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BANKRUPTCY'S QUIET REVOLUTION

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Bankruptcy's Quiet Revolution

Douglas G. Baird[†]

Abstract

Over the last few years, reorganization practice has undergone a massive change. A new device—the restructuring support agreement—has transformed Chapter 11 negotiations. This puts reorganization law at a crossroads. Chapter 11's commitment to a nonmarket restructuring with a rigid priority system requires bankruptcy judges to police bargaining in bankruptcy, but the Bankruptcy Code gives them relatively little explicit guidance about how they should adjust when a new practice alters the bargaining environment. This essay shows that long-established principles of bankruptcy should lead judges to focus not on how these agreements affect what each party receives, but rather on how they can interfere with the flow of information needed to apply Chapter 11's substantive rules.

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Bankruptcy's Quiet Revolution

Over the last few years, reorganization practice has undergone a massive change. Such tectonic shifts in large-firm Chapter 11 practice are, of course, nothing new. They take place every decade or two. A decade ago, going-concern sales changed the landscape; the decade before it was the exploitation of bankruptcy's venue rules to shift major cases to Delaware.[1] But each time there is such a change, it is necessary to take stock. The principal business of Chapter 11 is the bargaining over a plan of reorganization, and the structure of the bargaining environment dramatically affects who gets what. A new device—the restructuring support agreement—has transformed the plan-formation process. It lacks any basis in the Bankruptcy Code, and no statute allows it, one still needs to understand how bankruptcy judges should respond.

In the past, the debtor initiated multiple rounds of negotiations in which everyone participated. Each party would push back against the claims of the other, and a consensus eventually emerged that left things roughly in equipoise. This has now changed. Instead of bargaining in which everyone participates, there is now a sequence of two-party bargains, beginning with the key players (typically the senior creditor and the debtor). Each bargain fixes the share of the participating creditor.

Changing the structure of bargaining in this fashion would not matter much if there were not much to bargain over. If the substantive rules allowed for little variation in what each party received or if the debtor had an incentive to limit what each creditor group received, changing the rules would not change outcomes. But neither is the case, at least not any more. Priority rights in bankruptcy are sufficiently uncertain that there are a broad range of confirmable plans in any case, each with radically different distributional consequences. And modern debtors are interested in a speedy and successful exit from Chapter 11. They are rela-

[1] For an empirical study of the rise of going-concern sales in large Chapter 11 cases, see Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 Stan. L. Rev. 673 (2003). For a critique of the migration of cases to Delaware, see Theodore Eisenberg & Lynn LoPucki, Shopping for Judges: An Empirical Analysis of Venue Choice in the Bankruptcy Reorganization of Large, Publicly Held Companies, 84 Cornell L. Rev. 967-1003 (1999).

tively indifferent to how rights in the firm are divided. In crafting the plan, those controlling the debtor join forces first with those who can do most to help them exit bankruptcy quickly. They do not care how much of the reorganized firm they give away as long as the amount is still within the range of what a bankruptcy judge will approve.

This essay tries to make sense of this state of affairs. Chapter 11 depends on negotiations and bankruptcy judges need to police them, but the Bankruptcy Code gives them relatively little explicit guidance about how they should respond to changes in the bargaining environment. The emergence of a sequence of two-party bargains and the growing indifference of directors to how assets are distributed have become manifest only in the last few years, and there is little wisdom about how the bankruptcy judge should respond to these changes.

Part I identifies the uncertainty that leads to bargaining in bankruptcy. Chapter 11 vindicates priority rights through nonmarket valuations. The judge can do little more than find that any particular plan falls within a broad range of what is reasonable. Any number of different bargains can be struck and still yield a plan that the bankruptcy judge will approve. Part II shows that courts typically have relied on the debtor and each of the creditors to push back against efforts to overreach. Policing the bargaining has been largely limited to ensuring that parties to the negotiations did not neutralize the debtor by making payoffs or "gifts."

The rest of this essay begins the job of asking whether and to what extent bankruptcy judges should do more in light of new conditions. Part III examines how things have changed. It reviews the basics of restructuring support agreements and identifies how the bargaining over the shape of the plan has become transformed into a series of two-party agreements between the debtor and other key players, beginning typically with the senior secured creditor group.

Parts IV and V show that, even though bankruptcy judges have done relatively little policing of such negotiations, long-established principles suggest how bankruptcy judges should go about this task. Judges should focus not on how these agreements affect what each party receives, but rather on how they can interfere with the flow of information to the judge. Negotiations that lead to a confirmable plan should be problematic only to the extent they keep the judge in the dark.

I. Approximate Priority

In theory, the Bankruptcy Code implements a regime of absolute priority.[2] Senior creditors are allowed to recover what they are owed and no more. General creditors are entitled to be paid in full before equityholders receive anything.[3] Strict adherence to absolute priority should protect those who are not parties to a restructuring support agreement. Parties should not able to use them to appropriate value to themselves, as those are adversely affected should be able to assert that their priority rights have been violated.

Matters are not so simple, however. Chapter 11's strict regime of absolute priority takes as its benchmark the value the firm would have if it could be sold as a going-concern. When there is an actual sale, distributing the proceeds is relatively easy. Assume that the debtor's only assets were ten one-dollar bills and payouts had to be in cash. If a senior creditor were owed six dollars, there is not much to bargain about. The bankruptcy judge will approve a plan only if it gives the senior creditor exactly six dollars. But when there is a traditional reorganization we have what is, in effect, a hypothetical sale. A plan of reorganization depends crucially upon an imputed value of the firm. This estimate of value, like all estimates of value, is inherently noisy.[4]

Bankruptcy judges are able to distill testimony from the experts and make unbiased valuations, but they can do little more than find that the valuations put forward in a plan fall within the range of what is reasonable. It is not possible for them to do more. Valuations of firms can easily differ by ten or twenty percent among different experts, even when each is unbiased and hase no axe to grind.[5] Among other difficulties, some-

[2] See, e.g., Elizabeth Warren, A Theory of Absolute Priority, 1991 Ann. Surv. Am. L. 9, 9 (1992) ("At the heart of corporate law is a fundamental ordering between the equity owners and the creditors: in the event of collapse, creditors will be paid in full before equity will receive any distribution from the company.").

[3] See 11 U.S.C. §1129(b)(2)(B)(ii) (plan must ensure that shareholders "not receive or retain under the plan on account of [their] interests any property").

[4] Fischer Black, Noise, 41 J. Fin. 529, 533 (1986) ("All estimates of value are noisy.").

[5] See, e.g., Steven N. Kaplan & Richard S. Ruback, The Valuation of Cash Flow Forecasts: An Empirical Analysis, 50 J. Fin. 1059, 1076 (1995) (finding

one who values a firm must take account of idiosyncratic risk. The value of a firm may turn entirely on whether it will be able to navigate the regulatory hurdles that block its access to the licenses it needs to operate. Another firm's fortune may turn on whether its new product line will find favor in the marketplace.

Assessing such things requires judgment, and economic training provides little assistance. Even experts are not very good at making predictions about events even just two or three years in the future,[6] and assessing the value of any firm depends on any number of such judgments. In the face of this uncertainty, the exact value that the plan ascribes to the firm thus becomes a subject of negotiation. The bankruptcy judge can do little more than assess whether the valuations on which a plan is based are reasonable. For this reason, many plans with a range of values for the firm are confirmable.

Moreover, the priority position of each creditor is often uncertain. This too creates room for bargaining. To be sure, recent reforms of nonbankruptcy law, particularly the overhaul of Article 9 at the beginning of this century, have made the job of obtaining priority simpler, but it is by no means easy. Obtaining priority with respect to ordinary property like equipment and accounts receivable is relatively straightforward. It typically requires only maintaining a simple filing with the secretary of state in the debtor's place of incorporation. But it is possible to err even here. More than a billion dollars of J.P. Morgan's priority position in the General Motors bankruptcy was rendered uncertain by a simple misstep with the filing system.[7]

Elsewhere, matters are much more complicated. When a firm owns real estate, it must make a proper recording in the local records. Intellectual property has particularly obscure rules. With respect to copyrights,

that between 37 and 58 percent of valuations sampled showed errors of less than 15 percent).

[6] See Philip E. Tetlock, Expert Political Judgment: How Good Is It? How Can We Know? (2006) (empirical finding that experts as a group do no better than chance or simple algorithms with respect to predicting events three years hence).

[7] See In re Motors Liquidation Co., 777 F.3d 100 (2d Cir. 2015) (mistaken termination of financing statement nevertheless authorized and therefore effective).

for example, it is not even well-understood what needs to be done even in the simple case of unpublished work (which includes, among other things, any proprietary computer code that a firm owns).[8] With respect to some types of collateral (such as broadcast licenses) it is not clear whether priority can be taken at all.[9] The conventional wisdom is that there is some defect in a senior creditor's collateral package in almost every case. There is a serious defect in perhaps twenty percent of cases.

Priority may be uncertain for other reasons as well. In many cases, the senior priority position is asserted by a creditor who provided financing for a leveraged transaction or that otherwise involved transfers of value from corporations to shareholders (or from subsidiary corporations to their parents). These priority positions are voidable to the extent that the transaction rendered the firm insolvent.[10] Even when it does not seem likely that the firm was insolvent at the time of the transaction, the possibility that insolvency could be shown must be taken into account in negotiating the plan. A one-in-twenty chance of prevailing on the merits translates to a five percent discount on the senior creditor's payout. With a billion-dollar line of credit, this translates to a $50 million pool of assets for general creditors, who might otherwise have received nothing at all.[11]

[8] Compare In re Peregrine Entertainment, Ltd., 116 Bankr. 194 (C.D. Cal. 1990) (Kozinski, J., sitting by designation) (security interests in registered works must be filed with Copyright Office) with In re World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. 2002) (security interests in unregistered work need to be filed with Secretary of State of the state where the debtor is located).

[9] See, e.g., Sprint Nextel Corp. v. U.S. Bank Nat'l Assoc. (In re TerreStar Networks Inc.), 457 Bankr. 254, 262 (Bankr. S.D.N.Y. 2011) ("[A] lien cannot exist on the license itself."). The fighting issue is whether proceeds that a license generates can be subject to a prepetition security interest. For a discussion of this issue, see Kathryn Brooke Bates, Security Interests in the Airwaves: The Viability of Liens on FCC Licenses, 64 Ala. L. Rev. 903, 918 (2013).

[10] See, e.g., In re TOUSA, 680 F.3d 1298 (11th Cir. 2012) (guaranteeing a loan in order to forestall bankruptcy does not constitute reasonably equivalent value).

[11] For such a case, see Motorola, Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007) (dispute between priority and ordinary general creditors over division of a $37.5 million settlement of an avoidance action against a senior lender owed $800 million).

Creditors are owed not simply the principal they lend, but, when their collateral is large enough to cover them, interest, fees, and reasonable costs such as professional fees as well.[12] To recognize the priority position of a secured creditor, all of these must be taken into account, as long as the total amount is less than the value of the collateral. The amount of principal is easy to determine, but much else is not.

In recent years, for example, the liability of a debtor for "make-whole" payments has been actively litigated. In the *Energy Futures* bankruptcy, for example, a single creditor stood to gain $100 million if the make-whole clause was enforceable.[13] In its reorganization, the restructuring support agreement effected a partial settlement of the dispute of how much money it was owed, and the bankruptcy judge deferred to the debtor's judgment in deciding whether to approve it.[14]

The extent of any creditor's priority position, like the value of the firm itself, is therefore somewhat uncertain. This is not to suggest that matters are hopelessly muddled, but in large cases some fraction of what creditors are owed is subject to negotiation and compromise. There are many plans that provide different distributions to the senior creditor that can be reasonably argued provide the senior creditor with what she is owed.

Even if the value of the firm were fixed, priority positions clear, and amounts owed unambiguous, another source of uncertainty arises from the coin with which each creditor is paid. Even if one knows with certainty the discounted present value of a firm's future cash flows, one cannot value a note the firm issues without estimating the volatility of this income stream. A note from a firm whose assets are treasury bills is worth more than an identical note from a firm whose assets consist solely of a lottery ticket with the same expected value. In a reorganization, each creditor's old stake in the firm is exchanged for a stake in the reor-

[12] 11 U.S.C. §506(d). Oversecured creditors are entitled to costs and fees only if the loan agreement provides for them, but they almost always do.

[13] In re Energy Future Holdings Corp., 533 Bankr. 106, 113 (Bankr. D. Del. 2015) aff'd, 2016 WL 627343 (D. Del. 2016) ("Blue Mountain believes it would recover in the form of a make-whole payment should the automatic stay be lifted is slightly more than $100 million.").

[14] See Delaware Trust Co. v. Energy Future Intermediat Holdings, LLC., 527 Bankr. 157 (D. Del. 2015).

ganized firm whose value respects its entitlement under bankruptcy's priority rules. The reorganization plan must assess the riskiness of each note that it issues and provide an interest rate that ensures it has the value that the Bankruptcy Code requires. This introduces another point of negotiation. The bankruptcy judge again cannot do more than assess whether the notes issued in a reorganization have roughly the value that the plan imputes to them.[15]

In short, rather than a regime of absolute priority, it more reasonable to say that existing law puts in place a regime of approximate absolute priority. In practice, plans are confirmable as long as the values given each of the creditors fall within a reasonable range. The bankruptcy judge does not value the firm, determine priority positions, set the amount of claims, or fix interest rates. Instead, she decides whether the plan put before her meets the requirements of the Bankruptcy Code over each of these dimensions.

The judge gives de facto deference to a plan and those objecting to it must cross a hurdle before they can defeat a plan. The bankruptcy judge confirms a plan unless a dissenting creditor or a dissenting class of creditors can successfully lodge an objection. As a result, there are many plans that are confirmable, and each can have significantly different distributional consequences. The types of bargaining that are allowed in the plan confirmation process will determine exactly how much of a share each party receives.

II. Bargaining in the Shadow of a Judicial Valuation

The judge's inability to implement a legal rule with precision is not in the first instance troublesome, nor unique to bankruptcy. Legal decisionmaking is not an exact science, and the inability of the judge and the jury to apply the substantive legal rule perfectly is not necessarily costly. As long as the relevant legal rule is applied in an unbiased fashion, the legal rule should give parties the right set of incentives.

[15] Some courts have found that, instead of trying to establish an interest rate, they are obliged to start with a base rate and add a risk premium. The amount of the risk premium, however, is itself contestable. See In re MPM Silicones, LLC, 2014 WL 4436335, at *25 (Bankr. S.D.N.Y. 2014) aff'd, 531 Bankr. 321 (S.D.N.Y. 2015).

Parties are free to settle parts of a piece of litigation, stipulate to facts, limit discovery, set briefing timetables, and otherwise set the course of civil litigation.[16] This might seem to introduce another distortion, but settlement in the shadow of an uncertain legal rule is not problematic either. The ability of each party to fall back on their rights ensures that the bargaining reflects the substantive legal standard in expectation, even if it cannot be measured with precision.

Bankruptcy might seem cut from the same cloth. Just as in civil litigation, bargaining in Chapter 11 is done in the shadow of the law. The drafters of the Bankruptcy Code believed that these bargaining dynamics would lead to settlements that respected the priorities that the Bankruptcy Code put in place. They were well aware of these inherent uncertainties in implementing the absolute priority rule in a nonmarket environment. But they believed that no group would be able to take advantage of the other and a bargain would emerge that would vindicate the priority scheme the Bankruptcy Code put in place. Each party in interest would have an incentive to push its own position. The plan that emerged would be in the middle of the possible confirmable plans. The equipoise among various parties would ensure that distributions took on the pattern that the drafters wanted.[17]

[16] Indeed, the *Federal Rules of Civil Procedure* affirmatively encourage both the court and the parties to settle. See, e.g., F.R.C.P. §16(a)(5) ("In any action, the court may order the attorneys . . . to appear for one or more pretrial conferences for such purposes as . . . facilitating settlement.").

[17] Indeed, it is the change in this balance that has led both to advocate bankruptcy reform in recent years. See, e.g., Richard Levin & Kenneth Klee, Rethinking Chapter 11, International Insolvency Institute, Twelfth Annual International Insolvency Conference (June 21–22, 2012), at p. 6, available at http://www.iiiglobal.org/component/jdownloads/finish/337/5966.html (arguing, in light of the changing dynamics of Chapter 11 for "rebalanc[ing the Code] to take account of the appropriate interests of each class of creditors in protecting their own positions while respecting the rights of other classes").

The idea of imputing intent to the drafters of legislation is decidedly unfashionable these days, but the drafting of the Bankruptcy Code itself was placed in the hands of two gifted young lawyers. Even without power over the substance of the Bankruptcy Code, they were witness to the various forces at work and can testify to what they were charged with doing, what they tried to do, and what political forces were at work. Hence, whatever its relevance, the intention of the drafters of the Bankruptcy Code is accessible.

In such an environment, the danger that loomed largest appeared to be that secured creditors might obtain a plan that suited them making "gifts" to those in control of the plan so that they would not push back. As long as outright bribes were forbidden, a balanced plan would emerge.

The Bankruptcy Code itself does not have an explicit prohibition on gifting, but it exists implicitly in its requirement that a plan can be confirmed over the objection of a class of creditors only if it is "fair and equitable."[18] This word is a term of art that imports into the Bankruptcy Code the principles in a line of cases that included *Boyd v. Northern Pacific Railroad*.[19] These included a prohibition on plans in which a shareholder received a payout and a dissenting class of claims of general creditors was not being paid anything.[20]

The senior creditor is not free to divert value to the old equity even when she is not being paid in full. Substantively, of course, the "gift" from the senior creditor to the old equity is unproblematic. If the firm is not worth enough to pay the senior creditor in full, the firm belongs to her. She should be able to share what she receives with anyone she pleases. That the recipient turns out to be an old shareholder should not itself be of any moment. But we need to worry about the effect that the gift has on the integrity of the bankruptcy process.

Asserting that the senior creditor is not paid in full assumes away the question that the plan confirmation process is designed to answer. When there is a nonmarket reorganization, the only way to tell whether the firm is worth less than what the senior lender is owed is through a judi-

[18] 11 U.S.C. §1129(b)(1).

[19] See Northern Pacific Railway v. Boyd, 228 U.S. 482 (1913). Even though *Boyd* itself does not use the words "fair and equitable," these terms have long been understood to embody its principles. See Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 115 (1939) ("The words 'fair and equitable' . . . are words of art which . . . acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations. [T]he term 'fair and equitable' included, inter alia, the rules of law enunciated by this Court in the familiar case[ ] of *Northern Pacific Railway Co. v. Boyd*.").

[20] See, e.g., Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738, 744 (1988) ("The basic lesson of *Boyd* . . . is that leaping over an intermediate class triggers special scrutiny.").

cial valuation or a set of negotiations done in the shadow of a judicial valuation. A prohibition on gifting ensures that these negotiations are not distorted.

A recent case from the Second Circuit illustrates this understanding of the anti-gifting rule.[21] ICO Global Communications founded DBSD in 2004 to develop a mobile communications network that would use both satellites and land-based transmission towers. In its first five years, DBSD made progress toward this goal, successfully launching a satellite and obtaining certain spectrum licenses from the FCC, but it also accumulated a large amount of debt. Because its network had not become operational, DBSD had insufficient revenue to service its debt.

The senior lenders negotiated a deal with ICO, in which they would receive new notes and the bulk of the equity in the reorganized firm, worth between half and three-quarters of the amount they were owed. Unsecured creditors would receive a small slice of the equity, and ICO itself would receive both shares and warrants. The senior lender and ICO filed for bankruptcy and sought to confirm this plan. One of the unsecured creditors objected. The Second Circuit held that this plan violated the rule of *Boyd* and refused to confirm it.[22]

The shareholders in *DBSD* were not diverse public shareholders with no role in running the affairs of the company. Rather, they had formed a holding company that completely controlled the debtor. It is possible to characterize the "gift" in that case as the price that those controlling the debtor (and hence the reorganization process) could demand in advance of the filing for supporting the plan of reorganization. The shareholders had a fiduciary duty in exercising their control that ran to all the investors in the firm. They were not being paid for any future value or services they might contribute to the business; on the contrary, they were being paid for putting in place a reorganization plan that one set of investors wanted to implement at the expense of others.

Members of the board have a duty of loyalty. That the action in question (a plan that otherwise comports with the absolute priority rule) is

[21] Dish Network Corp. v. DBSD, North America, Inc. (In re DBSD, North America, Inc.), 634 F.3d 79 (2d Cir. 2010).

[22] *Id.* at 100–01 ("although Congress did soften the absolute priority rule in some ways, it did not create any exception for 'gifts' like the one at issue here").

sensible is not the point. Directors are supposed to make independent decisions and are not supposed to accept any payoffs in the course of doing the right thing. The anti-gifting rule is a prophylactic rule that nips such mischief in the bud. It aims at ensuring that the plan-formation process is squeaky clean. As the Second Circuit put it, "if the parties here were less scrupulous or the bankruptcy court less vigilant, a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders."[23] The "anti-gifting" principle ensures that secured creditors are not able to buy off the old equity and advance a plan that promotes their interests at the expense of general creditors. In the course of bargaining with the debtor in advance of bankruptcy, creditors can negotiate with those who control the reorganization process, but they cannot bribe them.

The anti-gifting principle is located in the provision of the Bankruptcy Code governing the confirmation of plans.[24] In this sense it appears to be too narrow. Consider a recent case from the Third Circuit. Jevic Transportation ceased operations without any advance notice to its workers and then filed a Chapter 11 petition.[25] By the time the Chapter 11 had run its course, the debtor had only $1.7 million left, all of which was subject to the lien of two secured creditors, one of which was the private equity investor. The creditors' committee brought a fraudulent conveyance and preference action against the two secured creditors and survived a motion to dismiss.

A round of settlement negotiations ensued, and an agreement was reached. One of the secured creditors put $2 million into a fund to pay the debtor's and the committee's fees and other administrative expenses. The remaining $1.7 million that was subject to liens was placed into a trust to pay tax and administrative claims and then general unsecured creditors. Finally, the case would be dismissed.

Left out of the bargain were the WARN Act claims of the workers, claims they asserted against both the debtor and the private equity fund. Most of these were priority wage claims that would ordinarily prime the

[23] *DBSD,* 634 F.3d at 100.

[24] See 11 U.S.C. §1129(b)(1).

[25] Official Committee of Unsecured Creditors v. CIT Group/Business Credit, Inc. (In re Jevic Holding Corp.), 787 F3d 173 (3d Cir. 2015).

claims of ordinary unsecured creditors. Because the funds were placed into the trust, the general creditors received funds that, had they been in the estate, would have gone to the truckers.

It seems that the truckers were unable to settle the WARN Act claims because the private equity fund (which was also a secured creditor) was unwilling to join a settlement that put funds at the disposal of an illiquid party bent on litigation against it. As its counsel explained, "If the money goes to the WARN plaintiffs, then you're funding someone who is suing you who otherwise doesn't have funds."[26]

The deal between the secured creditors and the creditors' committee had the effect of skipping over a class of creditors, but by its terms, the "fair and equitable" requirement did not apply, as the deal was implemented outside of a plan of reorganization. The bankruptcy judge was convinced that if he did not approve this deal, no one other than the secured creditors would receive anything. The most senior creditor's lien might be vulnerable to a fraudulent conveyance attack in theory, but as a practical matter no one would bring it. As the bankruptcy judge explained, "any lawyer or firm that signed up for that role should have his head examined." In approving the settlement, he was deciding on a course that left unsecured creditors with either "a meaningful return or zero."

The Third Circuit found that, even though the prohibition that the "fair and equitable" imposes on plan of reorganizations, did not explicitly apply, the principle was at work nevertheless. A settlement that skipped over some creditors is "likely to be justified only rarely." It nevertheless affirmed, over a strong dissent, finding that the Code permits a structured dismissal when "the traditional routes out of Chapter 11 are unavailable and the settlement is the best feasible way of serving the interests of the estate and its creditors." By approving the structured dismissal, the bankruptcy judge made some creditors better off without making anyone else worse off.

But the big issue in such cases may not be on the substantive distribution in the case itself, but the way in which permitting such payments alters the bargaining environment in all cases. We need to worry that it gives parties an incentive to create situations in which accepting such a

[26] See 787 F.3d 173, 186 (3d Cir. 2015) (Sirica, J., dissenting).

bargain becomes the best option. The willingness of a judge to accept such bargains makes it more likely that parties will find ways to orchestrate an environment in which it is the best option. The rationale for refusing to enforce such agreements is the same as the rationale as outlawing the payment of ransom or putting in place a policy of never negotiating with terrorists.

We always need to worry that mischief may be going on beneath the surface. Consider the following. Debtor owes Senior Lender $50 million. Uncontroverted expert testimony shows that Debtor is worth less than $50 million. Debtor has both institutional debt and trade debt; all of it is unsecured. The institutional debt, amounting to about half of the debt of Debtor, is held by five sophisticated and aggressive hedge funds based in the Southern District of New York. The trade debt, also amounting to about half the debt of Debtor, is dispersed among hundreds of mom-and-pop suppliers. Some live in Peoria, but most are located in smaller, more rural, towns.

The trade creditors are not active in the case, but the hedge funds make noises about the validity of Senior Lender's liens. These, however, become muted once plan negotiations start in earnest. Debtor puts forward a plan, supported by Senior Lender and the hedge funds. Senior Lender receives all the equity of the reorganized debtor. All the unsecured creditors are paid 5 cents on the dollar. In a side deal, Senior Lender promises to give each of the hedge funds a 40-cents-per-dollar premium.

In substance, the hedge funds have secured a settled an avoidance action and captured the proceeds for themselves. When seen together with the side-payment, the plan violates Bankruptcy Code's pro-rata sharing principle. One might argue that such a plan should not be confirmed even if the trade creditors were in a class by themselves and consented to the plan. Bankruptcy is designed so that the most active and vigilant creditors protect others at the same priority level. Side payments are objectionable even other rules are satisfied. When the hedge funds challenge the validity of the liens, all the general creditors should benefit.

The Bankruptcy Code requires the judge to be satisfied that a plan must be proposed in good faith. This provision does not explicitly import the idea of "fair and equitable" into the definition of good faith, but

it is possible—and indeed sensible—to take account of anti-gifting principles in assessing the good faith of the plan proponent.

Bush Industries illustrates.[27] Bush's core business was the manufacture of ready-to-assemble furniture. It expanded aggressively and then faced severe financial problems when the economy turned. As a group, the secured creditors entered into negotiations with the debtor. The debtor agreed to propose, and the secured creditors agreed to accept, a plan of reorganization in which the secured creditors would have their notes substantially scaled back and receive the equity in the reorganized corporation. All other creditors would be paid in full, but the interests of the old equityholders would be cancelled. The old equityholders objected to the plan.

The court rejected the argument that the shareholders were in the money. It was satisfied that the value of the business was less than the $160 million owed the senior creditors.[28] The senior lenders, however, promised to continue to pay the CEO of the company, even though there was no expectation that he would do any work. (Indeed, he had already left the company and moved to Florida.) The court was not objecting to the "golden parachute" per se. As the court explained, "So long as allowed claims exceed the value of a reorganized debtor, the class of pre-petition interest holders has no inherent right to object to an employment contract whose cost is effectively paid by new owners of the reorganized debtor."[29] But the golden parachute along with the release showed that the officers and directors had advanced their own interests, not the interests of the shareholders.

The CEO of Bush was also a shareholder, but nothing about the logic of the opinion requires it. The fact of the agreement itself showed that the debtor did not put forward a plan in good faith. The objection was not to the golden parachute in its own right, but to the way in which they distorted the plan process. If the process is not fair to the nonparticipating investors, then the plan that arises from it cannot be confirmed, regardless of whether it has been modified along the way to comply with any substantive rules of the Bankruptcy Code.

[27] In re Bush Industries, Inc., 315 Bankr. 292 (Bankr. W.D.N.Y. 2004).

[28] *See id.* at 301–02.

[29] *Bush,* 315 Bankr. at 305.

Taking full account of the "anti-gifting" principle is an important part of applying the Bankruptcy Code faithfully. Consider, for example, whether it should apply when a senior creditor offers to reimburse expenses of the creditors' committee who are consenting to a sale of the assets. Other postpetition expenses enjoying the same priority are not being paid in full. Such payments fall outside the scope of the anti-gifting doctrine as traditionally conceived. There is no plan that is confirmed and the assets do not properly belong to the estate.[30] Nevertheless, the potential mischief such side-payments might cause seems the same.

Broadening the scope of the anti-gifting rule in this fashion is entirely sensible, but one should not assume that a properly articulated anti-gifting rule should demarcate the extent to which the bankruptcy judge polices the bankruptcy bargain. Bankruptcy judges enjoy broad equitable discretion to ensure the integrity of the process and each new development in bankruptcy practice requires them to assess how that power should be used. Restructuring support agreements do not typically involve gifts, but they have changed the bargaining dynamics significantly and therefore require recalibration of the bankruptcy judge's responsibilities. Before doing this, however, it is necessary to look first at restructuring support agreements themselves and examine how they have evolved and how they have been used.

III. Restructuring Support Agreements and Creditor Control

In the late 1990s, senior lenders began to devise various ways to exercise control over the reorganization process. In particular, it became common for a senior creditor to gain control of the Chapter 11 process by exploiting the rules governing the debtor's ability to obtain postpetition financing.[31]

[30] It was for this reason—that no property of the estate passed to the prepetition creditor—that the Third Circuit refrained from holding the payment was suspect. See In re ICL Holding Co., Inc., 802 F.3d 547, 555 (3d Cir. 2015) ("In this context, we cannot conclude here that when the secured lender group, using that group's own funds, made payments to unsecured creditors, the monies paid qualified as estate property.").

[31] See Harvey R. Miller & Shai Y. Waisman, The Creditor in Possession, 21 No. 1 Bankr. Strategist 1, 4 (2003);

To prevent the debtor in possession from taking risks that jeopardize a senior creditor's priority position, the Bankruptcy Code makes it hard for the debtor to borrow from anyone else.[32] Few want to lend to a debtor in bankruptcy without taking collateral, and there are severe limits on the ability to grant such priming liens over the objection of the senior lender. Hence, the senior lender will agree to finance the debtor only after the debtor agrees to many conditions. Senior creditors have become accustomed to conditioning postpetition financing of the debtor's operations on quick going-concern sales or a fast-track towards confirmation.[33] In short, the senior creditor is able to gain control through its ability to limit the debtor's ability to obtain financing from anyone else and to place conditions on its own financing.

Over the last decade, secured creditors have also discovered that they could increase their control over the debtor in a different fashion—through the use of restructuring support agreements. Restructuring support agreements are a natural outgrowth out of the Bankruptcy Code's affirmative commitment to prepackaged bankruptcies.[34] Restructuring support agreements ensure that everyone can be confident that a prepackaged plan that parties shape outside of bankruptcy is implemented inside of bankruptcy. Creditors do not want to back a plan unless they know the debtor will back it as well. For its part, the debtor wants to be sure that the creditors will vote for the plan and place no hurdles in the way of its smooth adoption.[35] An agreement among the parties to support a plan ensures that the course through bankruptcy is an easy one.

When parties cannot agree on a plan, restructuring support agreements provide a base camp. Either before bankruptcy or during it, two or more parties can agree on a time table and the basic elements of a

[32] 11 U.S.C. §364.

[33] Robin Phelan & Ocean Tama, The Use of DIP Financing As A Mechanism To Control The Corporate Restructuring Process, 44 Tex J. Bus. L. 15 (2011).

[34] This commitment is manifest from §1121(a), which permits a debtor to file a plan with its petition, §1125(g), which provides for the solicitation of votes before the petition, and §1126(b), which provides that these votes may be counted.

[35] Quite apart from seeking to change their vote, absent of any commitment to the contrary, they would be able to assert other rights, such as demanding adequate protection or objecting to the agreed-upon dip financing order.

plan. Even if the details need to be worked out and additional parties brought on board, it at least provides a point of departure. Restructuring support agreements provide conspicuous benefits. They provide a clearer, quicker, and more reliable path toward exit from Chapter 11.

Restructuring support agreements, when entered into or modified after the start of the case, might not seem permissible under the Bankruptcy Code. Once a debtor files for bankruptcy, §1125 seems to limit the ability of parties to strike deals with each other. It prohibits "solicitation or rejection of a plan" before the court has approved a disclosure statement.[36] When a debtor in bankruptcy negotiates with a particular creditor and exacts its binding promise to support a particular restructuring, it might seem that the debtor has "solicited" the "acceptance" of a plan of reorganization. But for restructuring support agreements even to be permissible, this cannot be so.

The text of the Bankruptcy Code is hard to square with many features of modern bankruptcy practice. The section governing disclosure is a conspicuous example. The section is a relic of the New Dealers' concern that courts overseeing reorganizations needed to prevent insiders from negotiating plans that benefitted themselves at the expense of innocent outsiders.[37] Today's players in large reorganizations are sophisticated distressed debt investors and have little in common with those §1125 was intended to protect. Moreover, a broad reading of §1125 that resulted in a flat prohibition on restructuring support agreements would make it nearly impossible for consensual plans of reorganization to emerge.

To be sure, it is possible for multiple parties, without any formal agreement, to sign up to be "co-proponents" of a plan. The process of reaching this point in their negotiations does not run afoul of §1125 be-

[36] *See* §1125.

[37] See, e.g., Jerome N. Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization, 19 Va. L. Rev. 541, 569 (1933) ("There is every reason why that court should approve and foster active supervision by the lower courts of reorganizations so as to protect the average security holder who is otherwise helpless. Courts of equity have a tradition of aiding the helpless, such as infants, idiots and drunkards. The average security holder in a corporate reorganization is of like kind."). Jerome Frank succeeded William O. Douglas as the chair of the Securities and Exchange Commission.

cause it stops short of a binding commitment to vote in a particular fashion.[38] Parties to it can always withdraw. Similarly, one-on-one discussions between sophisticated stakeholders do not pose a problem either, even if the communication is a draft plan. And obtaining informal, nonbinding assurances from a creditor to support a particular plan does not violate §1125 either.

The informal understandings and assurances such as these, however, are often not enough in a world in which claims trade constantly. The holder of a particular claim may be a bank one day and a vulture investor the next. To push the plan process forward, it is useful to bind parties and theirs successors to ensure support garnered today persists.

One path to circumnavigating §1125 is to couch a restructuring support agreement as a settlement. Even settlements include stipulations that oblige a creditor to support a particular plan do not run afoul of §1125.[39] The typical restructuring support agreement, however, is hard to fit within this Procrustean bed.

Nevertheless, most bankruptcy judges find that postpetition agreements in which parties commit to support a particular plan are permissible and do not constitute improper solicitations under §1125.[40] These courts point to clauses that give fiduciary outs to the parties, the existence of various termination events, and the fact that creditors cast their actual votes only after the disclosure statement is approved. Most importantly, they read the section in light of its original purpose—to protect uninformed outside investors. Negotiations among sophisticated

[38] *See, e.g.*, In re The Heritage Org., LLC, 376 Bankr. 783, 791 (Bankr. N.D. Tex. 2007) ("[I]f a creditor believes that it has sufficient information about the case and the available alternatives to jointly propose a Chapter 11 plan with another entity …, it is absurd to think that the signing of a term sheet by those parties … is an improper solicitation of votes in accordance with §1125(b).").

[39] *See, e.g.*, In re Texaco, Inc., 81 Bankr. 813 (Bankr. S.D.N.Y. 1988) (finding agreement not to support other future plans is not solicitation to reject current plan).

[40] *See, e.g.*, Century Glove, Inc. v. First Am. Bank of N.Y., 860 F.2d 94, 101 (3d Cir. 1988) ("We agree with the district court that 'solicitation' must be read narrowly."); In re Kellogg Square Partnership, 160 Bankr. 336, 340 (Bankr. D. Minn. 1993) ("However, there is no significant reason not to apply *Century Glove's* rationale to the debtor in reorganization, so as to limn [sic] the concept of 'solicitation' as coeval with the formal polling process.").

insiders cannot be "solicitations" if reorganizations are to work in a fashion consistent with the overall structure of the Bankruptcy Code. As Judge Shannon explained in *In re Indianapolis Downs, LLC*:

> [All the parties are] sophisticated financial players and have been represented by able and experienced professionals throughout these proceedings. It would grossly elevate form over substance to contend that §1125(b) requires designation of their votes because they should have been afforded the chance to review a court-approved disclosure statement prior to making or supporting a deal with the Debtor.[41]

But the benefits of restructuring support agreements come with costs. Most conspicuously, they enhance the powers of senior creditors. Senior creditors have learned to have exploit restructuring support agreements to gain an additional lever of control over the debtor. Support agreements have evolved well beyond a straightforward document that sets out the substance of the plan that the parties intend to put before the court. It sets out not simply the outline of a plan, but also the process for getting it confirmed.

The typical support agreements now contain a number of milestones. The dip financing order and the disclosure statement must be approved by a specified date. Deadlines are similarly fixed for voting and plan confirmation. The plan support agreement fixes not only the particular substantive terms in a plan, but the bankruptcy process itself.

Restructuring support agreements often work in conjunction with a debtor-in-possession financing agreement. Senior creditors often agree to provided debtor-in-possession financing or consent to cash collateral at the same time they enter into restructuring support agreements. There are often cross-default clauses, such that a failure to meet a milestone under the restructuring support agreement is a default under the dip. Similarly, a failure of the debtor to comply with the conditions of the

[41] 486 Bankr. 286, 296 (Bankr. D. Del. 2013). Judge Shannon's opinion in this case, as well as Judge Houser's opinion in *Heritage*, have done much to allay the concerns that Judge Walrath raised on the bench in In re Stations Holding Co., Inc., No. 02-10882 (Bankr D. Del. Sept. 25, 2002); *see* In re NII Holdings, Inc., No. 02-11505 (Bankr. D. Del. Oct. 22, 2002), where she expressed doubt about the ability of parties to commit themselves to supporting a plan postpetition.

postpetition financing agreement is a default under the restructuring support agreement that entitles the senior creditor to walk away from the plan that was on the table.

The powers that senior creditors enjoy are limited only by their own imagination and the willingness of the debtor to grant them. The debtor promises not to bring any avoidance actions against parties to the agreement.[42] It promises to oppose the appointment of a trustee or an examiner with expanded powers.[43] The appointment of an equity committee terminates the support agreement.[44] The debtor promises to provide the consenting creditors access to information.

Some restructuring support agreements can be even more aggressive. In *Molycorp*, for example, the support agreement initially put forward required the debtor to appoint a named individual as its chief restructuring officer and gave that individual broad powers over the reorganization and the operations of the firm.[45] In *Walter Energy* the support agreement tried to prevent the debtor from assuming any executory contracts or leases without first obtaining the consent of the steering committee of the first-lien lenders, and consent was to be in the committee's sole discretion. Similarly, it tried to prevent the debtor from seeking approval of any employee retention plan without the written consent of the steering committee, consent again being within its sole discretion.[46]

It is important, however, to distinguish between a senior creditor's efforts to exert control over the debtor from her efforts to capture a larger share of the going concern for herself. When senior creditors use the restructuring support agreement to put the plan on a tight timetable or to insist that the debtor appoint a chief restructuring officer, their pursuit of their own self-interest may work to everyone's advantage. The

[42] *Magnetation* at §4(b)(iii).

[43] *Magnetation* at §4(a)(iii).

[44] Hercules Offshore, Inc., Draft Disclosure Statement (Form 8-K), p. 26, Exhibit B Plan Term Sheet p. 16 (Time line appended to RSA) (July 13, 2015).

[45] The restructuring support agreement required the CRO to undertake a review of the business and present recommendations to the Board. It would be a default under the restructuring support agreement if the Board failed to accept the recommendations unless Board members found that doing so would violate their fiduciary duties.

[46] Walter Energy Restructuring Support Agreement §11(g) & (h) (2015).

chief restructuring officer can improve the internal operations of the firm and make its finances more transparent. This oversight benefits the senior creditor, but at the same time it yields benefits to the junior creditors as well.

The benefits that secured creditors enjoy from entering into restructuring support agreements turn in the first instance on the willingness of the debtor to grant the conditions that it demands. The drafters of the Bankruptcy Code assumed that those negotiating on behalf of the debtor would push back against the efforts of the senior creditor to push through a plan.[47] The board was put in place by the shareholders and their loyalties in the first instance might lie with them, at least if they were not bought off with gifts. Those managing the debtor also had long-term relations with suppliers and others who formed the bulk of the unsecured creditors. The outlook of those in charge of financially distressed firms has changed dramatically over the last several decades. Boards of directors think about their duties differently today from the way they did when the Bankruptcy Code was written. This change, which we explore in the next part, make restructuring support agreements much more troublesome and render a simple prohibition on gifts inadequate to ensure that the plan that emerges maintains the balance among the players that the drafters originally envisioned.

IV. Bargaining in the Shadow of Chapter 11

Fifty years ago, directors of large corporations were relatively passive, and, when forced to act, they were inclined to look after the interests of the shareholders. By the early 1990s, however, that creditors became more independent and less somnolent.[48] Delaware courts have made it

[47] See Douglas G. Baird, Chapter 11's Expanding Universe, 87 Temple L. Rev. 975, 981-84 (2015) (summarizing empirical work of LoPucki and Whitford).

[48] In Credit Lyonnais Bank Nederland, N.V. v. Pathe Communication Corp., 1991 WL 277613 (Del. Ch. 1991), the court found that, at least when the firm was financially distressed, directors could take account of the interests of creditors as well as those of the shareholders. As later cases made plain, however, it is one thing to say that a shareholder cannot prevent directors from looking after the interests of creditors when the firm is insolvent and quite another to say that a creditor can bring an action against the directors for failing

clear that it was quite wrong to think that board members were bound to favor equityholders to the exclusion of others. Their duties go to the firm as a whole, rather than to existing equityholders.[49]

Board members of firms in Chapter 11 may hold equity stakes in the business, but these are not likely to be a large part of her own portfolio and they are not worth much when the firm is in financial distress. They are likely to be replaced no matter what the outcome. As a result, they care most about ensuring that the firm emerges successfully and quickly from Chapter 11. What happens to the old shareholders or any other constituent is an afterthought. The day has long passed when shareholders of large firms in Chapter 11 expect to receive anything. Those with holding stakes at the time of the reorganization are in any event professionals who specialize in distressed debt. Those in control of the Chapter 11 debtor have no particular sympathy for them. What they care about are their reputations. What keeps them up at night is the reputational hit they will take if the firm blows up on their watch. They will be judged by whether the firm reorganizes successfully, not how ownership interests in the firm are divided among the stakeholders.

When a senior creditor presses for a restructuring support agreement that gives it control rights and other provisions that capture a comparatively larger share of the reorganization pie, those representing the debtor are not inclined to push back and ensure other constituents receive more. Instead, they are focused on whether the restructuring support agreement, regardless of how it divides the spoils, is likely to put the debtor on a course to a confirmed plan.

Each successive restructuring support agreement affects the dynamics of the bargaining over the one that is negotiated next. Those who come first are the ones—typically the senior creditors—who can do the most to ensure the firm reorganizes successfully. They tend to do better than those who come later. Creditors who do not join such agreements are, in principle, entitled to insist on their substantive rights at the end of the day, but they may find that they are left with relatively little. Because

to look after their interests. See, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

[49] See Quadrant Structured Products Co. v. Vertin, 102 A.3e 155 (Del. Ch. 2014).

their priority rights cannot be defined with precision, it is easy for those in control to leave them short-changed.

Debtors today have little incentive to push back and make sure those senior take as little as possible and no more than their share. Members of the board and the professionals they retain are more than happy to enter into a restructuring support agreement with senior creditors that puts the firm on a path to a successful reorganization. The restructuring support agreement provides the runway needed for a smooth landing. If the price is a somewhat larger share of the reorganized business, it is a price they are happy to pay.

The new dynamic in Chapter 11 recalls Louisiana Governor Huey Long's appeal to prospective backers: "Those of you who come in with me now will receive a big piece of the pie. Those of you who delay, and commit yourselves later, will receive a smaller piece of pie. Those of you who don't come in at all will receive—Good Government!"[50] From the perspective of those who are not part of the restructuring support agreement, the theoretical ability to vindicate their substantive rights at confirmation is equivalent of being entitled to "good government."

Restructuring support agreements allow the debtor to give larger shares to the creditors capable of causing the most trouble. The restructuring support agreement enhances the debtor's ability to shape the reorganization and coral the various creditor groups. As long as the firm reorganizes successfully, everything else is a detail.

Restructuring support agreements can themselves involve gifts and be problematic on that account. A restructuring support agreement in *Caesar's* was put forward that went into effect only if those holding more than fifty percent of the debt signed it. The agreement rewarded creditors who joined it with a "forbearance fee," paid at the time the agreement became effective. This fee was funded by its nondebtor parent.[51]

[50] For one of many accounts of this episode in Long's life, see Christopher Hitchens, No One Left to Lie To: The Triangulations of William Jefferson Clinton 17 (2000).

[51] See Caesars Entertainment Corp., Form 8-K, filed on July 21, 2015, at Item 1.01 (parent has invited second-lien holders to enter a restructuring support agreement that requires them to instruct their indenture trustee to stay litigation in return for a pro rata share of $200 million).

A critical provision of the restructuring support agreement called for those joining it to instruct their indenture trustee to forbear from pursuing separate actions against the parent. Because the agent was obliged to follow instructions by a majority, the deal, if it went into effect, would bind all the creditors. Such a deal might not have been possible outside of bankruptcy because of the Trust Indenture Act. Nor could it be implemented in a Chapter 11 plan readily, as those in the class who consented received something (the forbearance fee) that those who refused to join the agreement did not.

Those declining to join this restructuring support agreement immediately dismissed it as "coercive" and its forbearance fee "improper."[52] They also asserted that the noteholders joining it held equity in the parent as well. From their perspective, the forbearance fee was a gift that distorted behavior even if it was not the ordinary gift that is given in return for supporting a plan.

However such comparatively unusual gifts are treated in the context of restructuring support agreements, the most important challenge for the bankruptcy judge is discovering how to police such agreements when there is no "gift" and, if she is, how she should go about exercising this power.

The question of what bargains a senior creditor and the debtor can strike in the their efforts to reorganize a firm first reached the Supreme Court in 1868 in *Chicago, Rock Island & Pacific Railroad Co. v. Howard*.[53] When the Chicago Rock Island was hopelessly insolvent and, by all accounts, not worth enough to pay its senior creditors in full, its senior creditors attempted to foreclose on the assets. The shareholders, rather than resisting, agreed to facilitate the sale of the railroad to a new entity, provided they were given a small stake in the new entity. After the assets were transferred to the new entity, the junior creditors appeared and demanded that the securities promised the shareholders be turned over to them instead. The Supreme Court found in their favor.

[52] See Statement from Official Committee of Second Priority Noteholders of Caesars Entertainment Operating Company, Inc., July 21, 2015, available at http://www.kccllc.net/CEOCNC.

[53] 74 U.S. 392 (1868).

The Supreme Court found that the transaction in *Howard* could not extinguish the rights of the general creditors. Regardless of form, a transfer, however indirect, that diverts assets from an insolvent corporation and puts them in the hands of the shareholders cannot cut off the rights of creditors. The general creditors are entitled to reach the assets just as if they were still in the hands of the corporation.

It has been long recognized that *Howard's* reasoning is a specific manifestation of familiar fraudulent conveyance principles.[54] But fraudulent conveyance doctrine seems to fall short of explaining why this transaction is suspect. The apparent vice—the sweetheart deal between the senior creditor and the shareholder—is objectionable on fraudulent conveyance grounds only if there is illegitimate transfer of value *from the corporation* to the shareholder. It does not have any traction when the senior creditor uses its own money to buy cooperation from the old shareholders. There has to be a transfer from the firm to a shareholder. On its face, a transfer from a senior creditor to the shareholders falls outside its reach.

The ability to reach assets from the shareholders depends crucially on being able to characterize the transaction as a transfer of *corporate assets*. One could equally characterize the transaction as one in which a senior creditor gave her own assets to the shareholder. Once the senior creditor forecloses on an asset that is not worth enough to pay it in full, the asset belongs to her. She is entirely free to give it to anyone she wants. Fraudulent conveyance law reaches only transfers of the *debtor's* assets. To apply it in this context, one has to explain why characterizing it as a transfer of the corporation's assets rather than the creditor's makes sense.

In the wake of *Howard*, the view took hold that, in the typical equity receivership, the ownership interest that old shareholders received in the reorganized railroad could not be characterized as a transfer of the corporation's assets. The protective committee acquired the railroad at a foreclosure sale using the bonds of the senior stakeholders. Junior creditors could not complain about how the committee then chose to divide these interests. The senior creditors were free to strike any deal they wanted with the old shareholders. As long as the deal was at arms' length, it was unobjectionable. The vice of *Howard* was that there was a

[54] Frank, supra note 37, at 541-42.

pre-existing deal in place between the senior creditor and the shareholder to divert value. This was different from an equity receivership in which there was a receivership followed by arms' length bargaining among the interested parties.

J.P. Morgan represented the interests of the bondholders and oversaw the restructuring of the *Northern Pacific*. As was typical for railroads of this era, his plan called for the senior bondholders to acquire the railroad free and clear. (Again, given their right to all the proceeds at the foreclosure sale, they could bid up to the amount of their bonds without being out of pocket.) As part of the restructuring, Morgan gave the shareholders the right to acquire interests in the equity of the reorganized railroad if in return they contributed new capital.[55] Old general creditors who were frozen out objected to this transaction and invoked *Howard*.

The lawyers representing J.P. Morgan (partners at the predecessors to the Cravath and Davis Polk firms respectively) successfully rebuffed this argument. J.P. Morgan was entitled to reorganize the railroad and distribute new securities in it as he saw fit. What mattered was that the committee representing the senior creditors was the high bidder at the foreclosure and that there was nothing underhanded or suspect with the arms' length bargains struck with the other stakeholders. To be sure, in the case of the *Northern Pacific* receivership, J.P. Morgan did not share any of the value of the railroad with the unsecured creditors, and he did share some of the value with the old shareholders, but this was his choice.

During this era, investment bankers were constrained by their need to return to the same investors again.[56] Investors would give them their capital for new projects only if they reorganized troubled railroads suc-

[55] The capital the old equityholders contributed turned out to be less than the amount at which the new equity traded, but this was a detail. This was not the expectation of the shareholders before the fact. In other cases (such as the reorganization of the AT&SF), the stock had value significantly in excess of the cash they needed to contribute.

[56] Carlos D. Ramirez, Did J. P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century, 50 J. Fin. 661, 664 (1995) (finding that Morgan's participation likely lowered the cost of capital).

cessfully and distributed the new stakes equitably and fairly. A court was not obliged to do more than ensure that there was nothing underhanded. Bargains between investment bankers and various stakeholder constituencies were self-enforcing. If they violated the expectations of investors when they parceled out securities in reorganized firms, they would pay the price.

The purpose of the equity receivership was to allow people like J.P. Morgan to strike deals. It was his task, not the court's, to come up with a plan of reorganization. As long as there was not a deliberate attempt to undermine the rights of the unsecured creditors, the general creditors could not object to the agreements between stakeholders. For the court in *Paton v. Northern Pacific Railroad*, there was nothing objectionable "unless it can be said that it was a scheme to defraud creditors." As the court explained,

> it is suggested by [the junior creditors] that, upon any plan of reorganization, the parties in interest are not to be at liberty to contract with each other; but that the plan of reorganization should be formulated and imposed upon the parties by a court of equity. Courts are created for the purpose of enforcing contracts which parties have made, not for the purpose of making contracts for parties. It would be more than doubtful, if power was conferred upon a court to make a contract for parties, whether it could make as fair and just and equitable a contract as could the parties themselves.[57]

This opinion invokes the idea of a restructuring being "fair and just and equitable." It is one of the early harbingers of what became the "fair and equitable" test in §1129(b)(1) of modern Chapter 11. Significantly, the court in *Paton* does not look at the terms of the reorganization nor at whether assets are transferred from the old firm to the shareholders, but at the negotiations between the players.

Under this view, the protection for the general creditors in a reorganization lies in the judicial supervision of the bargaining process. If the shareholders were willing to strike a deal and put in new cash and the senior creditor was willing to enter it, the court had no ability to intervene, as long as there is nothing underhanded about the way the bargain

[57] Paton v. N. Pac. R. Co., 85 F. 838, 843 (C.C.E.D. Wis. 1896).

is struck. Among other things, the court is simply not competent to insist on details of the plan of reorganization. There was no virtue in shifting assets among different investors in a railroad and there was the possibility of doing serious harm.

When the Supreme Court confronted this same question the next year, it again focused on the standard of review that had to be brought to the negotiations between the parties that crafted the reorganization plan. The Court required the court to examine reorganization bargains more closely than the court in *Paton* had suggested. In its view, a court could "never rightfully become the mere silent registrar of the agreements." Courts had to draw a distinction between the right of the senior bondholder "who has acquired absolute title by foreclosure to mortgaged property to thereafter give of his interest to others," and an illegitimate attempt on the part of the senior bondholders "to destroy the interest of all unsecured creditors, to secure a waiver of all objections on the part of the stockholder, and consummate speedily the foreclosure."[58] The Court, however, did not offer much guidance about how this line was to be drawn, but its focus was again on the way the bargain is struck and not on whether equity ends up holding a stake in the reorganized firm.

Monon did imply that the court was to give greater scrutiny than the court in *Paton* suggested, but this part of the opinion was largely ignored in corporate reorganization practice. The Supreme Court visited this issue again a decade and a half later. It was reviewing the same reorganization of the Northern Pacific Railroad that was reviewed by the circuit court in *Paton*. It involved a different creditor (Boyd), one who needed almost two decades of litigation to establish his right of payment. Notwithstanding the passage of time, Boyd retained his right to challenge the plan once he had proved his claim. This case became the canonical case that embodies the "fair and equitable" principle.[59]

[58] Louisville Trust Co. v. Louisville, New Albany & Chicago Railway, 174 U.S. 674, 688, 19 S. Ct. 827, 832, 43 L. Ed. 1130 (1899). The railroad was known as the Monon, and among reorganization lawyers it was commonly referred to as the "*Monon* case."

[59] *Boyd* did not actually use the word "fair and equitable," but the Supreme Court long ago concluded that these words embodied the principles it em-

Boyd has been a focal point for bankruptcy scholarship ever since it was decided. *Boyd* is commonly understood to prohibit "gifting," at least when it distorts the incentives of those who are party to the plan negotiations. But the Court did more than protect the substantive right of general creditors to receive distributions before shareholders. The Court insisted that process mattered. The lawyers representing the railroad (the same partner from the precursor to Davis Polk who defended the reorganization plan in *Paton*) urged that the general creditor had not been harmed by the reorganization, as the assets were insufficient to pay the senior creditors in full. Hence, any value that passed from the senior creditor to the shareholder was properly its own money and not the debtor's The Court rejected this argument by pointing to the way that the payment affected the plan-making process. It was not enough to assert that there was not enough to pay the secured creditors in full because this "assumes the very fact which the law contemplated was to be tested by adversary proceeding." The shareholders were not required to contest this question (and in the process "necessarily have protected unsecured creditors," but the shareholders join forces with the creditors.

Boyd does more than merely follow *Howard*. It does not focus simply on plans in which assets of the estate skipped over junior creditors and end up in the hands of the shareholders. The shareholders entered into an agreement in which they bound themselves not to push back against the senior creditors. This was the defect that required the court to intervene and strike down the plan.

Boyd holds that, in negotiating, the shareholders could not enter into a side deal that had the effect of compromising the rights of the general creditors. Boyd would have nothing to complain about if the stockholders simply walked away and did not challenge the foreclosure. But as soon as the shareholders struck a deal with the creditors, they lost the ability to ignore the general creditors. It was enough that they were parties to a deal that froze out the general creditors. There is nothing in the logic of *Boyd* that limits its reach to transfers of property of the debtor. It does not matter whether the shareholders receive consideration from the debtor as opposed to the senior lender or whether they received any-

braced, see Case v. Los Angeles Lumber Products, 308 U.S. 106 (1939), and Congress took account of this practice when it incorporated the "fair and equitable" principle into the Bankruptcy Code. See note 19.

thing at all. The mere fact of a deal was enough to make it objectionable. To be "fair and equitable" within the meaning of §1129(b), the plan confirmation process itself must pass muster. Those in control of the reorganization could not strike a deal that froze some people out of the process.

Before *Boyd*, there was very little regulation of the contracting that was permitted in the reorganization. But this decision changed the way bargaining could be conducted, in addition to enhancing the substantive rights of creditors. Some types of bargains were ruled out of bounds. This case rejects the conclusion the court reached in *Paton* that it is not the judge's job to police contracting in the plan-formation process, short of actual intent to hinder, delay, or defraud.

The Court in *Boyd,* however, did not spell out exactly what sort of policing was appropriate. Until the relatively recent rise of restructuring support agreements and the change in the incentives of those representing the debtor in plan negotiations, the focus on what the phrase "fair and equitable" required was limited to gifts. Transfers of value should always trigger scrutiny of deals between the senior creditor and the debtor, but courts are empowered to police the plan process itself. Some types of bargains, even when there is no transfer of value to the debtor, are not "fair and equitable" and not filed in good faith. The principles of these cases are firmly embedded in the Bankruptcy Code. What is less clear, however, is the extent of the policing appropriate when no gift is involved.

V. Policing the Bargain

Bankruptcy judges regularly insist that part of their job is to ensure the integrity of the plan-formation process. In *Innkeepers*, a case involving a restructuring support agreement, the bankruptcy judge refused to permit the debtor to assume the restructuring support agreement for a reason that went beyond undue haste and capturing of additional assets to which the secured creditor was not entitled. The court found that the other creditors deserved "more of a process than what has been provided so far." The agreement instead had the support of only one creditor "among the critical mass of creditors needed to support a successful re-

structuring."[60] As the court explained, "[A] debtor's exclusive period was intended by Congress to provide for an opportunity for the debtor to negotiate with its constituents and reach a consensual plan."[61] Quite apart from the substance of the agreement, it created a process that was itself suspect.

But it is a mistake to suggest that bargaining is desirable for its own sake. Bargaining by itself in inherently wasteful. There is no reason to do it unless it serves some purpose. If the bargaining is done in pursuit of a plan of reorganization, it seems desirable. What about such bargaining should be suspect? The most obvious consequence of using restructuring support agreements is that they leave creditors with the greatest ability to put the reorganization off course with more and creditors who lack such power with relatively less. But this alone may not be cause for concern.

Even after deals are struck, the plan still has to be confirmable. The distortions of the distributions cannot be so great as to fall outside a certain range. The bankruptcy judge still has to find that it is consistent with the substantive provisions of the Bankruptcy Code. Moreover, the potential distortions need to be offset by the benefits that restructuring support agreements bring with them. The enhanced ability to form coalitions may offset to some extent the ability of individual creditor groups to extract value. If a restructuring support agreement between a senior creditor and a shareholder allows them to put in place a plan of reorganization that provides little or may payout to an out-of-the-money general creditor, the "distortion" that the restructuring support agreement brings may be closer to absolute priority than one where the general creditor could take advantage of the lack of a united front.

But it is not obvious that even a two-party bargain that allows senior creditors to be overcompensated at the expense of the junior creditors should trouble us greatly. The ability to reorganize a firm more quickly and more cheaply has direct efficiency benefits. On the other hand, overcompensating senior lenders in a way that is out of step with their nonbankruptcy entitlements has in the first instance only ex post distri-

[60] In re Innkeepers USA Trust, 442 Bankr. 227, 233 (Bankr. S.D.N.Y. 2010).

[61] Id. at 234.

butional effects. Some creditors will receive more and others less, but sophisticated creditors should be able to account for such effects and ensure that they still enjoy the market return on their capital.

To be sure, there may be indirect efficiency losses. Departing from nonbankruptcy priorities may make capital more costly and harder to obtain. But showing that these losses are large enough to care about turns out to be quite difficult. It is not even obvious that absolute priority itself—an invention of a Yale law professor in the 1930s—is efficiency-enhancing. Even if it is, as long as one is committed to a nonmarket sale, the relevant question is not how much loss these distortions relative to a perfectly implemented absolute priority rule, but how costly they are relative to the imperfect approximate priority regime that courts will implement when a debtor attempts to fashion plans without using restructuring support agreements.

But if the distributions themselves are not problematic, what exactly should a bankruptcy judge police? The sensible place to start is with the idea that the judge must have sufficient information to apply the confirmation rules to the case that is before her. When the restructuring support agreement limits the information coming from the debtor, information must come to the judge from somewhere.

Boyd's legacy is about ensuring the integrity of the process, beyond the distributional rules. This is best done not by trying to determine how much value is leaking or how large each creditor's share would be in a different bargaining environment, but rather by trying to ensure that the negotiations are done in a way that ensures enough information flows to the judge so that she can apply the Code's substantive rules. The way to incorporate *Boyd* then is not to worry about where money ended up or whether money passed hands, but process. If the debtor is not there to press for a different valuation or point to a deficiency in the senior creditor's lien, someone else needs to be there. A plan is not "fair and equitable" if it keeps the bankruptcy judge in the dark—even if the substantive terms of the plan itself are unobjectionable.

In ordinary two-party litigation, suppression of information by litigants is rarely a problem. A judge can reach the optimal outcome because there are liberal discovery rules and each litigant has an incentive to reveal what the other hides. The situation is more complicated when there are multiple parties and only some of them have access to the rele-

vant information. Often relevant information, such as information that goes the value of the firm, is not readily discoverable and individual creditors may lack the incentive to ferret it out. A restructuring support agreement may have the effect of silencing the person most likely to disclose the relevant information and indeed may have been entered into just for this purpose.

A case now before the Third Circuit in *Energy Futures* puts the permissible reach of restructuring support agreements into play. *Energy Futures* was one of the largest Chapter 11s ever. It was the largest provider of power in Texas. It was organized into two principal businesses, one regulated and the other unregulated. Among the creditors were holders of first-lien notes that gave them rights, indirectly, in the regulated utility. The notes came in two flavors: $3.5 billion were 10 percent notes due in 2020 and approximately $500 million were 6⅞ notes due in 2017. Apart from the difference in the interest rates and maturity date, the notes were identical, with rights to the same collateral and the same language in the make-whole clause. If the make-whole provisions were enforceable (and it was not clear if they were), the 10 percent notes would receive a payout of $1.19 for each dollar of principal and 6⅞ percent notes $1.08.

The debtor and a group of creditors that consisted mostly of 6⅞ percent noteholders entered into an elaborate restructuring support agreement, including a term that provided that, immediately after filing, the debtor would make a tender offer to all first-lien holders. For each dollar of principal, the noteholder would receive $1.05 in postpetition notes. Nearly all (97 percent) of the 6⅞ percent noteholders accepted the tender offer, but only 34 percent of the 10 percent noteholders accepted, and nearly all of these also held 6⅞ percent notes.

On the face of it, this tender offer did not freeze out any who chose not to participate. The creditors who did not accept the tender offer had exactly the same substantive rights after the tender offer as before. If the nonassenting 10 percent noteholders wanted to argue that they were entitled to make-whole payments, nothing in the restructuring support agreement prevented it. They might end up with less if they litigated and lost, but in this respect they were no different than any other creditor who is given an offer to settle a claim and chooses to turn it down.

That the settlement took the form of a tender offer has no effect on the substantive rights of the parties. Each creditor had a chance to accept a settlement or take her chances. The debtor could force them to take something less than full payment only by cramming down a plan. Indeed, in one sense the support agreement left nonassenting creditors better off. Because those who settled with the debtor were out of the picture, they would find it easier to gather the votes to reject the plan and force a full-scale hearing in which the judge would have to value both the firm and the value of the securities they received.

But it is easy to come up with a set of facts in which such a tender offer is problematic. Assume the same facts except that the 6⅞ percent notes are concentrated in the hands of a few extremely sophisticated and litigious hedge funds. The rest are widely dispersed among relatively remote and unsophisticated investors. The debtor enters into a restructuring support agreement with the hedge funds. Immediately after filing the bankruptcy petition, the debtor makes a tender offer for all of the first-lien notes. The hedge funds accept, and comparatively few of the unsophisticated investors do.

It might seem that the unsophisticated investors have only themselves to blame. They could have taken the tender offer. But the outside investors operated in a vacuum, and this allows for advantage-taking. They were forced to decide whether to tender before there was a disclosure statement. Indeed, in the case of *Energy Futures*, the noteholders had to make their decision before the debtor even filed its schedules.

Under these assumptions, the question whether the make-whole clause was enforceable will not be pursued aggressively. If the debtor had been unable to make this offer, the hedge funds would have remained in the case and aggressively pushed the enforceability of the make-whole provision. The comparatively unorganized and unsophisticated outsiders would have been able to free-ride on these efforts.

Most important, the plan itself would face judicial scrutiny. The judge has an independent obligation to ensure that the provisions of the Bankruptcy Code are satisfied before confirming a plan. She might decide that, by providing the same amount for each dollar of principal to the two types of noteholders, the outsiders holding the 10 percent notes were effectively receiving different treatment. Section 1123(a)(4) requires everyone in the same class receive the "same treatment." Creditors may

not receive the same treatment if someone owed $1.19 for each dollar of principal is paid the same amount as someone owed $1.08 for each dollar of principal.

In policing negotiations, the bankruptcy judge needs to ensure that sophisticated noteholders cannot enter into side deals that leave the less sophisticated worse off. It is not enough that unsophisticated creditors have the theoretical right to complain. The Trust Indenture Act limits the ability of sophisticated creditors to cut deals with the debtor outside of bankruptcy. By design, the Bankruptcy Code ensures that any deals cut in bankruptcy are subject to judicial oversight that gives meaningful protection to outsiders.[62]

Innocent outsiders would likely not contest a plan that gave nontendering claimholders nothing for their make-whole claim. Even if they did, they might well find themselves overmatched in any litigation. That they were still receiving their substantive entitlement under the letter of the Bankruptcy Code does not cure the problem. Reorganization law protects all the creditors holding claims in a particular class by requiring that negotiations are themselves done in a prescribed way and subject to prescribed scrutiny.

Ultimately, one needs to decide how to handle restructuring support agreements without explicit guidance from the Bankruptcy Code. One can turn to history and find a lesson there, but one can also argue that modern Chapter 11 should take account of the current environment. Those who chose not to tender in *Energy Futures* were not exactly the innocent outsiders that Chandler Act was meant to protect. The typical large reorganization today affects only the rights of sophisticated investors. Whether junior or senior in the capital structure, the players will be a hedge fund, a large pension fund, an insurance company, or a bank.

[62] Under the equity receivership, protective committees would form and amass enough of the senior securities to credit bid at the receiver's sale of the assets. (Instead of dollar-for-dollar, they were able to credit bid only for the proportion of the senior tranche they controlled and provide cash for the balance.) Because of their ability to credit-bid, no other serious bids would appear. The outsiders who did not tender their claims to the protection committees had only the right to their pro rata share of the artificially low credit-bid. Courts insisted that the protection committees bid a minimum amount. (They established an upset price.) But those who backed the Chandler Act found this was not enough.

There is no reason to think that the restructuring support agreement kept all the sophisticated parties on the sidelines. The remaining parties were as sophisticated and as informed as those who had reached a deal with the debtor.

In the modern reorganization world, negotiations done in the shadow of the substantive entitlements of §1129 should perhaps be given considerable slack. As long as distressed debt investors are active in the case with skin in the game, there is little danger that the bankruptcy judge will be left in the dark.

In deciding whether to approve the assumption of a restructuring agreement reached outside of bankruptcy or to bless one reached inside of bankruptcy, the bankruptcy judge should assess the integrity of the process as much as the terms itself. To return to *Bush Industries*, the reason to worry about the payout to the CEO was not the fact of the payment itself, but rather what the payment did to the process. In *Bush Industries*, the fear was that the controlling shareholders who would be wiped out had been bought off. When the person who is supposed to lead the negotiations is bought off, the full merits of the secured creditor's priority position is not fully tested. The other shareholders who would otherwise vicariously benefit from the efforts of the controlling shareholder are the ones who suffer. The right question to ask is are the sort of circumstances that should give rise to these process concerns.

Seen from this perspective, *Bush Industries* becomes a harder case. Although the agreement between the secured creditors and the CEO left him with no incentive to challenge the position of the senior creditors, the bankruptcy judge did appoint an equity committee. The committee vigorously contested the priority rights of the senior creditor, and the bankruptcy judge found that the senior creditors were owed much more than the firm was worth. The valuation problem turned in the end of the prospects of the ready-to-assemble office furniture market.

One can argue that the equity committee's participation in the case made up for the CEO's lack of the appropriate incentive to push for a valuation that would leave equity in the money. Of course, one might argue in the other direction. The CEO might have a sense of the prospects of landing another large customer that might not be accessible to the experts for the equity committee. But in deciding whether the plan was filed it "good faith" within the meaning of 1129(a)(3), it would have

made sense to focus on this question, rather than abstract intuitions about fair play or a multi-factored test.

Even if they have not articulated any theory of how this bargaining should be policed, bankruptcy judges do seem able to find sufficient objective markers to ensure that the process is one in which parties are not keeping information from them. *Residential Capital*[63] illustrates the tolerance postpetition support agreements enjoy, at least if square corners are cut. Residential Capital's plan support agreement was forged after the petition was filed, but the support agreement emerged only after many months of negotiation, aided in part by court-supervised mediation conducted by another bankruptcy judge. A chief restructuring officer who was not beholden to the debtor's parent represented the debtor, and the plan support agreement put the debtor on the path to settling billions of disputed claims. The court approved the debtor's entering the plan support agreement and also found that each of the parties to the agreement acted reasonably and in good faith.

In cases such as *Residential Capital*, the active participation of a sitting bankruptcy judge as a mediator of the negotiations that led to the negotiations made a difference, as did the fact that the debtor was represented by a newly appointed chief restructuring officer and was overseen by disinterested members of the board. The more these factors are present, the heavier the burden on the parties who object to explain how they are aggrieved or, more precisely, why any grievances they have are ones that they will not be able to voice at plan confirmation.

Ultimately, the question of how to police the bargaining can be put simply. The question is how the bankruptcy judge should assess the trade-off between getting the information and keeping the case on track. Moreover, the bankruptcy judge does not need that much information to figure out what is going on. She is a skeptical recipient of knowledge. She can draw inferences from what contesting parties tell her.[64]

What the court must do, however, is resist the temptation to unmoor the "fair and equitable" principle and similar language from history and

[63] In re Residential Capital, LLC, 2013 WL 3286198 (Bankr. S.D.N.Y. 2013).

[64] A familiar example arises when the judge distrusts experts who employ unusual methodologies without justification.

theory. Any general review for "fairness" risks a degenerative process that begins with some law clerk inventing a vacuous laundry list of factors to be considered. Such tests are seductive because they give the illusion of certainty, but such tests are always hopelessly malleable and indefinite. They invite those who adopt them to replace careful thinking with mechanical recitation and hand-waving. The judge should instead take direct measure of the agreement and the path that led to it. Any support agreement that forces the hand of the judge too much or keeps her from understanding the lay of the land should be suspect.

VI. Conclusion

The focus of this essay has been in one sense overtly positive. It has asked squarely the question of how the bankruptcy judge should react to a radical change in bankruptcy practice that takes place almost entirely off-stage. Such an approach accepts much as given. The Bankruptcy Code's commitment to a regime organized around a judicial valuation may itself be suspect. Moreover, the elaborate confirmation rules themselves are not God-given. Judges and lawyers, however, are not charged with such normative inquiries about the wisdom of the law. Nevertheless, judges must make normative judgments about how to interpret the law she is given.

A judge must be faithful to directives Congress put in place in 1978 as she attempts to make sense of a practice that was never contemplated by Congress and that does not fall within the explicit ambit of any statutory text. By incorporating language from previous opinions such as "fair and equitable," the Bankruptcy Code invites the judge to function as a common law judge and extract core principles from foundational cases and interpret them in a way that is consistent with and makes sense of the overall structure of the Bankruptcy Code.

Accepting such an approach requires a belief that there is more coherence to the Bankruptcy Code than can be gleaned from text standing on its own and that experience, often deep in the past, provides a sensible path. It is not an approach congenial to cynics or free-spirits, but it is one that bankruptcy judges and practitioners, or at least the very best ones, have embraced for a long time and that has served them well.