable for distress. The remainder of this part will unpack this argument.

A. Characteristic Bankruptcy Interventions

In thinking about what corporate bankruptcy law can profitably do, it is helpful to start by observing what bankruptcy in fact does. A rough-and-ready taxonomy identifies three kinds of intervention characteristic of Chapter 11.

First, Chapter 11 alters the judicial role in supervising business decisions. Bankruptcy is a federal process, and the federal judge who superintends it effectively takes the place of a state judge—whether corporate law specialist or otherwise—who, absent a bankruptcy petition, would be tasked with adjudicating complaints about the soundness of managers' choices. But Chapter 11 does not just change the identity of the judge. It also puts the judge center stage, requiring managers to seek permission to make a variety of operational and financial decisions that state law polices only after the fact or when an investor affirmatively seeks injunctive relief.[61]

Second, the law imposes wealth transfers. One kind is government subsidy, usually in the form of a tax advantage for recapitalizing in bankruptcy. For example, the Bankruptcy Code immunizes property transfers made under a plan of reorganization from state and local stamp taxes that would otherwise apply.[62] The effect is to secure more wealth for the debtor's investors—as a group—and less for the public treasuries. Another kind of wealth transfer is intra-firm, in the sense that it privileges one kind of corporate constituent over another. Consider, for example, Chapter 11's treatment of interest on unsecured debt. Interest payable after a petition is filed is excluded from the allowable amount of a creditor's

[61] *See, e.g.*, 11 U.S.C. §§ 362–64 (2012) (conditioning authority to conclude a variety of transactions outside the ordinary course of business on judicial approval).

[62] *Id.* § 1145(a).

unsecured claim.[63] Because the total value of the claims to be allocated at the case's conclusion is fixed, this rule tends to transfer wealth from those who lent at high interest rates to those who lent at low rates and from priority unsecured creditors to junior claimants.[64]

Third, bankruptcy circumscribes investors' nonbankruptcy control rights while seeking to preserve their economic stakes. The automatic stay furnishes a good example.[65] Consider our friend Acme by way of illustration. We can think of the company as a collection of inflatable plastic fun houses coupled with an algorithm saying who gets to decide what to do with them. In ordinary circumstances, Acme's managers control the inventory. Only they get to choose which birthday parties to cater and on what terms. But their control is subject to the rule that, if Acme defaults on its loan, the Bank can elect to sell the bounce houses to the highest bidder. Outside bankruptcy, the Bank holds a real option. For the most part, a bankruptcy petition leaves relations as they were.[66] But the automatic stay in effect transfers the Bank's option to liquidate Acme to the company's managers (as long as the bankruptcy judge is satisfied that the Bank's interests have "adequate protection").[67] The Bank is still entitled to the value of its repossession right. Now, however, that value is to be determined by a judicially administered procedure rather than the Bank's own estimation.[68]

The first two kinds of intervention—altering the judicial role and mandating wealth transfers—are not easy to justify on economic grounds. As a matter of first principle, it is hard to see why the identity of the judicial officer responsible for evaluating managerial discretion should matter. The source of a judge's commission does not obviously bear on her expertise or impartiality in any predictable way. In the United States, because of the

[63] *Id.* § 502(b)(2) (instructing judge to disallow claim "to the extent that . . . [the] claim is for unmatured interest").

[64] The rules for plan confirmation are complicated, so this tendency, while remarkable, is only that. The disallowance of post-petition interest does not inevitably lead to a wealth transfer. For a thorough and instructive discussion of the rule's interaction with other Code provisions, see generally In re Energy Future Holdings Corp., 540 B.R. 109 (Bankr. D. Del. 2015). The treatment of undersecured creditors similarly can amount to a wealth transfer. *See* United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 382 (1988).

[65] 11 U.S.C. § 362(a).

[66] The doctrine that nonbankruptcy law determines, or ought to determine, entitlements, absent a bankruptcy-specific rationale for deviating, is associated with Butner v. United States, 440 U.S. 48 (1979) (holding state law governs property interests that are not determined by federal law). That doctrine, much celebrated among economically oriented scholars for a generation, is, however, unfortunately question-begging, since it is precisely a rationale for bankruptcy that one is after. Professor Casey makes this point in a recent manuscript. Casey, *supra* note 17 at 15–16; *see also* 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 (discussing *Butner*'s essential ambiguity).

[67] 11 U.S.C. § 362(a), (d)(1).

[68] *See infra* notes 153–154 and accompanying text.

Constitution's Contracts Clause, some kind of federal instrumentality may be needed to finally discharge liabilities.[69] But discharge is irrelevant in a corporate bankruptcy case.[70] And while it may be good policy to judicially license (rather than second-guess) some kinds of business decisions, the wisdom of such a policy is neither clearly connected to financial distress nor uniquely in a federal court's power to impose.

Nor does a company's financial distress call for wealth transfer in any generalizable way. This is true both of government and investor-to-investor subsidies. There may be sound reasons to subsidize particular people, companies, industries—even places[71]—but the reasons to do so, at least in the corporate context, are only loosely related to financial leverage or illiquidity, and are poorly vindicated by generic redistributive rules (like the stamp tax immunity) or judicial whim. To the extent subsidies are intra-firm, moreover, the rent-seeking they are bound to induce as investors jockey for position will likely be a net drag on the enterprise.[72]

B. Bankruptcy as a Control Rights Toggle

More promising—and the subject of the rest of my discussion—are rules that alter control rights while leaving economic entitlements intact. Judge Calabresi and Professor Melamed's famous typology helps show why.[73] The enduring contribution of their paper was, of course, to identify and elaborate two alternative means of vindicating legal entitlements to a resource.[74] A property rule, in their framework, grants the beneficiary unilateral control over the resource's use and exchange. If another wants access, he must buy it from the beneficiary at a price she accepts.[75] Ordinary market transactions illustrate the property rule's predominance in everyday life. A liability rule, by contrast, declares that another may appropriate the resource from the beneficiary on the condition that he pay her an officially

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[69] U.S. CONST. art. 1, § 10 ("No State shall . . . pass any . . . law impairing the obligation of contracts . . . .").

[70] If a corporation has no assets to levy on, the formal persistence of its debts (or not) is practically meaningless.

[71] Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 833–38 (2019) (discussing relationship between bankruptcy law and arguments for place-based subsidy).

[72] *See* Douglas G. Baird & 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, 100–01 (1984) ("[These] 'grab' rules undermine the very advantages sought in a collective proceeding."). *See generally* Roe & Tung, *supra* note 28 (documenting investor efforts to improve their priority in the bankruptcy system).

[73] *See* Calabresi & Melamed, *supra* note 11.

[74] We can safely ignore "inalienability" rules in the present context. *Id.* at 1111.

[75] *Id.* at 1092 ("An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller.").

determined price.[76] The paradigmatic illustration is of a judge determining just compensation—for a taking or a tort, say. But the notion of a liability rule—certainly as used in this Article—encompasses more than that. Liability rules can rely on private opinion as much as, or more than, on the judgment of a heroic judge or bureaucrat. What is distinctive about liability rules is that they price entitlements using third-party assessment rather than second-party consent.[77]

The respective costs and benefits of property and liability rules are the subject of an immense literature. Broadly speaking, property rules are cheap to administer and uniquely incorporate unverifiable private information and idiosyncratic (infra-marginal) valuations, while liability rules tend to be preferable where "the cost of establishing the value of an initial entitlement by negotiation is so great that even though a transfer of the entitlement would benefit all concerned, such a transfer will not occur."[78]

Commentators following Judge Calabresi and Professor Melamed observed that property and liability rules are elemental, raw materials out of which more elaborate governance regimes, or meta-rules, can be built.[79] One such governance regime, simple in form but crucial to the present account of bankruptcy, features state-contingent toggling between property and liability rules. The form is a meta-rule declaring that a property rule will vindicate so-and-so's entitlement to a resource unless and until such-and-such state of the world arises, at which time a liability rule will take its place.[80]

Students of the law will recognize the structure and economic logic of state-contingent meta-rules in the classic necessity-at-sea cases, *Ploof v. Putnam* and *Vincent v. Lake Erie Transportation Company*.[81] When the weather is fine, a property rule governs access to private docks. The captain who wants to come ashore must secure the owner's permission and is a trespasser without it. But when the weather turns foul, so that being on the water risks injury to person or property, a liability rule takes over. The owner's unilateral right to exclude gives way. The captain is entitled to dock,

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[76] *Id.* ("Whenever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule.").

[77] *Id.*

[78] *Id.* at 1106.

[79] *See, e.g.*, Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703, 704–07 (1996) (reconceptualizing property and liability rules as auctions with differing lengths and rules for distributing proceeds); Saul Levmore, *Unifying Remedies: Property Rules, Liability Rules, and Startling Rules*, 106 YALE L.J. 2149, 2150, 2153–63 (1997) (expanding the Calabresi–Melamed theory into a four-rule framework).

[80] This kind of meta-rule has also been described as a "pliability rule." *See* Abraham Bell & Gideon Parchomovsky, *Pliability Rules*, 101 MICH. L. REV. 1, 5 (2002).

[81] Ploof v. Putnam, 71 A. 188 (Vt. 1908); Vincent v. Lake Erie Trans. Co., 124 N.W. 221 (Minn. 1910). It seems to have been Justice Cardozo who first plucked these obscure cases from the law reports. *See* BENJAMIN N. CARDOZO, THE PARADOXES OF LEGAL SCIENCE 40 (1928).

and the owner is liable for preventing access.[82] Yet the owner's economic interest in the dock persists even as her control of it fades, because the captain must pay for any objectively determinable damages the boat's berth might cause.[83]

Toggling between property and liability rules can optimize the terms of cooperation. A competitive market is the analog to the fair-weather scenario. The captain has many potential docks to choose from, and her choice set constrains the dock owner to charge something like anticipated cost. Under these circumstances, there is no reason to bear the administrative costs and risk of undercompensation that a liability rule entails. When the weather turns foul, however, the situation changes. The costs of a liability rule remain, but now a holdout problem weighs on the other side of the balance. The captain's imperative to get to shore means that she and the dock owner are locked in a bilateral monopoly. Even if agreement will, in expectation, yield a large surplus (by saving cargo from peril), hard bargaining by each party to capture the lion's share can preclude agreement—and in any case, the desire ex ante to avoid being taken advantage of in the event of a storm will induce wasteful precautionary measures. Reference to a third party's estimate of the dock owner's damages becomes the dominant approach.[84]

Corporate finance has the same conflictual structure as the maritime misadventure cases. Distress can give rise to a bilateral monopoly (or series of bilateral monopolies) where holdout incentives threaten to dissipate joint wealth and so make a liability rule relatively more attractive than in times of financial health.

A hypothetical, generic lender's situation will illustrate the dynamic. Her decision to advance funds is a decision to allow an entrepreneur to use her capital. (It is akin to the dock owner's decision, in *Vincent*, to permit the boat to retain the use of his dock.) The governance question is how the lender's interest in the capital should be protected.

The lender faces potential expropriation. The entrepreneur, alone or in concert with other parties, can implement a variety of strategies that will tend to reduce the likelihood of full repayment. Running to a court to ask for damages for diminution of the expected value of her claim is expensive since

[82] *Ploof*, 71 A. at 188–89 (holding dock owner liable for damages caused by employee unmooring boat from dock in time of private necessity).

[83] *Vincent*, 124 N.W. at 221–22 (holding boat owner liable for damages incurred while boat remained docked during storm).

[84] *Cf.* Richard A. Epstein, *A Clear View of* The Cathedral*: The Dominance of Property Rules*, 106 YALE L.J. 2091, 2109–11 (1997) (giving similar account of *Ploof* and *Vincent*); Richard A. Epstein, *Holdouts, Externalities, and the Single Owner: One More Salute to Ronald Coase*, 36 J.L. & ECON. 553, 577–79 (1993); Todd J. Zywicki, *Libertarianism, Law and Economics, and the Common Law*, 16 CHAP. L. REV. 309, 316–18 (2013).

malfeasance may not be easily verifiable and damages may be hard to prove. Meanwhile, as long as the entrepreneur is financially healthy, the lender lacks leverage to hold up the company's other constituents by threatening to withdraw. The existence of other potential financiers ready to take the lender's place in the capital structure checks opportunistic ambition.[85] In these circumstances, a property rule, which allows the lender to withdraw her investment unilaterally on stated grounds, may be optimal while the borrower is financially healthy. And of course, property rules are ubiquitous in lending relationships, their contours being defined by the debt's maturity and associated covenants.[86]

When a company becomes financially distressed, however, things change. The lender continues to face the prospect of expropriation, but now she also imposes a holdout threat of her own on the company's other constituents. If keeping the lender's capital in place is crucial to the company's prospects, the entrepreneur, the lender, and the company's other constituents may be stuck with one another. Because of the company's default risk, outside investors are no longer willing to supply replacement capital on similar terms. The nub of the problem is that the total nominal value of outstanding debt exceeds the company's enterprise value. If each of Acme's 100 bondholders stands on her contract, demanding to recover $10, and there are only enough assets to give each the equivalent of $8 in the future, then the net result can be to yield only $3 today.[87] As in the maritime cases, the parties may consume resources haggling and may fail altogether to strike a mutually advantageous deal.

Under these circumstances, a liability rule, which allows the entrepreneur to retain use of the capital and pay lenders what a judicially managed process ultimately finds fair, may be the optimal rule. To be clear, this conclusion does not always follow. Much turns on what exactly the liability rule entails and how it is implemented. The more costly or error-prone the valuation method, the less attractive it will be relative to a property rule that yields a certain amount of bargaining failure. The goal for now is

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[85] There are, of course, fixed costs to refinancing that can give incumbents leverage. Depending on context, there may also be information-asymmetry problems. And if interest rates have spiked and the lender bore interest-rate risk, she may have reason to withdraw ahead of schedule. I am not asking the reader to believe in a zero-transaction-costs world. Far from it. The idea is just to see the *relative* advantages and disadvantages of unilateral withdrawal rights.

[86] The simplest debt contract—a bullet loan without covenants—can be understood as a way to discipline business managers by introducing state-contingent control rights. *See generally* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992) (arguing that state-contingent control rights may be optimal with incomplete contracts and wealth constraints); Mathias Dewatripont & Jean Tirole, *A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence*, 109 Q.J. ECON. 1027 (1994) (discussing manager discipline and control rights).

[87] *See supra* text accompanying note 24.

just to spell out the optimistic case for bankruptcy intervention. The toggle to liability rule is it.[88]

If a property rule is superior when the company is financially healthy and inferior when it is distressed, then a meta-rule that toggles between them on a state-contingent basis may be optimal. Toggling rules, implicit as often as explicit, are commonplace in corporate finance. As we saw, for example, the use of priority debt can be understood as a way practically, if not legally, to neuter the control rights of subordinated creditors in times of financial distress.[89] In a perfect world, investors could arrange these rules perfectly, specifying the precise nature of the property rule, the liability rule, and the conditions under which one or the other is to govern. Bankruptcy law could not be expected to improve things in such a world.[90] That, in any case, is the upshot of the institutional competence critique leveled above.[91] But in our world, notwithstanding remarkable developments in financial engineering, there are in fact, as we shall see, still domains where contract is inadequate to create state contingency. Sometimes law forbids it; sometimes technological limitations make it practically infeasible.

The pieces are now in place to see what bankruptcy law can offer in the face of the institutional competence critique: namely, state contingent-control rights in domains where investors cannot cheaply arrange them. More precisely, a bankruptcy intervention can improve on corporate and commercial law in situations where: (1) a property rule governs the relationship between a company and one or more of its constituents in the

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[88] Notice, too, that the prospect of a toggle can help the ex post markets identified above to function effectively. Recall that a robust distressed debt market concentrates ownership of debt so that the holdout problem disappears. *See supra* notes 44–49 and accompanying text. If but two or three sophisticated funds emerge with large stakes, they are bound to cut a deal where cooperation is needed to maximize value. But the existence of a property rule can dissuade a creditor from selling into the secondary market, just as it can induce her to hold out in restructuring negotiations. The creditor may rightly reason that she need not sell her debt—inevitably for less than its face value—if enough *other* creditors do. A stubborn property rule can thus stop secondary-market buyers from building sufficiently large stakes to overcome holdout. By contrast, the creditor's belief that a liability rule will be imposed in any event, cutting off the value of holding out, may prompt her to sell into the market.

[89] *See supra* note 57 and accompanying text.

[90] *Cf.* Barry E. Adler & George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 AM. BANKR. L.J. 563, 564 (2017) (discussing reasons to modify creditor priority and suggesting that courts "should not order efficiency-motivated adjustments that the parties could have achieved themselves").

[91] Suppose, for example, that ship captains could cheaply contract for weather-dependent dock-use rights with a variety of proprietors along their route—perhaps with a mechanism like American Society of Composers, Authors, and Publishers (ASCAP) song licensing. Would the necessity-at-sea cases still have ballast?

The idea of the institutional competence critique is not that every ex ante specification of state-contingent control rights will in fact lead to a value-maximizing disposition of assets ex post. It is that specification can be expected to beat judicial second-guessing (especially since the terms of the deal can specify *that a third-party should decide ex post*).

ordinary course; (2) the property rule is ordinarily efficient; (3) a liability rule is preferable under conditions of distress; (4) bankruptcy toggles from property rule to liability rule; and (5) legal or practical impediments would make it difficult for investors to arrange on their own for a distress-specific rule toggle.

III. Three Applications

This Part applies the framework to three important features of bankruptcy practice. It contends that bankruptcy law plays an important and arguably value-enhancing role in two of these features: prepackaged recapitalizations and going-concern sales. In both instances, the structure of background legal rules—federal statute in one case and state law in the other—frustrates parties' ability to assign control rights on a state-contingent basis. As a result, certain property rules are more stubborn than is probably optimal. But this part also argues that a third feature taken for granted among bankruptcy scholars and practitioners, the automatic stay of secured creditors' foreclosure rights, flunks the test. The contracts that establish these rights are flexible to such a degree that the automatic stay is hard to justify.

A. The Prepackaged Plan

One of the most common uses of bankruptcy, accounting for upwards of a third of all public-company Chapter 11s,[92] is to put into effect a "prepackaged" plan—a deal struck outside bankruptcy between a debtor and a bloc of creditors whose claims are to be restructured.[93] Excessive leverage is the culprit in these cases. The company's cash flows are too meager to service existing debt, but its managers and most of its creditors agree that assets are being put to good use. The solution is to change the debt's terms: exchange it for equity, extend its maturity, or reduce the principal or interest rate.

In the standard prepackaged case, the debtor's nonfinancial creditors, such as landlords, vendors, and employees, "ride through" the bankruptcy unimpaired. To them it is as if no petition was ever filed. Only financial claims are restructured. The happiest cases yield full compensation for the

[92] *See* Stuart Gilson et al., Cashing Out: The Rise of M&A in Bankruptcy (Mar. 6, 2016) (unpublished manuscript at tbl.1) (on file with the *Northwestern University Law Review*), https://ssrn.com/a=2547168 [https://perma.cc/M93X-J59H?type=image] (finding that 124 out of 350 public-company bankruptcies filed from 2002 to 2011 were prepackaged cases). There is some evidence that the rate of prepackaged or otherwise prearranged filings has increased in recent years. *See* John Yozzo & Samuel Star, *For Better or Worse, Prepackaged and Pre-negotiated Filings Now Account for Most Reorganizations*, 37 Am. Bankr. Inst. J. 18, 18 (2018). But the recent wave of bankruptcies caused by low energy prices—where recapitalization is an especially straightforward response—may exaggerate the picture.

[93] The Code allows binding solicitation of plan acceptance *before* the petition is filed. 11 U.S.C. § 1126(b) (2012).

financial creditors as well, albeit in a new coin—equity instead of debt, for example. Or the creditors take a haircut, receiving less than the face value of their claims but more than what they could fetch in the secondary market or from a liquidation. Because restructurings along these lines can keep assets in their highest value use, and therefore produce a surplus, they can attract broad-based support.

But why use Chapter 11? Bankruptcy is expensive even in cooperative cases. If investors can predict what they would receive in Chapter 11, they should be willing to restructure privately, in bankruptcy's shadow, so to speak, to avoid the incremental expense and so produce a greater recovery.[94] How, then, does the *bankruptcy* aspect of the prepackaged bankruptcy create value?

There are two basic reasons. One is to capture regulatory advantages, especially tax benefits, available only with the bankruptcy court's blessing.[95] From the standpoint of a company's investors, it makes good sense to procure a judge's stamp of approval if the associated savings are worth more than what the stamp costs. But from a social standpoint, it is hard to defend a program that consumes real resources to bring about a simple regulatory arbitrage. A dollar leaves the Treasury, but the debtor gets only ninety-nine cents.[96]

The other, socially more promising, reason to use bankruptcy is to supplant a property rule associated with publicly tradable bonds. Section 316(b) of the Trust Indenture Act of 1939 declares that indentures governing publicly tradable bonds may not permit amendment of core financial terms—the amount of principal, the rate of interest, or the repayment schedule—without the bondholders' unanimous consent.[97] Unanimity is hard to achieve.

[94] *See* Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595, 595 (1993) (noting that private workouts should "Pareto dominate" because borrowers and creditors can predict outcomes in Chapter 11).

[95] Speaking very generally, private restructuring can generate cancellation-of-debt income and impair the debtor's ability to use net operating loss carryforwards to offset future income. Tax law limits the significance of these effects for restructurings that occur in bankruptcy. 26 U.S.C. § 108(a)(1)(A) (excluding debt discharged in bankruptcy from income); *Id.* § 382(l)(5)–(6) (limiting consequence of general net operating loss (NOL) carryforward restrictions in change-of-control situation). For a thorough outline of the tax consequences of bankruptcy relative to out-of-court workout, albeit one now out-of-date on some particulars, see Linda Z. Swartz, Bankruptcy Tax Issues (2005) (unpublished manuscript), https://bit.ly/2wtxNc9 [https://perma.cc/K3ZS-5YZR]. For an overview of changes wrought by the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054, see *Final Tax Bill Will Have Significant Impact on Business Decisions and Operations of U.S. Companies*, KIRKLAND ALERT 8–10 (Dec. 22, 2017), https://bit.ly/2D0pw2V [https://perma.cc/HGF9-9S3W].

[96] For discussion of the bankruptcy anomaly as a matter of tax policy, see Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103 (1996), and Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153 (1995).

[97] Pub. L. No. 76-253, 53 Stat. 1173, codified at 15 U.S.C. § 77ppp(b). The law allows indentures to provide for amendment by majority for non-core terms. *See infra* notes 102–103 and accompanying text.

In practice, issuers trying to restructure debt without resort to bankruptcy (where the rule does not apply) must instead hope for a successful exchange offer. An issuer must persuade a sufficient number of bondholders to surrender their securities for new instruments with less onerous payment terms. In effect, the Trust Indenture Act requires that a property rule govern bondholders' core repayment rights.

The rule is plausible enough on the merits insofar as it applies to financially healthy companies. As is well known, majority- and supermajority-rule arrangements invite insiders to expropriate wealth from dispersed, minority creditors.[98] To illustrate the intuition, recall Acme Bounce House Corporation and its $1000 of bonds held pro rata by 100 bondholders. Suppose the bond indenture were to permit a two-thirds vote to modify repayment terms. It would now be in the interest of Acme's shareholders for the company to acquire $670 of the bonds—assuming for simplicity it could buy them at par—and vote to cancel repayment obligations outright. Acme would in this way expropriate $330 from the bondholders. It would take a total loss on the bonds it bought but realize a gain from cancellation of debt that would more than offset the loss.

To be sure, a scheme so indelicate would be impossible to pull off even absent the unanimity requirement for amending core payment terms. Among other things, bondholder vote tallies disregard the views of the issuer's insiders.[99] But more creative ways of accomplishing a similar end are well-known. Exchange offers conditioned on the exchanging bondholder's consent to amend terms "on the way out," for example, can replicate the economics of the simple hypothetical.[100] If the bondholders are sufficiently concentrated or can coordinate effectively, they can resist expropriation; but if they are dispersed and unable to coordinate, then, depending on their strategic calculations, a coercive exchange offer can succeed.[101]

[98] The logic of expropriation as well as many of its various instantiations have been thoroughly explored in the legal and financial literature. *See* Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1824–25 (1992); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1212, 1224–33 (1991) (discussing threat of bankruptcy and prisoner's dilemma via exit consent solicitation); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 246–48 (1987) (discussing insiders' purchase of controlling bloc and exit consents).

[99] 15 U.S.C. § 77ppp(a).

[100] *See, e.g.*, Coffee & Klein, *supra* note 98, at 1212 ("[B]y exploiting the threat that bondholders will be made worse off, corporations can achieve favorable recapitalizations through exchange offers that put the bondholders into a kind of prisoner's dilemma, thereby coercing the bondholders to accept an amendment to their indenture that in their unconstrained choice they would reject.").

[101] The details of such schemes are, for our purposes, secondary. What is important to see is only that if the terms of a bond issue are governed collectively, then an issuer's ability to treat bondholders differentially implies the possibility of expropriation. *See* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 605–06, 617–18 (1995).

Section 316(b) rules out the most straightforward forms of expropriation by allowing individual bondholders to insist on the bonds' initial repayment terms. This is not to say the rule blocks all avenues of expropriation. The stricture applies only to core repayment terms. Indentures can and typically do permit a majority or supermajority of bondholders to amend ancillary covenants that affect the bonds' value, sometimes very substantially.[102] Issuers can expropriate by persuading the requisite fraction of bondholders to relinquish valuable but nonfinancial covenants, such as those restricting the incurrence of additional, senior debt.[103] But the Trust Indenture Act at least arguably makes expropriation less likely by cutting off the clearest route.

The case for section 316(b)'s mandatory property rule weakens substantially, however, when the issuer faces financial distress, for distress introduces a creditor holdout problem to rival the insider expropriation problem.[104] Distress may cause the issuer to forgo valuable new investments or to sell off valuable old ones.[105] It may be sensible for bondholders (viewed as a group) to restructure their claims. Even where this is so, however, each bondholder acting alone has an incentive not to agree to restructure her own claim. Even if she is better off compromising than holding out and watching a restructuring attempt fail, she is *best off* holding out while a sufficient number of fellow bondholders compromise. The dynamic has been neatly summarized:

> Those debtholders who do not tender can see the value of their bonds rise if the exchange offer is successful since tendering creditors forgive some of the debt and reduce the default risk of the original debt. Although public debtholders as

[102] Bond governance varies substantially and can be quite complicated. For discussion of frequent patterns, see Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040, 1044–53 (2002).

[103] For the most recent judicial pronouncement to this effect, see Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp., 846 F.3d 1 (2d Cir. 2017). Section 316(b) declares that a bondholder's "right . . . to receive payment" cannot be "impaired or affected" without her consent. The question in *Marblegate* was whether an arguably coercive transaction, involving the stripping of a parent-company guarantee and the effective subordination of a bondholder without its consent, violated section 316(b). *Id.* at 3–4. The Second Circuit blessed the transaction because it did not involve amending the indenture's financial terms. (In fact, it did not involve amending the indenture at all.) *Id.* at 17. *Marblegate* leaves open at least two sets of practically important questions. First, to what extent will state-law rules such as the duty of good faith and fair dealing confine the magnitude of exit consents' effect? Second, can exit consents be used to strip payment obligations from guarantors? On the second issue, see Marcel Kahan, *The Scope of Section 316(b) After* Marblegate, 13 CAP. MKTS. L.J. 136, 141–44 (2018) (arguing for importance of structural relationship of guarantor to issuer).

[104] The connection between the holdout problem and the Trust Indenture Act was first analyzed in detail in Roe, *supra* note 98. A number of important papers subsequently addressed it. *See, e.g.*, Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1191 (1991); Stuart C. Gilson et al., *Troubled Debt Restructurings*, 27 J. FIN. ECON. 315, 322–23 (1990); Kahan, *supra* note 102, at 1055–56; Schwartz, *supra* note 94.

[105] *See* Ayotte & Skeel, *supra* note 30, at 1570–79.

a group would be better off if the exchange offer goes through, those with small stakes have an incentive to hold out. Thus, it can be very difficult to complete an exchange.[106]

The filing of a bankruptcy petition displaces section 316(b). In its place, Chapter 11 establishes a complex governance scheme designed to deliver bondholders a sum approximating fair value for their investments. The rudiments are familiar and quite simple insofar as prepackaged bankruptcies go. A supermajority of bondholders of each class—two-thirds by dollar-value and one-half by number—can, in general, impose the terms of a plan of reorganization on dissenters.[107] The power of the many to impose equal terms on all dissolves the payoff to brinksmanship and so increases the likelihood that value-enhancing restructurings will come off. But while supermajority rule solves the holdout problem, it also reintroduces the prospect of expropriation by corporate insiders or others with multiple (conflicting) investments in the debtor. To limit this problem's magnitude, Chapter 11 thus interposes the bankruptcy judge as arbiter of procedural as well as substantive checks on the power of the vote. As a matter of procedure, the bankruptcy judge is authorized to designate the votes of bondholders proceeding in bad faith.[108] As a matter of substance, the Code establishes a floor on the recovery any dissenting bondholder can be forced to accept—namely, the amount a judge reckons the bondholder would receive in a liquidation.[109]

Some kind of toggle could make sense, but could investors arrange one without the Bankruptcy Code? The short answer is no—at least not without substantially distorting financing decisions. Section 316(b) itself is the reason. The Trust Indenture Act is a federal statute and does not permit indentures to opt out of its unanimity rule on a state-contingent basis.[110] If a borrower wants access to the public debt markets, it must rely on bankruptcy

[106] Gertner & Scharfstein, *supra* note 104, at 1191.

[107] 11 U.S.C. § 1126(c) (2012) (establishing the classified voting rule); *Id.* § 1129(a)(8) (conditioning consensual plan confirmation on acceptance by impaired classes).

[108] *Id.* § 1126(e) ("On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.").

[109] *Id.* § 1129(a)(7)(A)(ii) (prohibiting plan confirmation unless every dissenting creditor "will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date"). The concern for minority interests in collective proceedings, even where nominally equal treatment is assured, is nothing new. For discussion of the roots of the "best interests" test, see Douglas G. Baird, Statutory Interpretation, Three Ways: The "Best Interests of Creditors" Test in Chapter 9 (Jan. 29, 2018) (unpublished manuscript at 7–10) (on file with the *Northwestern University Law Review*).

[110] The stringency of section 316(b) was not lost on its New Dealer proponents. On the contrary, their aim was precisely to force reorganizations into a bankruptcy forum, where a federal judge could ensure fair play to retail and otherwise dispersed creditors. *See* SKEEL, *supra* note 37, at 121–22.

to reliably restructure core financial terms. So, here is a situation where bankruptcy law's intervention facilitates valuable state contingency.[111]

One should not overstate what bankruptcy delivers in this regard. The Trust Indenture Act applies only to securities registered with the SEC. It does not apply to loans or to notes issued under an exemption to the registration requirements—for example, under section 506 of Regulation D.[112] A private note offering could provide for a springing collective-action clause on just about any terms the issuer thinks sensible.[113] Borrowers willing to confine themselves to private sources of capital could thus replicate bankruptcy's rule-toggling function contractually. As the cost to borrowers of forgoing public markets has diminished, so, too, has the correlative significance of section 316(b). Nevertheless, bankruptcy still has, and for the foreseeable future will have, a role to play in curtailing the holdout dynamic the Trust Indenture Act encourages.

B. The Section 363 Sale

This Section argues that bankruptcy can usefully facilitate the sale of distressed businesses by toggling rules addressing asset tainting and shareholder voting. In today's practice, Chapter 11 is frequently used to sell the debtor's business as a going concern. The simplest case has just two steps: assets are sold as a package to the highest bidder, and proceeds are distributed to creditors according to their rank. The economic logic of such sales is clear. They solve distress-induced coordination problems by separating productive assets from associated debts. The puzzle is not how going-concern sales resolve distress. It is what bankruptcy law can offer given that the institutions of state corporate law specialize in effecting and policing just this kind of change-of-control transaction.

The framers of the Bankruptcy Code did not foresee the significance of the going-concern sale device. In 1978, when the Code was enacted, there were few well-capitalized private equity or buyout funds, and none specialized in distressed assets.[114] Distressed companies of any size faced two

[111] As the reader will notice, amendment of section 316(b) might be a superior alternative. My aim is not, however, to prescribe optimal law. My analytical approach instead assumes background legal and technological conditions and asks how bankruptcy law could be useful, taking what is given.

[112] 17 C.F.R. § 230.506 (2019).

[113] A puzzle is why we do not in fact observe these. The existence of a bankruptcy system may be the reason. If the claims of *some* creditors will be subject to restructuring only in bankruptcy, then *other* creditors who want their de facto repayment priorities to match their de jure rights may need to bargain for matching procedural protection. This is so even if the optimal arrangement in a world without section 316(b) would be for none of the creditors to demand judicial process. In any case, the question is worth exploring more deeply.

[114] For a brief account of the origins of private equity, see Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 17–21 (2008).

realistic prospects—a restructuring of obligations or the piecemeal liquidation of assets—and so the Code did not feature provisions directed toward facilitating orderly going-concern sales.[115] Until the late 1990s this state of affairs persisted.[116] But the rise of distress-focused investment funds (chasing returns from the leveraged buyout bust), coupled with the increasing power of senior bank lenders (who, as we have seen, often have an incentive to push for a sale), set the stage for an active distressed M&A market.[117] Bankruptcy lawyers began to lean on section 363(b) of the Code, which generically authorizes the debtor, during the pendency of the case and subject to judicial approval, to "use, sell, or lease" property outside the ordinary course of business.[118] That provision became the principal fount of authority to sell. And today section 363 sales are a common event. Many debtors enter bankruptcy with the sole aim of consummating a sale.[119]

The financial logic of the going-concern sale is straightforward. A sale, like a negotiated reorganization, has the capacity to keep efficient configurations of people and assets together without interruption and to induce efficient new investments in the face of distress. This is so because a sale, like a reorganization, ratchets down the enterprise's leverage. They have the same financial significance. Both are in effect recapitalizations.[120] A reorganization alters the right side of the balance sheet to fit operations; a

[115] The Code did expressly acknowledge that a plan of reorganization could provide for the "sale of all or any part of the property of the estate ." 11 U.S.C. § 1123(a)(5)(D) (2012).

[116] The conceptual appeal of the going-concern sale was recognized as early as the 1980s. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136–38 (1986); JACKSON, *supra* note 24, at 223 ("There is no reason why chapter 7 could not be used as the vehicle to sell the firm as a going concern in the same way that companies go public."). But one study of cases in the Bankruptcy Research Database reports that only "about a half-dozen cases before 1995 involved important [section] 363 issues." Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 535 (2009).

[117] *See supra* notes 41–49 and accompanying text.

[118] 11 U.S.C. § 363(b).

[119] Exactly what fraction of cases result in a going-concern sale is hard to say both because there is variance year-to-year and because arbitrary definitional issues (e.g., size of firms of interest, meaning of "going-concern," etc.) cloud the subject. Nevertheless, for what they are worth, empirical studies of large-debtor bankruptcy resolutions have quoted a range of between one-fifth and two-thirds of all cases. *See* Ayotte & Morrison, *supra* note 58, at 520–21 (finding that out of 153 large-business Chapter 11s in Qs 3 and 4 of 2001, the "entire firm" sold in sixty-six percent of cases); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675–79 (2003) (finding ninety-three large-business Chapter 11s resolved in 2002; in conservative interpretation of data, forty-five were going-concern sales—another seven were major sales—and additional twenty-six were prepacks); Gilson et al., *supra* note 92, at 1–2 (including a sample of 350 public-company Chapter 11s from 2002–11; fifty-three percent do resort to § 363 sale, but authors code only about twenty percent as "going concern"); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 43–44 (2007) (graphing large, public-company section 363 sales through 2006); *see also* ABI COMM'N REPORT, *supra* note 6, at 85 (tabulating section 363 sales by year).

[120] Indeed, because the effect of the two transactions on capital structure is the same, the reorganization process has been described as a "hypothetical sale" to existing creditors. *See, e.g.*, Baird, *supra* note 116, at 128.

sale moves the operations into a firm whose balance sheet is already appropriately structured. Each transaction has its place. The downside of a going-concern sale is that it requires a well-capitalized (liquid) buyer, at least for large operations; the upside is that competitive bidding can provide an arm's-length valuation.

The question is not whether going-concern sales can relieve financial distress. The question is rather what economic role bankruptcy can play in the matter. State corporate law, after all, is competent to effect and regulate change-of-control transactions, and specialized benches, such as the Delaware Court of Chancery, are staffed by sophisticated observers of M&A market trends and experts in policing managerial self-interest. It is unlikely that bankruptcy judges enjoy any systematic comparative advantage in procuring favorable deal terms.[121]

Moreover, a typical sale process in fact looks remarkably similar whether conducted in or out of bankruptcy—at least from the 30,000-foot view. The standard process begins in either case with the debtor's management retaining financial advisors to value and market the firm's assets to potential buyers. After a bidder is identified as offering the best or highest price, the parties execute term sheets and definitive purchase agreements, which allow the seller to accept a better subsequent offer but also promise to compensate the initial, or "stalking horse," bidder should the seller ultimately choose another bid. A formal auction follows in some, but not all, cases. Auctions are more common in bankruptcy than nonbankruptcy sales; but in any case, the deal documents frequently permit the seller to shop for, and almost always allow it to accept, better offers. The seller then decides which, if any, transaction to close—although in either case judicial intervention is possible. The difference is a matter of timing and procedural posture. In bankruptcy, the seller needs permission to close. Outside bankruptcy, the seller can close unless a judge enjoins the sale.

[121] Critics of current section 363 sale practices frequently assume that the appropriate comparison is to a plan of reorganization or even to a woefully inadequate series of foreclosure proceedings under local real estate law and Article 9 of the Uniform Commercial Code. *See, e.g.*, Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 789–806 (2011); Jacoby & Janger, *Ice Cube Bonds*, *supra* note 52, at 895–905; Charles J. Tabb, What's Wrong with Chapter 11? (Mar. 14, 2019) (unpublished manuscript at 14–15), https://ssrn.com/a=3352137 [https://perma.cc/QW6J-G8LB?type=image] (arguing that secured lender in § 363 sale should get only the foreclosure value, and not the going-concern value, of the collateral); Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765, 768–72; *see also* Stephen J. Lubben, *The Board's Duty to Keep Its Options Open*, 2015 U. ILL. L. REV. 817, 821 (summarizing gist of debates on 363 sales as debates on the question, "[W]hat do 363 sales replace: chapter 11 cases or liquidations?"). But as the discussion above suggests, this is not at all obvious. The most natural comparison is between a section 363 sale and a routine M&A transaction under state law. One of the few to make this connection explicit is David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243, 1266–69 (2000).

The mechanics of bankruptcy and nonbankruptcy sale transactions differ in important ways, of course. But their process similarities underline the conceptual puzzle about bankruptcy law's contribution. They suggest, in particular, that bankruptcy is unlikely either to reduce the transaction costs associated with effecting a sale or to increase the likelihood that the highest-value potential buyer will emerge. The question, then, is how, if at all, bankruptcy can increase the net value of a company's assets.

Under current law, there are some purely redistributive (regulatory) advantages to conducting a going-concern sale in bankruptcy that may be privately advantageous for managers but are hard to justify in economic terms. Most significantly, asset sales effected under a plan of reorganization—but not under section 363—are immune to state and local transfer taxes that would otherwise attach.[122] But bankruptcy also intervenes along two dimensions to turn property rules into liability rules where contract would struggle to do likewise. These interventions—to wash away liens and other taints of debtor property and to cut off equity investors' voting rights—suggest bankruptcy law can enhance the value of market-mediated resolutions of financial distress.

1. Washing Tainted Assets

Asset-tainting rules comprise an important genus of property rule in corporate finance. These are rules that allow a debtor's personal creditors to look for satisfaction from the buyer of assets that once belonged to the debtor. The expectation of creditors' rights under these doctrines *marks* a debtor's assets, so to speak, reducing their value to potential arm's-length buyers. The ordinary lien is both the simplest and most prominent example. A perfected lien entitles the lienor to repossess its collateral upon the debtor's default—in whosoever's hands the collateral might be found—and pay itself from the proceeds of the collateral's sale. Two kinds of tainting rule in addition to the lien are also important to change-of-control transactions. Fraudulent transfer law allows a seller's creditors to reclaim property from the buyer if the buyer paid less than "reasonably equivalent value" and the seller was insolvent or nearly so.[123] Successor liability doctrines, which make

[122] *See* 11 U.S.C. § 1146(a); Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc., 554 U.S. 33, 52–53 (2008) (interpreting section 1146(a)'s stamp-tax exemption to apply only to transfers made under a confirmed Chapter 11 plan).

[123] UNIF. VOIDABLE TRANSACTIONS ACT §§ 4(a)(2), 5(a) (UNIF. L. COMM'N, amended 2014) (UVTA). The primary remedy is avoidance rather than repossession and sale, so it's not quite a lien. *Id.* § 7(a). *But see id.* § 7(b) (permitting creditor who has obtained a judgment to levy execution on the fraudulently transferred asset).

the buyer of tainted assets (and not just the assets themselves) liable for the seller's debts, likewise have special bite in the going-concern sale context.[124]

Asset-tainting doctrines share a common logic despite important differences. They allow a creditor to insist on full satisfaction of her claim even if doing so disrupts a mutually beneficial transaction. They protect her interest with a property right. Buyer and seller must persuade the creditor to accept less than the nominal amount of her claim.

Asset-tainting rules are sensible in the ordinary case. They protect creditors from a range of opportunistic tactics that a debtor and its third-party confederate could otherwise arrange and that purely contractual means are powerless to prevent. A debtor's gift of all of his property to a trusted friend is only the most flamboyant example. The problem generally stated is a debtor's ability to dispose of property for less than fair value. Without asset tainting, creditors would in such cases be left with recourse only to an empty or near-empty husk.

But the balance weighs differently when a distressed company is seeking to recapitalize with a going-concern sale. Managers in these cases may still have private reasons to offload the business for less than market value, of course. To the extent they or their friends are potential buyers, managers of distressed companies face the very same conflict of interest that motivates much of M&A law. In distress, however, asset-tainting rules provoke a reciprocal holdout problem among the creditors whom the taints protect.

Junior creditors of an insolvent firm who, due to their rank, will not be fully compensated may withhold support even for fair-value sales and then seek recovery from the buyer. Potential buyers, anticipating creditor sandbagging, will value the business less than they otherwise would. Asset-tainting rules can thus generate two kinds of problems. First, individual creditors may be able to improve their standing in the capital structure at the expense of others with superior claims. Second, and worse, value-maximizing transactions may be thwarted altogether.

Two variations on the Acme story will help to illustrate the dynamics. Acme wishes to resolve its financial distress by selling its stock of bounce houses and distributing the proceeds to its creditors. Acme's $1000 of debt

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[124] *See, e.g.*, Berg Chilling Sys., Inc. v. Hull Corp., 435 F.3d 455, 464–65 (3d Cir. 2006). *See generally* Frank Fagan, *From Policy Confusion to Doctrinal Clarity: Successor Liability from the Perspective of Big Data*, 9 VA. L. & BUS. REV. 391 (2015) (analyzing the factors courts seem to care about in assigning successor liability). For additional discussion of successor liability's relationship to M&A activity, see generally Albert H. Choi, *Successor Liability and Asymmetric Information*, 9 AM. L. & ECON. REV. 408 (2007); John H. Matheson, *Successor Liability*, 96 MINN. L. REV. 371 (2011); Mark J. Roe, *Mergers, Acquisitions, and Tort: A Comment on the Problem of Successor Corporation Liability*, 70 VA. L. REV. 1559 (1984).

is held by two creditors: C_1, who is owed \$600, and C_2, who is owed \$400. In the first version of the story, both debts are unsecured but C_1 has a priority claim. The highest-value buyer of the business, Childhood Conglomerated, values it at \$800. For simplicity we can imagine it will pay its full reservation price. C_1 will be made whole, and C_2 will recover half of what it is owed (\$800 – \$600 = \$200). But now suppose that C_2 has a viable successor liability claim against whoever buys the bounce houses. Childhood will no longer bid \$800, because it expects C_2 to come looking for an additional \$200 after the transaction closes. The solution is to bid \$400, all of which goes to C_1, and to pay C_2 in full after the fact. Successor liability effectively turns C_2's subordinated claim into a first-priority claim. There are second-order problems with this kind of priority jump, but ultimately the business is deleveraged and goes to the high-value buyer.[125]

In the second variation, both creditors have viable successor liability arguments. On this variation, Childhood will not bid for the business at any price. No matter how little it were to pay Acme for the bounce houses, one or the other creditor, or both, could seek full repayment after closing. Only by paying the full amount of their claims—that is, \$1000—can Childhood prevent subsequent repossession, but \$1000 exceeds its reservation price. To be sure, C_1 and C_2 might bargain with one another to release their claims and ensure the sale to the high-value buyer closes. Just as in the bondholder holdout problem described above, it is true that sufficiently concentrated creditors can reach deals to that effect. But where the potential beneficiaries of an asset taint are numerous—and recall that successor liability as well as fraudulent transfer determinations are made post hoc—the taint itself may prevent the assets moving to a high-value buyer.

Bankruptcy washes tainted assets. Section 363 of the Bankruptcy Code authorizes the judge to declare that a buyer of debtor property may sell that property "free and clear of any interest."[126] The most important Courts of Appeals for bankruptcy purposes, the Second and Third Circuits, have read this provision expansively to permit the extinction not only of in rem interests, such as security interests and mortgages, but also personal liability under successor liability theories.[127] And bankruptcy sale orders in fact

[125] *See* Roe & Tung, *supra* note 28, at 1270–78 (discussing significance of creditors' tactics to improve effective priority in bankruptcy).

[126] 11 U.S.C. § 363(f)(5) (permitting sale of debtor property "free and clear of any interest in such property" if the person whose interest is to be destroyed could be compelled "to accept a money satisfaction of such interest").

[127] *See In re* Motors Liquidation Co., 829 F.3d 135, 155–56 (2d Cir. 2016); *In re* Trans World Airlines, Inc., 322 F.3d 283, 288–290 (3d Cir. 2003); *see also* Illinois Dep't of Revenue v. Hanmi Bank, 895 F.3d 465, 472–75 (7th Cir. 2018) (holding that 363 sale blocks tax collector's statutory right to follow assets in bulk sale transaction); *In re* Chrysler LLC, 576 F.3d 108, 123–26 (2d Cir. 2009), *vacated*, Indiana State Police Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2010). This broad reading is implausible on textual

invariably track the Code's language. As a consequence, creditors of a selling debtor are obliged to accept the economic value of their claims as conclusively determined by the bankruptcy sale process.[128] State law lacks the tools to wash assets ex post in this manner. Formally speaking, foreclosure sales are fit for the task. But they are unwieldy and, for larger enterprises, difficult to coordinate across multiple jurisdictions.[129] So bankruptcy law effects a toggle the states are ill-equipped to decree.

But can parties themselves arrange state-contingent rules that sunset creditors' property rights in the event of a distressed asset sale? For many taints, practical reasons preclude such arrangements. Fraudulent transfer and successor liability, as well as a variety of miscellaneous liens, apply as a matter of law rather than contract. It is frequently impossible to determine ex ante who will benefit from them ex post. There may be no contractual relationship at all between a debtor and the creditors who invoke tainting doctrines. Think of tort creditors and government regulators, including taxing authorities. In other cases, the beneficiaries of a tainting rule may be contractually related to the debtor, but the stakes in each individual relationship may be too small to justify dickering.

The question is harder when it comes to negotiated security interests and mortgages. It seems at least plausible that credit agreements could toggle lenders' enforcement rights on a state-contingent basis. One can imagine, for example, a provision declaring that the secured creditor will not assert its

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grounds, because successor liability is not a theory of interest in property. Like alter ego or veil piercing doctrines, successor liability rather describes a theory by which one person ought to make good for an injury that a different person appears on the face of things to have caused. Whether it is good policy is another matter. *Cf.* ABI COMM'N REPORT, *supra* note 6, at 141–45 (advocating an expansive notion of "free and clear" not limited to interests in rem).

[128] I should emphasize that asset washing is not always justified, even where, as will often be the case, it can be expected to increase sale proceeds. The current practice is to authorize free-and-clear sales almost as a matter of course when bidding procedures are adequate. That is too lax. It ignores some important justifications for tainting doctrines. Among other things, taints provide a way to give priority status to involuntary debts. For a general discussion of this point, with special reference to environmental claims, see Stephanie Ben-Ishai & Stephen J. Lubben, *Involuntary Creditors and Corporate Bankruptcy*, 45 U.B.C. L. REV. 253 (2012). See also generally Joshua Macey & Jackson Salovaara, *Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law*, 71 STAN. L. REV. 879 (2019), applying insight in context of recent coal company bankruptcies.

[129] Judge Harner documents recent state legislation purporting to allow receivers and assignees for the benefit of creditors to sell debtor assets free and clear of creditor interests. *See* Michelle M. Harner, *Rethinking Preemption and Constitutional Parameters in Bankruptcy*, 59 WM. & MARY L. REV. 147, 188–93 (2017). She questions the validity of these innovations. But even to the extent they are valid, their usefulness is probably limited to businesses operating in a single state. Bankruptcy courts, by contrast, are constituted with the power to assert authority over debtor property nationwide. *See* STEPHEN J. LUBBEN, THE LAW OF FAILURE: A TOUR THROUGH THE WILDS OF AMERICAN BUSINESS INSOLVENCY LAW 7–8 (2018) (remarking on the efficiency of "applying a single set of rules to a company's collapse, regardless of whether its assets might be located in Irvine or Nashua"); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 547–52 (1994) (commenting on state courts' limited jurisdiction over persons and property situated extraterritorially).

lien against a subsequent buyer who acquires the collateral in a distressed sale with such-and-such procedural safeguards. Whether courts would honor and specifically enforce such a provision is another matter. If bankruptcy law stopped washing assets, we might find out. On the other hand, we might not. Senior secured lenders rarely object to free-and-clear going-concern sales, at least in today's corporate finance landscape.[130] To the contrary, it is they who are most likely to agitate for such a sale. After all, the additional proceeds attributable to selling assets free-and-clear go to the senior creditors until their claims are paid in full. The secured lender who objects to a sale is almost invariably a second-lien or otherwise subordinated lender, and subordinated lenders increasingly have proved willing to sign away their governance rights to the first-lien lenders through intercreditor agreements.[131] One suspects they would likewise agree to have distressed going-concern sales extinguish their liens if bankruptcy could not be counted on to do just that. In summary, then, bankruptcy law's asset-washing function appears to do what investors cannot do themselves in some instances and to achieve something harmless if potentially unnecessary or redundant in the case of secured debt.

2. *Disabling Equity Vote*

State corporate law conditions the sale of all or substantially all of a company's assets on shareholder approval.[132] The vote of a majority of the outstanding shares, not just of a quorum, is required. This relatively high bar acts as a quasi-property rule[133] bulwark against directorial misbehavior and is sensible in the ordinary case. To be sure, it is easy to imagine a world with no shareholder franchise norm. Dual-class structures give an indication of

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[130] The extraordinary terms of the sale in Chrysler elicited the one major exception to this generalization. *See generally* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010) (analyzing the unique elements of the Chrysler bankruptcy, including the unevenness of compensation to prior creditors).

[131] *See* Ayotte & Morrison, *supra* note 58; Ayotte et al., *supra* note 56; Skeel & Triantis, *supra* note 56.

[132] *See, e.g.*, DEL. CODE ANN. tit. 8, § 271(a) ("Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets . . . upon such terms and conditions and for such consideration . . . as its board of directors or governing body deems expedient and for the best interests of the corporation, when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon . . . ."); MODEL. BUS. CORP. ACT § 12.02(a) (AM. BAR ASS'N, amended 2016) ("A sale, lease, exchange, or other disposition of assets, other than a disposition described in section 12.01, requires approval of the corporation's shareholders if the disposition would leave the corporation without a significant continuing business activity.").

[133] One can quibble about classification. The shareholder-vote mandate is in one sense not a pure property rule, because it does not by its terms give any one investor a unilateral blocking right. On the other hand, the rule will in many cases functionally resemble a unilateral right: where voting rights are concentrated, as in a closely held firm or a firm with dual-class stock, and where a sizeable bloc of shareholders share an economic interest. Classification is not in the end very interesting, though, because the framework on offer, like the Calabresi–Melamed framework itself, is only a heuristic.

what that world would look like. But the right to vote on fundamental changes bears a straightforward logic. A board considering an acquisition offer faces a last-period problem. Its members cannot easily be counted on to maximize proceeds, and the shareholders, as claimants to the marginal dollar of proceeds, have the strongest incentive to ensure both that the board has fetched an adequate price and to accept the deal if it has.[134] Shareholders *also* have recourse to liability-rule protections, of course. Fiduciary-duty suits and appraisal proceedings supply a judicial backstop for minority shareholders in cases where the majority might prefer a below-value sale price.[135] But proving one's case is sufficiently difficult that it may make good sense for shareholders to have a blocking right.

When a company is distressed, however, the case for a shareholder veto power is far weaker. The shareholders of an insolvent firm do not have a claim on the value of its assets. On the contrary, a variety of legal rules bar distributions to shareholders while the corporation is insolvent or nearly so.[136] Even a commercially reasonable going-concern sale will typically leave them out of the money. Consequently, shareholders will in general be poor arbiters of fair value. They may rationally withhold their approval, scotching a commercially reasonable transaction, in the hope either of a long-shot recovery or extracting a concession from creditors.[137]

Although state corporate law does not adjust voting rights in distress, bankruptcy law can effectively cancel shareholders' blocking position on a state-contingent basis. Section 363 conditions the closing of a transaction on the bankruptcy judge's approval only.[138] Plans of reorganization calling for a going-concern sale likewise can be confirmed over shareholder dissent.[139] In either case, the distribution to shareholders, if any, comes in the main only after creditors have been satisfied.[140] In other words, shareholders' recoveries

[134] This is a standard account. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67–70, 79–80 (1991) (discussing the risks of voting rights).

[135] *See, e.g.*, Charles R. Korsmo & Minor Myers, *The Structure of Shareholder Litigation: When Do the Merits Matter?*, 75 OHIO ST. L.J. 829, 855–67 (2014).

[136] *See* DEL. CODE ANN. tit. 8, § 170(a) (dividend restriction); MODEL. BUS. CORP. ACT § 6.40(c) (same); UVTA § 4(a)(2) (fraudulent transfer).

[137] *See* David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 508 (1992).

[138] 11 U.S.C. § 363(b) (2012). The ABI Commission highlighted and approved of this feature. *See* ABI COMM'N REPORT, *supra* note 6, at 194 ("A debtor in possession's board of directors or similar governing body should be able to act on behalf of the debtor in possession in the chapter 11 case without seeking or obtaining approval of the debtor's equity security holders, including with respect to transactions under section 363 of the Bankruptcy Code.").

[139] 11 U.S.C. § 1129(b) (setting out conditions on which a bankruptcy judge may cram down plan over dissent of impaired class).

[140] It should come as no surprise that the fraction of bankruptcy resolutions violating absolute priority is inversely related to the fraction of cases featuring a going-concern sale. *See* Ayotte & Morrison, *supra* note 58, at 513, 523 (finding deviation from absolute priority in no more than nine percent of cases).

track their place in the capital structure and, in particular, the value of their economic interests as determined by a judicially managed process.

Bankruptcy law's elimination of the shareholder veto may be expected to increase asset values if investors cannot effectively arrange for a superior state-contingent toggle on their own. Whether they can is an open question.[141] The state-law voting mandate applies, as I say, to corporations in all financial conditions. But it may be possible to alter the predicates to which the mandate attaches so as to make it practically inapplicable when the company is distressed. Under Delaware law, for example, the denominator to which the majority-vote mandate applies is defined as the "outstanding stock of the corporation entitled to vote [on the sale resolution]."[142] Delaware appears to allow a corporation to condition the "entitle[ment] to vote" on contingent facts. In particular, the law declares that "[a]ny of the voting power[]" to which a class of stock is entitled "may be made dependent upon facts ascertainable outside the certificate of incorporation or of any amendment thereto."[143] And the "facts" that can activate or curtail the voting rights of a class of stock include "a determination or action by any person or body, including the corporation."[144] Together, these rules seem to permit investors to arrange tailored, state-contingent voting arrangements. If that is so, then state law should be sufficient. But the chain of inference is sufficiently long, and the attitude of corporate law to state contingency sufficiently untested, that as things stand bankruptcy's toggle may do some good.[145]

C. The Stay of Foreclosure

The filing of a Chapter 11 petition stays a wide range of creditors' collection activities, from lawsuits and simple dunning to, most importantly, the enforcement of liens against debtor property.[146] The drafters of the Bankruptcy Code saw the automatic stay as a lynchpin of the system. The Senate's Committee Report on the bill went so far as to call it "one of the

[141] If investors are willing to forgo corporate status, they can almost certainly arrange for a state-contingent voting rule that courts will honor. The LLC form, for example, is famously flexible. But there are many implications to opting out of the corporate form. A workaround that involves using an entirely different entity form is a tall ask.

[142] DEL. CODE ANN. tit. 8, § 271(a) (2019).

[143] *Id.* § 151(a).

[144] *Id.*

[145] For discussion of the view that bankruptcy's prominence has relieved state lawmakers from the need to consider distress-specific voting rules, see David A. Skeel, Jr., *supra* note 39, at 506–09 (1994); see also Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. (forthcoming 2020) (on file with the *Northwestern University Law Review*), https://ssrn.com/a=3286081 [https://perma.cc/NVU8-SCFH?type=image], arguing that Delaware courts have unwisely abandoned responsibility for policing insolvency-related opportunism.

[146] 11 U.S.C. § 362(a) (2012).

fundamental debtor protections provided by the bankruptcy laws."[147] The aim was to stop secured creditors from withdrawing important collateral from the business—which absent the stay they could do unilaterally—as long as the reorganizing debtor was protecting the *value* of the creditors' liens.[148] In the early years of the Code, debtors frequently sought relief under Chapter 11 precisely to take advantage of the stay, using the "breathing spell" it provides to negotiate debt relief. Today it is less common for debtors to declare openly that they hope bankruptcy will cut them some slack from the rigor of creditors' claims. But the stay is still important to practice, and it generally thought to be a necessary and central feature of bankruptcy.

Common wisdom notwithstanding, the automatic stay of secured creditors' foreclosure rights is hard to justify. The stay is a kind of property-to-liability-rule toggle. It displaces secured creditors' right to take collateral (or decide what concessions are compensatory), in favor of a judicial power to decide whether the creditors' interests are adequately protected.[149] The stay thus resembles the interventions discussed above. But in another way, it is different. Investors can write tailored, state-contingent foreclosure rules on their own. Indeed, in some respects they already do. If parties want to use security interests, but want to limit the conditions of default on which lenders can foreclose, they can; and if they want to establish payment priorities associated with liens, but want to jettison altogether foreclosure without judicial process, they can for the most part do that, too. The flexibility of contract to provide for and specify state-contingent rule-toggling suggests that bankruptcy law's intervention is likely to be at best redundant.

Security interests have two generic functions. These are what Professors Bebchuk and Fried have called the "priority" and "repossessory" functions.[150] A creditor with a (superior) lien can demand full repayment of its claim, up to the value of the collateral, before others recover anything. Security interests are thus useful tools for constructing hierarchically stratified capital structures.[151] They also truncate procedural barriers to debt

[147] S. Rep. No. 95-989, at 54–55 (1978) ("The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.").

[148] 11 U.S.C. § 362(d)(1) (directing the bankruptcy judge to lift the stay absent adequate protection of interests in collateral).

[149] Vincent S.J. Buccola, *The Bankruptcy Firm*, 167 U. PA. L. REV. ONLINE 1, 4–6 (2019) (developing the idea that the automatic stay shifts control rights while leaving economic interests intact).

[150] Bebchuk & Fried, *supra* note 18, at 860–61.

[151] *See supra* notes 50–56 and accompanying text. There is perennial debate about whether priorities can reduce a company's total cost of capital—and if so, how. *See* Danielle D'Onfro, *Limited Liability Property*, 39 CARDOZO L. REV. 1365, 1392–1406 (2018); *see also* Ronald J. Mann, *Explaining the*

collection, because secured creditors can seize and sell collateral, rather than litigate, in the event of default. Put crudely, the lien allows a secured creditor to shut down operations before an otherwise similarly situated unsecured creditor would be able to do so.[152] Bankruptcy largely respects the priority function, but the automatic stay undermines the repossessory function.

The reader will by now anticipate the automatic stay's formal structure. A lien creates a property rule inasmuch as it allows the secured creditor to withdraw its investment unilaterally. If a debtor wants to hold onto collateral, it must persuade the creditor to forbear. The automatic stay blocks the right's exercise. In place of foreclosure, bankruptcy offers the secured creditor a judicially mediated procedure ostensibly designed to yield the economic value of its lien. If at any time while the case is pending it appears that the process will be unable to deliver that value—if, to use the statutory language, a secured creditor's interests are not "adequate[ly] protect[ed]"—the bankruptcy judge is directed to lift the stay and allow foreclosure.[153] Crucially, though, it falls to the judge to decide both the nature of adequacy and the size of the secured claim,[154] and so the automatic stay replaces a property rule with a liability rule.

The case for the automatic stay is, however, substantially weaker than the case for the interventions previously discussed. With respect to foreclosure, investors can deploy state contingency on their own if they wish to do so. Credit agreements already feature provisions that curtail secured creditors' repossession rights upon default. They are called grace periods: intervals after a default during which the borrower can cure and so prevent foreclosure rights from ripening.[155] Grace periods are usually a fixed number of days—thirty or sixty days are common—but there is no reason investors could not modulate length in accordance with the borrower's financial condition. Secured creditors could even covenant not to foreclose at all until specified conditions hold in addition to the fact of default, and these conditions could be rule-like (for example, using balance-sheet metrics) or standard-like (for example, using third-party discretion). We do not see such

Pattern of Secured Credit, 110 HARV. L. REV. 625, 627–29 (1997) (describing debate and providing evidence of managers' views of the significance of security interests).

[152] Lenders rarely want to foreclose. *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 164, 221–22 (1997) (reporting that lenders forcibly repossess collateral only rarely). Instead, they use the right do so as a source of leverage. What the creditor principally wants is influence over the debtor's operational and financial policy. Foreclosure rights are thus best understood as cumulative with other sources of creditor influence.

[153] 11 U.S.C. § 362(d)(1) (2012).

[154] To be precise, it is a creditor's "interest in property" that must be adequately protected. *Id.* Its "interest in property" is limited to the size of its allowed secured claim, which itself, if contested, requires judicial valuation of the collateral. *Id.* § 506(a)(1).

[155] *See* BELLUCCI & MCCLUSKEY, *supra* note 53, at 445.

provisions today. They would serve no purpose as long as the automatic stay is in place. But they would not be especially hard to draft.

A potential objection to this line of reasoning arises from the temporally staged nature of corporate finance. In the real world, a firm's operations are not financed all at once, but over time, and this fact can vitiate otherwise sound inferences one might draw from observed patterns of financing. In particular, Professor Ayotte has developed a model with staged financing in which a stay of foreclosure rights may be efficient.[156] The conclusion holds under three conditions: first, the debtor has firm-specific assets that cannot easily be replaced; second, bargaining frictions exist between secured creditor and debtor such that renegotiation might not lead to an allocatively efficient disposition of the collateral; and third, earlier-in-time lenders can neither prevent later-in-time secured lending nor charge for its subordinating effect on their claims.[157] When these conditions hold, Ayotte shows, a debtor and later-in-time lender can together use a lien to extract wealth from earlier-in-time creditors.[158] It follows that staged financing choices will yield too many liens. The automatic stay (partly) unwinds the capacity to expropriate and so may, under the model's conditions, improve financing incentives ex ante.

The reasoning is sound, but the model's conditions are unlikely to obtain in most real-world situations. Specifically, the third condition—that earlier-in-time lenders cannot prevent or price the effect of subsequent secured credit—is unrealistic where institutional debt is the primary source of financing. Earlier-in-time lenders can, and frequently do, bargain for a negative pledge precisely to avoid being later subordinated without compensation.[159] The negative pledge is a standard covenant that the borrower will not encumber or dispose of property to secure subsequent borrowings unless when doing so it equally and ratably secures the earlier-in-time lenders.[160] The effect is to force a debtor who wishes to borrow on a secured basis either to redeem existing debt or procure a waiver or modification under whatever terms the debt instruments provide.

[156] *See* Kenneth Ayotte, On the Mandatory Stay of Secured Creditors in Bankruptcy (Apr. 2017) (unpublished manuscript at 6–22) (on file with the *Northwestern University Law Review*).

[157] *Id.* at 3.

[158] *Id.*

[159] The negative pledge is an old covenant. *See, e.g.*, Louis S. Posner, *The Trustee and the Trust Indenture: A Further Study*, 46 YALE L.J. 737, 757 (1937).

[160] William W. Bratton, *Bond and Loan Covenants, Theory and Practice*, 11 CAP. MKTS. L.J. 461, 470–71 (2016). A covenant restricting sale-leaseback transactions—the significance of which for unsecured creditors is the same—is nominally distinctive from the negative pledge but is invariably coupled with it. *Cf. id.* at 471, 480. I omit reference to sale-leaseback covenants in the text for simplicity.

To be sure, negative pledges bind only the issuer, not prospective later-in-time lenders who might want collateral.[161] Security granted in violation of a negative pledge is still good security, and the lender with it has priority whatever the debtor might have promised in an indenture. But that subtlety of doctrine can hardly matter outside cases of fraud. The violation of a negative pledge puts the issuer in default. It allows the earlier-in-time lenders or their representative to accelerate repayment obligations.[162] The hypothetical later-in-time lender who procures security is therefore advancing funds *into a default*—not exactly a well-designed strategy for expropriation.

In a world where bankruptcy law did not impose a stay, there would, of course, be cases that run contrary to investors' expectations, instances where a debtor could find a value-enhancing deal if but only if it could have more leash than its secured creditors would give. But absent reason to believe investors are systematically wrong in their estimations of discipline's value, one struggles to see how the automatic stay could be expected to increase the net value of debtor assets. Nor should one be surprised to find investors dispensing with a debtor-initiated reprieve. A "breathing spell" does not obviously offer much in the modern era. There is no magic to a bankruptcy petition. It generates no new information. If a deal to preserve a company's business is available—whether through a debt restructuring or a going-concern sale—its managers can learn about it equally well whether or not a Chapter 11 case has begun.

IV. THE ESSENTIAL CHAPTER 11

An exhaustive accounting of bankruptcy law would assess its many interventions one by one. It would consider everything from the way bankruptcy alters the decision space for quotidian matters of corporate governance, such as executive compensation,[163] to the extraordinary power the law grants firms to do things like assume breached executory contracts and leases[164] and subordinate existing creditors to new lenders.[165]

My central aims in this Article—to develop a framework with which one can serially assess bankruptcy interventions in real market contexts and

[161] *See* Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773, 1812–13 (2013).

[162] *See, e.g.*, Kahan, *supra* note 102, at 1049.

[163] Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653 (2019) (finding that the 2005 law banning Chapter 11 debtors from paying retention bonuses had little impact on executive compensation).

[164] 11 U.S.C. § 365(a) (2012).

[165] *Id.* § 507(a) (prioritizing certain obligations incurred after petition's filing); *id.* § 364 (authorizing debtor-in-possession to borrow in ways it could not outside bankruptcy).

to illustrate that framework's promise—are more modest. That said, under the criteria offered here, it will prove hard to justify a wide variety of bankruptcy interventions that are central to modern practice and that occupy a good deal of judicial and advisory resources.

The rules governing debtor-in-possession financing are an important case in point worth sketching very briefly. Outside bankruptcy, a company's ability to borrow on a high-priority basis is limited by the rights of its existing lenders.[166] If the debtor wants to subordinate their claims, it must persuade them. In bankruptcy, however, the same company can access high-priority, and therefore low-cost, credit subject only to judicial approval. The Code effectively imposes a distress-specific liability rule. By providing access to liquidity, the borrowing rules can do real good.[167] But they can also do harm.[168] It is easy enough for investors to design ex ante the kind of borrowing rights they want the debtor to have ex post—to create unilateral access to priority borrowing, to interpose a third-party arbitrator to settle disputes about such access, or otherwise. Bankruptcy's imposition of distress-specific borrowing rules thus seem hard to defend in the same way the automatic stay is.

Taking bankruptcy's cathedral seriously would imply major changes. Getting rid of the automatic stay alone would force a significant recalibration of reorganization practice. Getting rid of bankruptcy-specific financing rules would do the same. And so on. Altogether the emerging picture is that of a stripped-down bankruptcy regime in which the importance of a distinction between pre- and post-petition affairs dwindles and in which the judge's supervisory role diminishes or disappears entirely.

It is thus worth reflecting in closing, at least briefly, on what a Chapter 11 designed to reflect bankruptcy's essential functions would look like. I want to suggest that supervision of the debtor's business would, for the most part, be left to the institutions of corporate law. The bankruptcy judge's responsibilities would center on the consideration of extraordinary balance-sheet transactions designed to relieve financial distress. Upon receiving an application, the bankruptcy judge would have two basic jobs: first, to certify that the conditions for rule toggling are satisfied;[169] and second, to determine

[166] Lenders frequently limit the amount of additional debt a borrower may incur. *See, e.g.*, BELLUCCI & MCCLUSKEY, *supra* note 53, at 370–74. State law, with certain limited exceptions, *see* U.C.C. § 9-324 (AM. LAW INST. & UNIF. LAW COMM'N 1977) (granting priority to perfected purchase-money security interests), prevents subsequent lenders from jumping to the front of the queue in any case. *Id.* § 9-322(a).

[167] Adler & Triantis, *supra* note 87, at 567–70; Ayotte & Skeel, *supra* note 30, at 1558.

[168] *See* Triantis, *supra* note 36, at 927 ("[T]he issuance of priority debt may create excessive incentive to invest, causing overinvestment in risky . . . projects.").

[169] This determination could, but need not, be left to the judge's intuition. One could imagine, in the alternative, debt documents spelling out observable metrics, as financial covenants routinely do, to define eligibility, or even punting discretion to a preferred third party.

whether the transaction proposed to relieve financial distress treats the investors fairly. The criteria the judge would use could in principle be the same as those under existing law. Current rules for plan confirmation[170] and norms for washing assets in a going-concern sale[171] could still prevail. In this sense, the court's role might not look too different from a typical prepackaged case. A record would be created. Dissenting voices would be heard. A judgment would be reached.

An "essential" Chapter 11 might look structurally similar to the National Bankruptcy Conference's 2014 proposal to streamline prepackaged cases.[172] The proposed Chapter 16, as it was called, had no automatic stay, lacked any notion of an "estate" distinct from the debtor's nonbankruptcy property, and did not contemplate subjecting debtor management to extraordinary judicial supervision.[173] A business could operate in the ordinary course and use bankruptcy at the same time to compose debts that would otherwise be hard to restructure because of the Trust Indenture Act and associated contracting norms. If the requisite supermajorities were willing to compromise their claims and the debtor's plan did not unfairly single out dissenters, the court could effect the restructuring without rigmarole. What the Conferees saw, at least implicitly, is that no elaborate jurisdiction is needed to toggle out of the Trust Indenture Act's property-rule regime.

The same could be said of other toggles that the Conferees' proposal did not cover. Chapter 16 did not provide a way to effect a going-concern sale. One can see, however, how a similarly motivated proposal might streamline the process to wash taints and disable equity vetoes. Other dispositions to relieve financial distress may also, as I have said, be justified. The generic point is that the things bankruptcy law can usefully do in the modern economy can be done more cheaply and with less interruption to business than is possible with the current institutional apparatus in place.

It is an old saying in the reorganization bar that a bankruptcy court sits as "a court of equity."[174] The saying is meant to imply the need for, and a settled policy in favor of, a wise chancellor who can wield extraordinary discretion to see that justice is done in complex disputes. Setting aside the question whether American bankruptcy courts were ever courts of equity

[170] 11 U.S.C. § 1129.

[171] *Id.* § 363(f).

[172] NAT'L BANKR. CONF., PROPOSAL FOR A NEW CHAPTER FOR RESTRUCTURING BOND AND CREDIT AGREEMENT DEBT (CHAPTER 16) (2015).

[173] *Id.* at 7.

[174] The phrase seems to have originated with Justice Story. *See* Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity*, 79 AM. BANKR. L.J. 1, 11–16 (2005).

strictly speaking,[175] it may well be that a freewheeling jurisdiction was once valuable. One way to grasp the kind of bankruptcy envisioned here is to see that the judicial role would be quintessentially that associated with the common law, not equity. The judge would be presented with essentially binary choices: do the conditions warrant displacing the ordinarily prevailing property rules, and if so, does the proposed transaction give those whose interests are being transformed fair compensation?

The advantages of a stripped-down bankruptcy should be easy to see. They are in one sense this Article's central subject. A minimal regime would preserve legal mechanisms to de-lever distressed businesses where holdout incentives might otherwise interfere. But it would do so at lower cost and with less scope for inefficient continuation or wrangling to get "in" or stay "out" of bankruptcy—concepts with little meaning in a world where bankruptcy courts have no need to assert ongoing jurisdiction. The idea, in short, is for the institutions of bankruptcy to focus on what they uniquely can do.

In principle, a wise judge could do better by doing more. She could strictly improve on whatever private ordering might call for by adhering to contractual norms in the typical case but intervening—ordering a stay and administering the estate—in the standout case.[176] Frauds and cases driven by noninstitutional debt present the strongest argument for retaining at least a potential managerial role for the judge. These are the situations where panic and disorder are most likely. Where the managers of a company with institutional debt are honest about performance, crisis is unlikely. After all, distress is a continuum. Sophisticated creditors know when important debts are due to mature and, therefore, when liquidity is a concern. They update their views on an ongoing basis. A distinctive *bankruptcy* jurisdiction is unlikely to add much if everyone is doing their job. But if, for example, it is suddenly revealed that a company's managers have been cooking the books and the magnitude of fraud is unknown, chaos may quickly dissipate value.

This is just to say there is an insuperable rule/discretion trade-off when it comes to the judicial role. A stripped-down bankruptcy law in its purest form would get rid of judicial discretion to impose liability rules inconsistent with the contracts and other artifacts of private ordering. But the purest form is not the only form worth thinking about.

[175] *See id.*

[176] The automatic stay is in effect a grant of discretion to the bankruptcy judge. It halts collection activities *unless* the judge decides that lifting the stay or dismissing the case outright is in the interests of justice. 11 U.S.C. § 362(d)(1) (instructing judge to lift stay "for cause"); *id.* § 1112(b)(1) (instructing judge to dismiss case if doing so is "in the best interests of creditors and the estate").

How a minimal understanding of bankruptcy would look in the real world would depend ultimately on implementation. There are at least three ways the law could move, each with its unique political economy and practical effects. The purest is a wholesale legislative scuttling of Chapter 11 as we know it. Congress would take the lead in trimming bankruptcy's jurisdiction. The vision is clear, but it will not happen anytime soon. A more realistic legislative move would be less radical. Congress would authorize something like the "menu" approach advocated by Professor Rasmussen.[177] It would preserve the existing system as an option to which companies could pre-commit in their organizational documents, while allowing them to swear off the prospect of all but the most minimal interventions. This would have the merit of testing first principles against investor demand.[178]

A third approach—judicial implementation—is the most politically expedient and so the most practically intriguing. This implementation would turn not on amending the Bankruptcy Code, but on altering judicial attitudes toward their own, considerable discretion under the Code. It could only ever deliver an adulterated version, since a substantial amount of bankruptcy law is nondiscretionary. The Code says that there *is* an automatic stay, for example, not that bankruptcy judges should consider imposing one. No amount of judicial interpretation will change that. And the law is clear about a variety of distributional rules hard to square with the principles identified here. These would not change. But bankruptcy judges could do a lot to encourage practical norms consistent with its insight. They could do so most profoundly by signaling impatience with the automatic stay even where post-petition liquidity is arranged.[179] They could ask that debtors file a credible proposal for a rebalancing transaction along with their petition and get to the merits, whether contested or not, quickly. And to the extent bankruptcy judges need to supervise debtor affairs in the interim, they could seek to

[177] Rasmussen, *supra* note 5. This was part of a broader debate in the 1990s about the merits of privately designed, or contractual, reorganization schemes. Other important proponents include Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Schwartz, *supra* note 94; and Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998). For critical assessments, see Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503; Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999); and Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

[178] One is reminded of Nevada's attempt to win incorporation business allowing more flexible corporate arrangements than Delaware. The theory was plausible, because Nevada offered a strictly larger set of possible fiduciary norms, but the experiment largely a failure—certainly much less successful than its promoters hoped it would be. *See* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935 (2012); Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 REV. FIN. STUD. 3593 (2014). The lesson is that network effects create path dependence, so that first principles of contract theory need testing. It might turn out that something analogous is at play in reorganization contexts.

[179] The Code instructs judges to lift the stay "for cause." 11 U.S.C. § 362(d)(1).

mimic otherwise applicable standards. The result would be a substantial shift in practice toward an economically justifiable bankruptcy law.

CONCLUSION

Bankruptcy is predicated on the notion that a company's distress constitutes an exceptional case justifying departure from the ordinary governance rules. Just as severe weather permits a ship captain to commandeer another's dock, private necessity temporarily supplanting the standard rule of trespass, the ordinary norms of corporate and commercial law should give way in financial distress. The creditors' bargain model has been fruitful because it shows how and why distress can lead to suboptimal decisions when coordination is difficult. What the model has lacked is an inherent reference to the technologies of investor coordination other than the law itself.

My aim in this Article has been twofold—first, to develop a normative framework that takes dynamic account of contractual technologies; and second, to begin exploring where such a framework takes us practically in the modern American setting. The normative framework locates a justification for law's distress-specific intervention when five criteria are satisfied: (1) an investor's economic interest is ordinarily protected by a property rule; (2) that rule is ordinarily efficient; (3) a liability rule would be more efficient when the debtor is financially distressed; (4) law intervenes to toggle from property rule to liability rule; and (5) legal or practical impediments would make it difficult for investors to arrange a distress-specific toggle on their own.

The conclusion for now is that some limited forms of legal intervention are justifiable—calls to abolish bankruptcy law outright are too strong. On the other hand, the costs associated with the robust bankruptcy jurisdiction we know today may be unnecessary. What bankruptcy can offer in the modern era can be had from a regime radically curtailed both in power and expense.